INVESTMENT AND BUSINESS CLIMATE

1.40

The investment climate depends on many factors such as the international situation, risks, expectations of business people, the efficiency of institutions and the structure of the economy. Within the global economic crisis caused by the COVID-19 virus pandemic, the Serbian economy recovered relatively quickly, but the lasting negative consequences remained. They are visible in the current investment cycle.

INVESTMENT CYCLE

Serbia has had three investment cycles in the last 15 years. The first wave lasted between 2006 and 2009, peaking in 3Q2007. The second one had a peak in 3Q2012 and ended in 2016, while the third occurred in the period 2017-20 with a peak in 4Q2019 (see Fig.1.1). The pandemic abruptly brought down the third investment cycle, but regardless of that, the volume of investments from 2019 was not sustainable. It resulted from a transient expansion in construction and significant infrastructural investments in roads and a gas pipeline (Turkish Stream). In this sense, the investment cycle would go down independently of the pandemic (see Figure 1.2). However, the pandemic dropped the share of investments in GDP by 1% over this period, which is a significant adverse effect. True, the low share of investment of 19% in GDP from 2Q2020 recovered quickly, but the negative consequences for the investment cycle remained. The shaded area in Fig. 1.2 shows a long-term loss of investment due to the COVID-19 crisis.

Investments this year will be crucially affected by the exit from the recession caused by the COVID-19 virus pandemic. The decline in aggregate demand has been offset by the Government and the central bank interventions, while broken production chains were slowly repairing with a more significant presence of European suppliers. The trade war between China and the United States is still under control. Both countries will have high GDP growth rates in 2021, 8.1% and 7.0%, respectively. Globally, the world economy will grow by about 6.0%. Due to that, the risks for investing are slowly decreasing worldwide, which will aid Serbia in coming out of the investment cycle bottom.

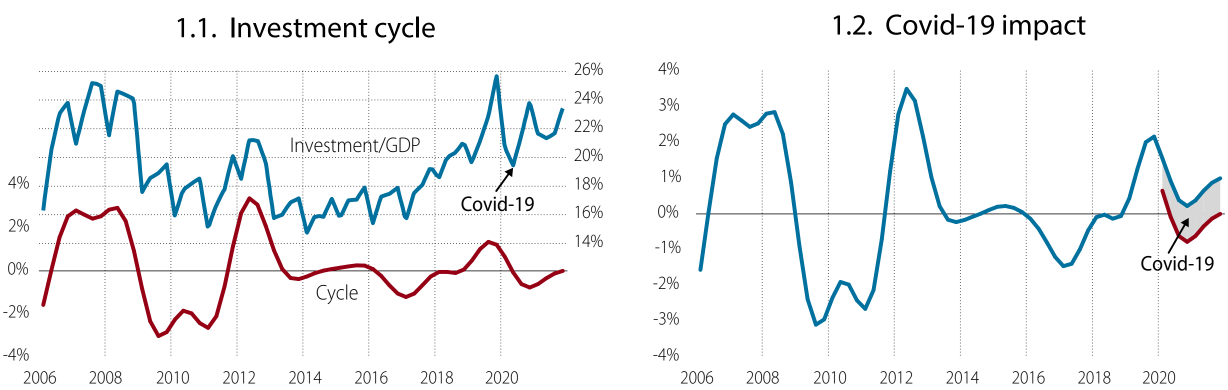
SOURCES OF INVESTMENT

Long-term sustainable high GDP growth depends on investment. According to the Millennium Development Goals, countries such as Serbia should have at least a 25% share of investment in GDP, which would bring a sustainable GDP growth rate of 5% per year. Serbia only achieved that goal in 2006 in the last fifteen years, but this share of investment in GDP was not sustainable.

