INVESTMENT AND BUSINESS CLIMATE

1.00

The investment climate has not improved compared to the previous edition of the White Book. Despite emerging from the economic recession triggered by the COVID-19 pandemic, Serbia's economy has entered a stagnation phase accompanied by rising inflation. While many initially attributed this situation to the ongoing conflict in Ukraine, a more careful analysis reveals that the war is not solely responsible for these challenges. For instance, inflation within Serbia is primarily a result of domestic factors, notably the surge in food prices. Simultaneously, Serbia's growing dependence on foreign trade introduces additional vulnerabilities, especially as the country moves further away from the prospect of EU membership. Compounding these concerns, the growth in public and foreign direct investments has been insufficient to counterbalance the decline in private investments. The goal of achieving a 25% share of total investments in GDP remains a distant aspiration. Although Serbia's credit rating hasn't deteriorated, it has failed to improve and continues languishing below investment grade. In such a challenging environment, Serbia's accession to the European Union could potentially provide a significant boost to enhance the investment climate. However, this endeavour necessitates a sincere collaboration between Serbia and the EU.

WORLD ECONOMY

The pandemic of the Covid-19 virus pushed 2020 the world economy 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 increase in unemployment were due to the closure of the economy, the disruption of production chains and the slowing of foreign trade flows (partially due to the trade war between China and the USA).

No one expected the re-formation of recession in 2022. Many governments have meanwhile injected significant financial resources into their economies to combat the pandemic, which has raised consumer demand without adequate change on the supply side. Inflationary pressures started to form, and the fundamental question was how much the central banks would tighten the monetary policy to keep inflation within the target framework. However, nobody talked about the recession.

Then the war in Ukraine started, significant economic sanctions were introduced to Russia, the prices of energy products (oil, gas and electricity) skyrocketed, and in parallel with that, the prices of food and primary metals. Many supply chains have been disrupted. Inflation has increased drastically, and interest rates have begun to rise, with expectations of a new economic recession. The latest IMF forecasts speak of a slowdown in the economy and increasing inflation but not a recession except in Germany (see Table 1).

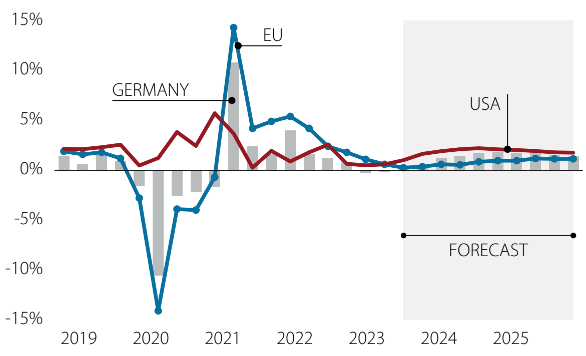
TABLE 1: IMF FORECAST

	GDP		GDP Forecast		
	2021	2022	2023*	2023**	2024**
World	6.1	3.5	3.0	3.0	2.9
Euro Ares	5.4	3.3	0.9	0.7	1.2
Germany	2.8	1.8	- 0.3	- 0.5	0.9
Italy	6.6	3.7	1.1	0.7	0.7
USA	5.7	2.1	1.8	2.1	1.5
Russia	4.7	- 2.1	1.5	2.2	1.1
China	8.1	3.0	5.2	5.0	4.2

Source: IMF, *April 2022; **October 2023

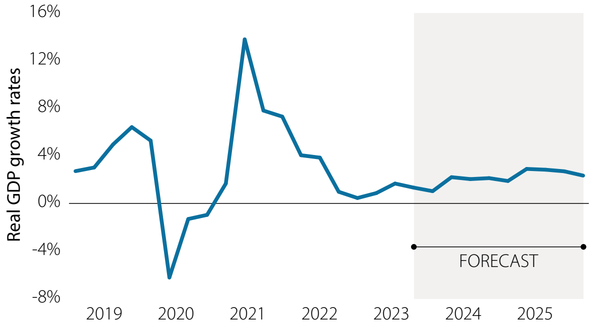
What is particularly worrisome from Table 1 is the severe drop in GDP both in the Euro Zone and in Germany and Italy, which are our biggest export markets. Germany will come out of the recession next year, and Italy will have an average growth of around one per cent. Russia will move from recession to mild growth, but our business with this country is significantly reduced, even without formal sanctions. China will have solid growth, higher than the world average. The USA will not be in recession, but high GDP growth is not predicted. Inflation is higher than expected because the restrictive measures of central banks were milder than those needed to bring inflation back to its sta-

