Rating Action:

Moody's changes outlook on Serbia's sovereign rating to positive from stable, affirms B1 rating

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Frankfurt am Main, March 18, 2016 -- Moody's Investors Service ("Moody's") has today changed the outlook on the Government of Serbia's rating to positive from stable and affirmed the B1 long-term issuer and senior unsecured debt ratings.

Moody's decision to assign a positive outlook to Serbia's B1 rating reflects the authorities' commitment to addressing the deterioration in the sovereign's debt burden through:

(1) the implementation of structural reforms and enhancements in institutional quality against the backdrop of IMF technical assistance and progress in EU accession; and

(2) a fiscal consolidation programme which is expected to improve Serbia's fiscal outlook

The affirmation of Serbia's B1 rating balances a range of factors, including the forecast improvement in Serbia's growth prospects and the fiscal consolidation under way, against the continued rise in the government's debt burden with debt projected to peak at slightly less than 80% of GDP in 2016, and external risks stemming from Serbia's high external debt.

The B2/NP long-term and short-term foreign-currency deposit ceilings and the Ba2/NP long-term and short-term foreign-currency bond ceilings remain unchanged.

RATIONALE FOR CHANGING THE OUTLOOK TO POSITIVE

The first driver for the change in the outlook on Serbia's B1 government bond rating to positive from stable is the expected impact of past and planned structural reforms and enhancements to Serbia's institutions. Serbia has undergone material improvements, and the authorities plan to go further in the coming few years. Pursuant to the Stand-By Arrangement (SBA) signed with the IMF in February 2015, Serbian authorities have already implemented a number of reforms to remove obstacles to investment and to support business, to restore confidence in the financial sector and to consolidate the fiscal position.

These included a set of laws and amendments to previous regulations introduced in 2015 to enhance investment and competiveness, as well as to improve the efficiency of the public administration, incentivize the shift from informal to formal economy and attract foreign investment. An exercise similar to the ECB's Asset Quality Review, the Special Diagnostic Studies (SDS), was carried out by the National Bank of Serbia in order to assess the resilience of the major banks in Serbia. Adopted in August 2015, The Strategy for Resolving Non-Performing Loans (NPL) is going to be implemented through legislative actions, mainly focused on the Bankruptcy Law and creditors' rights, and strengthened reporting by banks and supervision by the National Bank of Serbia (NBS).

Separately, Serbia's government formally opened two chapters of negotiations for EU accession. The experience of other Accession Countries suggests that the accession process will yield a number of enhancements to the quality of Serbia's institutions, for example higher independence and accountability of key institutions. Indeed, recent years have already seen a number of enhancements, recognized in improvements to Serbia's Worldwide Governance Indicators on government effectiveness, rule of law and control of corruption.

The second driver is the improved fiscal outlook in light of the fiscal consolidation planned within the IMF programme. The government has already implemented a number of fiscal measures to improve the collection of tax and social contributions and to cut public wages and pensions. Planned reforms of the public sector -- the downsizing of the Public Administration and the restructuring of state-owned enterprises have been deferred but are scheduled for implementation in 2016 and 2017. The downsizing will aim to reduce the public sector wage bill to 7% of GDP, down from 10.6% of GDP in 2015. The restructuring of the SOE sector will aim to eliminate the costs associated with subsidies, unpaid taxes and contributions and guarantees for the sector, which amounted to around 2% of GDP in the years prior to 2012, and 3% of GDP in 2014.

A combination of reform measures implemented, faster than expected recovery and one-offs amounting to 1% of GDP resulted in a 2015 fiscal deficit of 3.8% of GDP, significantly outperforming the targets in the IMF programme (from the initial 5.9% at the time when the SBA was signed to the 4.1% of its Third Review). Moody's expects deficits of 4% and 2.9% in 2016 and 2017 respectively on the basis of progressive implementation of the structural reforms of the public sector. This path of fiscal consolidation will mark a significant shift in the fiscal position of Serbia, and will stabilize the debt over GDP ratio at around 80% in 2017, according to Moody's projections.

These improvements are taking place against the backdrop of a faster than expected recovery. Real growth surprised on the upside in 2015, increasing 0.7% year on year against expectations of a -0.5% fall. Amid renewed lending activity, investment activity drove real growth in 2015, mainly in the construction sector. Investment is likely to continue to drive accelerating real growth in the coming years, supported by continuing FDI inflows that offset the current account deficits. In 2015 net FDI registered a 4-year high, at 5.6% of GDP, attracted by the enhanced economic climate and expected progress in EU accession. Moody's projects Serbia's real growth above 3% in the period 2018-20.

Despite risks from the upcoming early elections (24 April 2016) and the potential impact of the intensifying refugee crisis on the fiscal outlook, Moody's believes that the balance of risk has shifted to the positive. Polls suggest the government will secure a new mandate, and the cost for Serbia of transiting migrants through its territory is expected to be limited -- the IMF estimates to only 0.1% of GDP.

RATIONALE FOR AFFIRMING THE B1 RATING

Serbia's credit profile exhibits a range of positive features which could, in themselves, support a higher rating. Serbia's economic diversity and per-capita income compare favorably to rating peers. Its well-educated workforce makes the economy attractive to foreign investors, particularly in the manufacturing and export-oriented sectors. The institutional framework also compares well to those of Serbia's rating peers, and supported Serbia being granted full candidate status by the EU in 2012.

However, the public debt burden still remains a major credit challenge. After years of large fiscal deficits, averaging 5.5% of GDP between 2009 and 2014, and crystallizing contingent liabilities, Serbia's debt to GDP ratio rose from 32.1% of GDP in 2009 to 76.5% at the end of 2015, well above the median of B-rated countries. While the large share of debt granted by bilateral and official lenders at concessional terms improves the affordability of the Serbia's public debt, the upward trajectory of the debt burden represents an important constraint on the rating. This deterioration is expected to continue until 2017, when fiscal consolidation and real growth will stabilize the debt-to-GDP ratio at around 80% of GDP.

Serbia's other key credit challenge is its external vulnerability. In 2015, Moody's estimates that external debt amounted (in dollar terms) to almost 80% of GDP, up from 71% in 2014 due to significant appreciation of the US dollar against the Serbian Dinar. The risks associated with such a large volume of gross external debt are mitigated by the fact that the external debt is almost entirely long term, with 47.5% of the public and publicly-guaranteed share (almost one third of total external debt) due to official creditors and on concessional terms, and 80% of the private quota represented by intercompany lending. The current account deficit has narrowed and is expected to continue to be fully covered by FDI in the coming period.

WHAT COULD MOVE THE RATING UP/DOWN

We would consider upgrading Serbia's government bond rating if we were to conclude that the government will continue to make progress on enhancing the quality of its institutions and on fiscal consolidation, reflected in ongoing reduction in the fiscal deficit and, eventually, in debt levels. Evidence that growth will be sustained at levels which reduce existing macroeconomic imbalances would also support an upgrade.

We would move the outlook on Serbia's B1 rating back to stable, and could eventually consider a downgrade, if we saw fiscal and economic reforms being deferred, leading to further economic dislocation and a continued weakening in Serbia's fiscal metrics.

GDP per capita (PPP basis, US$): 13,378 (2014 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 0.7% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.5% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -3.8% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -4.8% (2015 Actual) (also known as External Balance)

External debt/GDP: 79.4% (2015 Estimated)

Level of economic development: Low level of economic resilience

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

On 16 March 2016, 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 improved. The issuer's institutional strength/framework, have materially increased. The issuer's governance and/or management, have materially improved. 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.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings 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.

Source: Moody's.