In the long run, the investment share curve has the shape of the Latin letter "U". The other end of this letter is slowly approaching the desired goal, despite the negative impact of COVID-19 in 2020. Before the outbreak of the crisis, the share of investment in GDP was 22.5%, to fall by 1% during the crisis. We estimate that the share of investments in 2021 will exceed the pre-crisis level and to be around 23%, primarily due to public investments.

The problem remains with the low level of private investment. In 2006-11, private investments had the shape of the inverted letter "U" with the peak in 2008. After that, they

FIGURE 1: INVESTMENT CYCLES IN SERBIA



1 Private investment is calculated as the difference between total investment (data from the Republic Bureau of Statistics), government capital expenditure (data from the Ministry of Finance) and net foreign direct investment (NBS data).

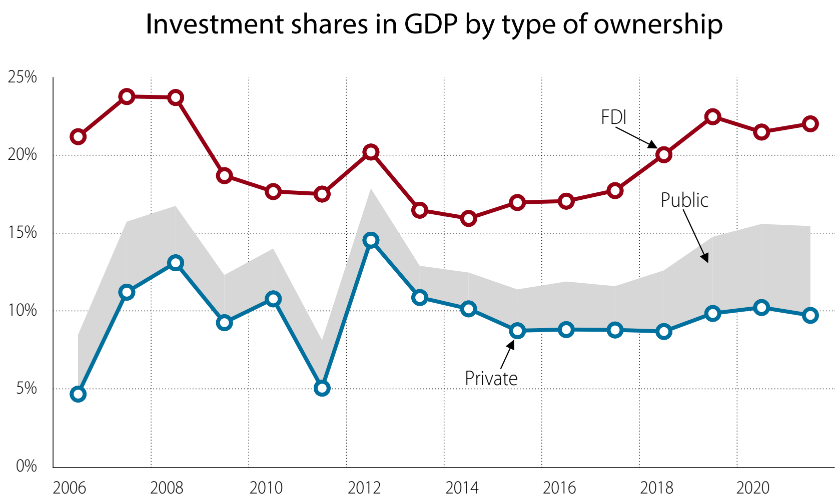


FIGURE 2: INVESTMENT IN SERBIA BY OWNERSHIP RIGHTS

have the shape of a flattened letter "U", which has not much changed in the last three years. Private investment was still below the historic peak in 2012-13.

On the other hand, public investments are growing and reaching 7.8% of GDP according to the second budget revision for 2021. Within that framework, 1.5% of GDP goes to unproductive investments in weapons and military equipment.

Foreign direct investment is likely to recover from the direct negative effect of the COVID-19 crisis but will be below 2018-2019 levels. In the last ten years, over 43 billion USD of direct investments have flowed into Serbia, as shown in Table 1. Most came from the Netherlands, followed by Austria, Germany, Cyprus and Russia. On the other hand, the outflow of direct investments from Serbia was ten times smaller. These investments mostly went to Bosnia and Herzegovina, Montenegro and Slovenia[2].

STRATEGY OF GROWTH

In our analysis, we use only official GDP statistics data, although they certainly require explanations. Figure 3 shows semi-annual data on contributions to the formation of the GDP growth rate on the production side and on the use side. In 2Q2021, Serbia achieved an extremely high GDP growth rate of 13.7% (which gives a semi-annual growth rate of 7.6%). That, in itself, is not strange because the Eurozone also had a growth rate in the same period of 13.6% and the United States of 12.2%. What attracts attention, however, is the fact that growth factors were fundamentally changing in a very short period. In 2019, growth

