Republic of Serbia Outlook Revised To Stable From Negative; 'BB-/B' Sovereign Ratings Affirmed

Overview

We are revising the outlook on the Republic of Serbia to stable from negative, and affirming the 'BB-/B' sovereign credit ratings.

The stable outlook reflects our opinion that external pressures facing Serbia have eased, and our opinion that, in line with the country's IMF program, budgetary consolidation will occur over the medium term.

Rating Action

On Dec. 1, 2009, Standard & Poor's Ratings Services revised its outlook on the Republic of Serbia to stable from negative. The 'BB-' long-term and 'B' short-term sovereign credit ratings were affirmed.

Rationale

The outlook revision reflects our view that the external pressures facing Serbia have eased. The ongoing narrowing of the country's previously large current account deficit and the government's commitment to comply with the IMF program have allayed concerns over pressures on Serbia's external liquidity and have helped to stabilize the exchange rate. In addition, we believe the current government's pragmatic policies, focusing on economic development and a renewed drive towards EU integration, have improved the prospects for Serbia's economic growth potential over the medium term.

Pressures emanating from the country's heavy external burden and the narrowing of the external credit channel have led the Serbian authorities to conclude a stand-by arrangement (SBA) with the IMF, amounting to around 10% of estimated 2009 GDP over 27 months. As part of the IMF SBA, the major banks have committed themselves to maintaining their cross-border exposure in Serbia and to adequately supporting their subsidiaries through 2010, which has helped to improve investor sentiment, despite the slowdown in credit and economic growth.

As a result of the agreement, the government tightened its fiscal policy in 2009, aiming for a deficit of 4.5% of GDP, which we consider is attainable. We also expect the government to present its 2010 budget in line with the IMF deficit target of 4% of GDP. The budgetary adjustment in 2010 is based on expenditure cuts--mainly a containment of the public wage bill. At the same time, the government is expected to start reforming its pension system to reduce the currently large level of pension outlays (of almost 14% of GDP in 2009)-- a step that we believe would improve the prospects for the medium-to-long term sustainability of public finances. In our opinion, as the government implements these much-needed structural reforms, we expect its commitment to the IMF program to be maintained, although it may be tested due to potential political tensions within the governing coalition.

Government debt-to-GDP has declined markedly despite growing deficits in recent years. However, we expect that higher projected fiscal deficits, reduced privatization revenues, and a weaker currency (raising the cost of the largely foreign currency denominated debt) will increase the government debt burden to around 36% of GDP in 2011.

Outlook

The stable outlook reflects our opinion that external pressures facing Serbia have eased, and our opinion that, in line with the country's IMF program, budgetary consolidation will occur over the medium term. The ratings could be raised if budgetary consolidation is accompanied by structural reforms in the public administration and pension system, thereby improving prospects for public finance sustainability. At the same time, we expect Serbia to make improvements in the business environment, which if coupled with progress towards EU integration, would lead to a faster recovery of investment flows and consequently a more balanced growth pattern following the current downturn. On the other hand, delays to the planned budgetary consolidation, postponement of the implementation of structural reforms, or renewed concerns regarding financial stability would keep the ratings at the current level or bring them under negative pressure.

Source: Standard & Poor's.