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Breaking through in the Balkans:

The improving investment case for Serbia's local currency debt

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The Global Income team focuses on the country as the unit of analysis, rather than capital markets. We believe that country research and policy analysis are key to building high-conviction views on a country's outlook. We then have the ability to express our views within our Global Macro and Emerging Markets Debt investment capabilities by investing across a country's entire capital market, with a particular focus on sovereign debt.

- While Serbia has witnessed a transformation in its economy and politics over the past two decades, the country's investment potential remains generally underappreciated by foreign investors.
- In our view, Serbia's short- to longer-term outlook is for continued improvement, with the popular, reform-minded government pushing forward an ambitious political programme anchored in fiscal consolidation, growth-enhancing reforms and a path to EU membership.
- Sovereign creditworthiness is strong, as demonstrated by a track record of sound fiscal management, improving public finances, healthy economic growth and credit ratings upgrades that reflect the improving investment case for Serbia's local currency debt.
- High real interest rates have helped to rein in inflation and raise confidence in the Serbian dinar. Relative to its peers, we view Serbia's high real rates as compelling and see the dinar as attractively valued, with medium-term prospects for continued appreciation against the euro.
- The Global Income team at Eaton Vance was an early investor in Serbia, entering the market in 2006. We continue to find opportunity there and view the country's commitment to economic reform as an important foundation for bondholder value within the emerging-market and frontier universe.

A country transformed

More often than not, to highlight Serbia as an attractive market for investment is to elicit surprise. Rarely does one find an audience familiar with Serbia's investment potential today or the significant progress the country has made in transforming its politics and economy since the regional turmoil erupted in the Balkans during the 1990s.

In illustrating the magnitude of economic change over the past two decades, a few figures are revealing. For starters, inflation fell from 70% in 2000 to 3% at the end of last year. Over the same period, economic liberalisation helped boost trade levels from 24% of GDP to 119% in Q1 2018. The standard of living, meanwhile, has steadily climbed, with GDP per capita tripling on a purchasing power parity basis to levels that today are roughly equal to that of Brazil and China.

As one of Europe's youngest democracies, the country's political progress over the period has been equally significant. Indeed, the cessation of regional hostilities, the consolidation of democratic institutions and national leadership by today's reform-minded government have led to a sea change in Serbia's political landscape.

Reform momentum

President Aleksandar Vucic, Prime Minister Ana Brnabic and the governing political alliance led by their Serbian Progressive Party, which holds a majority in parliament, have sustained strong reform momentum in more recent years. As part of an ambitious fiscal consolidation programme, the government slashed public pensions by 5% and public sector wages by 10% in 2014. The mass redundancy target of 19,500 positions was achieved mostly through attrition.

The government has also committed to privatising or closing 502 state-owned enterprises. In this respect, a major privatisation success was achieved through the sale of a concession for the private management of Belgrade's airport, Aerodrom Nikola Tesla. Valued at US$1.5 billion, the deal stands as not only one of the largest in frontier markets, but also one that has been exemplary in its transparency.

Among the other large businesses slated for privatisation, the government has included state-owned companies including Komercijalna Banka, the banking group, and PKB, which operates in agribusiness, as well as RTB Bor, the copper miner and smelter. Chemicals producers MSK and Petrohemija are also up for sale. The government recently initiated insolvency proceedings on Azotara, the fertilizer producer which failed to attract buyer interest.

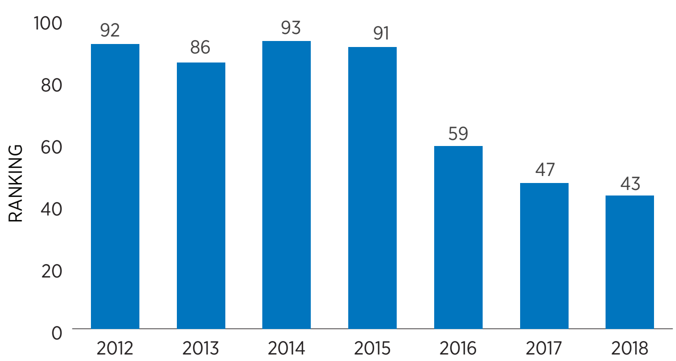
More detailed optimisation of bureaucracy will be another obvious step forward, as cuts to headline public employment, wages and pensions are largely complete. Although the unemployment rate remains high at 13.5% at the close of last year, it has fallen considerably from above 20% five years ago and resistance to public job cuts has waned in response to stronger private sector hiring.

