SERBIA

Highlights

- **Serbia returned to growth in 2015.** GDP grew by 0.8 per cent on the back of a low base after the 2014 floods, driven by increasing private investments and a pick-up in exports. Growth accelerated to 2.8 per cent in the first three quarters of 2016.
- **Fiscal consolidation under the IMF programme is showing results.** The fiscal performance since 2015 has been better than envisaged, but the "rightsizing" of the public administration and the restructuring of state-owned enterprises (SOEs) are progressing slowly.
- **Regulatory improvements are acknowledged by the marked upgrade in the World Bank Doing Business ranking, but further reforms, as well as the full and consistent implementation of existing ones, are needed.** New legislation on construction permits, capital markets, corporate income tax, public companies and employees, agricultural land, investments and public-private partnerships (PPPs) and concessions has been adopted since September 2015.

Key priorities for 2017

- **Sustainable fiscal adjustment requires further structural measures.** The streamlining of public administration and timely restructuring of SOEs (in particular for the railways, the power utility EPS and the gas company Srbijagas) are necessary to reduce the long-term burden on public finances.
- **The reform momentum on business environment measures should be maintained.** Para-fiscal charges, which amount to more than 2 per cent of GDP, should be cut further, and more efforts are needed to increase the efficiency of the judicial system and bankruptcy/liquidation procedures, enhance the enforcement of contracts and improve public procurement and inspection practices.
- **Non-performing loans (NPLs) should be reduced further.** Consistent implementation of the NPL resolution strategy is needed to support more market-based transactions. Other regulatory changes are also needed to create a more liquid market for NPL sales and transfers and allow a faster clean-up of banks' balance sheets.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	-1.0	2.6	-1.8	0.7	2.5
Inflation (average)	7.3	7.7	2.1	1.4	1.0
Government balance/GDP	-6.8	-5.3	-6.2	-3.7	-2.4
Current account balance/GDP	-11.5	-6.1	-6.0	-4.8	-4.2
Net FDI/GDP [neg. sign = inflows]	-2.3	-3.8	-3.7	-5.5	-4.8
External debt/GDP	80.9	74.8	77.1	78.5	n.a.
Gross reserves/GDP	34.5	32.7	29.7	31.0	n.a.
Credit to private sector/GDP	49.5	43.6	43.4	44.1	n.a.

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Macroeconomic performance

Serbia returned to growth in 2015. After a recession with a drop in GDP of 1.8 per cent in 2014, aggravated by severe floods, GDP expanded by 0.8 per cent in 2015. Growth was supported by exports on the back of stronger EU demand and increasing private investments (including high foreign direct investment inflows). Supply-side factors (the re-launch of operations in a major steel plant as well as normalisation of coal extraction and power generation after the 2014 floods), monetary easing and low oil prices also helped. Stronger growth of 2.8 per cent year-over-year in the first three quarters of 2016 was underpinned by robust investments, exports and the recovery of consumption. The country's credit rating was upgraded in June 2016 by Fitch Ratings from B+ to BB-.

Fiscal performance under the International Monetary Fund (IMF) programme has been better than expected but additional measures are needed to ensure long-term sustainability. The general government deficit improved from 6.2 per cent of GDP in 2014 to 3.7 per cent of GDP in 2015, significantly better than the 1.5 percentage point adjustment envisaged by the IMF programme. This good fiscal performance continued in 2016, reflecting measures taken earlier including public wage and pension cuts, as well as attrition rules, but also stronger revenues and the sale of 4G mobile licences. However, public debt remains high, exceeding 72 per cent of GDP in August 2016. In July 2015 the parliament adopted a law on the central registry of employees, while a decision regarding the maximum number of employees in the public sector came into effect in December 2015. This, together with a functional review of the public administration, allowed the "rightsizing" process to start. Until now, as envisaged, around 20,000 people have left the public sector since 2015, in large part through natural attrition. In order to improve control over the public wage bill, a new law on the public sector salary system, with unified wages for similar positions, was adopted in March 2016.

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 global commodity prices, inflation was at 0.6 per cent in September 2016 and has stayed below the National Bank of Serbia's target band (4±1.5 per cent) since March 2014. Subdued inflation expectations and a lower risk premium allowed a gradual monetary easing, bringing the policy rate down from 11.75 per cent in April 2013 to 4.0 per cent as of July 2016. Inflation is expected to stay low in the short term, but further easing will depend on continuing fiscal adjustment, the effects of a diverging euro area and US monetary policies, administered price hikes and uncertainties over the development of commodity prices.

Private investments will continue to be the main GDP growth driver, supported by further recovery of consumption, if the reform momentum is maintained. After a strong momentum (2.8 per cent year-on-year) in the first three quarters of 2016, the Serbian economy is expected to grow by 2.5 per cent in 2016 and by 2.7 per cent in 2017. Private investments will continue to be the main growth driver, supported by the recovery of consumption, partially offset by declining contribution from net exports. The main upside risk for the projection comes from the potential upscaling of production in the recently privatised large steel mill where the Chinese owner announced ambitious investment and production plans while future oil price developments and possible weak external demand may be a drag on growth next year. Medium-term prospects are favourable, but will depend on the pace of reforms envisaged in the IMF programme, further improving the investment climate, supporting NPL resolution and corporate restructuring to support the economic recovery, and accelerating the implementation of major infrastructure projects.

