INVESTMENT AND BUSINESS CLIMATE

1.20

The investment climate has changed since the last year's edition of the White Book. The world economy is approaching stagflation triggered by the war in Ukraine and adverse climate changes. Moreover, the international order is in a turbulent adjustment, which is great uncertainty for anyone, especially for small open economies like Serbia. As for the risks, IMF found three types of them on the downside: economic, geopolitical, and ecological. This report elaborates on the first one. Within that context, the Council of Foreign Investors evaluates the reform achievements in Serbia and proposes recommendations for further improvement.

WORLD ECONOMY

The Covid-19 virus pushed the world economy in 2020 into recession, from which it recovered relatively quickly in 2021. The American economy was in recession for only three quarters, and the European economy for two quarters longer. The decline in production and the rise in unemployment were due to the closure of the economy, the disruption of production chains and the slowing of foreign trade flows.

No one expected the return of recession in 2022. Many governments have meanwhile injected significant financial resources into their economies to boost demand, which, however, has not triggered adequate change on the supply side. That developed inflationary pressure imposing the fundamental dilemma of how much the central banks would tighten the monetary policy to keep inflation within the target framework. But nobody expected a recession.

Table 1: GDP Forecast

	IMF Forecast			FIC Forecast			
	2021	2022	2023	2022	2023	2024	2025
World	6.0	3.2	2.7				
Euro Area	5.2	3.1	0.5	3.0	0.1	0.3	1.0
Germany	2.6	1.5	-0.3				
Italy	6.6	3.2	-0.2				
USA	5.7	1.6	1.0	2.1	1.6	2.7	2.3
Russia	4.7	-3.4	-2.3				
China	8.1	3.2	4.4				
Serbia	7.4	2.5	2.3	2.7	2.5	2.2	2.8

Source: MMF, Belox

Then the war in Ukraine started, severe economic sanctions were imposed on Russia, the prices of energy products (oil, gas, and electricity) rose sharply, and in parallel with that, the prices of food and primary metals. Inflation has increased drastically, interest rates have started to grow, and with them, expectations of a new economic recession. Many discuss the possibility of re-entering the recession, but few dare to forecast it. Moreover, the latest IMF forecasts expect a slowdown in the world economy and an increase in inflation, but not a recession (see Table 1).

Nevertheless, Table 1 worries Serbia. A severe drop in GDP is expected for the Euro Area in 2023, with the recession in Germany and Italy, which are Serbia's key export markets. Moreover, no one knows what will happen this winter due to the energy crisis. The gas supply from Russia to Europe has been cut, driving natural gas prices even higher. In the meantime, the German economy entered a recession in Q3 this year (a GDP drop of -0.4%). Therefore, the IMF forecast based on data for Q2 2022 in Table 1 might be too optimistic.

Our forecast includes the possibility of a recession in the US and the EU. In Figure 1 (left), we provide a forecast for the US economy (based on a three-factor model: GDP, inflation, and unemployment). The model links disinflation to the recession but not to a dramatic deterioration in the labour market. Therefore, the slowdown would last longer than in the previous case but with a milder rate of decline in economic activity.

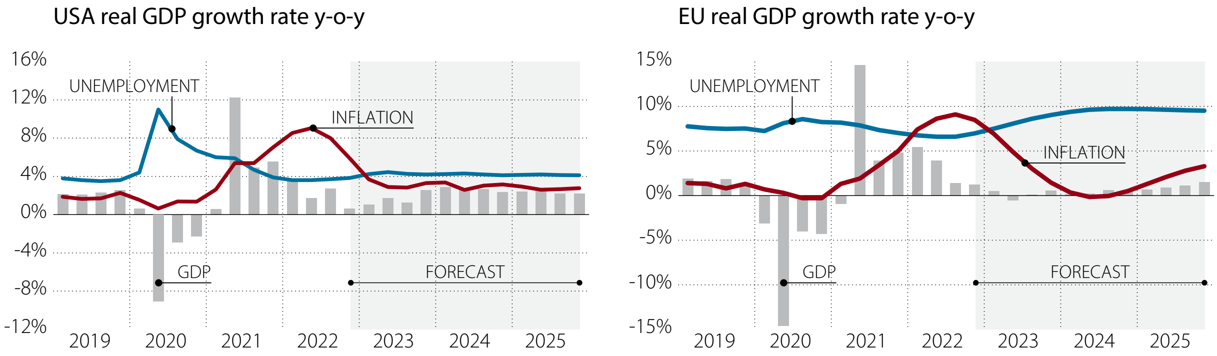
In Figure 1 (right), we provide a forecast for the EU, based on the same model, with the addition of a fourth growth factor: external demand based on the movement of GDP in the USA. In this case, too, disinflation would be associated with negative GDP growth rates, much stronger than in the case of the USA, and increased unemployment (2023-24). After two years of fighting inflation and recession, both economies will stabilize in 2025.