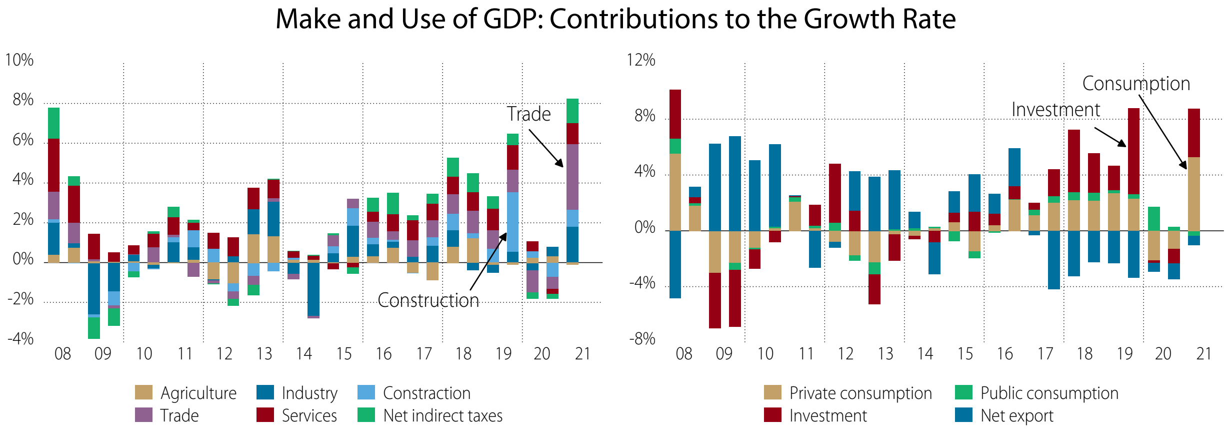
TABLE 1: INFLOW AND OUTFLOW OF FDIS

Inward Direct Investment		Outward Direct Investment	
The Nederlands	8,183	Bosnia and Herzegovina	1,027
Austria	4,574	Montenegro	742
Germany	2,919	Slovenia	659
Cyprus	2,791	Switzerland	244
Russian Federation	2,664	Russian Federation	212
Others	22,714	Others	2,884
TOTAL	43,845	TOTAL	4,123

2019, US Dollars, Millions
https://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5&sId=14823310484112&sId=1482186404325

2 IMF, Coordinated Direct Investment Survey, https://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5

FIGURE 3: FACTORS OF GROWTH IN SERBIA



depended on investments, on the side of GDP use, and construction, on the production side. However, in 2021, growth switched to consumption, on the side of GDP use and trade, on the production side.

Serbia's economic growth factors were changing dramatically in the short term. If there were a stable growth strategy, that would not be possible. In the absence of such a growth strategy, it is challenging to predict GDP developments because it is uncertain what factors will create GDP growth in the future. Will it still be the trade, even though agriculture's contributions to growth are non-existent, and industry is pretty weak? Will it be state investments in infrastructure, even though it causes unsustainable growth of the country's indebtedness? Will it be foreign investment, to the detriment of domestic private investment, as the trends in Figure 2 suggest? The answers to these questions will significantly affect the future investment climate in the country.

INTERNATIONAL CONJUNCTURE

The world economy has recovered from the COVID-19 crisis. What is especially important for us is that growth of 4.6% is projected for the Eurozone this year, while growth between 6.0% (IMF) and 6.5% (NBS) or 7.0% (Ministry of Finance) is projected for Serbia. We accepted the IMF forecast and presented it in Figure 4 at a quarterly frequency[2].

