

# MOODY'S

## RATINGS

### **Rating Action: Moody's Ratings changes Serbia's outlook to positive from stable, affirms Ba2 ratings**

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30 Aug 2024

London, August 30, 2024 -- Moody's Ratings (Moody's) has today changed the outlook on the Government of Serbia to positive from stable and has affirmed the Government of Serbia's Ba2 long-term issuer and senior unsecured debt ratings.

Our decision to change the outlook to positive reflects prospects of a further sustained improvement of Serbia's economic and fiscal strength, with the possibility of GDP growth and fiscal performance exceeding our expectations. Moreover, Serbia's credit profile is supported by diminishing fiscal risks from the State-Owned Enterprises (SOEs) energy sector and continuing progress on structural reforms under the country's IMF programme.

The affirmation of Serbia's Ba2 ratings reflects moderate economic, fiscal, and institutional strength balanced by the sovereign's susceptibility to event risk, the latter driven by geopolitical risks.

Serbia's local and foreign-currency ceilings remain unchanged at Baa1 and Baa2, respectively. The four-notch gap between the local currency ceiling and 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 moderate policy effectiveness and external indebtedness.

#### RATINGS RATIONALE

##### RATIONALE FOR CHANGING THE OUTLOOK TO POSITIVE FROM STABLE

##### UPSIDE RISKS TO MEDIUM-TERM GROWTH PROSPECTS AND INCREASING RESILIENCE SUPPORTED BY STRUCTURAL REFORM PROGRESS

The first driver of the positive outlook reflects solid medium term economic prospects, with the possibility that the growth performance will exceed our expectations, driven by the acceleration in investment and supported by further structural reform progress.

After expanding by 2.5% in 2023, we project real GDP growth to accelerate to 3.8% in 2024 and 4.2% in 2025, mainly driven by stronger domestic demand, supported by lower inflation, favorable labour market dynamics and a pick-up in investment, while we expect a negative contribution by net exports. That said, the authorities' development plan could support growth beyond our expectations, if focused on productive investment to address infrastructure gaps.

The government is focusing on the implementation of the "Leap into the Future—Serbia EXPO 2027" development plan, which is expected to increase public investment spending over the period 2024-2027. The plan envisages an investment plan of EUR 17.8 billion over the coming years, equivalent to about 23% of estimated 2024 GDP. The programme aims to raise public investment to about 7.5% of GDP by 2027 from 7% in 2023 with a significant portion allocated to transportation infrastructure. Investment will also be supported by the New Growth Plan for the Western Balkans announced by the European Commission in 2023 covering the period 2024-2027, with an initial allocation of EUR 1.6 billion (about 2% of GDP) to Serbia and the final allocation depending on progress on EU-related reforms.

The strong performance under the current Stand-by Arrangement (SBA) with the IMF has helped Serbia to preserve macroeconomic stability, anchor fiscal policy, and support liquidity amid the implications from the Russia-Ukraine war. Risks related to the energy sector and to the spillovers of the Russia-Ukraine war have receded since the SBA was agreed in 2022. Reforms to address structural issues in the energy sector are progressing, along with efforts to diversify energy sources and import routes and to increase gas storage capacity. Additional measures undertaken under the IMF programme would also gradually improve public investment management to prioritize project quality while energy transformation could improve the sector's security over the long term, increasing the resilience of Serbia to future shocks.

#### POTENTIAL FURTHER STRENGTHENING OF PUBLIC FINANCES DUE TO PRUDENT FISCAL MANAGEMENT

The second driver of the positive outlook reflects the prospect of enduring improvement of Serbia's fiscal strength, reflecting declining general government debt to GDP and diminishing fiscal risks posed by the energy SOEs due to the reforms undertaken under the IMF programme.

Public finances have progressively strengthened, with moderate fiscal deficits and declining public debt-to-GDP ratio, supported by a track record of fiscal prudence. In 2023, the general government deficit stood at a slightly better than planned 2.2% of GDP, mainly reflecting broad-based revenue overperformance, and lower-than-planned expenditure despite some ad-hoc spending measures tied to the electoral cycle.

We project the fiscal deficit to remain at 2.2% of GDP in 2024 and reach 2.5% of GDP in 2025, before gradually declining. These projections are in line with the authorities'

draft Fiscal Strategy for 2025-2027 that foresees a postponement of the new fiscal deficit rule to accommodate higher investment under the development plan. The fiscal deficit rule – that envisages a deficit of 1.5% of GDP – was expected to become effective in 2025 under the revamped fiscal framework.

Despite the postponement of the deficit rule, we expect public debt-to-GDP to remain on a downward trajectory over the medium term, supported by solid nominal growth, assuming the pension indexation mechanism and the public wage rule (limiting the share of salaries to 10% of GDP) of the fiscal framework remain in place. General government debt has declined in recent years, reaching 52.3% of GDP in 2023 from 57.8% of GDP in 2020. We project general government debt to further decline slightly to 51.7% in 2025, and likely approach 50% of GDP in 2027.

Stronger than expected fiscal performance due to further progress on fiscal structural reforms, including public sector wage reform and tax administration reform, as well as the continuation of the fight against tax evasion supporting revenue collection poses an additional upside risk to fiscal strength.