Major structural reform developments

EU accession negotiations began in December 2015, almost two years after the formal start of talks. The first two negotiating chapters were Chapter 32 (financial control) and Chapter 35 (normalisation of relations between Serbia and Kosovo). The two chapters relating to the rule of law – Chapters 23 and 24 – were opened in July 2016.

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Regulatory changes adopted in the past year aim to stimulate investments. To help attract private sector investors and ease the burden on public finances the law on public-private partnerships (PPPs) was amended in February 2016, with aims to improve tendering procedures. In October 2015 parliament also adopted the law on investments to reduce the regulatory uncertainty faced by foreign investors, improve the system of investments support and expand a set of tools and mechanisms available to local governments to attract foreign investments. Secondary legislation (for example, on power purchase agreements) adopted in 2016 has unlocked investment opportunities in the renewable energy sector (including in wind farms). Lastly, the law on agricultural land adopted in December 2015 facilitates the leasing of state-owned agricultural land to firms and individuals and provides preferential access to investors.

Progress on privatisation has been limited. While most of the 502 companies in the privatisation portfolio entered bankruptcy in 2015, the companies with the largest negative fiscal implications have remained under state ownership. So far, banks have opted for debt write-offs and the adoption of restructuring plans which foresee improved management and operational efficiency in these companies. Železara Smederevo, the country's largest steel mill, has been sold to a Chinese steel company, which has announced ambitious production and investment plans. For the time being the government has put on hold the privatisation of the state-owned telecommunications operator, Telekom Srbija. Applications have been called for a strategic partnership in pharmaceutical company Galenika and a privatisation adviser has been appointed for the sale of Belgrade airport and the second-largest bank, Komercijalna banka.

Much-needed restructuring of public companies has been running behind schedule. On the positive side, the new law on public companies, adopted in February 2016, aims to improve corporate governance in SOEs by setting stricter criteria for the selection of general managers and increase the transparency of hiring procedures. However, rightsizing has not yet begun in the state railway company Železnice Srbije and the power utility EPS, and an electricity price hike planned for May 2016 will only be implemented in October. The government took over some €200 million of state-guaranteed debt in December 2015 from the public gas company Srbijagas and restructuring of the company has started.

Financial market development was supported by regulatory changes and efforts for regional integration of stock exchanges. In December 2015 lawmakers adopted changes to the law on the capital markets, enabling international financial institutions to issue dinar-denominated bonds and other instruments. Earlier in 2016 the Belgrade Stock Exchange joined the SEE Link platform (with Bulgaria, Croatia, FYR Macedonia and Slovenia), allowing improved access for foreign companies to the Serbian equity market. The listing of dinar-denominated government bonds should also improve their liquidity. The South East European Power Exchange (SEEPEX), a joint venture between the state power grid operator EMS and the European Power Exchange EPEX SPOT, was successfully launched in February 2016 involving day-ahead electricity trading and enhancing regional electricity trade.

NPL resolution is supported by regulatory changes, but consistent implementation of the NPL resolution strategy is lagging behind. Despite sales by several banks, corporate NPL levels remain high (above 20 per cent of total loans in June 2016) even by regional standards. The government's NPL resolution strategy, prepared with the assistance of international financial institutions, addresses the key obstacles to NPL resolution but has not yet been implemented consistently. Further amendments, among others, in tax and banking secrecy legislation, and greater clarity about the status of synthetic sales (where economic risks and benefits of a loan are transferred to the buyer but the seller remains the lender of record), together with enhancing court and out-of-court restructuring practices, would accelerate resolution processes.

Regulatory changes adopted since 2014 contributed to the improvements in the business environment. According to the World Bank's *Doing Business 2017* report, Serbia is 47th out of 190 countries for ease of doing business (54th in 2016.)[1] The ranking improved on the back of improvements in dealing with construction permits, starting a business, registering property and paying taxes. The introduction of an online system and a streamlined process in dealing with construction permits resulted in the largest improvement (116 places to 36th). The time needed to register a business was also reduced, while the property transfer process was simplified by the introduction of effective time limits for issuing new property titles. The improvement in paying taxes is also due to the expansion of the indicator set which now includes measures of post-filing processes relating to tax audits and VAT refund where Serbia performs well. Room for further improvement still remains in several areas, most notably in getting electricity, paying taxes, protecting minority investors and enforcing contracts. The positive regulatory developments are also reflected in broad-based improvements in Serbia's rankings in the World Economic Forum's *Global Competitiveness Report 2016-2017*. However, the country still ranks relatively low at 90th out of 138 countries (up by four places from last year) due to weak market efficiency, business sophistication, institutions, innovation capacity and labour market efficiency.

[1] The rating for 2016 reflects the change in the methodology. According to the old methodology Serbia was ranked 59th in 2016.