Moody's affirms Serbia's Ba2 ratings; outlook stable

London, September 08, 2023 -- Moody's Investors Service (Moody's) has today affirmed Government of Serbia's Ba2 long-term issuer and senior unsecured debt ratings. The outlook remains stable.

The decision to affirm the ratings reflects Serbia's sound medium-term growth prospects and economic resilience despite a challenging external environment, underpinned by sizeable and diversified foreign direct investment (FDI). The rating also reflects a track record of fiscal consolidation that affords space to absorb shocks, supported by a recently revamped fiscal framework, and significant structural reform progress with the IMF support. These factors are balanced against the sovereign's susceptibility to event risk, driven by geopolitical risks in the context of the Russia-Ukraine war, and structural constraints related to some governance weaknesses with respect to the rule of law.

The stable outlook balances Moody's expectations that Serbia will maintain a prudent fiscal stance and will continue to progress on structural reforms under the IMF programme given its positive track record in reform implementation against the risks posed by still present (albeit diminishing) vulnerabilities in the energy sector, and the uncertainty stemming from geopolitical risks.

Serbia's local and foreign-currency ceilings remain unchanged at Baa1 and Baa2, respectively. The four-notch gap to the sovereign rating reflects predictable institutions and government actions, a moderate government footprint in the economy and financial system, moderate political risk and low external imbalances. The one-notch gap between the foreign currency and local currency ceiling reflects policy effectiveness and moderate external indebtedness.

RATINGS RATIONALE

SOUND MEDIUM-TERM GROWTH PROSPECTS AND ECONOMIC RESILIENCE TO SHOCKS DESPITE CHALLENGING EXTERNAL ENVIRONMENT

The affirmation of Serbia's rating reflects its sound medium-term economic prospects and economic resilience, supported by a relatively dynamic manufacturing sector as well as a favorable investment climate and educated labor force that help attract large and diversified FDI inflows. Structural reforms in recent years, facilitated by the assistance from the IMF and the EU, have helped to preserve macroeconomic stability throughout the pandemic and more recently amid the spillovers from the Russia-Ukraine war. The ongoing Stand-by Arrangement (SBA) with the IMF has helped Serbia navigate domestic and external challenges by anchoring fiscal policy and supporting liquidity.

After a temporary slowdown, Moody's expects economic growth to gradually improve in the medium term as external challenges moderate and resilience further strengthens on the back of the ongoing reform efforts. Moody's projects real GDP to expand by 1.8% in 2023 constrained by high inflation, before accelerating to 3.2% 2024 and 4% in 2025, in

line with potential growth, supported by prudent macroeconomic policies and continuing robust FDI inflows.

The current account deficit, which has been fully and consistently covered by FDI inflows in recent years, is projected to narrow to below 4% from 7% of GDP in 2022 while foreign exchange reserves (excluding gold and IMF SDR holdings) are at all-time high at $22.9 billion as of July 2023, compared with $12.4 billion in April 2022.

These strengths are balanced against several structural challenges that, despite recent progress, continue to weigh on competitiveness and constrain growth potential, which includes weaknesses in respect of the rule of law, a sizeable informal economy, and adverse demographics. The economy also remains susceptible to spillovers from adverse developments in the energy sector while FDI inflows could be affected by geopolitical developments.

While inflationary pressures have proved more persistent than Moody's expected, over recent years Serbia has built a track record of effective monetary policy, with inflation gradually declining from the double-digit levels experienced early in the last decade and remaining below 4% between end-2013 and early 2021. Inflation increased significantly at the start of the Russia-Ukraine war, mainly driven by the increase in global food and energy prices. After peaking at 16.2% in March 2023, it has started to gradually decline, reaching 12.5% in July. Moody's expects tightening monetary policy to help inflation to gradually converge towards the upper end of the central bank's target band, reaching 4.5% by end-2024.

CONSOLIDATING PUBLIC FINANCES AND STRUCTURAL IMPROVEMENTS DRIVEN BY REFORMS UNDER THE IMF PROGRAMME

General government debt has been on a declining trajectory since 2015, when it exceeded 70% of GDP, and only temporarily increased in 2020 due to the pandemic shock. Moody's expects it will continue to gradually decrease, reaching 51.7% of GDP in 2025 from a projected 53% in 2023, supported by a track record of fiscal prudence and a revamped fiscal framework.

Moody's expects Serbia's fiscal deficit at 2.8% of GDP in 2023, slightly lower than in 2022. The deficit is projected to gradually decline to 1.5% of GDP in 2025, in line with the new fiscal deficit rule that becomes effective that year. Serbia has enhanced its fiscal framework with a fiscal deficit ceiling to be adjusted based on public debt levels and rules for public wage and pensions expenditure, but in Moody's view a track record of implementation and adherence to these rules has yet to be established. Indeed, under the recently presented 2023 budget revision, the additional fiscal space created by revenue overperformance and lower energy sector support has been used to finance additional spending measures which includes an ad-hoc pension increase beyond the pension indexation mechanism of the fiscal rule.

Serbia's debt affordability has also improved in recent years, with the interest payment-to-revenue ratio declining to 3.5% in 2022 from 7.7% in 2015, well below the 2022 Ba-rated median of 8.3%, although expected to increase gradually from 2022 onward. The improvement partly reflects Serbia's strong revenue performance and lower debt, but also

early redemptions of relatively more expensive debt and new financing at below-market costs.