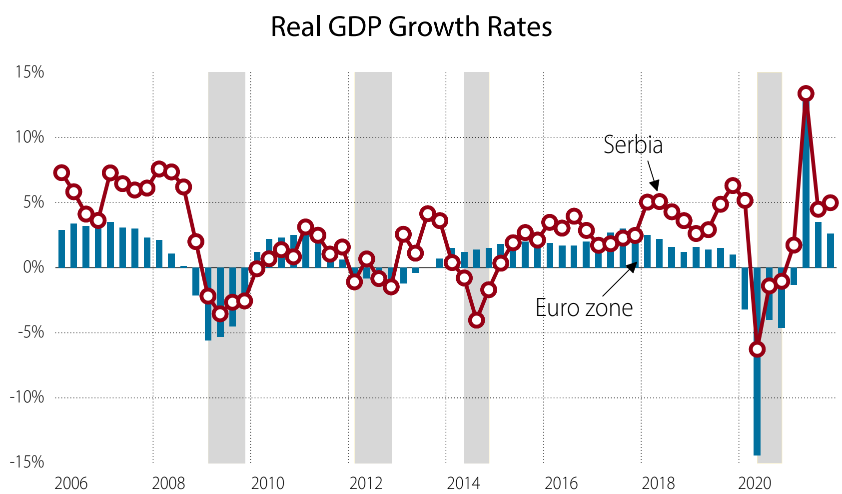


FIGURE 4:
REAL GDP GROWTH RATES IN EURO ZONE AND SERBIA

3 For the Eurozone see: https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=320.MNA.Q.Y.I8.W2.S1.S1.B.B1GQ._Z._Z._Z.EUR.LR.GY

The economies of Serbia and the Eurozone are highly integrated. That can be demonstrated by direct investments, exports and imports figures, as well as by the recession and expansion dynamics that are synchronised with a shift of one quarter. The only exception was the recession in Serbia in 2014, which Eurozone did not follow.

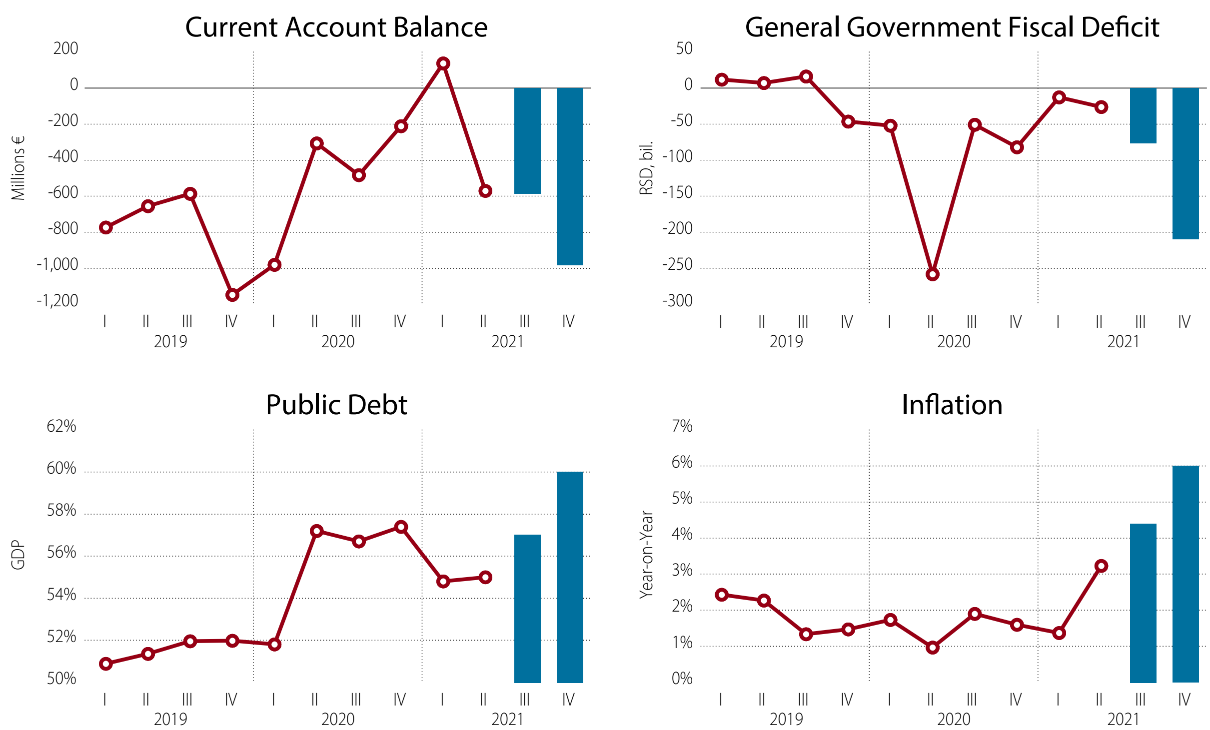
According to the IMF, the Eurozone will have relatively high growth this year, but much lower in the next five years (from 3.8% to 1.3%). On the other hand, stable growth of 4% to 4.5% was forecasted for Serbia. In any case, higher growth in the Eurozone would help Serbia achieve the projected GDP growth rates because the Serbian economy trades more than 50% of all its goods with the EU market. In the long run, we do not believe that economic activity in Serbia will move against the economic trend in Europe. That is why the recovery of the EU economy is of crucial importance for the domestic economy.

