Republic of Serbia and Planned London Club Exchange Bond Assigned 'B+' Ratings; Outlook Stable

Credit Rating: B+/Stable/B

Rationale

On Nov. 1, 2004, Standard & Poor's Ratings Services assigned its 'B+' long-term and 'B' short-term sovereign credit ratings to the Republic of Serbia. The outlook is stable.

Serbia is the 106th sovereign government to be assigned credit ratings by Standard & Poor's.

At the same time, Standard & Poor's assigned its 'B+' long-term senior unsecured debt rating to the proposed London Club exchange bond, to be issued by Serbia. The bond will be tendered in exchange for Serbia and Montenegro's share in the defaulted commercial debt of the former Federal Republic of Yugoslavia. The Republic of Serbia and the Republic of Montenegro have agreed that Serbia will be the sole obligor in respect of the new bond. The debt rating is contingent on the completion of the debt rescheduling agreement between Serbia and its London Club of commercial creditors.

The ratings on Serbia balance significant political risks and a vulnerable external position with expectations of continued prudent economic policies and further progress in structural reforms. The local and foreign currency ratings are the same due to very low levels of financial intermediation and shallow domestic debt markets.

Despite Serbia's recent short-lived and weak coalition governments, progress with institutional and legal reforms, and toward macroeconomic stability, has been fairly steady. Growth has resumed and is projected to reach about 6% in 2004 and 5% in 2005, while inflation should fall to less than 10% in 2005. The general government deficit has been reduced to less than 3% of GDP in 2004, and the government's commitment to fiscal austerity should keep deficits well below that level over the medium term. Meanwhile, the general government debt to GDP is forecast to decline to about 65% by year-end 2004 from 74% in 2003, largely reflecting the debt write-off in the rescheduling agreement. With regard to structural reforms, Serbia's current government is committed to accelerate privatization in the year ahead (particularly bank privatization), and to enact several important laws such as those on bankruptcy and VAT. In particular, the bankruptcy law is expected to help speed the long-delayed restructuring of the remaining, large, state-owned enterprises.

Political risks are Serbia's key rating constraint. Although recent governments have always been reform-oriented, infighting among coalition partners, largely reflecting personality-driven politics, has frequently undermined government stability and resulted in early elections. Politics in Serbia remain very polarized, with the anti-reformist and extreme nationalist parties consistently winning more than one-third of the electorate's vote. In addition, unresolved issues such as the future of the union with Montenegro, the status of Kosovo, and cooperation with The Hague's International Criminal Tribunal for former Yugoslavia also heighten political risk and limit policy predictability.

Although on a downward trend, Serbia's external indebtedness as a percentage of current account receipts (CARs) remains high. Public debt is estimated at 145% of CARs for year-end 2004, and net public-sector external debt at 72% of current account receipts. The current account deficit is estimated at a high 14% of GDP in 2004, and is set to decline only slightly in 2005, to about to 12% of GDP. Sustaining high GDP growth and generating export capacity will be essential for Serbia to sustain its ability to service its external debt, particularly later in the decade when debt-service requirements (excluding short-term external debt) are projected to peak between $1 billion-$1.5 billion per year. Despite the sizable external gap, the National Bank of Serbia has been able to rebuild reserves to an estimated $3.7 billion by year-end

2004, not least due to large unregistered inflows. The unpredictability of the latter, however, highlights the vulnerability of Serbia's external accounts and a need to improve transparency and the quality of balance-of-payments data.

Outlook

The stable outlook reflects Standard & Poor's expectation that--despite the fragility of the current governing coalition--the government will adhere to its prudent policy program, and that the agreement with the IMF will remain on track. The possibility of early elections during 2005, which seems increasingly likely, could temporarily disrupt reform implementation. It is expected, however, that any disruption will be limited--as seen earlier this year with the change of government--and any slippage addressed successfully by a new reformist government. Any lasting setback to fiscal performance or reform, however, would endanger macrostability, international financial support, and Serbia's debt sustainability, and put downward pressure on the ratings. By contrast, improvements in the political environment and more stable governments would facilitate the implementation of Serbia's challenging reform agenda, support the inflow of much-needed foreign direct investment, and help to rebuild the economy's competitiveness. Together, these would eventually improve Serbia's creditworthiness.

Source: Standard & Poor's.