Fitch Rates Republic of Serbia 'BB-'

Fitch Ratings-London-19 May 2005: Fitch Ratings, the international rating agency, has today assigned Long-term foreign and local currency ratings of 'BB-' (BB minus) to the Republic of Serbia. The Outlooks on the ratings are Stable. The agency has assigned the rating of 'BB-' (BB minus) to the US dollar-denominated global bonds maturing in 2024 arising from the recent exchange with the London Club of commercial creditors and to euro-denominated domestic bonds known as "Frozen currency" bonds. At the same time Fitch has assigned a Short-term rating of 'B' and a Country Ceiling of 'BB-' (BB minus).

"Serbia's 'BB-' ratings are supported by its improving public finances, comfortable public and external liquidity position, and good prospects for continued structural reforms and GDP growth, anchored by potential EU accession," says Edward Parker, Senior Director in the Fitch Sovereigns Group. "However, the ratings are constrained by risks associated with Serbia's large current account deficit, structural weaknesses revealed by high unemployment and low export capacity, as well as potential, albeit diminishing, risks of political instability."

The Serbian government has made significant strides over the past 12 months in implementing structural reforms, tightening budget discipline and regularising international and creditor relations, building on progress since the overthrow of the Slobodan Milosevic regime in 2000. Serbia benefits from a high level of human capital and potential, as demonstrated by its income per capita (excluding Kosovo) of around USD2,980, not dissimilar from Bulgaria and Romania, both rated investment-grade. GDP growth was a buoyant 7.5% last year. However, to sustain growth the authorities will need to implement further difficult reforms to restructure and privatise state-owned companies, cut spending on subsidies and social benefits and improve the business climate.

Relations with the international community have been enhanced by the authorities' cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY). In March, a European Commission feasibility study recommended that Serbia and Montenegro should start negotiations this year on a Stability and Association Agreement. This is a key milestone on the road to EU accession, which should help to anchor economic policy and political stability, as in other Eastern European transition countries - though EU membership itself remains a distant and uncertain prospect. In April, Serbia completed the restructuring of USD2.6 billion of London Club debt into USD1.08bn of new global bonds. This follows its Paris Club debt reduction agreement in 2001, which should lead to a further 15% Paris Club write-off on the completion of Serbia's IMF programme later this year.

Debt restructuring and prudent fiscal policy have helped to reduce Serbia's government debt to 59% of GDP at end-2004 from over 200% at end-2000, though it is still above the 'BB' range median of 51%. But Serbia has a relatively low debt-to-revenue ratio and near-term debt service burden, which support debt sustainability and reduce refinancing risks. Moreover, the introduction of VAT in January has boosted tax compliance and revenues so that Fitch expects the government to agree with the IMF to tighten fiscal policy and run a budget surplus of around 0.6% of GDP this year. The budget surplus, privatisation receipts, low debt service costs and GDP growth should keep the public debt ratio on a downward trajectory. However, around 96% of government debt is denominated in foreign currency, rendering public finances vulnerable to exchange rate shocks.

Despite sizeable foreign direct investment and grants, Serbia's large current account deficit, which was 15.6% of GDP in 2004, means it has a substantial external financing requirement that is leading to rising private sector debt and is a potential source of vulnerability. These concerns are accentuated by the somewhat fragile nature of macroeconomic stabilisation, with inflation in double digits and a high level of "euroisation", which complicates the conduct of monetary and exchange rate policies. Nevertheless, Fitch expects the current account deficit to narrow this year to around 11.5% of GDP, helped by strong recent export growth. Foreign exchange reserves are rising, indicating that financing is currently ample. Furthermore, the low 7% share of short-term debt, grace periods and long maturity of the debt mean that the current liquidity position is relatively comfortable.

Serbia's ratings have upward potential over the medium-term if it continues to implement prudent fiscal policy and structural reforms. However, it faces a daunting agenda. The Stable Outlook balances this upside potential against uncertainty of delivery and downside risks from external financing and political shocks.

Source: Fitch Ratings.