SERBIA

Highlights

- **Fiscal consolidation under the new €1.2 billion IMF programme is showing early results.** In light of high fiscal deficits and public debt, fiscal measures have been front-loaded; performance in the first half of 2015 was better than expected.
- **Important legislation was passed to improve the business climate**. In the second half of 2014 the government pushed through major privatisation, bankruptcy and labour laws, a bill on land ownership rights, as well as introducing to parliament a law on public administration reform.
- **A new non-performing loan (NPL) resolution strategy was adopted.** The comprehensive strategy is a key element of the IMF programme and focuses on removing obstacles to NPL sales and transfers.

Key priorities for 2016

- **The government should continue reforms to achieve sustainable long-term fiscal adjustment.** Consistent implementation of structural reforms envisaged under the IMF programme (most notably the reforms of public administration and state-owned enterprises) is key to achieving sustainable long-term fiscal adjustment and improving growth prospects.
- **Efficient execution of public investments is necessary for long-term convergence.** Public investments significantly underperformed the plan this year. The preparation and implementation of public investment projects should be accelerated in order to support long-term growth. An improved transport network (including corridors VII and X) could be a major growth driver, with positive long-term spillovers on foreign direct investment and external trade.
- **NPLs must be tackled.** The level of NPLs in Serbia is high even by regional standards. The government's NPL strategy, prepared with assistance from international financial institutions, addresses the key obstacles to NPL resolution but needs to be implemented consistently.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	1.4	-1.0	2.6	-1.8	0.5
Inflation (average)	11.1	7.3	7.7	2.1	1.7
Government balance/GDP	-4.1	-6.8	-5.3	-6.3	-4.0
Current account balance/GDP	-8.6	-11.5	-6.1	-6.0	-4.0
Net FDI/GDP [neg. sign = inflows]	-9.9	-2.4	-3.8	-3.7	-3.5
External debt/GDP	76.5	92.6	88.0	82.7	n.a.
Gross reserves/GDP	33.5	35.4	33.9	27.5	n.a.
Credit to private sector/GDP	47.6	49.5	43.6	43.8	n.a.

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Macroeconomic performance

Serbia experienced three recessions in the last six years, but a modest recovery is under way in 2015. Economic conditions in 2014 were difficult, exacerbated by the severe mid-year floods, pushing the economy into recession of -1.8 per cent. The floods in May 2014 caused damages of up to €1.5 billion, or about 5 per cent of GDP. The agricultural and energy sectors, along with road and railway infrastructure and houses in flooded areas, were badly affected. After a GDP drop of 2.0 per cent (year-on-year) in the first quarter of 2015, due mainly to lower consumption, the economy started to recover in the second quarter (1.0 per cent year-on-year) supported by the low base effect after the floods and a pick-up in exports on the back of stronger demand from the European Union and investments, which is partly offsetting short-term negative effects from the fiscal consolidation.

Front-loaded fiscal consolidation supported by structural measures is showing early results. Owing to permanently large fiscal deficits over several years, public debt (expressed as a percentage of GDP) increased by almost 40 percentage points since 2009, to over 70 per cent of GDP at the end of 2014. The general government deficit, including called guarantees, was 6.7 per cent of GDP in 2014. Difficulties in financing widening fiscal imbalances forced the government to seek a new IMF programme. A three-year precautionary Stand-By Arrangement (SBA) of €1.2 billion was approved in February 2015. The programme envisages a two percentage point fiscal adjustment in 2015 supported by a broad-based economic programme of ambitious structural reforms. The front-loaded fiscal measures have already shown good results in 2015, as the budget execution outperformed the plan. Sustainable adjustment, however, will require a broad-based public sector reform, including "right-sizing" public administration as well as restructuring and privatising state-owned enterprises.

Fiscal adjustment and low inflationary pressures enabled the central bank to progressively cut the key policy rate. On the back of weak domestic demand and the decline in oil prices the inflation rate has been below the central bank's target range (4±1.5 per cent) since March 2014. As inflation expectations have continued to recede, the National Bank of Serbia has eased monetary policy through a series of key policy rate cuts, bringing it down from 11.75 per cent in April 2013 to 4.5 per cent as of October 2015. Inflation is expected to stay low, but further easing will depend on monetary policies in developed economies as well as domestic inflationary developments.

