Republic Of Serbia Long-Term Ratings Raised To 'BB' On Reform Momentum And Political Stability; Outlook Stable

Overview

In our opinion, the Republic of Serbia's political stability and policy implementation has significantly improved.

We are therefore raising our long-term local and foreign currency sovereign credit ratings on Serbia by one notch to 'BB', and we are affirming its short-term ratings.

The stable outlook on the ratings balances our expectation that fiscal and external performance will continue to strengthen against what we view as Serbia's still-limited monetary and external flexibility.

A significant deviation from fiscal policy targets or worsening external liquidity would put downward pressure on the ratings, while faster-than-expected progress on institutional and structural reform could advance prospects for EU integration, which we believe would support Serbia's creditworthiness.

Rating Action

On March 16, 2011, Standard & Poor's Ratings Services raised its long-term local and foreign currency sovereign credit ratings on the Republic of Serbia to 'BB' from 'BB-'. We also changed Serbia's transfer and convertibility (T&C) assessment to 'BB' from 'BB-'. At the same time, we affirmed the 'B' short-term local and foreign currency credit ratings, as well as Serbia's '4' recovery rating. The outlook is stable.

Rationale

The upgrade reflects our view of Serbia's markedly improving economic policy implementation, and its new momentum regarding fiscal consolidation, structural reform, and economic rebalancing. The upgrade also reflects the emergence of political consensus supportive of European integration, which we expect will further anchor the direction of economic policymaking. We expect these improvements will continue beyond the upcoming general elections due in 2012.

The ratings on Serbia reflect our opinion of its growth potential. The sovereign is emerging from the global economic and financial crisis with ongoing economic-structure rebalancing. The ratings also reflect our expectation that the sovereign will continue to comply with its fiscal consolidation plan. We expect the government will adhere to recent fiscal rules, on the back of the IMF program successfully implemented in 2009 and 2010, while continuing its structural reforms.

That said, the ratings also reflect our view of vulnerabilities emanating from relatively high external debt, and from limited monetary flexibility due to heavy domestic use of the euro and high inflation.

Following GDP growth of an estimated 1.8% in 2010, led by a recovery in exports, we believe that the Serbian economy is rebalancing faster than expected--toward becoming less-dependent on domestic demand. We estimate that Serbia's GDP growth could accelerate to between 3% and 4% during 2011-2013. The narrowing of Serbia's current account deficit in 2009 continued through 2010; the deficit fell to an estimated 6.4% of GDP from a peak of 21% in 2008. We believe that over the forecast horizon the

current account deficit will continue to moderate to about 5% of GDP. We anticipate this will reduce Serbia's dependence on net external borrowing and direct foreign investment.

Despite occasionally-diverging political views, the ruling coalition has managed to stabilize its fiscal stance. There was a slight widening of the fiscal deficit to an estimated 4.4% of GDP in 2010. During 2009 and 2010, the government complied with the IMF program's expenditure targets by maintaining a nominal freeze on public wages and pensions. New fiscal rules adopted in late 2010 oblige the government to reduce the deficit to 1% of GDP by 2015 and to ensure public debt is no higher than 45% of GDP. The government is aiming for a fiscal deficit of 4.1% in 2011, which we believe is within reach.

We believe that following the April 2011 conclusion of the current Stand-By Arrangement with the IMF, a new agreement with the IMF--which current information indicates would be precautionary--would further anchor Serbia's compliance with the new fiscal rules and its implementation of structural reforms. We expect the government to continue reforming the pension system and the public sector, together with a renewed restructuring of loss-making public enterprises and/or a privatization push.

We also forecast reduced fiscal deficits and increased privatization revenues against the backdrop of a strengthening recovery. We expect the public-sector debt burden--including all public enterprise debt, much of which carries a state guarantee, and the National Bank of Serbia's (NBS') liability to the IMF--will decrease to 35% of GDP in 2013 from around 40% of GDP in 2010.

Despite the decision not to draw €1.4 billion from the €2.9 billion made available by the IMF, the NBS' official foreign reserves covered almost six months of current account payments at end-2010. Nevertheless, we believe external liquidity and leverage remain significant constraining factors on Serbia's rating while the level of financial intermediation in the economy is only moderate (with domestic credit accounting for around half of GDP). The banking system's capital ratio is about 21%, and has built up large credit-provisioning buffers against nonperforming loans, which are largely foreign-currency denominated. We believe that since foreign-owned banks account for around 75% of system-wide assets, contingent liabilities for the government in case of financial stress are moderate.

Outlook

The stable outlook balances our view of Serbia's monetary and external vulnerabilities against its stronger political environment and commitment to economic reforms. The ratings could be raised if the government continues restoring fiscal discipline and reforming pensions and the public sector, while improving the business environment, rebalancing the economy, and increasing growth potential. We could also raise the ratings if Serbia were to make meaningful progress in strengthening its institutions, and accelerating EU integration.

Conversely, the ratings could come under downward pressure if political maneuvering before the parliamentary elections, or a post-electoral policy shift, were to cause a significant negative deviation from Serbia's fiscal policy targets, leading to higher public debt or inflation. The ratings could also come under downward pressure if external liquidity worsens significantly.

Source: Standard & Poor's.