MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes outlook on Serbia's rating to positive, affirms Ba3 rating

06 Sep 2019

London, 06 September 2019 -- Moody's Investors Service ("Moody's") has changed the outlook on the Government of Serbia's Ba3 ratings to positive from stable. Concurrently, Moody's has affirmed the Ba3 long-term issuer and senior unsecured ratings.

The key drivers for the change in the rating outlook to positive from stable are:

(1) Serbia's improving debt metrics that will bring the government debt-to-GDP ratio in line with the median of Ba-rated peers; and

(2) The country's robust medium term economic growth outlook, on the back of more balanced growth drivers, which in turn should support the country's positive fiscal and debt trends.

The affirmation of Serbia's Ba3 sovereign ratings balances its high wealth levels compared to similarly rated peers against the country's sizeable informal sector. Serbia's institutional framework benefits from ongoing enhancements as part of its European Union (EU) accession process although weaknesses in the rule of law and judicial independence persist. The progress made on the restructuring of state-owned enterprises (SOEs) reduces immediate fiscal risks, although contingent liabilities still remain sizeable. While government debt has fallen precipitously, the gradually declining but still large share denominated in foreign currency poses a credit risk, as does the still high degree of euroisation in the banking sector. Moody's expects the Serbian government's commitment to the EU accession process, together with the recent International Monetary Fund (IMF) programme, will support broad policy continuity.

Serbia's long-term foreign-currency bond ceiling remains Ba1 and the long-term foreign-currency bank deposit ceiling remains B1. The long-term local-currency bond and bank deposit ceilings remain unchanged at Baa2. Finally, the short-term foreign-currency bond and bank deposit ceilings remain at NP.

RATINGS RATIONALE

RATIONALE FOR CHANGING THE OUTLOOK TO POSITIVE

FIRST DRIVER: IMPROVING PUBLIC SECTOR DEBT METRICS, WITH DEBT-TO-GDP RATIO NEARING THE MEDIAN FOR Ba-RATED PEERS

Serbia's fiscal metrics have been improving since March 2017, the time of the last rating action, at a faster pace than expected by both Moody's and international financial institutions (IFIs), with the general government debt burden reaching 54.5% of GDP at the end of 2018 compared to 68.8% at the end of 2016.

While favourable exchange rate dynamics have benefitted debt metrics, Serbia's marked fiscal consolidation, with primary budget surpluses averaging 2.7% of GDP since 2016 on the back of both spending constraints and strong revenue generation, gives Moody's confidence that the substantial fiscal gains can be maintained. The 2018 restatement of national accounts, which the IMF notes has helped to improve coverage of the informal economy, also contributed to the decline in the debt to GDP ratio.

Despite moving to a more procyclical fiscal policy stance since 2018, including plans to further raise public sector wages and pensions, Moody's expects ongoing primary surpluses and strong nominal GDP growth will support continued favourable fiscal dynamics. The authorities are targeting overall budget deficits of around 0.5% of GDP through to 2022 according to its Draft Fiscal Strategy, which would still allow the government debt to GDP ratio to fall to around 50% of GDP by the end of 2020, in line with the median of Ba-rated peers. If met, Serbia's debt reduction over the 5 years to 2020 would amount to around 21 percentage points, the fastest among any Ba-rated sovereign.

Moody's also expects improving debt affordability will provide additional budget space, helped by favourable market conditions in light of the stronger fiscal position and early redemptions of relatively expensive dollar

denominated debt.

Importantly, continued engagement with the IMF, through a new Policy Co-ordination Instrument signed in 2018, will help to preserve the prudent budgetary stance and support fiscal reforms. Furthermore, Serbia has continued to make progress in reducing the fiscal risks posed by SOEs, reflected in state aid falling to 2.7% of GDP in 2018 from a peak of 4.9% in 2014 and recent successful privatizations.

SECOND DRIVER: ROBUST MEDIUM TERM GROWTH PROSPECTS, WHICH IN TURN WILL SUPPORT FISCAL CONSOLIDATION

Serbia's economic growth prospects have been on an improving trend, reflecting a better balance between internal and external growth drivers as well as improving investment prospects, with GDP growth averaging 3.2% between 2016-2018, compared to around 1% in the three years prior. Continuing strong growth prospects in the medium term, with GDP growth expected to average around 3.4% in the coming years, will in turn assist the government's efforts in strengthening its balance sheet by reducing indebtedness.

Serbia's economic growth has become more balanced as the country's export potential has benefitted from a shift to the tradeable sector while stronger investment spending, alongside sustained improvements in labour market conditions, will help to support domestic activity in the face of more challenging external conditions.

