SERBIA

Highlights

- **After a robust performance in 2018, economic growth is moderating in 2019.** Lower growth primarily reflects stagnation in the agricultural sector and a fall in industrial production.
- **Foreign direct investment (FDI) inflows have been strong in the past few years, especially in 2018, more than covering the growing current account deficit.** Nevertheless, the structure of FDI has changed to more labour-intensive projects, requiring low-skilled labour and supported by high subsidies.
- **Non-performing loans (NPLs) in the banking sector have continued to decline, but the financial sector remains highly euroised.** The NPL ratio fell to 4.9 per cent in August 2019, mainly due to mandatory write-offs. Euroisation of loans and deposits remains at close to 70.0 per cent.

Key priorities for 2020

- **Serbia has to systematically address the institutional causes of chronically weak growth.** Average growth between 2010 and 2018 was just 1.7 per cent, significantly below that of regional peers. The focus should be on strengthening the rule of law, fighting corruption and increasing domestic private and public investment.
- **The governance of state-owned enterprises (SOEs) and public projects needs to be improved.** The government should focus on improving the efficiency of large SOEs, also through necessary legal changes and/or stronger implementation of existing legislation. A single pipeline for all public projects should be developed, enabling proper cost-benefit assessment and monitoring while project implementation should be strengthened further.
- **Public administration reform should be high on the agenda.** Planned reform measures, including the introduction of a new public-sector pay grade system, as well as professionalisation and de-politicisation of public administration, have been postponed several times and should be implemented without further delay.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	1.8	3.3	2.0	4.4	3.2
Inflation (average)	1.9	1.2	3.0	2.0	2.0
Government balance/GDP	-3.5	-1.2	1.1	0.6	-0.5
Current account balance/GDP	-3.5	-2.9	-5.2	-5.2	-5.5
Net FDI/GDP [neg. sign = inflows]	-5.1	-5.2	-6.2	-7.5	-6.1
External debt/GDP	73.5	72.1	65.3	62.7	n.a.
Gross reserves/GDP	29.1	27.8	25.4	26.3	n.a.
Credit to private sector/GDP	40.7	41.0	40.3	41.5	n.a.

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Macroeconomic performance

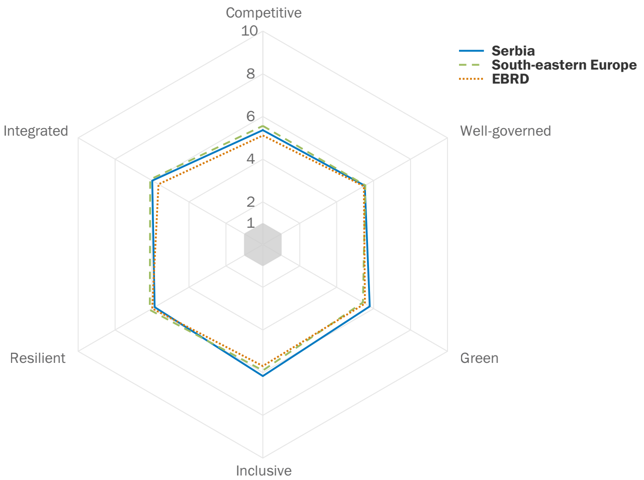
Growth was strong in 2018, but has subsided during 2019. GDP expanded by 4.4 per cent in 2018, driven by private consumption and investments and supported by a strong agricultural season. On the other hand, a negative contribution by net exports acted as a drag on growth for the second year running. In addition, mining and utilities output started to fall again in the second half of 2018, indicating governance problems at the state-owned electricity company EPS. Unfavourable trends in industrial production continued in the first half of 2019, with industrial output declining by 2.0 per cent year-on-year on the back of falling mining and manufacturing, while utilities output stagnated. In addition, agricultural output stagnated. As a consequence, the overall growth rate slowed to 2.8 per cent year-on-year in the first half of 2019.

The general government budget remained in surplus for the second year in a row. The 2018 budget recorded a surplus of 0.6 per cent of GDP, versus an initially planned deficit of 0.7 per cent. Although prudent fiscal policy is desirable, persistent significant over-performance of the planned budget targets indicates a need for better budget planning. In addition, the composition of expenditures is heavily weighted towards consumption, while public investments, despite the increase in 2018 and 2019, remain low. Public debt continued to decline, reaching 54.5 per cent of GDP at the end of 2018, but remained broadly at the same level in the first half of 2019. In September 2019, the Fitch agency upgraded Serbia's credit rating from "BB" to "BB+" (with a stable outlook), citing among other factors the maintained fiscal discipline and decreasing public debt. In October, the 2019 budget was revised to account for additional capital spending, a one-off payment to pensioners and public-sector wage increases. That moved the budget from a small surplus in the first eight months of the year to a deficit of 0.5 per cent of GDP expected for the year as a whole.

Inflationary pressures have been low, also thanks to the strong exchange rate. Inflation fell to 2.0 per cent in 2018, coming closer to the lower bound of the central bank's target band (3 ± 1.5 per cent). In 2019, it initially picked up, reaching 3.0 per cent year-on-year in April, but then fell back to 1.1 per cent in September. After keeping the policy rate unchanged at 3.0 per cent for more than a year, the central bank cut the rate again in the third quarter of 2019. In October 2019, the rate stood at 2.5 per cent. The central bank also continues to actively intervene in the foreign exchange market, on both the purchase and sale sides, but has remained a net buyer of foreign exchange.