MACROECONOMIC STABILITY

Figure 5 shows the key macroeconomic aggregates. The Serbian economy is recovering from the shock caused by the COVID-19 virus and is returning to relatively stable growth. The expected GDP growth is quite high, triggering higher inflation. Inflation is approaching the upper limit of the target corridor. Aimed inflation is 3% +/- 1.5%. The average price increase in 2021 will be around 3.0% compared to 1.6% last year. Despite that, the exchange rate remained stable, contributing to contain price increase[4]. The average exchange rate in 2020 was 117.58 RSD/EUR, the same as in the first quarter of 2021. In the second quarter, the dinar nominally appreciated to 117.57, and in the third quarter to 117.56. In real terms, the dinar appreciated by over 3%.

The current account deficit is also stabilising and will be until the end of 2021 between - 5% and - 5.8% of GDP.

FIGURE 5: SHORT-TERM MACROECONOMIC INDICATORS (BARS SHOW FORECAST)



4 Granger's causality test shows that the exchange rate an inflation are highly integrated and influenced each other

Exports of goods and services in the first two quarters of 2021 increased by 28%, while imports soared by 20%. Significantly, secondary incomes increased by 30% in the same period, which strongly contributed to reducing the current account deficit.

On the other hand, the general government deficit, after a record high of -8.1% last year, is planned at -6.9% of GDP this year. Due to a better collection of public revenues in the amount of 3.3% of GDP, the second budget revision for 2021 envisages a reduction of the general government deficit to -4.9% of GDP. The reduction in the fiscal deficit is due to an increase in the tax burden that now amounts to 43.5% of GDP. Neverthelless, the public debt will increase 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 same quarter last year by 3.3%, thus neutralising the negative effect of the COVID-19 crisis.

Since S&P downgraded the country's credit rating from BB + / positive to BB + / stable in May 2020, it has not changed it further. Fitch retained a BB + stable rating from 2019, and Moody's raised its rating in March 2021 from Ba3 / positive to Ba2 / stable. All those grades are still below the investment grade.

FIC RECOMMENDATIONS

In June 2021, Serbia has concluded a 30-month arrangement with the IMF called the Policy Coordination Instrument. The IMF states that Serbia's recovery is on the right track due to significant state intervention, but the economic prospects remain highly uncertain. Higher and more sustainable growth in the medium term will require the improvement of the business environment, the rule of law, the efficiency of state-owned enterprises and environmental policy, all in line with last year's recommendations of the Foreign Investors Council.

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

- Restore fiscal stability and reverse the growth of the country's public debt,
- Complete the restructuring of infrastructure enterprises, including the closure of failed state-owned enterprises, thus reducing fiscal deficits,
- Realise public expenditures in infrastructure transparently and sustainably concerning the country's public debt,
- Continue negotiations with the EU on membership in order to harmonise domestic regulations with European standards, and
- Optimise the fiscal burden for countercyclical action, continue to improve and reorganise the tax administration and reduce uncertainty in applying tax regulations.

5 PCI is available to all IMF members who do not need the Fund's financial resources at the time of approval. It is designed for countries seeking to demonstrate a commitment to reform in order to secure funds needed from other official or private investors.