INVESTMENT AND BUSINESS CLIMATE

The investment climate depends on the efficiency of institutions, as well as on the world trade conditions, risks of doing business, expectations of businessmen, and the structure of the economy. In the context of the global economic crisis caused by the COVID-19 virus pandemic, economic policy measures can significantly affect economic activity and mitigate the severity of the recession.

INVESTMENT CYCLE

The investment climate is heavily influenced by the current investment cycle. Serbia has had three investment cycles in the last 15 years. The first lasted between 2006 and 2009; the second ended in 2016, and the third lasted between 2017 and 2020. The pandemic abruptly brought down the third investment cycle, but, regardless of that, the amount of investments from 2019 was not sustainable. It was a consequence of a temporary expansion in construction and large infrastructural expendutures in roads and a gas pipeline (Turkish Stream), which is not sustainable. It is unrealistic to expect that the level of foreign direct investment that Serbia attracted during the last investment cycle will return quickly, particularly under the uncertainty related to the pandemic and its negative economic consequences.

Investments this year were crucially affected by the recession caused by the COVID-19 virus pandemic. This recession has two components that did not usually go with each other before. On the one hand, there was a sharp drop in aggregate demand, and on the other hand, production chains were broken. All of this was followed by a trade war between China and the United States. Therefore, the risks for investing are high, which will not contribute to getting out of the lower phase of the investment cycle quickly.

STRUCTURAL CHARACTERISTICS

The impact of breaking production links can be analysed via the input-output table. This table exists for 2015 and will undoubtedly change this year, but we still don't know in which direction. What we can assess is how a fall in demand would affect a fall in GDP within a given production structure.

The components of final demand are private and public consumption, exports and gross investment. We tested what would happen if the components of final demand, each for itself, fell by 10%. The results of this simulation are shown in Table 1. GDP will fall the most if there is a decrease in private consumption -4.8%. Then comes the negative impact of the decline in exports -3.0%, following the decline in investment -1.2% and public spending -1.1%.

The Government cannot influence exports because it does not want to devalue the RSD. Also, it cannot affect investments, because there is no funds for subsidies, and the risk of investing is significantly increased. In that sense, the space for economic policy is reduced to private and public consumption. Assume that private spending will increase by 2% in real terms due to Government transfers and public spending by 3%. On the other hand, investments will probably fall by 5% and exports by 10%. Under these assumptions, the annual GDP decline would be -2.3% ("Policy mix" column).

Of course, by sectors, the situation would be completely uneven. The most affected sectors would be the production of primary metals, electrical appliances, water transport, motor vehicles, means of transport, the IT sector,

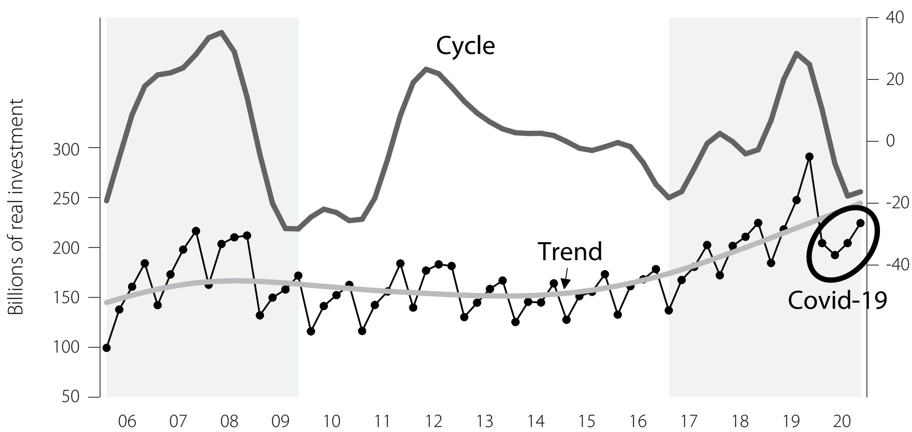


Figure 1:
Investment cycles in Serbia

Table 1: Final demand decline and structural disruptions within the input-output system