What does all this mean for investments? That is an atypical situation in which investments are not the driver of economic growth but an outcome of the economy's cyclical movement. We expect investments to regain their role as a growth factor only after stabilizing the world economy in 2025.

BUSINESS CYCLE IN SERBIA

The economy of Serbia depends on the economic trends in the EU. Our forecast is given in Table 1 (annually) and Figure 2 (quarterly). Serbia will also slow economic growth, but we do not expect a recession like the one in 2020. Inflation will grow until the end of the year, calm down afterwards and remain above the target corridor (3% +/- 1.5%). As for unemployment, it is structural and relatively insensitive to

FIGURE 1: BUSINESS CYCLES IN THE US AND THE EU



Source: FED, ECB, FIC

inflation and changes in GDP. Therefore, GDP growth will be slow and cyclical but positive and modest.

Long-term sustainable high GDP growth depends on investments. According to the Millennium Development Goals, countries such as Serbia should have at least a 25% share of investments in GDP, which would bring a sustainable GDP growth rate of 5% per year. However, figure 3 shows that the share of investments in GDP in Serbia is constantly below the target level. The underinvestment problem lies in the low level of private investments, which should increase from 3% to 4% of GDP.

On the other hand, public investments are growing and approaching 6% of GDP. That would be fine if this amount did not include unproductive investments in military equipment (between 0.6% and 1.0% of GDP). Also, IMF strongly recommends fiscal tightening in 2023, which might affect public investment.

Foreign direct investment has recovered from the immediate negative effect of the Covid-19 crisis, recording 5% of GDP. However, it is uncertain what the further impact of the war in Ukraine will be on them. IMF issued warnings that capital outflow might hit emerging market economies in 2023.

EU ACCESSION

The economies of Serbia and the Eurozone are highly integrated. That fact can be proved not only by data on direct investments, exports and imports in Serbia but also by the phases of recession and expansion, which are synchronized with a shift of one quarter. In that sense, the expected recession in the EU can be a severe problem for Serbia. But not the only one.

In the Serbia 2022 Report, the EU Commission strongly underlined the need for Serbia to align with any of the EU's restrictive measures on Russia, including tough economic sanctions:

