Republic of Serbia L-T 'BB-' Rating Affirmed; Outlook Positive

Rationale

On April 25, 2007, Standard & Poor's Ratings Services affirmed its BB-' long-term and 'B' short-term foreign and local currency sovereign credit ratings on the Republic of Serbia. The outlook is positive.

The ratings on Serbia remain constrained by significant political risks relating to the status of Kosovo and the inability to date to form a national government following the January 2007 elections. The ratings are supported, however, by good macroeconomic prospects.

In addition to the main political risks mentioned above, the delay since May 2006 in Stabilization and Association Agreement talks (SAA), which concern Serbia's potential integration into the EU, could increase the risk of policy reversal. It is expected, however, that the prospect of further SAA talks will improve following a resolution of Kosovo's status, and EU integration is likely to remain a key driver for political stabilization in the medium term.

Although the economic indicators have slipped somewhat compared with the expectations at the time the positive outlook was assigned in February 2006, the ratings remain supported by continued strong real GDP growth (averaging about 5%-6% annually), rising exports, buoyant foreign direct investment (FDI), a broadly balanced budget, and the declining government debt ratio. Serbia's current account deficit is large (estimated at 10% of GDP in 2007), but FDI is expected to fund the bulk of it. Macroeconomic stability has improved, as demonstrated by declining inflation, which is expected to remain near 7% in 2007, from a high 18% in 2005, notwithstanding high nominal wage increases last year. Privatizations and the sale of universal mobile telecommunications system (UMTS) licenses raised FDI inflows in 2006 to a record 17% of GDP.

The central government budget recorded a balanced position in 2006 (excluding UMTS license sale receipts, equivalent to 1.4% of GDP, and clearance of pension arrears). The 1.5% of GDP surplus in 2005 also fell in 2006 following the implementation of the national investment program. General government debt is expected to fall to 37% of GDP in 2007 from 59% in 2005, owing partly to further official debt relief and privatization receipts used for debt prepayments.

Outlook

The positive outlook on Serbia assumes that a government will be formed by the end of May 2007 and new elections, which would further defer structural reforms, can be avoided. The outlook also hinges on the new government's passing and implementing a prudent 2007 budget in a broadly balanced position. Solid public finances combined with continued structural reforms and tight monetary policies would attenuate some of the risks emanating from Serbia's weak external position, and could lead to an upgrade.

Failure to form the government by the constitutional deadline at the end of May might lead to further slippage in economic reform progress and could increase the pressures on competitiveness and growth. Such a scenario would lead to the outlook being revised back to stable. Similarly, an upgrade would be precluded if the resolution of the Kosovo question, expected to occur later this year, were to jeopardize political and economic stability in Serbia.

Source: Standard & Poor's.