Republic of Serbia Outlook Revised To Positive On Reform Progress; 'BB-' L-T Rating Affirmed

Credit Rating: BB-/Positive/B

Rationale

On Feb. 28, 2006, Standard & Poor's Ratings Services revised its outlook on the Republic of Serbia to positive from stable. At the same time, the 'BB-' long-term and 'B' short-term foreign and local currency sovereign credit ratings on Serbia were affirmed.

The outlook change is based on Serbia's progress with fiscal consolidation and resultant decline in the government debt burden, good macroeconomic prospects, and legislative progress underpinning the government's reform agenda and EU integration. There has been noteworthy progress on negotiations for a Stabilization and Association Agreement (SAA) with the EU (the first step toward eventual EU membership), notwithstanding the risk of temporary disruptions due to insufficient co-operation with the International War Crimes Tribunal in The Hague. Also, the successful implementation of the three-year IMF borrowing program will result in a final 15% debt write-off by the Paris Club official creditors.

Fiscal consolidation, debt relief, and high nominal economic growth have significantly reduced the general government debt burden, projected at less than 40% of GDP in 2006, compared with 45% in 2005. The central government balance, at a surplus of 1.6% in 2005 and expected to remain steady in the next few years, provides further momentum to the decline in government debt in the medium term. The government's commitment to complete reforms of the pension system and health care sector, as well as an improving investment environment, should sustain the budget surplus over the medium term. Further structural reforms, the restructuring and completion of privatization of the banking sector and large state-owned companies in key sectors, and an increase in capital spending are expected to keep annual GDP growth rates higher than 5% during the remainder of the current decade.

The ratings are constrained by uncertainties stemming from a crowded and challenging political agenda and by Serbia's large current account deficit of about 8% in 2005. Macroeconomic stability also remains vulnerable, as reflected in an upsurge in inflation to 17% in 2005. Inflation is forecast to fall to 8% by 2008 as a result of tight fiscal and monetary policies. Meanwhile, the external gap will remain large at around 8% of GDP, but will mainly be financed by healthy foreign direct investment (FDI) inflows.