

Republic of Serbia 'BB-/B' Ratings Affirmed; Outlook Remains Negative

Rationale

On Dec. 19, 2008, Standard & Poor's Ratings Services affirmed its 'BB-' long-term and its 'B' short-term sovereign credit ratings on the Republic of Serbia. The outlook remains negative.

The ratings on Serbia are constrained by the country's large external imbalances in the wake of the global credit market dislocation and slow progress on the structural reform agenda. Offsetting these constraints are Serbia's strong growth potential, declining debt burden, and improved prospects of EU integration.

External imbalances have been increasing rapidly in Serbia. During 2008, the current account deficit nearly doubled to around 18% of GDP from 10.0% of GDP in 2005 on the back of surging imports, driven by buoyant domestic demand. Financing the external gap in the current environment could become problematic. While Western European banks hold the dominant share of country's banking system, given the current market conditions, some of these banks may be reluctant to add to their existing cross-border exposure, which could lead to a rapid slowdown in credit and economic growth. We expect GDP growth to decelerate to just below 2% during 2009, before picking up again toward 5% by 2011. Inflation will gradually recede across the forecast horizon.

Concerns over Serbia's external vulnerabilities in the current global economic conditions have led the authorities to conclude a 15-month precautionary stand-by arrangement with the IMF, which requires the adoption of a restrictive fiscal stance and continuous progress on structural reforms. In line with the IMF agreement, the 2009 and 2010 budgets are expected to be restrictive, based on freezing pension levels and capping wage increases in line with inflation in order to reach deficits of 1.5% of GDP and 1% of GDP, respectively. The gross debt-to-GDP ratio has been on a declining trend despite recent growing deficits since 2006, and is expected to continue to decline over the medium term.

The pro-EU coalition that emerged from the May 2008 elections boosts Serbia's prospects for EU membership, which will remain a key anchor for political stability in Serbia, as already evidenced by improved cooperation with the International Criminal Tribunal for Former Yugoslavia and the government's unilateral decision to fully implement its part of the Stabilisation and Association Agreement with the EU. With the economic slowdown taking the main stage, the debate over Kosovo has somewhat subsided, also due to a more pragmatic and less populist approach to the issue.

Outlook

The negative outlook on Serbia reflects our opinion that further downside risks prevail to the economic and fiscal outlook as the current global credit market crisis continues. Given the large external financial imbalances, the risk of the credit squeeze resulting in an even sharper downturn in growth and further widening of the fiscal imbalances would lead to downward pressure on the ratings. Conversely, a lasting improvement in external financing conditions or a successful budgetary consolidation in the near term would support the ratings.

Source: Standard & Poor's.