Much-needed fiscal adjustment will keep growth at modest levels in the near future with upside risks mostly stemming from stronger exports. A recovery of 0.5 per cent is expected in 2015, driven by stronger external demand and lower oil prices. Exports will continue to be the main growth driver, supported by recovery of EU demand, the re-launch of operations of a major steel plant, as well as normalisation of coal extraction and power production after the damage of last year's floods. The pace of growth is expected to pick up from 2016 in line with an increase in investment, moderate export growth and recovery of private consumption. Medium-term prospects remain favourable if macroeconomic and external stability is sustained and economic reforms progress, backed by relatively good human capital endowment and a speed-up in the EU accession process.

Major structural reform developments

Legislative reforms introduced in 2014 are being implemented. The legislative changes could help reinvigorate the private sector and ease the burden on public finances. The new labour law, which was amended in 2015, eased conditions for temporary employment and severance payments, making the labour market more flexible. Given still-weak economic growth it will take some time before these changes are translated into employment growth. The new bankruptcy law allows the authorities to shut down companies without meaningful economic activity. While this may help reduce the number of unviable enterprises, achieving shorter bankruptcy procedures – another main goal of the new legislation – this will also require a more efficient judicial system.

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The privatisation, restructuring and liquidation of a large number of SOEs is under way. State-owned companies in the privatisation process, that have no chance of finding new owners in their current state, are entering bankruptcy. Seventeen strategically important companies will stay under bankruptcy protection until May 2016, allowing them to restructure their operations. Despite this acceleration, privatisation proceeds in the first half of 2015 were 40 per cent lower compared with the same period in 2014. The government initiated the privatisation process of the telecommunications operator Telekom Srbija, and privatisation of several other large companies can start in the near future.

Restructuring of SOEs in transport and energy infrastructure has also started. During 2015 the state railway company Železnice Srbije, the power utility EPS (with the assistance of the World Bank and the EBRD) and the public gas company Srbijagas have started the restructuring process. After a failed privatisation attempt, professional management is being introduced in the state-owned steel mill Železara Smederevo.

The government introduced legislation on public sector employment, supporting fiscal sustainability. The government adopted a law on the central registry of employees and a law on determining the maximum number of employees in the public sector which should remove obstacles to the down-sizing of the public sector. This, together with a functional review of the public administration allows the government to start with the rightsizing of the public sector in order to achieve budgeted savings in the public wage bill.

A new energy law allows households and small enterprises to choose electricity and gas suppliers. The law, adopted in December 2014, transposes the EU Third Energy Package in the areas of gas, electricity and renewable energy sources. It is expected to facilitate new investment in the energy sector.

Efforts to resolve high NPLs have been stepped up under the IMF arrangement. NPLs were at 22.3 per cent of total loans in August 2015, more than 10 percentage points above their level at the end of 2008. The share of problem loans is particularly high in the corporate sector (24.4 per cent). The strategy for NPL resolution, developed in cooperation with international financial institutions, is soon to be adopted by the government. Most notably, the new strategy aims to remove obstacles to writing off and selling NPLs, reinforce the in-court insolvency system, introduce a personal insolvency statute, promote out-of-court debt restructuring and support the development of the market for bad debt.

Serbia's ranks poorly in terms of business environment, but improvements are under way. The World Bank's *Doing Business 2016* report ranks Serbia 59th out of 189 countries for ease of doing business compared with 68th in 2015.[1] The ranking improved on the back of amendments to the law on planning and construction, simplifying the procedures and shortening the time needed for construction permits, while the new e-filing system in the tax administration and amendments to the law on inspections oversight reduced administrative costs and enhanced tax collection. The government also adopted the law on investments, streamlining the system of investments support and expanding the set of tools available for local governments to attract foreign investments. Another new law on conversion of land use to ownership rights, adopted by the parliament in July 2015, may stimulate new (foreign) investments by enabling a more permanent title. Despite positive regulatory developments, Serbia still ranks 94th out of 140 countries in the World Economic Forum's *Global Competitiveness Report 2015-2016*. The rating reflects low business sophistication, market inefficiency, weak institutions and an unstable macroeconomic environment.

[1] The rating for 2015 reflects the change in the methodology. According to the old methodology Serbia was ranked 91st in 2015.