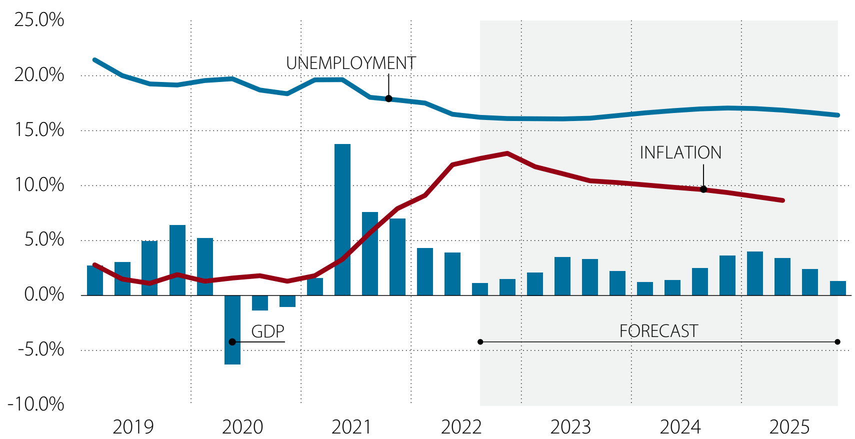


FIGURE 2: REAL GDP GROWTH IN SERBIA

Source: RZS, NBS, FIC

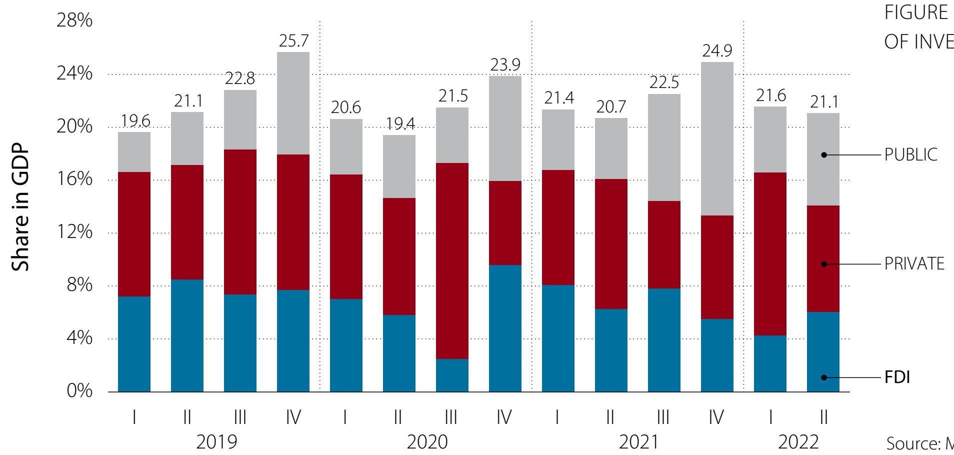


FIGURE 3: OWNERSHIP STRUCTURE OF INVESTMENTS IN SERBIA

Source: MinFin, NBS, Belox

"In the coming year, Serbia should, in particular, improve, as a matter of priority, its alignment with EU Common Foreign and Security Policy, including sanctions, and avoid actions and statements that go against EU positions on foreign policy".

The costs of this policy are already present. For example, Serbia will not be able to import cheap Russian oil, but the import of expensive natural gas is not forbidden, as the trade with Russia. Moreover, access to international financial institutions is still undisturbed. In addition, there are hidden effects of sanctions. Serbian banks and companies with the EU's founding capital will violate sanctions if they trade with or lend to Russia. Also, European citizens cannot be on their management boards if they do business with Russia, even though they work in Serbian business entities.

There is, however, a bigger problem than foreign policy harmonization. Serbia is highly integrated into the European market but not in the institutional set-up of the EU. Imposing sanctions on Russia will not solve that problem. The Stabilization and Association Agreement (SAA) between Serbia and the EU entered into force in September 2013, and Serbia's accession negotiations opened in January 2014. Since then, Serbia has continued implementing the SAA, although some compliance issues remain. The Serbian government has continued to declare EU membership its strategic goal, but the pace of reforms and membership progress slowed. Figure 4 reveals both paths: the accession progress (measured by the accession scores) and reforms towards EU standards (measured by the FIC scores of accepting its recommendations)[1].

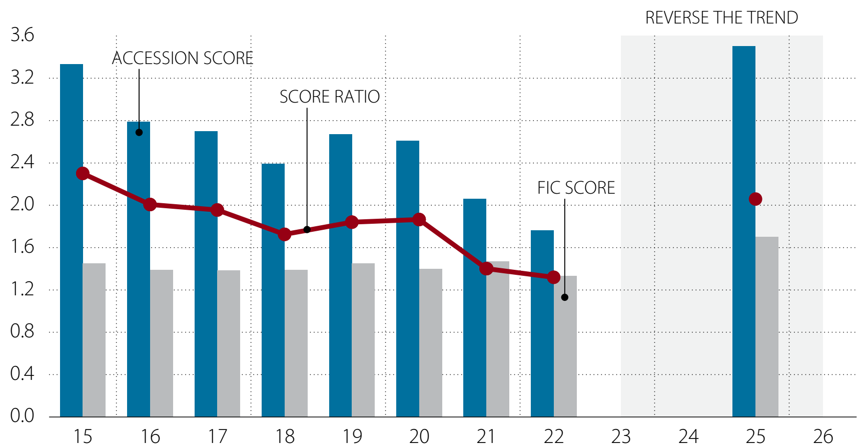


FIGURE 4: EU ACCESSION AND FIC RECOMMENDATIONS

1 For thirty-three chapters, we used the following grading scale equivalent of the EU Commission's verbal assessments of the Serbia's negotiation progress: no progress (0 points), limited progress (1 point), little progress (2 points), some progress (3 points), moderate progress (4 points) and good progress (5 points). For forty-five economic sectors, FIC scores compiling the acceptance rate of its recommendations are based on the similar approach: no progress (1 point), some progress (2 points) and good progress (3 points).

