

Rating Action: Moody's affirms Albania's B1 rating, maintains stable outlook

21 May 2021

London, 21 May 2021 -- Moody's Investors Service, ("Moody's") has today affirmed the Government of Albania's B1 long-term foreign and local currency issuer ratings and the B1 foreign currency senior unsecured debt ratings. The outlook remains stable.

The decision to affirm the ratings balances the following key rating factors:

- (1) Albania's resilience to the coronavirus shock despite narrow economic base and persisting structural challenges;
- (2) High public debt burden balanced against Moody's expectations that fiscal consolidation will resume post-pandemic and that fiscal risks will remain contained;
- (3) Albania's susceptibility to event risk remains moderate, mainly driven by banking sector risk.

The stable outlook reflects Moody's view that the B1 rating appropriately balances the risks to Albania's credit profile. Moody's anticipates that economic growth will return to its pre-pandemic rate in the medium term, while the government's debt burden, after having increased significantly in 2020, will resume its downward trajectory. Moody's also expects Albania's banking sector and government liquidity risks to remain contained. The stable outlook is also supported by Moody's anticipation of policy continuity, in particular in the context of the reforms under the EU accession process, and moderate external imbalances.

The local currency country ceiling remains unchanged at Baa3. The four-notch gap with the sovereign rating reflects predictable institutions, a contained government footprint in the economy and financial system, manageable political risk and moderate external imbalances. The foreign currency country ceiling remains unchanged at Ba2. The two-notch gap to the local currency ceiling reflects relatively weak, albeit improving, policy effectiveness and moderate external indebtedness.

RATINGS RATIONALE

FIRST DRIVER: ALBANIA'S ECONOMIC RESILIENCE TO THE CORONAVIRUS SHOCK DESPITE NARROW ECONOMIC BASE AND PERSISTING STRUCTURAL CHALLENGES

The first driver of the rating action relates to Albania's relative economic resilience to the coronavirus shock despite its narrow economic base and persisting structural challenges. Albania has been significantly affected by the coronavirus pandemic, as the shock came at the time in which the economic momentum was already weakening after the earthquake in late 2019 and was exacerbated by the significant dependence on the tourism sector (accounting for about 9% of GDP pre-pandemic).

Nevertheless, macroeconomic stability was preserved and the contraction was milder than expected, with real GDP declining by 3.3% in 2020, also compared with regional peers, as the decline in manufacturing and services was mitigated by the solid performance of agriculture (which accounts for slightly less than 20% of GDP), electricity generation and construction sectors while the decline in tourism was in part mitigated by domestic tourism and tourists coming from neighboring countries.

Moody's expects that economic growth will resume in 2021, with real GDP expanding by 4.8%, driven by the recovery in domestic demand supported by accommodative monetary and fiscal policy, and large public investment, in part reflecting continuing post-earthquake reconstruction efforts. Albania's medium-term growth outlook remains favorable, with potential growth of around 3-3.5%, supported by the enhancement of institutions and closer economic integration with the EU under the accession process.

Nevertheless, while progress in the areas of rule of law has improved the business environment, Albania's economic strength remains constrained by structural challenges that include weak property rights and infrastructure, skill shortages and large informality, while the narrowly diversified export base and exposure to environmental risk continue to expose Albania to domestic and external shocks.

SECOND DRIVER: HIGH PUBLIC DEBT BURDEN BALANCED AGAINST MOODY'S EXPECTATIONS THAT FISCAL CONSOLIDATION WILL RESUME POST-PANDEMIC AND THAT FISCAL RISKS WILL REMAIN CONTAINED

The second driver is underpinned by Moody's expectations that Albania's debt metrics, despite having deteriorated significantly due to the coronavirus shock, will improve in the medium term as gradual fiscal consolidation resumes post-pandemic after the reconstruction efforts approach completion. The economic contraction, the decline in revenue and the response measures due to the effect of the pandemic led to a widening of the fiscal deficit to 6.9% of GDP in 2020 from 1.9% of GDP in 2019. Concurrently, the general government debt to GDP increased to 77.6% of GDP in 2020 from 67.3% in 2019, which exceeds the median of B-rated peers of 59.3% of GDP as of 2020. Debt affordability has deteriorated slightly in 2020, with interest payments absorbing about 8% of revenue in 2020 compared with 7.6% in 2019, still in line with a median of 8.3% for B-rated peers.

The 2020 fiscal deficit was financed with a mix of higher domestic issuances and concessional and non-concessional external borrowing, including the IMF emergency support and the successful issuance of a Eurobond. Moody's projects that the fiscal deficit will remain above 6% also in 2021, mainly driven by significant capital expenditure, in part due to the post-earthquake reconstruction.

Albania entered the coronavirus crisis with a stronger fiscal framework thanks to the improvements implemented in recent years. Albania's fiscal deficit had been contained pre-pandemic, averaging 1.8% of GDP over the period 2016-2019 which contributed to put the debt on a declining trajectory and provided some fiscal room to respond to the shock. While the policy response to the pandemic was relatively small compared to some regional peers, it was timely and well-targeted. The authorities activated the escape clause to the fiscal rules in 2020 due to the earthquake and the pandemic, but in 2021 intend to comply with the provision of the Organic Budget Law (OBL) according to which the debt should decrease every year until reaching 45% of GDP. The authorities have also signaled their commitment to fiscal consolidation in July 2020 by approving further amendments to the OBL that introduce a requirement for a primary balance of at least zero from 2023 onward.

