SERBIA

Highlights

- **Growth is recovering in 2018.** After modest growth in 2017, the economy grew by 4.9 per cent in the first half of 2018 on the back of faster domestic demand growth, primarily investment.
- **Further progress has been made towards eventual EU membership.** The new European Commission Enlargement Strategy for the Western Balkans, published in February 2018, has set 2025 as the year when Serbia could be ready for EU membership, provided it makes further progress in reforms.
- **Non-performing loans (NPLs) have declined to below 7 per cent.** This significant reduction over the past year is mostly a result of the National Bank of Serbia's decision to make the write-offs of fully provisioned NPLs mandatory.

Key priorities for 2019

- **Public sector reforms, including privatisation and restructuring of state-owned enterprises (SOEs), should be advanced.** Significant contingent fiscal risks still stem from large, unreformed SOEs. Better SOE management could also contribute to stronger growth performance and increased resilience to shocks.
- **Small and medium-sized enterprises (SMEs) need better access to finance and clear rules.** SMEs would benefit greatly from the development of non-bank financial institutions and improved tax-related practices, including simplified tax procedures, lower para-fiscal charges, and better predictability of tax decisions and services to tax payers.
- **Further efforts are needed to support market transactions in NPLs.** Efforts should focus on easing access to information for potential investors on NPL portfolios, improving out-of-court restructuring and conducting more efficient judicial processes.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-1.8	0.8	3.3	2.0	4.2
Inflation (average)	2.1	1.4	1.1	3.0	2.1
Government balance/GDP	-6.6	-3.7	-1.3	1.2	0.7
Current account balance/GDP	-6.0	-3.5	-2.9	-5.2	-5.5
Net FDI/GDP [neg. sign = inflows]	-3.7	-5.1	-5.2	-6.2	-6.0
External debt/GDP	77.1	78.3	76.5	69.5	n.a.
Gross reserves/GDP	29.7	29.1	27.8	25.4	n.a.
Credit to private sector/GDP	43.4	43.4	43.4	43.0	n.a.

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Macroeconomic performance

Growth slowed in 2017, but has accelerated in 2018. GDP growth decelerated to 2.0 per cent in 2017, from 3.3 per cent in 2016. The slow-down was mainly a consequence of a fall in agricultural production due to the summer drought and some difficulties in mining and electricity generation. On the expenditure side, growth was led by rising private consumption and investment, the latter being supported by strong foreign direct investment (FDI) inflows. However, higher domestic demand translated into a fast rise in imports (around 11 per cent), offsetting the strong export performance and resulting in a negative contribution from net exports and a rise in the current account deficit to 5.7 per cent of GDP. Growth recovered strongly in the first half of 2018, reaching 4.9 per cent year-on-year. It was a result of continuing recovery of domestic demand with offsetting effects from net exports due to the continued strong growth in imports. Higher frequency indicators point to stable manufacturing growth, a stagnation in mining, and recovery in electricity production in the first half of the year.

After years of deficits, Serbia has started to record fiscal surpluses. In February 2018, Serbia completed its three-year Precautionary Stand-By Arrangement with the IMF. The programme was marked by significant fiscal over-performance over the whole period. In 2017, the general government registered a surplus of 1.2 per cent of GDP (versus 1.3 per cent deficit in 2016) on the back of higher tax revenues and lower current spending. Developments in the first seven months of 2018 (namely, higher revenues from social security contributions, taxes and excises) point to the possibility of another year of fiscal surplus. In view of the achievements so far, the government has continued to relax austerity measures. This includes a hike of public sector wages by 5 to 10 per cent, depending on the sector, and a 5 per cent increase of pensions from January 2018, as well as a one-off bonus of RSD 10,000 (around €85) to the security forces in December 2017. In addition, the law on reduction of above-average pensions was abolished at the end of September 2018. However, a ban on new hiring in the public sector, introduced in 2013, has been extended until the end of 2018. Public debt fell to 63 per cent of GDP at the end of 2017 and to 60 per cent of GDP at the end of June 2018. However, due to its currency structure (75 per cent in foreign currencies, close to 40 per cent of which is in US dollars), the debt is quite sensitive to exchange rate developments, including euro-dollar movements.

Amid low inflationary pressures, monetary easing continued. After undershooting the target (3±1.5 per cent) for two years, inflation picked up to 3 per cent year-on-year in 2017 on average. This acceleration came on the back of the rise in food and energy prices but was also supported by the increase in domestic demand and foreign inflation (notably in the euro area). However, in the first nine months of 2018 inflation moved to the lower half of the target band, mainly due to low food prices and the high 2017 base effect. The National Bank of Serbia (NBS) responded by lowering the key policy rate to a historic low of 3 per cent in April 2018.

Growth is expected to accelerate to 4.2 per cent in 2018 and slow down to 3.5 per cent in 2019. Faster growth is to be supported by further strengthening consumption and investment, with offsetting effects from higher imports. The risks to the projection are balanced, the main ones relating to the implementation of reforms envisaged under the IMF's Policy Coordination Instrument (PCI) and further pace of eurozone growth.

