Republic of Serbia 'BB-/B' Sovereign Ratings Affirmed; Outlook Remains Negative

Overview

We have affirmed our sovereign credit ratings on the Republic of Serbia.

The negative outlook reflects the likelihood of a downgrade if the country's external adjustment leads to greater-than-anticipated economic and financial pressures, particularly in the banking sector or public finances.

Rating Action

On July 31, 2009, Standard & Poor's Ratings Services affirmed its 'BB-' long-term and 'B' short-term sovereign credit ratings on the Republic of Serbia. The outlook is negative.

Rationale

The ratings on the Republic of Serbia are constrained by the country's dependence on external funding to support economic growth and its limited economic policy flexibility. The latter is due to a high degree of euroization and slow progress on structural reforms, in particular reforming the public sector administration and social security, restructuring state-owned enterprises, and improving competitiveness. Offsetting these constraints are Serbia's moderate government debt burden--a result of asset sales and double-digit revenue growth in recent years--and improved prospects of European Union accession.

Pressures emanating from the country's heavy external burden and the narrowing of the external credit channel have led the Serbian authorities to conclude a stand-by arrangement (SBA) with the IMF, amounting to around 10% of estimated 2009 GDP over 27 months. As a result of the agreement, we expect the 2009 and 2010 budgets to be subject to the government's deficit-reducing measures. However, given that the recession in Serbia is likely to be sharper than previously expected--and the subsequent large shortfall in revenues--we bel ieve the 2009 deficit is likely to be in the region of 5% of GDP, compared to the 3% of GDP target presented in the SBA. Because of the severity of the Serbian recession and the growing potential for political tensions within the governing coalition, we believe the IMF may focus on authorities' efforts to stem the deterioration of the budgetary position, rather than solely on the fiscal outcome.

Government debt-to-GDP has declined markedly despite growing deficits in recent years. However, we expect that higher projected fiscal deficits, reduced privatization revenues, and a weaker currency (raising the cost of the largely foreign-currency denominated debt) will increase the debt burden to 36% of GDP in 2011. Amid a deep recession, the current account deficit is shrinking and is expected to fall below 10% of GDP in 2009 from almost 18% of GDP in 2008. High current account deficits in the past have heightened Serbia's vulnerability to a sharp decline in the availability of external financing. As a part of the IMF SBA, however, the major banks have committed themselves to maintaining their cross-border exposure in Serbia and to adequately support their subsidiaries through 2010, which has contributed to improving investor sentiment, despite the slowdown in credit and economic growth in Serbia.

The governing pro-EU coalition has been a key driver for political stabilization in Serbia. Although faced with an additional set of priorities in terms of cushioning the impact of the difficult global environment, and despite growing tensions within the coalition, we expect the government to continue the progress it has made to date with EU integration.

Outlook

The negative outlook reflects the likelihood of a downgrade if the country's external adjustment leads to greater-than-anticipated economic and financial pressures, particularly in the banking sector or public finances. Conversely, the ratings would be supported by a lasting improvement in external financing conditions or successful implementation of the economic and budgetary program along the lines of the SBA.

Source: Standard & Poor's.