FIGURE 1: ECONOMIC GROWTH IN THE US AND THE EU



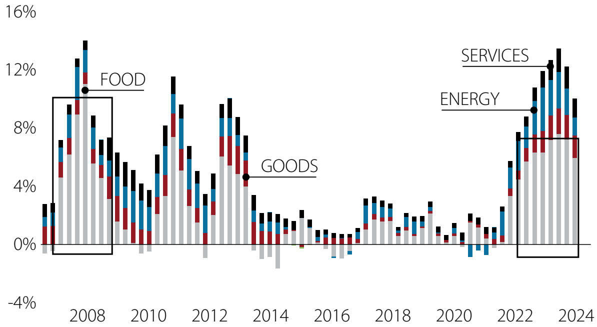
Source: Belox

FIGURE 2: BUSINESS CYCLE IN SERBIA



Source: Belox

FIGURE 3: INFLATION IN SERBIA



Source: SORS

ble state. At the moment, no one knows what will happen this winter due to the energy crisis as a consequence of the new war in the Middle East. In Figure 1, we provide a forecast for the movement of GDP in the USA (based on a three-factor model: GDP, inflation and unemployment), the EU Zone and Germany.

Our forecast indicates relatively low GDP growth rates in the coming period. We predict that the central banks will continue with restrictive policies to return inflation to normal (no more than 2 per cent per year) in the longer term.

What does all this mean for investments? We think this is an atypical situation in which investments are not the driver of economic growth but a consequence of the economy's cyclical movement and uncertainty. We expect investments to return to 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 GDP growth forecast is given in Figure 2. In Serbia, economic growth will also slow down, but at a slightly higher level than in the EU. Inflation will slowly start to come down in the coming period while staying above the target corridor (3% +/- 1.5%). As for unemployment, it is structural and relatively insensitive to inflation and changes in GDP. GDP growth will be slow and cyclical but positive.

The problem is inflation. If we look at Figure 3, we see a remarkable similarity with the 2008 crisis. The trajectory of inflation moderation will likely look like it did in 2009-10, without lowering it to the target level in the next two years. Both then and now, the most significant contribution to inflation comes from raw and processed food prices. The impact of the increase in energy prices is not negligible,

TABLE 2: PROJECTION OF THE MAIN MACROECONOMIC AGGREGATES

	2023/I-III	2024	2025	2023	2024	2025	2023
	FIC			**IMF**			**Government**
Real GDP	2.0	2.1	2.8	2.0	3.0	4.0	2.5
Inflation	14.0	6.7	4.5	12.4	5.3	4.0	8.0
Consumption				0.2	1.7	2.8	
Investment				1.9	1.2	-0.5	
Export				2.7	2.8	4.6	
Import				0.8	1.6	5.0	
Trade balance				-6.2	-6.8	-7.0	
Current account				-2.5	-3.4	-4.3	
Fiscal deficit				-2.8	-2.0	-1.6	
Public debt				55.4	53.7	51.7	

but it is not dominant in Serbia. We must not ignore its influence in the future, mainly due to the rise in the price of crude oil and the decrease in its global supply. Electricity prices will also rise, not because of external circumstances but because of the need to introduce additional excise taxes to finance the budget deficit. The state encourages inflation with its tax policy to stimulate consumer demand. However, consumption is no longer the main driver of GDP growth. Unfortunately, they are not investments either.

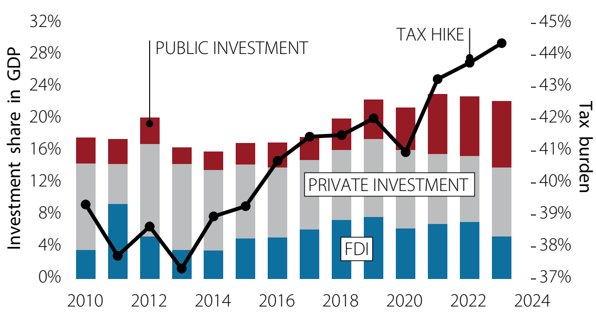
In Table 2, we have provided forecasts of the main macroeconomic aggregates for the period until the end of this year and eight quarters in the next two years. We are pretty sure how this business year will end. However, developments in the next two years depend on exports and imports. We assume further growth in exports with a decrease in imports. If that scenario does not materialize, of course, all other estimates of macroeconomic aggregates become questionable.

The message is evident if we are right with the above analysis. Economic policymakers must pay special attention to the country's position in international trade and, in general, international relations to reduce the country's exposure to risks.

