Serbia

Highlights

- **The economic recovery is slowing.** Domestic and external pent-up demand pressures resulted in strong, broad-based expansion in 2021, but Serbia's growth performance has been more moderate in the first half of 2022.
- **Key infrastructure improvements are advancing.** These include the high-speed railway, broadband in rural areas, the gas interconnector with Bulgaria, the modernisation of one of Europe's biggest landfills and the airport in Belgrade.
- **The energy sector is at a crossroads.** An energy crisis is affecting the country as structural vulnerabilities in domestic electricity production have come to light amid surging global energy prices. The authorities rolled out a set of short-term coping measures, while strategic plans are being developed.

Key priorities for 2023

- **The energy sector should be reformed with both immediate and long-term goals in mind.** As power production from coal proves undependable and expensive in light of domestic production weaknesses and the European Union (EU)'s forthcoming carbon border adjustment mechanism, the development of renewables should be accelerated by the adoption and implementation of the new regulatory framework. This should take place in tandem with the reform of state-owned enterprises (SOEs) in the sector and the finalisation of key strategic documents outlining the decarbonisation vision.
- **SOE reform needs to progress.** In line with the adopted action plan on state ownership policy, SOE reform should be stepped up to improve productivity and contain fiscal risk. Among the key measures needed are the centralisation of ownership, a unified legal framework and strengthened governance requirements.
- **The business environment needs improvement.** The playing field should be levelled for small and medium-sized enterprises (SMEs) and large foreign investors by streamlining business procedures and consistently applying legislation. The rule of law and the fight against corruption should be strengthened.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	4.5	4.3	-0.9	7.5	3.3
Inflation (average)	2.0	1.7	1.6	4.1	11.5
Government balance/GDP	0.8	0.0	-7.2	-3.3	-2.8
Current account balance/GDP	-4.8	-6.9	-4.1	-4.3	-8.4
Net FDI/GDP [neg. sign = inflows]	-7.4	-7.7	-6.3	-6.9	-4.8
External debt/GDP	62.2	61.4	65.8	68.4	n.a.
Gross reserves/GDP	26.3	29.1	28.8	30.9	n.a.
Credit to private sector/GDP	41.4	42.0	45.5	43.5	n.a.

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Macroeconomic developments and policy response

Growth has moderated in 2022. The 7.5 per cent gross domestic product (GDP) growth of 2021 was broad based, reflecting pent-up domestic demand pressures and a rebounding external sector. Growth continued at a more moderate pace of 4.3 per cent and 3.9 per cent year on year in the first two quarters of 2022, respectively. As inflation accelerated and real wage growth muted, the expansion of household consumption slowed from 7 per cent in the first quarter to 4 per cent in the second quarter of the year. Investment growth remained moderate throughout the period as construction output contracted. Imports surged in the first quarter due to high volumes of electricity imports, slowing to a more moderate expansion in the warmer second quarter of the year when export growth (20 per cent year on year) overshot import growth. The expansion of services, leading growth on the production side, moderated in the second quarter in line with lower household demand and retail trade output. This effect was partially offset by an increase in industrial activity which posted 5 per cent growth on the year in the second quarter, compared with 2 per cent in the first quarter.

Inflation has surged and the current account deficit has widened on energy imports. With food and, to a lesser extent, oil prices rising sharply, inflation had already been at the upper end of the central bank's target band from May 2021, overshooting it in September 2021. Since then, consumer price inflation has continued to rise, reaching 14 per cent year on year in September 2022. The increase in food prices is caused by rising import prices, coupled with poor weather conditions, which had a negative effect on this year's harvest. Energy prices did not go up in Serbia during the winter of 2021-22 as SOEs and the state absorbed the impact of surging global prices, while there was a higher-than-usual volume of electricity imports, caused by a breakdown at a vital power plant and lower supply of domestic coal. These higher import volumes at elevated prices were reflected in the current account deficit, which increased threefold year on year in the first seven months of 2022.

The authorities employed policy measures to shield the economy. Price caps on basic foodstuffs were set at the end of 2021 and on oil in February 2022, followed by a reduction in excise duty. From March 2022, multiple temporary export bans were put in place; those on wheat, flour and sunflower oil have since been abolished, but those on certain types of fuel and capped-price wood pellets remained in place as of October 2022. Subsidies for flour producers were introduced in June 2022. In July the government decided to cover the price difference in gas imports (compared with November 2021) for wholesale suppliers over the winter from the state budget, banning gas exports for a month in October. Moderate electricity and gas price increases (6.5 per cent and 9.0 per cent respectively) were adopted ahead of the 2022-23 winter. The National Bank tightened monetary policy seven times during the first 10 months of 2022, increasing the historically low policy rate from 1 per cent in March to 4 per cent in early October.

The economy is expected to continue growing at a slower pace. Growth is projected at 3.3 per cent in both 2022 and 2023. Serbia is not immune to the indirect effects of the war on Ukraine. These include an expected slowdown in eurozone export markets, which would impact Serbia's large manufacturing sector, and rising food and energy prices on global markets, which will weigh on the budgets of households, utility SOEs and the state. The continuation of sizeable public investment bodes well for Serbia's economic outlook, but the protracted energy crisis will be a drain on fiscal resources.