Fiscal risks arising from the energy sector have decreased. 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 SOEs aimed at improving their governance, efficiency, and financial viability. Energy SOEs financial position has improved, reducing the risk of budgetary support to the SOE sector.

## RATIONALE FOR THE AFFIRMATION OF THE Ba2 RATINGS

The affirmation of Serbia's ratings reflects a track record of macroeconomic stability and solid economic growth, supported by a relatively dynamic manufacturing sector as well as a favourable investment climate and educated labor force that help attract large and diversified FDI inflows. Serbia's institutional strength has benefited from the gradual strengthening of its laws and regulation under the country's EU accession process and significant structural reform progress under successive IMF programmes, although weaknesses in the rule of law and control of corruption continue to weigh on our assessment.

The rating also reflects Serbia's moderate government debt burden against risks from the large share denominated in foreign currency and still-present contingent liability risks. The rating also reflects a track record of fiscal consolidation that affords space to absorb shocks, supported by a recently revamped fiscal framework.

Susceptibility to event risk is driven by significant geopolitical risks due to a fragile relationship with Kosovo, as well as Serbia's non-alignment with EU foreign policy which both risk hampering the EU accession process. So far geopolitical considerations have not weakened foreign investment, but Serbia's non-alignment with EU foreign policy could discourage FDI if the conflict between Russia and

Ukraine were to escalate further. The challenging geopolitical context is balanced against Serbia's stable domestic political landscape. The latter has been conducive to policy continuity, despite frequent elections.

At the same time government liquidity, banking sector risk and external vulnerability risk remain contained. Financing risks have declined and remain low as the authorities have build-up a significant cash buffer. As of end July, cash reserves stood at about 8.5% of GDP, up from 5.5% of GDP at the end of 2023 in the context of large international issuances over the past two years. The authorities also intend to continue to treat the funds made available under the IMF programme as precautionary.

The banking sector is adequately capitalized and liquid, with sound asset quality although euroization still represents a risk, despite a declining euroization in recent years. External imbalances remain low given the moderate current-account deficit is fully covered by net foreign direct investment (FDI) and robust foreign exchange reserves that reached an all-time high at USD 24.8 billion at year-end 2023 (excluding gold and SDRs), up by USD 6.5 billion from end-2022. We project that the current-account deficit will widen to 4.2% of GDP in 2024 from 2.6% of GDP in 2023, but it will remain below historical level and fully covered by FDI inflows while foreign exchange reserves will remain elevated.

## ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Serbia's ESG Credit Impact Score is CIS-3, reflecting moderate exposure to environmental and social risks. Moderate governance strength, along with a track record of fiscal prudence that has afforded fiscal space to absorb shocks, bring some resilience to E and S risks.

Serbia's E-3 environmental issuer profile score mainly reflects its moderate exposure to physical climate risk. Given significant dependence on agriculture, similar to other Balkan countries, 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 management, natural capital depletion as well as from waste and pollution are mostly low.

Serbia's S-3 social issuer profile score reflects moderate exposure to social risks, and it is mainly related to demographics and labour market dynamics. Relatively high rates of youth unemployment and limited job opportunities have contributed to emigration, accelerating ageing, as emigrants tend to be younger and more educated. Labour participation among women is also low compared to the EU. Most of other social risk categories – such as education and health and safety – also pose a risk, albeit contained and less prominent than what typically observed in emerging markets.

Serbia's governance profile score is equivalent to G-2, supported by the gradual strengthening of its laws and regulation under the country's EU accession process

and significant structural reform progress under successive IMF programmes, although weaknesses in the rule of law and control of corruption continue to weigh on the assessment.

GDP per capita (PPP basis, US\$): 26,305 (2023) (also known as Per Capita Income)

Real GDP growth (% change): 2.5% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 7.6% (2023)

Gen. Gov. Financial Balance/GDP: -2.2% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: -2.6% (2023) (also known as External Balance)

External debt/GDP: 66.8% (2023)

Economic resiliency: baa3

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

On 27 August 2024, 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 not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially increased. The issuer's susceptibility to event risks has not materially changed.

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

Serbia's Ba2 ratings could be upgraded if the improvements in the country's fiscal metrics were sustained and fiscal risks remained contained, supported by further progress on structural reforms under the IMF programme. This would be credit positive particularly if accompanied by evidence that these debt dynamics are unlikely to be reversed thanks to adherence to the fiscal framework. A prudent and transparent implementation of the public investment programme would also be credit positive, underpinned by reforms to strengthen institutions – in particular, in the areas of rule of law and control of corruption – and by progress on the EU reform agenda. The latter could result in additional funding coming from the new EU growth plan for the region.

The positive outlook signals that the rating is unlikely to be downgraded in the near term. That said, the outlook could be changed to stable and eventually negative pressures 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 leading to less stable source of current-account financing, would also be credit negative. In addition, Serbia's ratings would come under pressure were susceptibility to event risk to rise significantly due to an increase in geopolitical risk materially impacting economic and fiscal strength and EU accession prospects.

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.

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