Republic of Serbia LT Ratings Raised To 'BB-' On Faster Reform, Lower Political Risk;Otlk Stbl

Credit Rating: BB-/Stable/B

Rationale

On July 18, 2005, Standard & Poor's Ratings Services raised its long-term sovereign credit ratings on the Republic of Serbia to 'BB-' from 'B+'. The 'B' short-term rating was affirmed. The outlook is stable.

The upgrade reflects Serbia's improved medium-term fiscal outlook, its diminishing political risks, and improved external indebtedness indicators.

The government has revised its medium-term fiscal target for 2005 to a surplus of about 1.5% of GDP, from a deficit of 1.4% of GDP. The new medium-term fiscal strategy envisages ambitious surpluses of about 3% of GDP in the period 2006-08. Standard & Poor's expects that the 2005 fiscal surplus will be achieved, largely because of booming tax revenues following the introduction of VAT in January 2005. The tighter fiscal stance should help to contain inflationary pressures. Inflation, which has accelerated to more than 15% by mid-2005 largely due to buoyant domestic demand, is expected to decline only gradually. Privatization, restructuring of large public companies, and preparatory work on pension reforms have gained pace over recent months. In the medium term, Standard & Poor's expects the government to maintain the budget close to balance by reducing subsidies to public companies, keeping real public sector wage growth in check, and trimming the high pension deficit that is currently running at about 5% of GDP. The general government debt-to-GDP ratio is forecast to decline gradually from 58% of GDP by year-end 2005 (including the expected write-off of 15% of Serbia's Paris Club debt) to below 50% of GDP by 2008.

Political risks have diminished following the EU's decision to start negotiations on a Stabilization and Association Agreement. This is helping to build consensus across reformist parties to pursue the goal of EU membership. Nevertheless, political stability is fragile and political risks weigh heavily on the ratings. These risks stem from unresolved issues, such as the status of Kosovo, the future of the union with Montenegro, and further cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY).

Serbia's external debt indicators have improved beyond earlier forecasts, reflecting higher-than-projected growth of exports and central bank foreign reserves. Net public-sector external debt is projected at 42% of current account receipts in 2005, down from 93% in 2003, largely owing to the London Club and Paris Club debt write-offs in 2004 and 2005, respectively. The external position, however, remains a concern, with the current account deficit projected to stay about 10% of GDP over the medium term. Despite the sizable external gap, the National Bank of Serbia has been able to rebuild reserves to an estimated $4.4 billion at the end of June 2005, not least due to large unregistered trade and capital inflows. The unpredictability of the latter, however, highlights the vulnerability of Serbia's external accounts and a need to improve transparency and the quality of balance-of-payments data.

Outlook

The stable outlook reflects Serbia's good medium-term economic prospects, with real GDP projected to grow between 4% and 5% per year, and expectations that the government will adhere to its prudent policy and economic reform program. The possibility of a general election before its due date in 2007 could temporarily disrupt reform implementation but any slippage is expected to be addressed successfully by a new reformist government. Any lasting setback to political stability, fiscal performance, or the reform agenda, however, would endanger macroeconomic stability and Serbia's debt sustainability, thereby placing downward pressure on the ratings. By contrast, further improvements in the political environment and good progress toward EU accession would support economic reforms,

Source: Standard & Poor's.