Investment -10%		Consumption -10%		Government consumption -10%		Export -10%		Policy mix		Systemic breaks	
R&D	-8.0%	Personal services	-9.9%	Public administration	-9.6%	Water transport	-7.5%	Basic metals	-7.6%	Basic metals	-12.8%
Machinery	-6.3%	Membership services	-9.3%	Health	-7.9%	Basic metals	-7.1%	Electrical equipment	-7.5%	Mining	-12.6%
Construction	-5.7%	Real estate	-9.1%	Education	-7.2%	Electrical equipment	-6.8%	Water transport	-7.2%	Wood	-12.1%
Elecrtonics	-5.1%	Fishing	-8.7%	Pharmaceuticals	-5.0%	Motor vehicles	-6.7%	Motor vehicles	-7.2%	Water transport	-11.9%
Vehicles trade	-4.9%	Travel	-8.3%	Professional services	-2.4%	Air transport	-6.4%	Transport equipment	-6.6%	Machine repairs	-11.3%
IT	-4.2%	Forestry	-8.3%	Printing	-1.9%	Rubber	-6.3%	IT	-6.5%	Mineral products	-11.1%
Transport equipment	-3.8%	Entertainment	-8.0%	Engineering services	-1.8%	Metal products	-5.6%	Machinery	-6.4%	Electricity	-11.1%
Mineral products	-3.3%	Telecommunications	-7.9%	Security services	-1.7%	Wood	-5.5%	Metal products	-6.3%	Metal products	-10.8%
Metal products	-2.3%	Sporting services	-7.9%	Travel	-1.5%	Advertisement	-5.0%	Rubber	-6.1%	Employment services	-10.8%
Electrical equipment	-2.0%	Water supply	-7.9%	Postal	-1.5%	Transport equipment	-5.0%	R&D	-5.9%	Rubber	-10.6%
Coefficient of variation	147%		53%		173%		68%		127%		67%
# Manufacturing sectors	6		3		1		7		7		8
# Service sectors	4		7		9		3		3		2
Average growth rate	-1.2%		-4.8%		-1.1%		-3.0%		-2.3%		-6.3%

the production of machinery and metal products, rubber and plastics, and research and development. Compared to the real situation in the first three quarters of this year, only the production of electrical appliances and metal products are holding up better than expected. However, if there were breaks in technological and business links at the same time, for instance at random with a negative effect of 5%, the decline in GDP would be -6.3% (column "Systemic breaks").

We do not know how business and technological ties between economic entities will be disrupted, but what is quite certain is that in this crisis, maintaining business ties is much more critical than maintaining aggregate demand. However, there is no valid experience in this area, and the measures that could be applied are far more subject to discretion than non-selective economic policy measures. That raises the question of the ability of economic policy makers to deal with structural disruptions, as well as the question of their impartiality. In that sense, the crisis has an entirely new dimension compared to 2009.

GLOBAL CONJUNCTURE

The new dimension of the crisis is also visible in Figure 2, where we compared the y-o-y GDP growth rates in Serbia and the EU. Serbia entered a recession in the second quarter of this year, while the EU was already in recession in the first quarter of 2020. That is the fourth recession for Serbia since 2008 and the third for the EU. The recession in Serbia lasted the shortest in 2014, ending after three quarters. Based on that experience, we can expect that a downturn will mark the whole of 2020.

