Fitch Revises Serbia's Outlook to Negative

Fitch Ratings-London-23 December 2008: Fitch Ratings has today revised the Outlooks on the Republic of Serbia's Long-term Issuer Default ratings (IDRs) to Negative from Stable. Its ratings are affirmed at Long-term foreign and local currency IDR 'BB-' (BB minus), and Short-term foreign currency IDR 'B'. Serbia's Country Ceiling is affirmed at 'BB-' (BB minus).

"The Negative Outlook reflects Fitch's view that the deterioration in global economic and financial conditions have heightened downside credit risk given Serbia's relatively high external debt stock, wide current account deficit and large external financing requirement" said David Heslam, Director in Fitch's sovereign team. "Success with narrowing the fiscal deficit in line with IMF conditions and lessening its external imbalances will be key considerations in the future direction of Serbia's IDRs."

Strong credit and investment growth and looser fiscal policy have contributed to a widening of Serbia's current account deficit (CAD), which Fitch forecasts will reach 18% of GDP in 2008 compared with 13.3% in 2007. The CAD needs to adjust sharply lower in order to return external finances to a more sustainable path. With Serbia's main euro-area export markets in recession in 2009 and lower prices for Serbia's key metal exports, it will be difficult for the country to increase exports as a way of narrowing the CAD. Therefore, adjustment will have to come predominately from lower domestic demand. Fitch expects real GDP growth to slow to around 2% in 2009, from 6% in 2008. Some of the adjustment will come from tighter fiscal policy. As part of a 15-month Precautionary Stand-By Agreement (SBA) with the IMF, the government is targeting a budget deficit of 1.5% of GDP in 2009 (compared with a Fitch forecast deficit of 2.5% in 2008).

Borrowing by the private sector has placed upward pressure on Serbia's gross external debt burden, which at an estimated 141% of external receipts (CXR) in 2008 is high relative to the median of 85% for sovereigns rated in the 'BB' range. Combined with a high level of "euroisation" of domestic balance sheets, these credit features have heightened Serbia's vulnerability in light of the global economic downturn and tighter availability of capital.

While risks have increased, a number of factors mitigate immediate threats to sovereign creditworthiness. In contrast with the private sector, the sovereign's external debt service burden is moderate and financing is available from international sources. However, it is impossible to isolate the sovereign from broader economic pressures. High external debt servicing requirements of the private sector, at a time when the availability of external credit is constrained, could place downward pressure on the currency and international reserves and lead to a deterioration in the sovereign balance sheet.

Serbia's high income level and strong institutional and development indicators relative to 'BB' range peers are underlying supports to creditworthiness. In USD terms, per capita income stood at USD5,400 in 2007, compared with a median of USD3,600 for sovereigns rated in the 'BB' range. Despite a looser fiscal policy, general government debt ratios have continued to improve. Reflecting strong nominal GDP growth and some external debt write-offs, general government debt is forecast by Fitch at 30% of GDP in 2008, half the level it was as recently as 2004.

The risk of a destabilising political shock has receded following the passing of Kosovo's declaration of independence, the 2008 election of a pro-EU government and the post-election break-up of the nationalist Radical Party. The lack of any scheduled elections for the next four years provides an opportunity for reforms driven by closer integration with the EU to be pursued on a consistent basis. However, the unwieldy governing coalition contains many parties elected on a populist platform promising generous increases in social spending. Although these ambitions should be frustrated by constraints on the budget deficit that have been agreed with the IMF, volatile coalition politics and resistance from vested interests and trade unions could combine to slow the pace of reforms.

Source: Fitch Ratings.