The all-time low of both processes coincided in 2022. That is a point of concern. The accession scores have a clear negative trend, while FIC scores stagnate with cyclical oscillations. The Council of Foreign Investors strongly encourages the Government of Serbia to reverse both trends, as proposed in the shaded part of Figure 4. The justification for that proposal is apparent. Members of the FIC mostly come from the EU, which market is the natural framework for their operations. On the other hand, accepting the EU standards widely coincided with the FIC proposals for improving the investment climate in Serbia.

FINANCIAL RISKS

The financial market reveals investment risks in Serbia by trading government bonds and comparing their yields with safe bond yields. Figure 5 shows the yields on government bonds in Serbia and Germany. Serbian government bond yields have risen significantly in the last six months (green line with dots versus lower red line). On ten-year bonds, yields rose to 7.9% (3% higher than in March). At the same time, Serbia's bond spread is between 4% and 6% compared to German's counterparts. Germany still has an AAA rating, even if yields on their government bonds are slowly rising (they were negative before the outbreak of the war in Ukraine).

Yields on Serbia's government bonds indicate the rising cost of borrowing and the expected deterioration of economic activity. Nevertheless, S&P and Fitch keep Serbia's credit rating at the BB+ level, with stable prospects for improvement. For Serbia to support such a credit rating, it has to conclude a new Stand-by arrangement with the IMF, which was already arranged in principle. Experience teaches us that every new arrangement with the IMF based on withdrawing funds implies a change in economic policy. That change will require, this time, a non-expansionary fiscal policy that balances restrictive monetary policy and support for the vulnerable part of the population and business. The indicators of such a policy are contained in the budget rebalance for 2022, which can be seen in Table 2.

MACROECONOMIC FORECAST

Table 2 shows the projection of the key macroeconomic aggregates the Ministry of Finance provided. The first column refers to the rebalancing of the budget for 2022, and the other columns are from the Fiscal Strategy. Immediate changes are indicated in the last column. We are highly curious about what will happen since the budget rebalances announced the new macroeconomic policy, which will revise the Fiscal Strategy. The new goal is to cover the rising current account deficit due to the increased cost of imported energy while holding the fiscal deficit under control. That will separate those two deficits that traditionally went hand in hand (so-called twin deficits) and propelled the issue of private savings deficit (with respect to private investment).

The Fiscal Strategy has rightly anticipated change in the growth strategy: investments should take over from consumption the role of the critical driver of growth, and industrial production from the provision of services. To illustrate the need for such a change, we have shown in Figure 6 the contributions to economic growth in the last five years on the supply side and final demand. Currently, private consumption (final demand), trade and services (supply) dominate. Such growth is unsustainable. The Council of Foreign Investors supports a new growth strategy based on investments and the production of goods (as a precondition to boost export). However, it seems that implementing such a strategy change is not on the horizon.

