Fitch Affirms Serbia At 'BB-'; Outlook Stable

Fitch Ratings-London-25 April 2006: Fitch Ratings today affirmed the Republic of Serbia's foreign currency and local currency Issuer Default Ratings ("IDR") at 'BB-' (BB minus) with Stable Outlooks. At the same time, the agency affirmed the Short-term rating and the Country Ceiling at 'B' and 'BB-' (BB minus) respectively.

Credit developments in Serbia have been mixed over the past 12 months. "Serbia is growing robustly, ran a budget surplus estimated at 1.6% of GDP last year, made important advances in structural reforms and started EU negotiations on a Stabilisation and Association Agreement," says Edward Parker, Head of Emerging Europe sovereigns at Fitch. "However, inflation climbed to 17.7% at end-2005, the current account deficit remains large and buoyant bank credit growth and rising non-performing loans signal risks to financial stability."

Encouragingly, GDP grew 6.5% last year, after 9.3% in 2004, with exports performing strongly and foreign direct investment picking up. The government has continued to implement reforms to restructure and privatise state-owned companies and banks, rationalise public finances and improve the business climate. The current prudent fiscal policy stance and favourable public debt dynamics provide support to the ratings. Serbia is targeting a general government budget surplus of 2.7% of GDP this year, which with buoyant privatisation receipts and a further USD0.6 billion Paris Club debt write-off in February, should reduce public debt to around 44% of GDP at end-2006, from 51% at end-2005, as well as increase the government's cash reserves. However, Fitch expects populist pressures to lead to a reduction in the budget surplus in 2007.

Political risks are a significant constraint on Serbia's ratings. The minority government has been able to implement difficult reforms, but its resolve could weaken ahead of elections due in 2007. Although another democratic and reformist coalition government appears the most likely outcome of the elections, a government led by the extreme nationalist Serbian Radical Party cannot be ruled out. The risk of political shocks is heightened by a series of difficult events this year including talks on the future status of Kosovo, Montenegro's referendum on independence and the need to hand over Bosnian Serb General Mladic to keep its EU negotiations on track.

Macroeconomic imbalances also constrain the ratings. Inflation in Serbia last year was the second-highest of the 98 sovereigns rated by Fitch. The underlying current account deficit remains substantial at close to 10% of GDP and Serbia's external debt ratios are well above the 'BB' range medians. These macroeconomic pressures are being exacerbated by the rapid pace of bank credit growth - 58% in 2005 - mainly in euros and partially sourced from external borrowing. Moreover, the jump in foreign banks' non-performing loan ratio to 16% at end-2005 from 6% at end-2004 is concerning, notwithstanding measurement difficulties.

Serbia's ratings have upward potential if it continues to implement structural reforms, grow robustly and reduce its debt ratios. However, the nexus of high inflation, large current account deficits, rapid bank credit growth and high "euroisation" point to downside macroeconomic risks. The risk of political shocks over 2006-07 also weighs on the Outlook.

Source: Fitch Ratings.