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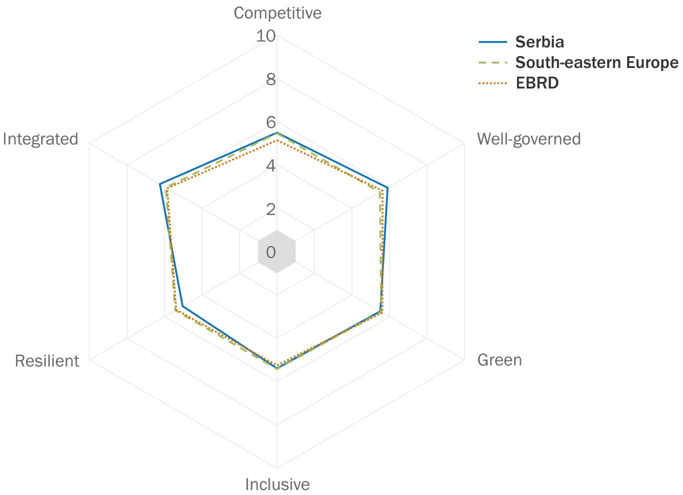
CHART Assessment of transition qualities (1-10)



Structural reform developments

EU accession negotiations are advancing, albeit slowly. After two years of stagnation, the end of 2021 saw the opening of Cluster 4 (green agenda and sustainable connectivity) of the EU *acquis communautaire*, comprising four negotiating chapters, bringing the total number of opened chapters to 22 out of 35. However, no new chapters have been opened in 2022. According to the European Commission, the future speed of negotiations will depend, among other things, on the pace of reforms with regard to the rule of law, as well as on progress on the normalisation of relations with Kosovo. The European Commission expects Serbia to align its foreign policy with the common foreign and security policy of the EU, including restrictive measures against Russia.

The energy sector is in crisis-management mode. Energy security concerns have increased as high global energy prices and geopolitical uncertainty caused by the war on Ukraine have intersected with vulnerabilities in domestic electricity production. High import volumes at high prices in the winter of 2021-22 raised costs for the utility SOEs and the state budget. The regulator approved a 9.0 per cent hike in the price of gas and a 6.5 per cent increase in the electricity price from August and September 2022, respectively. To ensure adequate coal reserves, the electricity SOE, EPS, signed import contracts in May and June 2022 with coal mines from Montenegro, Bulgaria and Bosnia and Herzegovina. While Serbia secured a new bilateral three-year contract to source the bulk of its gas supply from Russia at an oil-indexed price in May 2022, a significant share of gas continues to be bought on the market, weighing on the energy balance. Construction on a gas interconnector with Bulgaria began in February 2022 in an effort to diversify gas sources. To better manage gas demand in the peak winter months, the government reached an agreement with its Hungarian counterpart in March 2022, ensuring up to 500 million cubic metres of additional gas storage space in Hungary for the coming winter. Strategic energy documents, such as the National Energy and Climate Plan (NECP) and the National Energy Strategy, are expected to whet appetites for the development of renewables and to carve out the energy transition pathway.

Infrastructure improvements continue. A 75 km high-speed railway line, allowing trains to travel at up to 200 km per hour and connecting two of Serbia's biggest cities, Belgrade and Novi Sad, opened for passengers in March 2022. The stretch is the start of an ongoing project to connect Belgrade with Budapest as part of the Chinese government's Belt and Road Initiative. Other significant ongoing projects include the roll-out of ultra-fast broadband in rural areas, large public-private partnership projects to modernise Belgrade's airport, and for Vinca, previously one of Europe's biggest unmanaged landfills, to include a waste-to-energy facility. The construction of a gas interconnector between Serbia and Bulgaria started in February 2022.

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Capital markets development has been advanced. The Law on Capital Markets was adopted in December 2021, aligning the domestic legal and institutional framework further with the EU *acquis* in terms of increasing transparency and offering greater investor security guarantees, while also developing the offering of financial instruments on the market. Serbia had previously joined the Clearstream network in October 2021, enabling foreign investors to directly settle dinar-denominated government bonds. In January 2022 Serbia signed an agreement with Euroclear on the creation of a Euroclearable link once appropriate market conditions have been established.

A new model of fiscalisation has been introduced. Following the adoption of the amended Law on Fiscalisation in September 2021, the end of April 2022 was set as the deadline for implementing the new model, which introduces the use of electronic fiscal devices connected to the internet, making data immediately available to the Tax Administration. The new model aims to reduce the administrative burden, support revenue collection and help the authorities to reduce the size of the informal economy.

Amid incremental progress on SOE reform, broader public-sector adjustment has been delayed. A consolidated list of SOEs owned by the central government was developed and made public in December 2021, in a first step towards implementing the country's SOE reform plan. A new wage system that introduced pay grades to the public sector was set to come into force 2022, but was postponed to 2025 in December 2021, with the pandemic cited as the reason. The implementation of pay grades has been delayed several times since the original deadline of 2019.

Support for SMEs has been scaled up. A set of decrees adopted at the beginning of 2022 set aside RSD 2.5 billion (some €21 million) in financial support for SMEs, start-ups, and women and young entrepreneurs.