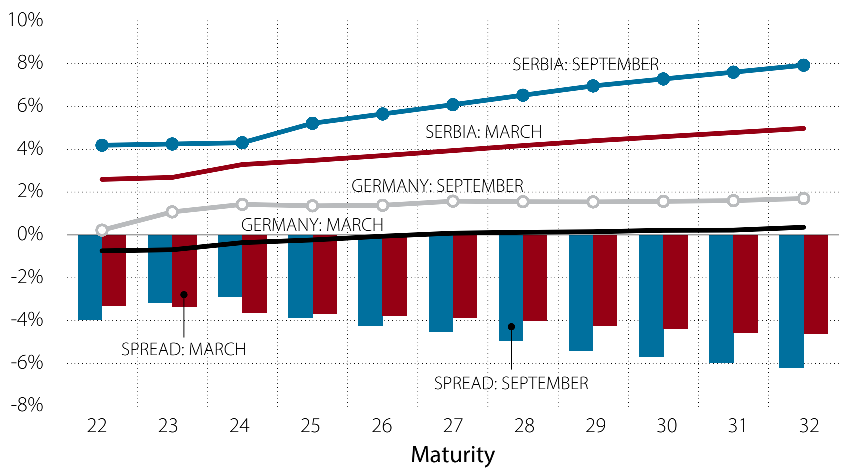


FIGURE 5: GOVERNMENT BONDS YIELDS

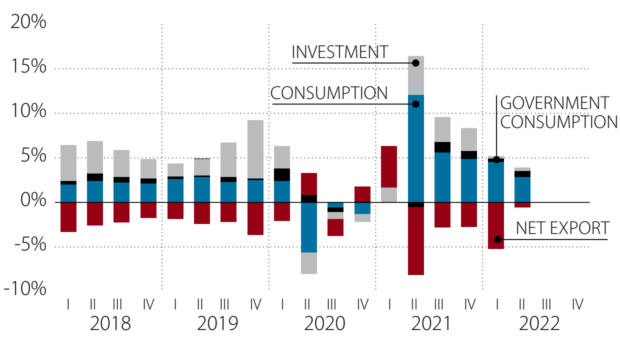
Source: www.worldgovernmentbonds.com

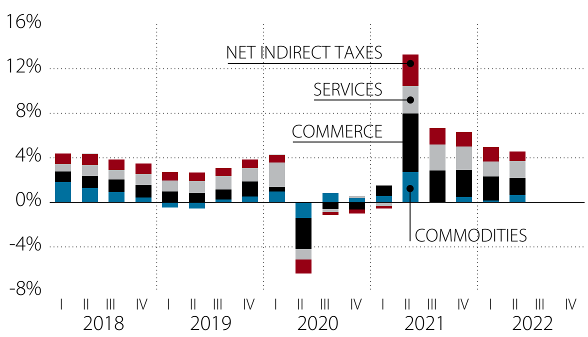
TABLE 2: PROJECTION OF MAIN MACROECONOMIC AGGREGATES

	Rebalance 2022	2023	Fiscal strategy 2024	2025	Adjustment effects	Our comments
GDP, %						
Real GDP growth rates	3.0	4.0	4.0	4.5	-0.5	Unsustainable
Consumers Price Index	11.6	5.3	3.0	3.0	2.4	Persistent
Breakdown od GDP components, %						
Consumption	3.9	3.8	3.0	3.0	0.8	Too optimistic
Public consumption	0.5	1.0	1.1	1.5	0.9	Stable
Investment	0.0	6.1	6.8	7.6	-3.0	Crisis indicator
Export	11.3	9.6	10.2	10.8	2.3	Stable
Import	12.7	8.0	8.4	8.9	4.1	Stable
Agriculture	-8.0	0.0	0.0	0.0	-8.5	Crisis
Industry	2.1	5.1	5.6	6.3	-1.6	Slowing down
Construction	-5,7	5,5	6,2	7,9	-7,1	Crisis indicator
Services	4.9	4.1	4.1	4.5	0.9	Engine of growth
Net Indirect Taxes (NIT)	4.7	3.8	3.0	3.0	0.7	High fiscal burden
Macroeconomic balances, % BDP						
Foreign trade balance	-13.0	-10.8	-10.1	-9.3	-2.3	Distortion
Current account balance	-9.0	-6.9	-6.4	-6.0	-2.3	Distortion
Fiscal deficit of general govt.	-3.9	-1.5	-1.0	-0.5	0.9	Squeezed
Public debt	55.5	53.1	52.0	50.7	0.9	Hardly sustainable

Source: Budget rebalance in 2022, Fiscal strategy 2023-25

FIGURE 1: BUSINESS CYCLES IN THE US AND THE EU





Source: RZS, Belox

FIC RECOMMENDATIONS

The Council of Foreign Investors changed its recommendations compared to the last year's White Book due to new circumstances:

- Intensify negotiations with the EU on membership status,
- Harmonize domestic regulations with European standards and reduce the risk for investments and foreign trade and
- Bring inflation back within the target corridor,
- Complete the restructuring of infrastructure companies, especially in the field of energy and
- Optimize the fiscal burden and public expenditures to prevent the country's public debt growth.