Our economy is fully involved in the European market where real GDP will shrink by about 7% this year, the most

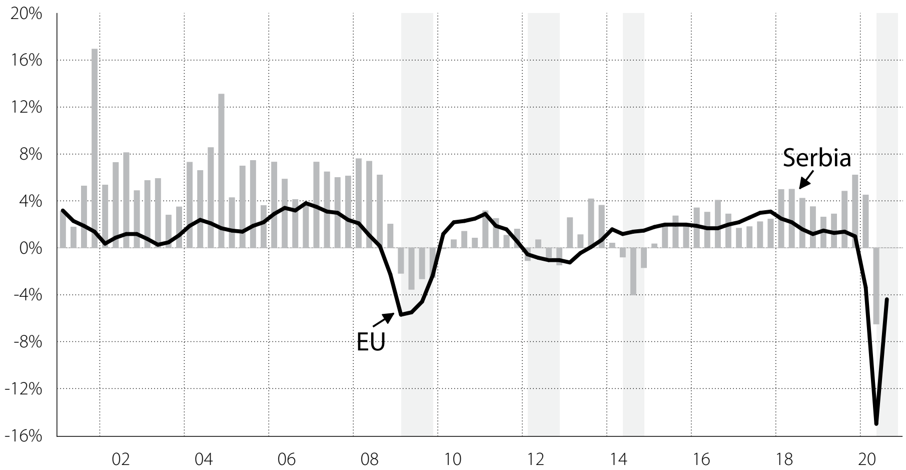


Figure 2:

GDP real growth rates in EU and Serbia

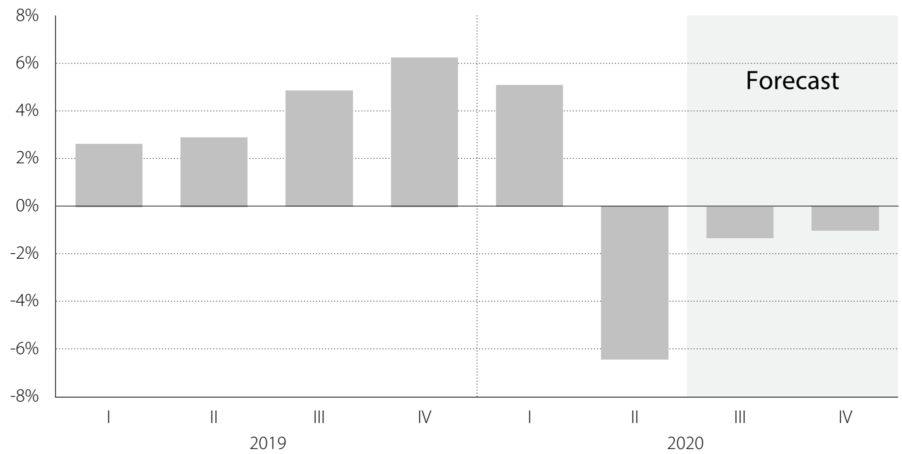


Figure 3:
GDP forecast for Serbia

significant drop since World War II to date. The expected recovery of 4.7% next year will not return real GDP in 2021 to the level that existed in the years before the crisis. Getting out of the recession, in that sense, does not mean returning to the path of long-term growth. That will have to adversely affect the Serbian economy, which exports 55% of all its goods to the EU market.

FORECAST

Many international institutions have forecast GDP trends for Serbia and other countries. The EBRD predicted a decline in GDP by -3.5%, the IMF by -3%, the World Bank between -2.5% and -5.3%, and the European Commission -4.1%. However, all of these forecasts are subject to quarterly revision due to high uncertainty. What we have demonstrated with the input-output analysis shows that for the recovery of the economy, not only measures to stimulate demand are necessary, but much more complicated structural measures are also needed. Stimulation of demand has its limit in the amount of public debt, while structural measures in the ability of economic policy makers to eliminate bottlenecks in the economy. Besides, for Serbia as a small open economy, the movement of demand from Europe and the trade war that currently exists in the world is significant because they increases the risks for foreign direct investment. In the first quarter, they were at the level of 2019, but they later dropped to 70% of that amount.

