

## **Republic of Serbia Outlook Revised To Stable On Fiscal Loosening; 'BB-' L-T Rating Affirmed**

### **Rationale**

On July 10, 2007, Standard & Poor's Ratings Services revised its outlook on the Republic of Serbia to stable from positive, due to a loosening fiscal policy that exacerbates the Republic's rising external imbalances. At the same time, the long-term 'BB-' and short-term 'B' sovereign credit ratings on Serbia, along with the 'BB-' long-term senior unsecured debt rating and '4' recovery rating on its foreign currency debt, were affirmed.

The outlook revision reflects the weakening of both fiscal and external indicators compared with our expectations at the time the positive outlook was assigned to the Republic in February 2006. Having analyzed the long-delayed budget law for 2007, which was approved by the Serbian parliament in early July, we now expect the central government to generate a deficit of 1.2% of GDP in 2007 (excluding universal mobile telecommunications system {UMTS} license sale receipts, equivalent to 1.1% of GDP), following a balanced budget in 2006. This fiscal loosening is driven by the acceleration of the national investment program, and primary current spending well in excess of nominal GDP growth. The loosening is particularly acute given that Serbia's current account deficit is rising (estimated at 13% of GDP in 2007). Although foreign direct investment (FDI) is expected to fund 60% of this deficit, external imbalances will remain high, fuelled by strong credit growth.

General government debt, meanwhile, is estimated to fall to 36% of GDP in 2007 from 41% in 2006, owing partly to further official debt relief and privatization receipts used for early debt payments.

EU integration is likely to remain a key driver for political stabilization in Serbia over the medium term. The EU's decision to restart Stabilization and Association Agreement (SAA) talks after a year's delay improves the prospects for Serbia's integration into the EU and reduces the pressure on a new government in the short term, particularly in light of the resolution of Kosovo's status, which is expected later this year.

The ratings on Serbia are supported by continued strong real GDP growth (averaging about 5%-6% annually), rising exports, strong FDI, and the declining government debt ratio. The level of inflation is expected to remain around 7% in 2007, fuelled by nominal wage increases, among other factors. Privatizations and the sale of UMTS licenses raised net FDI inflows in 2006 to a record 13% of GDP. Over the medium term, however, FDI is expected to decline to an average 6%.