Serbia's reform momentum is paying off. This is clearly illustrated in the improvement in its ease of doing business ranking, which currently stands at 43 out of 190 countries — an improvement of 50 places from 2014 (Exhibit A). Improvements in the business climate have coincided with substantial increases in foreign direct investment (Exhibit B).

Upgrade for Belgrade

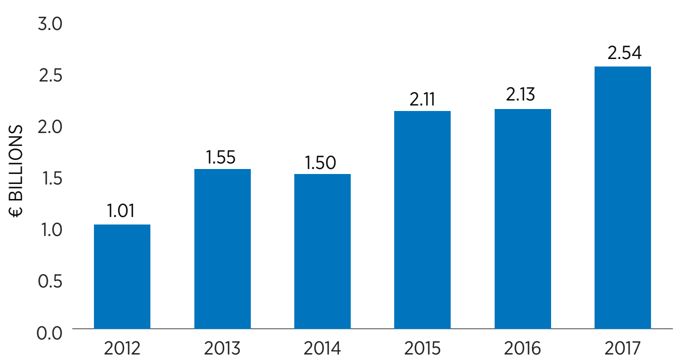
In response to fiscal reforms, the government has narrowed the budget deficit over successive years, posted a surplus in 2017 and may post another this year. Faster economic growth and sturdier public finances have aided a reduction in public debt ratios to

Exhibit A
Ease of doing business ranking.



Source: World Bank. As of 31 October 2017.

Exhibit B
Foreign direct investment inflows.



Source: National Bank of Serbia. As of 31 December 2017.

around 60% of GDP today from 76% just three years ago (when Serbia initiated a precautionary standby agreement with the IMF).

The fiscal improvements have underpinned upgrades to the country's sovereign credit rating from all major ratings agencies during last year: Moody's upgraded Serbia's long-term issuer and senior unsecured rating from B1 to Ba3 in March, while both S&P and Fitch Ratings upgraded their long-term foreign and local currency ratings to BB from BB- in December (Exhibit C).

The liquidity of Serbia's local currency debt has improved over recent years thanks to deepening domestic capital markets and the expanded range of longer-dated debt securities, which has helped to build out the local currency debt yield curve to 10 years. Notably, Serbia is pursuing inclusion on the JPMorgan Government Bond Index-Emerging Markets (GBI-EM), the principal benchmark for emerging-market local currency debt, and improvement in local market liquidity should be very helpful in attaining this goal.

Upon conclusion of Serbia's IMF agreement in February 2018, the country received glowing praise from the organisation for its policy progress. Ahead, risks of a policy shift appear minimal. The Serbian government signed onto a nonfunded, 30-month Policy Coordination Instrument (PCI) with the IMF in July 2018. The agreement provides support for Serbia's structural reform programme, including:

- Strengthening dinarization, a strategy promoting the use of the local currency in the financial sector.
- Reducing the tax burden on corporations and labour.
- Reducing debt, while increasing capital expenditure.
- Fortifying the legal framework for wage, pension and civil employment in order to crystalize earlier reforms.
- Privatisations of state-owned banks and other enterprises as well as the shuttering of less viable, burdensome companies.

Together with the country's ongoing accession chapter negotiations with the European Union — which are designed to harmonise Serbian and EU law across a number of core policy areas — the signing of the PCI is another sign of Serbia's commitment to sound policymaking, market-based principles and is further proof of the government's strong will to reform.

Central bank credibility

In recent years, the central bank's policy of maintaining high real interest rates helped to rein in inflation and to support confidence in the Serbian dinar, which local residents and businesses increasingly prefer over the euro for bank savings accounts and contracts. Notably, that preference has helped to reduce external vulnerabilities, with private external debt falling to an estimated 26% of GDP from 36% in 2013.

Inflation numbers are low, with the year-to-date high registering just 2.1% year on year in May (the target is 3% ±1.5%). The central bank has been able to maintain attractive real rates while still implementing a policy of gradual easing. Despite major central banks such as the Fed and ECB moving to tighten monetary conditions, the dinar has strengthened against the US dollar and euro this year. The central bank maintains a managed float against the common currency and has used open market operations to stem the Serbian currency's appreciation.

From a balance-of-payments perspective, the dinar appears well-supported. Although Serbia runs a current account deficit, foreign direct investment inflows more than offset the shortfall. Indeed, Serbia has done well in attracting capital from overseas. Foreign companies have been lured by its well-educated workforce, competitive wages and reductions in red tape. External liquidity is also supported by Serbia's more than €10 billion in foreign currency reserve holdings, which is equivalent to 243% of its short-term debt and sufficient to cover nearly half a year's imports of goods and services.