In particular, gross fixed capital formation, which grew more than 9% last year, will continue to benefit from Serbia's greater macroeconomic stability and a gradually improving business environment. In particular, private investment will be supported by the strengthening banking system with the resumption of positive lending growth to corporates and the improvement in banks' asset quality given the substantial decline in non-performing loans.

Moody's also expects an increasing role for capital expenditures, which reached 3.9% of GDP in 2018, the highest level since 2007, supported by ongoing enhancements to the public investment framework which improves spending execution. In particular, investment in the country's transport infrastructure, with support from EU and other IFI funding, will benefit medium term growth. For example, planned enhancements to the road and railway connections with Serbia's neighbours and central Europe, helping to address the deficiencies in public infrastructure development, which the IMF estimates is around 30% lower than the EU average, will help stimulate regional trade and support further investment.

Serbia's growth outlook will also continue to benefit from sizeable net foreign direct investment inflows (FDI), which reached 7.5% of GDP in 2018 according to the National Bank of Serbia. Moody's expects Serbia's relatively large and diverse manufacturing sector will continue to attract foreign investment, having accounted for around a third of FDI inflows since 2013, helping to support Serbia's export potential and job creation. FDI prospects are further strengthened by a broadening investor base, extending beyond the EU, which has traditionally accounted for the majority of FDI, most notably the increasing role of China (A1 stable) as an investor in Serbia.

RATIONALE FOR AFFIRMATION OF THE Ba3 RATING

The factors supporting the affirmation of Serbia's Ba3 sovereign rating include its relatively high per capita income and the structural reforms implemented since 2015, including to the labour market and SOE sector, which support real growth prospects. Serbia also benefits from the ongoing enhancements to its institutional framework as part of its EU accession process, although weaknesses with regard to the rule of law and judicial independence persist. Furthermore, the progress made on the restructuring of SOEs has helped to reduce immediate fiscal risks, although contingent liabilities still remain sizeable.

Balanced against these are Serbia's still sizeable informal sector while structural challenges in the labour market, including elevated youth unemployment, weigh on potential growth. While government debt has fallen precipitously, the gradually declining but still large share denominated in foreign currency poses a credit risk, particularly in the event of a sharp deterioration in the Serbian dinar, as does the still high degree of euroisation in the banking sector. At the same time, fragile relations with regional partners leave Serbia susceptible to periodic trade disputes.

The Serbian government's commitment to the EU accession process, together with the recent IMF programme, supports ongoing broad policy continuity and Moody's considers it unlikely that forthcoming parliamentary elections would significantly derail the reform agenda.

WHAT COULD MOVE THE RATING UP/DOWN

Serbia's rating would likely be upgraded if Moody's concludes that the government's policy stance will continue to support the fiscal consolidation and economic growth needed to ensure that the marked debt reduction gains in recent years are broadly preserved, and likely fall further. In particular, the ability to successfully navigate the fiscal pressures posed by the forthcoming parliamentary elections due to be held by late April 2020, including from promised increases in wages and pensions, without jeopardizing the downward trajectory in the government debt burden, would be credit positive. Measures that contain public expenditure will likely be a key element of such a policy framework, including adherence to the IMF programme targets. The positive outlook signals that Moody's would expect to draw such a conclusion, or not, over the next 12-18 months, and quite possibly within 12 months.

Subsequent upward pressure on the rating would arise from progress on fiscal reforms, including improvements to the fiscal framework which bolster the transparency and operation of fiscal rules. Progress on planned reforms and privatisations of state-owned financial institutions which further improve the soundness of the banking system would be similarly positive. Macroeconomic reforms that boost growth potential by addressing structural bottlenecks in the economy, including further reform of SOEs, would also support upward rating pressure in the future.

The positive outlook signals that a downgrade is currently very unlikely. However, the outlook, and ultimately the rating, could come under downward pressure from a reduced commitment on the part of the government to fiscal consolidation. An inability or unwillingness to provide offsetting fiscal measures in the face of a markedly weaker growth outlook, a sharp deterioration in the dinar which crystallizes exchange rate risks in the debt burden, or a need to provide substantial support to the SOE sector, would be negative for the rating. More broadly, a waning commitment to the current reform agenda, including reforms which continue to reduce the credit risks from the large SOE sector, would be negative. Finally, the emergence of structural imbalances in the form of a large and increasingly difficult-to-finance current account deficit would pose downward pressure.

GDP per capita (PPP basis, US$): 17,555 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4.3% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2% (2018 Actual)

Gen. Gov. Financial Balance/GDP: 0.6% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -5.3% (2018 Actual) (also known as External Balance)

External debt/GDP: 60.9% (2018 Actual)

Level of economic development: Moderate level of economic resilience

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 03 September 2019, a rating committee was called to discuss the rating of the Government of Serbia. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have increased. The issuer's institutional strength/ framework, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has increased. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in November 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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