Unaddressed structural issues in the energy sector, including weak governance and underinvestment, crystallized early last year, partly as a consequence of the spillovers from the Russia-Ukraine war. These issues weighed on both economic performance and the budget. Under the IMF programme, the authorities are implementing measures and reforms to address the challenges of the energy sector, including tariff hikes and the reform of State-Owned Enterprises (SOEs) aimed at improving their governance, efficiency, and financial viability. Beyond the focus on the energy sector and the introduction of new fiscal rules, Moody's expects that the additional reforms and measures undertaken under the IMF program will also gradually improve revenue collection and public investment management while energy transformation will increase the sector's security over the long term.

SUSCEPTIBILITY TO EVENT RISK, DRIVEN BY A COMPLEX GEOPOLITICAL ENVIRONMENT, WEIGHS ON THE CREDIT PROFILE

The Russia-Ukraine war and the related geopolitical tensions have increased Serbia's susceptibility to political event risks. While so far geopolitical considerations have not weakened foreign investment, over the longer term Serbia's non-alignment with EU foreign policy could hamper the EU accession process and discourage FDI, particularly if the conflict were to escalate further. Serbia energy dependency on Russia also remains significant: oil and gas account for about 13% and 22% of Serbia's energy supply mix, respectively, with about 90% of its natural gas imported from Russia at favorable prices.

The geopolitical context is balanced against Serbia's stable domestic political landscape that has been conducive to policy continuity, despite intermittent and recently intensifying protests and frequent elections. In addition, the relationship with Kosovo remains fragile despite the agreement on the path to normalisation reached earlier this year and the strong Western diplomatic engagement to de-escalate the tensions. The normalisation of the relationship with Kosovo, along with progress in the areas of rule of law, remains critical to progress on EU accession. While the government remains committed to EU membership, Moody's expects progress on EU accession to be very gradual, with limited progress in these two areas posing the main impediments.

STABLE OUTLOOK

The stable outlook balances Moody's expectations that Serbia will maintain a prudent fiscal stance and will continue to progress on structural reforms under the IMF programme given its successful track record of policy implementation in recent years against the risks posed by still present vulnerabilities in the energy sector, and the uncertainty stemming from geopolitical developments.

Adherence to the revamped fiscal framework will be key to preserve the gains achieved in terms of strengthened fiscal position, ensuring the medium-term sustainability of public finances. Moody's expects that reforms under the IMF programme will help to contain fiscal risks as well as the impact of economic spillovers from the Russia-Ukraine war.

Risks related to the energy shock and the spillovers of the Russia-Ukraine war have receded since the IMF financing programme was agreed last year, given declining macroeconomic imbalances, lower-than-originally-envisaged financing requirements, and progress in reducing the need for budget support in the SOE sector. Nevertheless, reforms in the energy sector are yet to be completed, and continued adherence to the new fiscal framework still needs to be proven.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Serbia's ESG Credit Impact Score is CIS-3, which indicates that ESG considerations have a limited impact on the current credit rating with potential for greater negative impact over time. Serbia's ESG profile reflects moderate exposure to environmental and social risks. Broadly average governance strength, along with moderate fiscal strength bring some resilience to E and S risks.

Serbia's credit profile is moderately exposed to environmental risks, reflected in its E-3 issuer profile score. While the share of agriculture in gross value added has fallen over the last decade, similar to other Balkan countries, Serbia remains exposed to the risk of temporary supply shocks stemming from adverse weather shocks, including drought, which adds to the volatility in GDP growth. Risks stemming from water, natural capital and waste and pollution are mostly low.

Exposure to social risks is moderate (S-3 issuer profile score), and it is mainly related to high rates of unemployment, including high youth unemployment, that has contributed to recurrent emigration of workers, primarily to the EU, which has led to a decline in the overall population over recent decades.

Serbia's governance profile score is equivalent to G-2, reflecting relatively weak rule of law and control of corruption that weigh on our assessment of institutions and governance strength, and constrain the business environment. This is mitigated by the benefits arising from the gradual harmonization of its laws and regulatory practices with EU standards as part of its accession process as well as structural and fiscal reforms through successive IMF programmes.

GDP per capita (PPP basis, US$): 23,920 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 2.3% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 15.1% (2022)

Gen. Gov. Financial Balance/GDP: -3.2% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: -7% (2022) (also known as External Balance)

External debt/GDP: 70.3% (2022)

Economic resiliency: baa3

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 05 September 2023, a rating committee was called to discuss the rating of the Serbia, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed. Other views raised included: The issuer's institutions and governance strength, have not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

WHAT COULD CHANGE THE RATINGS UP

Upward pressure on the rating would arise from a significant improvement of the government balance sheet, beyond Moody's current expectations, sustained fiscal consolidation and reduction of contingent liability risks. This would be credit positive particularly if accompanied by evidence that the gains achieved in strengthening public finances are unlikely to be reversed in the longer term thanks to adherence to an effective fiscal framework. Continued progress on structural reforms under the IMF programme and material steps toward EU accession in the context of easing of geopolitical tensions would also be credit positive.

WHAT COULD CHANGE THE RATINGS DOWN

Conversely, negative pressure on the rating would arise if the fiscal metrics were to deteriorate significantly due to a less prudent fiscal stance, materialization of contingent liabilities, or significant exchange rate depreciation. The emergence of external imbalances, due for example to a significant decline in FDI that would lead to less stable source of current-account financing, would also be credit negative. A significant increase in geopolitical risk impacting economic and fiscal strength and EU accession prospects would also be credit negative.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819. Alternatively, please see the Rating Methodologies page on https://ratings.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.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.
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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1288235.
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