Exhibit C

Sovereign credit rating and outlook changes.

	2012	2013	2014	2015	2016	2017
S&P	BB- negative				BB- positive	BB stable
Fitch	BB- negative		B+ stable	B+ positive	BB- stable	BB stable
Moody's		B1 stable			B1 positive	Ba3 stable

Key: Upward change to rating or outlook; Downward change; Neutral as Moody's first rating assessment of Serbia's debt.

Source: National Bank of Serbia. As of 31 July 2018.

The Kosovo question

Of course, a resolution to the disputed status of Kosovo will be a key requirement for the county's accession to the European Union, to which the government remains steadfastly committed. Here, President Vucic, who enjoys broad popular support, has signalled that the government would be willing to make meaningful compromises and has hinted that he will release his Kosovo plan soon. More broadly, accession negotiations are progressing apace, with 14 out of the 35 chapter areas needed for EU membership opened between Belgrade and Brussels as of mid-2018 (Exhibit E).

While treading the path toward EU membership, President Vucic has so far proven himself adept at foreign affairs. He has advanced Serbia's EU accession talks and done so while still fostering close relations with Russia. At the same time, Vucic has taken careful steps to improve the delicate relations with neighbouring countries in the Balkans — a region historically fraught with nationalist rivalry.

That said, it is important to recognise that whereas nationalist sentiment has played a more determinant role in shaping the political agenda for several Central and Eastern European countries such as Poland, Hungary and Turkey in the past few years, Serbia's leaders have won their electoral support by advancing a reform agenda to deliver improvements in governance and living standards. Fortunately, the country has continued to move forward in these areas, which offers an encouraging sign that Serbia's transformation will continue apace.

Conclusion

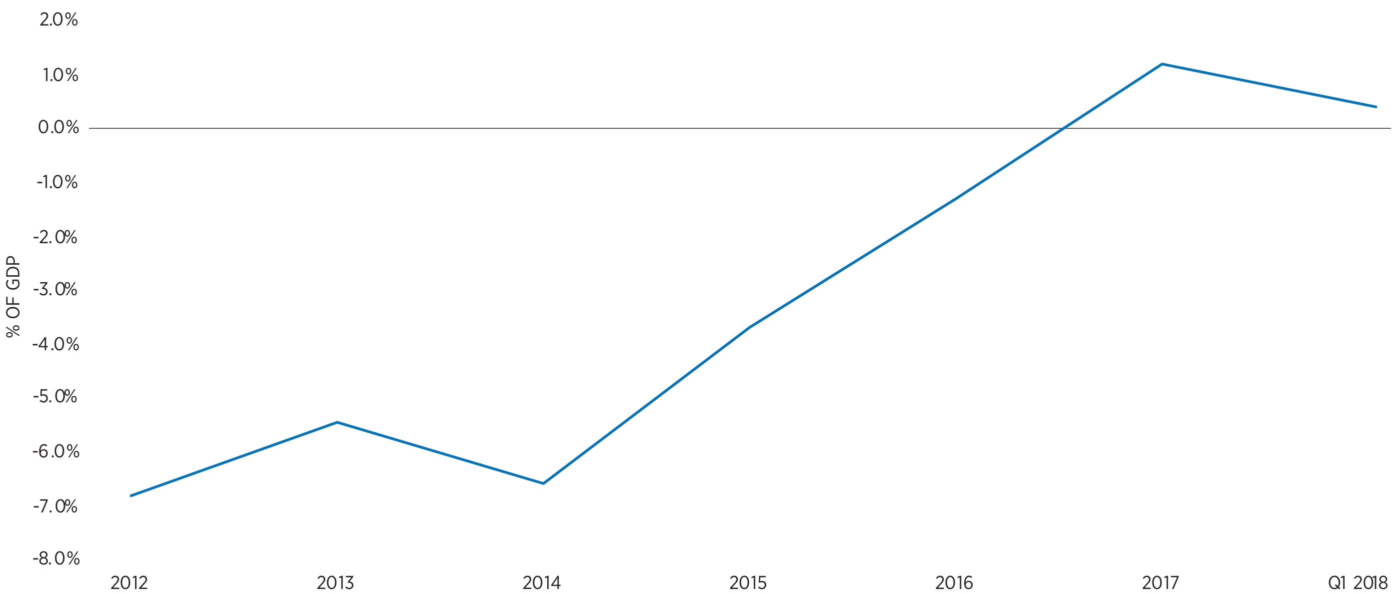
For many investors, Serbia remains an undiscovered and overlooked investment destination. Clearly, the country still faces challenges as a young democracy, but we view it as an emerging-market success story worthy of investor attention. We see strong investment potential and view the country's impressive track record of reform, its commitment to liberalising markets and improving conditions for private enterprise as an important foundation for bondholder and shareholder value within the frontier-market universe.