Moody's expects fiscal consolidation to resume in 2022, as the effect of the pandemic fades and the reconstruction ends, with the deficit narrowing to 2.9% of GDP and the public debt to GDP ratio returning to a gradual downward trend. While the implementation of the medium-term revenue strategy was postponed due to the pandemic and the electoral cycle, improving revenue mobilization remains key in order to accommodate the large capital expenditure foreseen over the medium term. Nevertheless, contingent liabilities from public-private-partnerships (PPPs) and SOEs continue to pose a risk to the fiscal consolidation path.

THIRD DRIVER: SUSCEPTIBILITY TO EVENT RISK REMAINS MODERATE, MAINLY DRIVEN BY BANKING SECTOR RISK

The third driver is the country's susceptibility to banking system risk and, to a lesser extent, risks stemming from the government's large financing needs and reliance on domestic banks. The banking system, which is mostly foreign-owned, is liquid and mainly funded by domestic deposits. Capitalization levels are high overall, although asset quality remains weak compared to peers. Financial euroization is significant driving elevated asset quality and funding risks, with about half of loans and deposits denominated in foreign currency, predominantly in euro, although this proportion has gradually declined since the adoption of the "de-euroization" package in 2018. The non-performing loans ratio has remained broadly stable at around 8% up to February 2021, after having more than halved in recent years because of credit restructurings and mandatory write-offs. However, the effects of the pandemic on the banking sector have not yet fully crystalized and asset quality is expected to deteriorate, although not to the extent of fully reversing the improvement achieved in the past few years.

Moody's expects gross borrowing requirements to remain large in 2021, exceeding 25% of GDP, well above the B-rated median of 14% of GDP and the level of regional peers. Over recent years the structure of the government domestic debt, which accounts for about half of the total, has improved due to the lengthening of maturity, but short-term debt continues to account for more than 30% of the total as of end-2020. Furthermore, domestic debt remains predominantly held by commercial banks. Nevertheless, Moody's expects that continuing support from the international institutions, including the EU macro-financial assistance this year, will mitigate liquidity risk.

External vulnerability risk has also remained contained despite the impact of the pandemic. After having widened to about 8.9% of GDP in 2020, due to the significant decrease in tourism exports and the fall in

remittances, Moody's projects the current account deficit to narrow to 7.7% of GDP in 2021, in line with the pre-pandemic level, remaining mostly covered by foreign direct investment inflows. Foreign exchange reserves are adequate, covering around eight months of imports of goods and services.

Finally, while Albania's susceptibility to political risk will continue to reflect the country's polarized domestic landscape, Moody's expects policymaking continuity to support the implementation of reforms under the EU accession process.

RATIONALE FOR THE STABLE OUTLOOK

The decision to maintain the stable outlook reflects the risks to Albania's credit profile being broadly balanced. The stable outlook balances Moody's expectations that Albania's credit metrics will remain commensurate to B1 rating as the damage of the pandemic on economic and fiscal strength will be repaired in the medium term. The stable outlook also reflects Moody's expectation that susceptibility to event risks will remain moderate due to contained risks to financial stability as the banking system remains broadly resilient to the expected erosion of asset quality, provided the economy recovers this year. The stable outlook also reflects Moody's expectations of policy continuity, enduring support of international organizations that mitigates government liquidity risk, and resilient external position thanks to adequate foreign exchange reserves and a current account deficit covered mostly by FDIs.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Albania's ESG Credit Impact Score is highly negative (CIS-4), reflecting moderate exposure to environmental risks, high exposure to social risks and moderately weak governance profile, the latter also explaining - along with weak fiscal metrics - the relatively low resilience.

Albania's credit profile is moderately exposed to environmental risks, reflected in its E-3 issuer profile score. Exposure to environmental risk is low or moderately negative across all categories, apart from physical climate risk which is highly negative. Albania is also exposed to environmental risks because of the agriculture sector's importance to the economy, its dependence on tourism and its almost exclusive reliance on hydropower for electricity generation. Power shortages as a result of drought can weaken economic growth and increase electricity imports.

Exposure to social risks is high (S-4 issuer profile score), and it is mainly related to the subpar quality of basic service and unfavourable demographics, given high emigration and an ageing population, which will weigh on growth over the long term. Health outcomes, housing, education and labour and income are also a source of credit risk, although to a moderate extent.

Albania has a moderately negative governance profile score (G-3 issuer profile), reflecting significant improvements in strengthening its institutions, though its performance in respect of rule of law and control of corruption remains relatively weak. The EU's recent decision to launch accession talks with Albania is likely to support progress in these areas.

GDP per capita (PPP basis, US\$): 14,534 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 2.2% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.2% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -1.9% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -7.9% (2019 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: ba2

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

On 18 May 2021, a rating committee was called to discuss the rating of the Albania, 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

FACTORS THAT COULD LEAD TO AN UPGRADE

Upward pressure on the rating would arise from an improvement in fiscal strength deriving from a material decline in public sector debt, and a reduction of the fiscal risks posed by contingent liabilities. An improvement of the country's institutions due to stronger fiscal policy effectiveness, thanks for example to effective revenue-enhancing measures, or additional reforms that result in progress in the area of rule of law and in an improved business environment and competitiveness would also be credit positive.

FACTORS THAT COULD LEAD TO A DOWNGRADE

Conversely, downward pressure on the rating would arise from a less prudent fiscal policy, significantly weaker growth prospects compared to Moody's expectations, and/or the materialization of contingent liabilities leading to a permanent reversal of the public debt-to-GDP ratio's downward trajectory. Furthermore, the emergence of challenges in funding the current-account deficit due to a significant decline of FDI would be credit negative. Reduced political commitment to the institutional and economic reform agenda would also exert negative credit pressure.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1158631. Alternatively, please see the Rating Methodologies page on www.moody.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.moody.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 http://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1263068.

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