Fitch Affirms Serbia at 'BB-'; Outlook Stable

Fitch Ratings-London-02 August 2007: Fitch Ratings has today affirmed the Republic of Serbia's foreign and local currency Issuer Default Ratings ("IDRs") at 'BB-' (BB minus) with a Stable Outlook. The Country Ceiling is affirmed at 'BB-' (BB minus) and the Short-term foreign currency IDR at 'B'.

"There have been some notable improvements in Serbia's measures of sovereign creditworthiness, bringing them into line with 'BB' medians," says Paul Rawkins, Senior Director in Fitch's sovereign team. "Nonetheless, fiscal policy has become more expansionary over the past 12 months, exacerbating macroeconomic imbalances, while political risk mostly associated with the future status of Kosovo will remain uppermost in the near term."

Political risk remains a material constraint on Serbia's sovereign ratings. The eventual formation of a new pro-democratic/reform coalition in May following elections in January was a positive development, avoiding the downside scenario of a nationalist government. However, the uncertain future of Kosovo and the International Criminal Tribunal for the former Yugoslavia ("ICTY") continue to cast a shadow over Serbia's credit ratings. Fitch notes that progress on the ICTY has helped to resurrect negotiations on EU membership, but the agency says that this is still a distant prospect, whereas potential disappointment over Kosovo's status could trigger damaging near-term political instability and limited appetite for further reforms. Negotiations over Kosovo remain blocked in the United Nations, heightening the risk of a unilateral declaration of independence, which could precipitate messy and unpredictable events.

Tighter monetary policy and a more flexible exchange rate have reduced inflation to around 5% in mid-2007 from 17.5% at end-2005 and curbed the growth of bank credit to the private sector. Meanwhile, buoyant privatisation receipts, strong GDP growth and a rising real exchange rate helped reduce general government debt to 37% of GDP in 2006 from 53% in 2005, slightly below the 'BB' median of 39%. Sovereign creditworthiness was bolstered further by a rapid build-up of international reserves to USD11.9bn, elevating Serbia to net public external creditor status. However, this measure takes no account of the USD4bn of domestically issued frozen foreign currency bonds, and with 94% of public debt denominated in foreign currency, Serbia's public finances remain vulnerable to exchange rate risk.

Elections in 2006 were accompanied by a more expansionary fiscal policy, which has proved difficult to contain in 2007. This has arrested a promising track record of fiscal consolidation and fuelled a current account deficit of some 13% of GDP in Q107. In the past, current account deficits have been more than covered by foreign direct investment but, with no major privatisation candidates in the pipeline for 2007, private external borrowing is set to rise sharply this year and beyond. This, in turn, will feed mounting private sector external indebtedness and larger gross external financing needs of 18% of GDP, leaving Serbia increasingly exposed to sudden shifts in investor sentiment.

Serbia's ratings are underpinned by its high level of human capital, which, together with its EU market access and perspective, gives it the potential to follow the successful development path of other countries in central and eastern Europe. Serbia will, however, need to demonstrate greater political will if it is to implement the structural reforms necessary to tackle such weaknesses as an extended public sector, high unemployment, a narrow export base, a gaping trade deficit and an inimical business climate. "A material diminution of political risk, coupled with renewed focus on fiscal consolidation and broader structural reforms in the context of eventual EU accession, will be central to enhancing sovereign creditworthiness." says Mr Rawkins.

Source: Fitch Ratings.