Assuming stable growth in public spending by the end of the year and a recovery in private consumption, the decline in GDP this year due to changes in final consumption could range between -1.1% and -1.5%. Figure 3 shows the optimistic variants of the GDP forecast. The forecast does not take into account the possible disruptions of structural ties in the economy, nor the introduction of restrictive health measures. According to official estimates, state aid amounting to 9% GDP saved 4% of GDP (drop of 1% instead of projected 5% decline). That raises doubts about the effectiveness of state aid and its sustainability in the medium term.

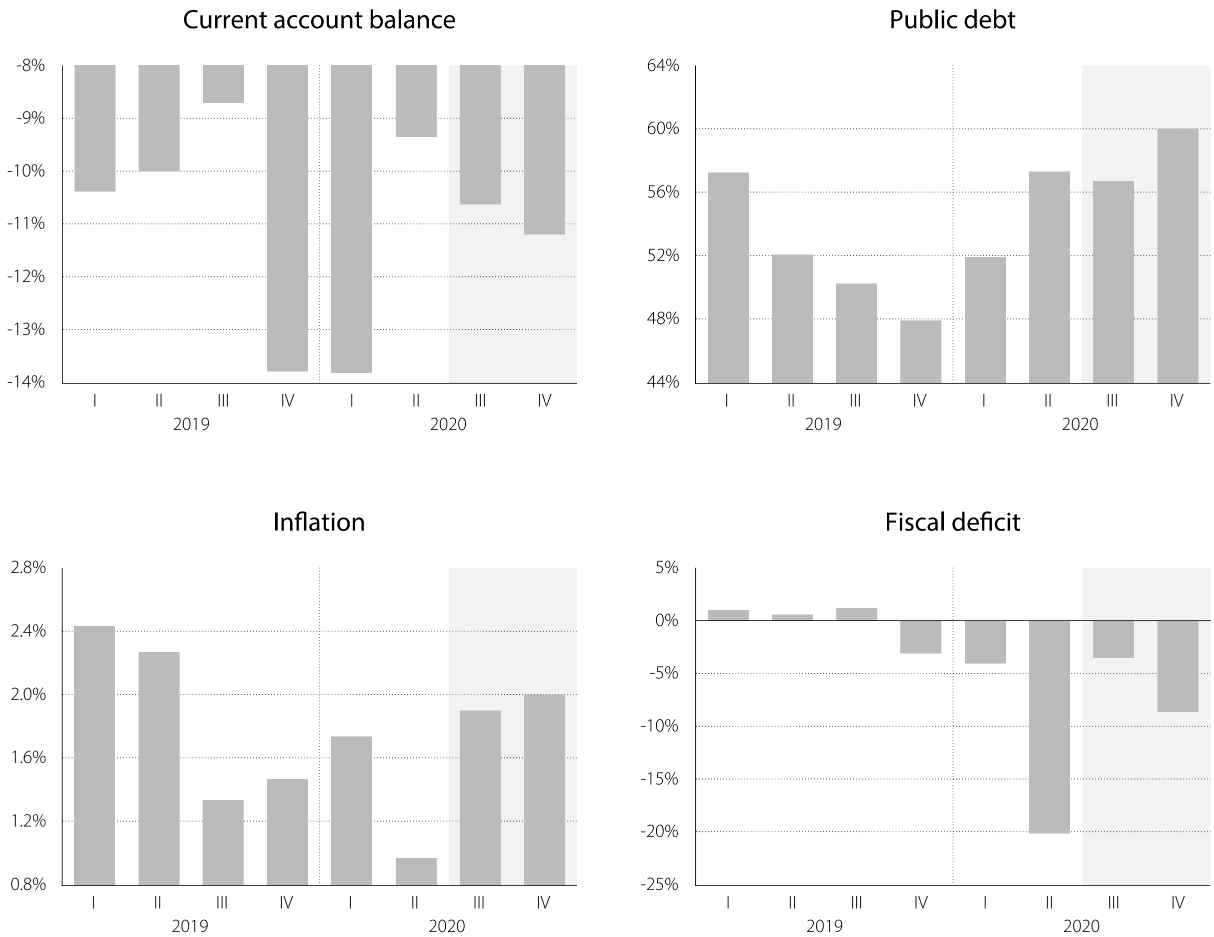
GDP growth in 2019 was based on investments and exports. Investments were exceptionally high in the fourth quarter. These activities will not be factors in the recovery of the economy in the second half of 2020, but public and private consumption. Their influence, however, has limited effect. In the short run, the broad impact of private consumption and domestic production (agriculture and food industry), as well as domestic services, may reduce the adverse effects of the crisis. Still, without investment and exports, those effects will return soon. Construction will be particularly affected by the fall in private demand, and the production of metals and minerals, equipment and means of transport, IT services and transport by the fall in export demand.

