MOODY'S
INVESTORS SERVICE

Rating Action: Moody's upgrades Serbia's ratings to Ba2, outlook stable

12 Mar 2021

London, 12 March 2021 -- Moody's Investors Service, ("Moody's") has today upgraded the Government of Serbia's long-term issuer and senior unsecured ratings to Ba2 from Ba3. The outlook has been changed to stable from positive.

The key drivers of the decision to upgrade Serbia's ratings are:

1) Serbia's relative economic resilience to the coronavirus shock and the country's solid medium term growth prospects;

2) Moody's expectation that Serbia's fiscal metrics will continue to outperform Ba peers over the next few years, with fiscal prudence being anchored by the continuation of reforms to strengthen the fiscal framework.

The stable outlook balances Moody's expectations that Serbia's economy will return to growth this year and that the government debt-to-GDP will start declining in 2022 against the risks posed to the debt trajectory by the potential crystallization of contingent liabilities from SOEs and guarantee schemes, which are expected to remain contained though. Moreover, the stable outlook reflects Moody's expectation that susceptibility to event risks are commensurate with Serbia's Ba2 rating thanks to low political risks, limited government liquidity and external vulnerability risks and a stable banking sector that is resilient to the foreseen deterioration in asset quality.

Concurrent to today's rating action, Serbia's local-currency country ceiling has been increased by one notch to Baa1 from Baa2. The four-notch gap to the sovereign rating reflects predictable institutions and government actions, moderate government footprint in the economy and financial system, low political risk and external imbalances. The foreign-currency ceiling has been increased by two notches to Baa2 from Ba1. The one-notch gap to the local currency ceiling reflects improved policy effectiveness and moderate external indebtedness.

RATINGS RATIONALE

RATIONALE FOR THE UPGRADE TO Ba2

FIRST DRIVER: SERBIA'S RELATIVE ECONOMIC RESILIENCE TO THE CORONAVIRUS SHOCK AND SOLID MEDIUM TERM GROWTH

The first driver of today's rating action relates to Serbia's relative economic resilience to the coronavirus shock and the country's solid medium term growth prospects. After averaging 4.4% in 2018-19, real GDP contracted by a preliminary 1.0% in 2020 due to the impact of the coronavirus shock. This contraction compares well with regional and rating peers, reflecting a robust economic momentum at the onset of the pandemic and the fiscal space created in recent years that allowed the implementation of a comprehensive fiscal response. Moreover, the structure of the economy adds to Serbia's resilience, including the relatively low reliance on sectors particularly affected by the pandemic such as tourism and the favorable performance of the agriculture sector.

Macroeconomic stability during the coronavirus crisis was also supported by the IMF Policy Coordination Instrument that ended successfully earlier this year. Under the program, Serbia made progress in reducing the fiscal risks stemming from the SOE sector and advanced its privatization agenda despite some delays. The authorities have signaled their commitment to another IMF non-financing program that would help to anchor fiscal policy by strengthening the fiscal framework, and continue the implementation of structural reforms.

Moody's expects that growth will resume in 2021, with real GDP expanding by 4.7%, driven by the recovery in domestic demand supported by the normalization of economic activity on the back of a relatively rapid vaccination rollout and significant public investment. The recovery will also be supported by additional fiscal measures that have recently been announced. Beyond the uncertainty posed by the course of the pandemic, the key downside risk arises from the evolution of external demand that depends on the pace of the recovery in the EU, which remains Serbia's largest trade partner. Serbia's medium-term growth outlook remains robust, with potential growth of around 3-4% supported by its reorientation towards exports and strong prospects for

investment.

More generally, Serbia entered the coronavirus crisis with an improved macroeconomic profile and reduced external imbalances achieved in recent years. The improved profile includes low and stable inflation, a relatively stable exchange rate, adequate foreign exchange reserves, more balanced growth supported by increased economic diversification, a stronger government balance sheet given the pre-pandemic marked fiscal consolidation, and lower -- albeit still present -- fiscal risks from contingent liabilities from SOEs.

SECOND DRIVER: EXPECTATION THAT FISCAL METRICS WILL CONTINUE TO OUTPERFORM Ba PEERS, WHILE FISCAL PRUDENCE WILL BE ANCHORED BY THE CONTINUATION OF REFORMS TO STRENGTHEN THE FISCAL FRAMEWORK

The second driver is underpinned by Moody's expectation that Serbia's fiscal metrics, despite deteriorating, will continue to outperform many Ba peers over the next few years. The substantial fiscal consolidation pursued in recent years has afforded Serbia with fiscal space to respond to the coronavirus pandemic. Despite the large fiscal response to the crisis, the fiscal metrics have deteriorated less than most Ba peers and the debt-to-GDP ratio is projected to resume its downward trajectory in 2022.