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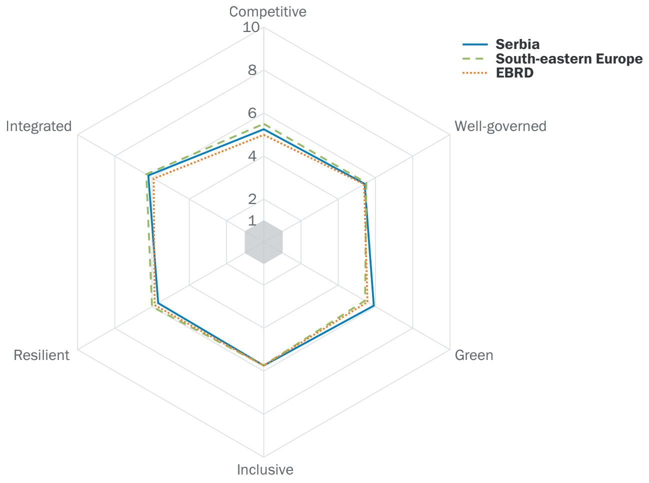
Assessment of transition qualities (1-10)



Major structural reform developments

The business environment remained broadly unchanged. In the World Bank's *Doing Business 2019* report Serbia ranked 48th out of 190 economies. Although it improved dealing with construction permits further (ranking 11th), by reducing time for processing permit applications, it did not make much progress in other areas, resulting in a decrease of five positions from last year's report. Enforcing contracts, resolving insolvency and protecting minority investors are still the most problematic areas for doing business. On the other hand, Serbia has slightly improved its standing in the World Economic Forum's *Global Competitiveness Report 2018*, ranking 65th out of 140 countries (up five places from the previous one).[1] As earlier, market efficiency, institutions and innovation capacity show the biggest gaps.

Serbia has signed a 30-month Policy Coordination Instrument (PCI) with the IMF. This non-financing instrument, signed in July 2018, is to support continued efforts for macroeconomic stability and structural reforms, following the successful conclusion of the three-year Standby Arrangement in February 2018. The new programme is centred around three areas: (i) fiscal policy (that is, safeguarding the fiscal adjustment; and reforming tax policy, tax administration, public employment and wage systems); (ii) monetary and financial sector policies (that is, strengthening the coordination of liquidity management between the National Bank of Serbia and the Ministry of Finance; promoting dinarisation; further reducing NPLs; reforming state-owned financial institutions; aligning financial regulatory and supervisory frameworks with EU standards; addressing identified weaknesses in the AML/CFT framework); and (iii) structural and institutional reforms (that is, tackling the large shadow economy and improving labour force participation; completing restructuring and/or privatisation of SOEs).

Reforms of the public administration have advanced slowly. Following legislation adopted in December 2017, pay levels are to be set across government departments in a more market-oriented, fair and transparent manner. Despite the announcement that coefficients under the new wage system will be applied from January 2019, in November 2018 the government decided to postpone their application to January 2020. "Rightsizing" of the state administration remains a key government priority and, since 2015, the number of public employees has been reduced by close to 30,000, as planned. However, merit-based recruitment and dismissal procedures have not been implemented, and problems remain with political influence in hiring and the high turnover of senior civil servants.

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[1] The rating for 2017 reflects the change in the methodology. According to the old methodology Serbia was ranked 78th in 2017.

Tax administration reform shows mixed progress. In December 2017 the government adopted a new Tax Administration (TA) Transformation Action Plan (2018-23) in order to create a modern tax administration that uses e-business processes, improved taxpayer services and a risk-based approach to compliance. The plan also envisages the removal of the TA's non-core activities and consolidation of core activities into fewer sites. In April 2018 the changes to the Law on Tax Procedure and Tax Administration were adopted. The goal was to reduce tax evasion by broadening the responsibilities for tax payments, extending the competences of tax inspectors, restricting the rights of taxpayers, and securing more efficient tax collection. The amendments also introduce tax services that will be provided by the TA to help the taxpayers settle their taxes in proper amounts and within the deadlines. However, more consultation with all relevant stakeholders in future would be needed since the practical application of some of the rules (including the new VAT Rulebook from October 2017) is unclear.

Privatisation and restructuring of SOEs has progressed somewhat. After several unsuccessful attempts to privatise the company, the government sold its 93.7 per cent stake in the drug-maker Galenika (one of 17 strategic SOEs) in November 2017. In September 2018, two other strategic SOEs were resolved (the Belgrade agricultural company PKB by privatisation and the copper mining and smelting complex RTB Bor by entering into a strategic partnership with a Chinese gold producer). The privatisation of Komercijalna banka has been postponed to 2019, while the resolution of three major loss-makers (all chemical companies) is progressing slowly. In total, around 115 companies (including 10 strategic SOEs) accounting for nearly 45,000 employees in the portfolio of the former Privatisation Agency, remain to be resolved. The restructuring of large public utilities (EPS, Srbijagas) is moving ahead slowly. Following the launch of a concession procedure a year earlier, in March 2018 the government signed a 25-year concession deal for Belgrade airport.

The NPL ratio has fallen significantly. In August 2017 the NBS adopted a Decree on the Accounting Write-Off of Bank Balance Sheet Assets, stipulating the mandatory write-off for loans covered in full by allowances for impairment. As a result, banks have intensified the writing-off of NPLs, which led to the NPL ratio almost halving from September 2017 to 6.5 per cent in August 2018. However, there is still further room for accelerating NPL sales and, eventually, restructuring the debtor companies. The main obstacles relate to strict bank secrecy rules, preventing potential buyers from getting adequate information on NPL portfolios, restrictions on retail NPL sales and NPL sales to foreign entities, as well as inefficient judicial processes.