In the long run, we do not believe that economic activity in Serbia will proceed against the negative trend from Europe. That is why the rapid recovery of the EU economy is of crucial importance for the domestic economy.

MACROECONOMIC STABILITY

Figure 4 shows the basic macroeconomic aggregates. Prices are fairly stable. The inflation target is 3% +/- 1.5%. The average price growth in 2020 will be around

Figure 4: Basic macroeconomic indicators



1.5% compared to 1.8% last year. Thus, inflation is at the lower level of the inflation target corridor. That is why the exchange rate is stable. The average exchange rate in 2019 was 117.85 RSD / EUR, and in the third quarter of 2020, it was 117.77 RSD / EUR. The dinar appreciated slightly in real terms.

The current account deficit was -10.8% of GDP last year, while it could grow slightly to -12% this year, under the of the state in general in Figure 3. On the other hand, the deficit of general government after a record high of -20.5% in the second quarter of this year, will end this year at the level of -9%, according to the latest budget revision. As a result, public debt would rise from 52% in the first quarter to 57% in the third quarter, with a tendency to reach 60% at the end of the year.

According to official data on registered employment, it increased in the second quarter compared to the first quarter of 2020, despite negative GDP growth. However, the ILO and the EBRD estimated that in the second quarter, about 15% of jobs were effectively lost due to the crises.

S&P downgraded the country's credit rating from BB + positive, which it gave in December 2019 to BB + stable, in May this year. Fitch Ratings confirmed its BB + stable rating in September.

CHALLENGES AND MEASURES

The biggest challenges to macroeconomic stability in Serbia are the recession in the EU and the trade war, on the one hand, and the growth of the fiscal deficit and public debt, on the other.

The fall in GDP is not the most significant challenge at the moment. The Government supported the economy with RSD 390bn (7.1% of GDP) in the first package of fiscal measures and with RSD 67bn (1.2% of GDP) in the second package. By the end of the year, state support will reach 9% of GDP. The NBS reduced the repo interest rate from 2.25% to 1.25%, introduced a moratorium on loan repayments (first for three months, and then for an additional two months) and enabled the use of corporate bonds in open market operations to stimulate liquidity in the economy (for transactions with the NBS in bonds denominated in dinars, and for transactions with the ECB in bonds denominated in euros). At the same time, it spent EUR 1bn to defend a relatively stable dinar exchange rate.

FIC RECOMMENDATIONS

The Council maintains last year's recommendations with minor changes due to new circumstances:

- Restore fiscal stability and halt the growth of the country's public debt, (3)
- Complete the restructuring of infrastructure companies as soon as possible, including the closure of failed state-owned companies, (2)
- Increase public spending on infrastructure, including investment in health, and diversify it to reduce the infrastructure gap and improve the business environment, (2)
- Continue negotiations with the EU on membership to harmonise domestic regulations with European standards and improve the legal framework for business and investment, (3)
- Optimize the fiscal burden for countercyclical action and continue work on reorganization of the tax administration, invest in further enhancement of knowledge and capabilities of the tax administration and reduce uncertainty in the application of tax regulations. (2)