Rating Action:

Moody's assigns B1 ratings to Serbia, stable outlook

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New York, July 14, 2013 -- 12 July 2013 -- Moody's Investors Service has today assigned B1 local and foreign-currency bond ratings to the Government of Serbia. The ratings have a stable outlook.

The main drivers of Serbia's B1 ratings are:

1. The government's rising fiscal deficits and debt levels.

2. The economy's subdued near-term growth prospects and wide current account deficits.

3. The institutional benefits of Serbia's future European Union accession process.

Moody's has also assigned local-currency bond and bank deposit ceilings of Baa3, a foreign-currency bond ceiling of Ba2 and a foreign-currency bank deposit ceiling of B2.

RATINGS RATIONALE

The first driver of the B1 sovereign rating is the government's weak financial position due to widening fiscal deficits and rising debt levels. The general government fiscal deficit increased to about 6.4% GDP in 2012 from 2.6% of GDP in 2008, while general government debt has risen to 60.9% of GDP from 30% over the same period. Moody's expects the general government deficit to remain high and for debt to rise to 64.0% of GDP in 2013 as (1) subdued GDP growth will limit revenue increases despite some announced tax increases; and (2) the government is unlikely to cut wages and pensions, which account for about half of total expenditures. Moody's also notes that the government's debt-servicing costs are vulnerable to exchange-rate fluctuations, as around 80% of total government debt is denominated in foreign currencies. Moreover, as the government has turned to the international bond market for its deficit financing needs in the last few years, public finances are increasingly vulnerable to international market volatility.

The second driver of Serbia's rating is the economy's relatively modest growth and its macroeconomic imbalances, as reflected in wide current account deficits, high inflation and unemployment and rising external debt. Having averaged about 5.5% in the five years prior to the global financial crisis, growth has decelerated to an average of 0.3% in the past three years, largely reflecting the effect of euro area uncertainties on trade and investment. GDP contracted by 1.7% in 2012 and Moody's expects GDP growth in the 1.5% -2.5% range for 2013-14, which is lower than the median growth rate for similarly rated peers.

In contrast, the country's per capita income levels are relatively high compared to similarly rated peers, and support its credit profile. Serbia's infrastructure and labor force education levels also compare favorably to several similarly rated peers. These factors could support future growth in combination with an increase in foreign investment and international competitiveness. Recent foreign investment in

the auto sector has indeed boosted growth, suggesting that if Serbia's manufacturing sector integrates into the regional supply chain, and regional growth accelerates, GDP growth could accelerate over the medium term.

The third driver underpinning Serbia's rating are anticipated institutional and economic benefits of participation in the EU accession process over the next several years. Moody's expects that Serbia, which was granted EU candidate status in 2012, will continue to harmonize its laws and regulatory practices with EU standards as part of its accession process, which should enhance the investment and growth environment.

RATIONALE FOR STABLE OUTLOOK

The stable outlook for Serbia's B1 rating reflects Moody's expectation that Serbia's credit metrics will remain within the range for B1 countries over the outlook horizon. This expectation is based on anticipated improvements in institutional strength as Serbia progresses towards EU accession balanced against a weakening fiscal position as well as a subdued GDP growth rate over the outlook horizon.

WHAT COULD MOVE THE RATINGS UP/DOWN

The rating outlook would improve with (1) a material reduction in government fiscal deficits and debt levels; or (2) a sustainable acceleration in growth that also reduces existing macroeconomic imbalances.

Conversely, downward pressure on the rating could arise from (1) continued high fiscal deficits and increases in government debt levels to levels beyond what the economy can sustain; or (2) a slowdown or disruption in the EU accession process that suggests that anticipated institutional and operating environment improvements will not occur.

The principal methodology used in these ratings was Sovereign Bond Ratings published in September 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

Source: Moody's.