Republic Of Serbia 'B+' L-T Ratings Affirmed On London Club Debt Exchange; Outlook Stable

Credit Rating: B+/Stable/B

Rationale

On April 8, 2005, Standard & Poor's Ratings Services affirmed its 'B+' long-term and 'B' short-term sovereign credit ratings on the Republic of Serbia, following the issue of the $1.02 billion London Club exchange bond, maturing in 2024. The outlook is stable.

With the issue of the exchange bond on April 8, 2005, Serbia's debt rescheduling agreement with the London Club has been completed. The bond will be tendered in exchange for Serbia and the Republic of Montenegro's share in the defaulted commercial debt of the former Federal Republic of Yugoslavia.

The 'B+' senior unsecured debt rating on the exchange bond reflects the ratings on the Republic of Serbia, which balance significant political risks and a vulnerable external position against expectations of continued prudent economic policies and further progress in structural reforms.

Despite Serbia's political instability, progress with institutional and legal reforms, and toward macroeconomic stability, has been fairly steady. Growth prospects are good, with GDP expected to expand by about 5% in 2005, while inflation should fall to less than 10%. The government's commitment to fiscal austerity should keep deficits well below 3% of GDP in the medium-term. Meanwhile, the general government debt-to-GDP ratio is forecast to decline to about 65% by year-end 2005 from 74% in 2004, largely reflecting the debt write-off in the rescheduling agreement.

Political risks are Serbia's key rating constraint. Although reform-oriented, fragile and short-lived coalition governments reflect still personality-driven politics and a highly polarized environment, with anti-reformist and extreme nationalist parties consistently winning more than one-third of the electorate's vote.

Although on a downward trend, Serbia's net public sector external debt is at a high 72% of current account receipts. The generation of export capacity and high GDP growth is crucial to sustain Serbia's ability to service its external debt, particularly later in the decade when debt-service requirements are projected to rise to between $1 billion and $1.5 billion.

Despite the sizable external gap, the National Bank of Serbia has been able to rebuild reserves to an estimated $4.3 billion as at end-March 2005, not least due to large unregistered inflows. The unpredictability of these inflows, however, highlights the vulnerability of Serbia's external accounts and a need to improve the 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 a general election before its due date in 2007 could temporarily disrupt reform implementation. It is expected, however, that any disruption will be limited--as seen with previous changes of government--and that a new reformist government will address any slippage successfully. Any lasting setback to political stability, fiscal performance, or reform, however, would endanger macroeconomic stability, 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.