The fiscal package implemented by the authorities was the largest in the region, at around 12.5% of GDP in 2020. This, along with the economic contraction, led to a deficit of about 8% of GDP and an increase of the general government debt to GDP to about 58% of GDP in 2020 from 52.9% in 2019, while remaining below the median of Ba peers (estimated at 63% of GDP as of 2020). The fiscal deficit will be reduced more gradually than envisaged in the 2021 budget due to the recent introduction of additional measures to support the economy. A third round of fiscal support measures was announced in February (equivalent to 4.3% of Moody's estimated 2021 GDP) and Moody's projects that the fiscal deficit will be around 4.6% of GDP in 2021.

Nevertheless, Moody's envisages that the pace of the fiscal consolidation will be more rapid for Serbia than for a number of Ba rated sovereigns and that debt-to-GDP, while approaching 60% this year, will remain about 10 percentage points below the median of the Ba rated sovereigns in 2021. Moody's also expects that the government will focus again on fiscal consolidation as the impact of the pandemic gradually fades, potentially under a new IMF non-financing program. This focus will support the debt-to-GDP ratio resuming its downward trajectory in 2022. Furthermore, Serbia's debt-to-revenue ratio -- at around 141% at end-2020 -- will continue to compare strongly with the median of Ba rated sovereigns (estimated at 283%), being the second lowest in the Ba rating category, reflecting also relatively higher revenue generation capacity.

Debt affordability has also improved in recent years and until the start of the pandemic, helped by favorable market conditions in light of the stronger fiscal position, early redemptions of relatively expensive debt and confidence instilled by the IMF program. Debt affordability metrics are also stronger than for many Ba rated sovereigns. In particular, general government interest payments as a percentage of revenue stood at 4.9% in 2020 from 7.7% in 2015, well below the median of the Ba category which stands at 11%.

The pre-pandemic track record of fiscal consolidation was accompanied by steps to improve the fiscal framework, including measures to enhance budgetary processes and transparency, contain public wages bill and pension spending, and address the fiscal challenges posed by the SOEs sector, progressing with the privatization agenda. While the reform progress have slowed in certain areas in part due to the impact of the pandemic (for example, the reforms of public sector employment and the fiscal rule were postponed), and contingent liabilities continue to pose fiscal risks, Moody's expects that the progress made in consolidating the public finances in recent years will continue with the assistance of international financial institutions. Hence, while Serbia's fiscal situation has been inevitably affected by the coronavirus crisis, the impact on Serbia's credit profile has been more contained than elsewhere.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Serbia's ESG Credit Impact Score is moderately negative (CIS-3), reflecting moderate exposure to environmental and social risks and an average governance profile, the latter also explaining a certain degree of resilience to E and S.

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, it continues to account for almost a fifth of total employment. As a result, Serbia is 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 and waste and pollution are low.

Exposure to social risks is moderate (S-3 issuer profile score), and it is mainly related to its demographic profile and high youth unemployment, that has contributed to recurrent emigration of workers. Most other social risk categories also pose a moderate credit risk.

Serbia's governance profile score is equivalent to G-2, reflecting weak assessments on international surveys for the rule of law and control of corruption that weigh on Moody's assessment of institutions and governance strength, and constrain the business environment. This is mitigated by the benefits arising from the ongoing harmonization of its laws and regulatory practices with EU standards as part of its accession process.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's expectation that the economy will remain resilient to the impact of the pandemic and growth will resume this year. It also reflects Moody's expectation that the government debt burden will start declining again from 2022 onwards supported by the track record of fiscal consolidation that the government demonstrated before the pandemic and that contingent liabilities, while continuing to pose a risk, will not lead to a material weakening of the government's balance sheet. Moreover, the stable outlook also reflects Moody's expectation that susceptibility to event risk will remain unchanged, due to low political risk despite frequent electoral cycles, and limited external vulnerability risk given adequate foreign exchange reserves and a current account deficit fully covered by FDIs. Moody's also expects government liquidity risk to remain contained and the banking sector stability to be preserved despite the foreseen deterioration in asset quality, while the progress in reducing the high level of euroization will not been reversed.

GDP per capita (PPP basis, US$): 18,972 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4.2% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.9% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -0.2% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -6.9% (2019 Actual) (also known as External Balance)

External debt/GDP: 61.5% (2019 Actual)

Economic resiliency: baa3

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

On 09 March 2021, a rating committee was called to discuss the rating of 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 has increased.

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

FACTORS THAT COULD LEAD TO AN UPGRADE

Upward pressure on the rating would arise from a material improvement of the government balance sheet due to significant post-pandemic fiscal consolidation accompanied by the evidence that the gains achieved in strengthening public finances are unlikely to be reversed in the longer term due to a stronger fiscal framework. A significant reduction of the risks arising from contingent liabilities and further progress with respect to dinarization would also be credit positive.

FACTORS THAT COULD LEAD TO A DOWNGRADE

Conversely, negative pressure on the rating would arise if the fiscal metrics were to deteriorate materially compared to peers due to a less prudent fiscal stance, materialization of contingent liabilities, significant exchange rate depreciation or the growth outlook underperforming Moody's expectations. 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.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 .

Alternatively, 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.

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 at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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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://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1243406 .

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