Growth is expected to moderate in the short term. GDP is expected to expand by 3.2 per cent in 2019 and 3.5 per cent in 2020. Domestic demand should remain the main growth driver, while net exports will most likely keep contributing negatively. On the other hand, the economic slowdown of the main trading partner, the European Union (EU), and the slow pace of reforms within the country might act as a drag on growth in the near term and make it more volatile. While the introduction of a 100.0 per cent tariff on Serbian products by Kosovo may have a negative effect on exports of up to €400 million a year, reliable assessments of the effects are not yet available.

Assessment of transition qualities (1-10)



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Major structural reform developments

EU accession negotiations are advancing, albeit slowly. Over the past year, three new chapters have been opened, making 17 in total (out of 35) since the opening of negotiations in January 2014. Two chapters were provisionally closed earlier. According to the 2019 European Commission's country report, the future speed of negotiations will primarily depend on the pace of reforms to the rule of law as well as on progress in the normalisation of relations with Kosovo. In October 2019, the country signed a free trade agreement with the Eurasian Economic Union, from which it has pledged to withdraw on the day of EU accession.

The business environment remained broadly unchanged. In the World Bank's *Doing Business 2020* report Serbia ranked 44th out of 190 economies. While the country made starting a business more complicated by requiring that entrepreneurs obtain an electronic certificate and register the ultimate beneficial owners separately after incorporation, the business environment improved in several other areas, resulting in an increase of four positions from last year's report. Enforcing contracts, getting credit and resolving insolvency are the areas where Serbia lags behind the frontier most. In the World Economic Forum's 2019 Global Competitiveness Report, Serbia's weakest areas are its financial system, adoption of information and communications technology (ICT) and its institutions. The country has worsened its overall standing in the report, ranking 72nd out of 141 countries (down seven places from the previous report). Over the past year there was no progress in establishing the legal framework for microfinance institutions.

The state's footprint in the economy remains large. Serbia has the third-largest share of SOE employment among the 21 central, eastern and south-eastern European countries, according to recent estimates by the International Monetary Fund (IMF). The financial performance of SOEs is also weak compared with the private sector. Recurring problems in mining and electricity generation at the electricity company EPS in the past couple of years, due to weak management, have decreased economic growth visibly. Improved resource allocation at SOEs could result in sizeable growth benefits, raising GDP by 2 per cent permanently, according to IMF estimates. Under the IMF programme, the government has committed to new reform targets related to SOEs, namely, publishing the full list of SOEs by the end of October 2019 and adopting the state ownership policy by the end of February 2020. However, recent examples of growing state ownership in certain sectors (for example, cable television) have raised concerns about increasing political influence. The resolution of SOEs that are not bankrupt or in the process of being privatised has been advancing cautiously.

Public administration reform is progressing slowly. Implementation of legislation related to much-needed public administration reform has been partial or delayed. Amendments to the Law on Civil Servants from December 2018 and new secondary legislation from January 2019 introduced criteria for the organisation of recruitment selection tests and a new performance assessment system. However, heads of institutions still have much discretion, for example, in setting up selection committees. In addition, the amendments to the law did not address the frequent misuse of provision on "acting" positions. Namely, the majority of senior staff are in such positions, making them more susceptible to political influence and limiting proper professional conduct. The introduction of the pay grade system, introducing "equal pay for equal work" for all public-sector employees, based on a law from 2016, has been postponed again to mid-2020. Tax administration reform is also progressing slowly.

Efforts are under way to fight informality. Amendments to the Law on Inspection Supervision, adopted in December 2018, give more remit to supervise unregistered activities. The coordination of inspections and risk-based approaches has advanced as well, including through the introduction of a unified inspection information platform. However, the law may need to be amended further in order to comply with the International Labour Organization's Labour Inspection Convention. Namely, contrary to the convention, which states that inspectors enter a company without previous notice, the current law requires written notice at least three days in advance, which opens the space for misconduct.

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NPL resolution has progressed further, but euroisation remains high. Over the past year, NPLs declined by 2.6 percentage points, to 4.9 per cent in August 2019, mostly due to mandatory write-offs. To address remaining issues, a new NPL resolution programme (2018-20) was adopted in December 2018. Despite regulatory efforts to discourage foreign currency lending and depositing, euroisation has remained high at close to 70.0 per cent, potentially posing financial stability risks if the dinar were to depreciate significantly. Foreign currency lending for households has declined, but mainly due to the increase in (often) long-term dinar-denominated cash loans that could pose risks to financial stability during a downturn. In response, in December 2018 the National Bank of Serbia limited the tenor of these loans to eight years from 2019, reducing it to six years from 2021. The privatisation of the third largest bank, Komercijalna banka is finally advancing and a tender was announced in May 2019. Four non-binding offers have been submitted and the submission of binding bids is expected by early December 2019.

A law on the conversion of Swiss franc mortgage loans was adopted. The new law, adopted in April 2019, envisages the conversion of mortgage loans denominated in Swiss francs to euros by July 2019, with a 38 per cent haircut and capped interest rates, and with the state covering 15 per cent of banks' related losses. The selected solution, relieving borrowers and banks of some of the financial consequences of their decisions, has budgetary costs of up to 0.2 per cent of GDP and may create moral hazard risks. Around 90 per cent of Swiss franc loans have been converted to euros.