Eaton Vance was an early investor in Serbia. Our Global Income team initiated a position in the currency in 2006 within our emerging-market strategies, and participated in the country's local debt auction for short-term paper three years later. We have continued to find opportunity in the country as the economic environment, sovereign creditworthiness and depth of local capital markets have improved.

In our view, interest rates remain compelling relative to peers in emerging and frontier markets and we believe the currency is attractively valued, with medium-term prospects of continued appreciation against the euro. Lastly, because Serbia is so often overlooked, its local currency bonds provide an effective source of diversification, as they are largely uncorrelated with other emerging-market and global assets.

Exhibit D

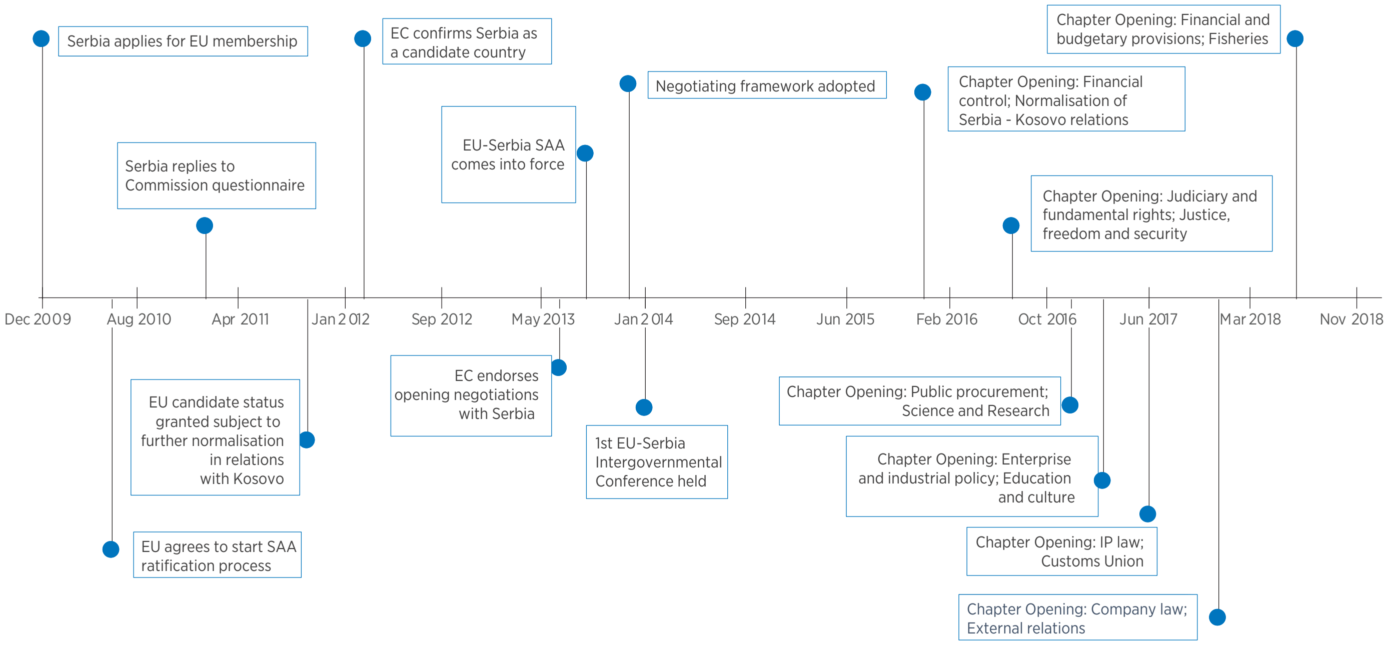
Consolidated fiscal balance.



Source: National Bank of Serbia. As of 31 July 2018.

Exhibit E

Serbia's path to EU membership – accession expected by 2025.



EU = European Union; EC = European Commission; SAA = Stabilisation and Association Agreement

Source: The Delegation of the European Union to the Republic of Serbia. As of 31 July 2018.

Important Additional Information and Disclosure

Source of all data: Eaton Vance, National Bank of Serbia, International Monetary Fund, World Bank, European Union unless otherwise stated. As of 1 August 2018 , unless otherwise stated.

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