INVESTMENTS AND TAX BURDEN

Support to the economy in the fight against the adverse effects of the COVID-19 pandemic was adequate but short-lived. In 2020, subsidies were significantly increased, state capital expenditures rose moderately, and the tax burden lowered. All this had a positive effect on the rapid recovery of the economy. However, in the following two years, the tax policy changed. The tax burden has increased while subsidies were reduced. At the same time, government capital expenditures jumped significantly.

FIGURE 4: TAX BURDEN AND SHARE OF INVESTMENTS IN GDP



Source: SORS, NBS, Belox

From 2019, the state is trying to increase the share of investments in GDP. The reason is understandable. To ensure a stable GDP growth rate of 5% per year, the share of investments in GDP must be at least 25%. However, the applied measures were contradictory. Especially in the last three years, the state has been increasing public investments, but the share of total investments in GDP is decreasing. Figure 4 provides an answer to this paradox. Shares of investments are represented by bars on the left scale and fiscal burden by a dotted line on the right scale. The state is constantly increasing the tax burden and leaving the private sector with less and less accumulation for investments. Parallel to the growth of public and foreign investments, there is a decline in private investments. The growth of the tax burden prevents the growth of private investments. The correlation coefficient is negative - 0.168.

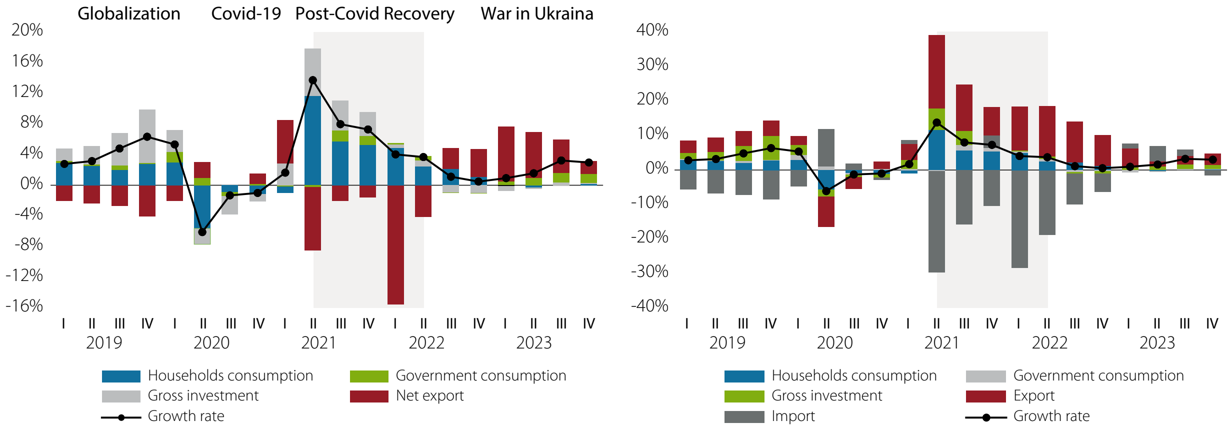
On the other hand, the correlation coefficients of the fiscal burden, public investments, and FDI are 0.877 and 0.307. The tax burden has a negative effect on private investments in Serbia and a positive effect on public and foreign direct investments. With this kind of fiscal policy, the target share of 25% of investments in GDP is a never-ending goal.

EXTERNAL EXPOSURE OF THE COUNTRY

In the last edition of the Investment Climate, we saw the need for a change in the economic growth strategy: we proposed to conduct such an economic policy that would encourage investments to take over from consumption the role of the key driver of growth, which would be based more on industrial production and less on the provision of services. We illustrated this on the graph that showed the contributions to economic growth in the last ten years on the supply and final demand side. Last year, private consumption dominated on the demand side, and trade and services on the supply side. In our opinion, such growth would be unsustainable, although we understand the situation representing the economy's recovery from the shock caused by the COVID-19 pandemic.

However, this recovery was interrupted by the outbreak of war in Ukraine. Again, a depression of economic activity took place. What we want to emphasize at this moment is a significant change in risk. In Figure 5, we have given two versions of the same phenomenon - contribution to economic growth by components of final demand. The difference between one and the other graph is that in the figure on the left, we have shown the contribution to growth by net exports, and

FIGURE 5: CONTRIBUTIONS TO ECONOMIC GROWTH IN SERBIA



Source: SORS

in the figure on the right, we have broken down net exports into two components: exports and imports. We shaded last year's recovery period and added a forecast for 2023.

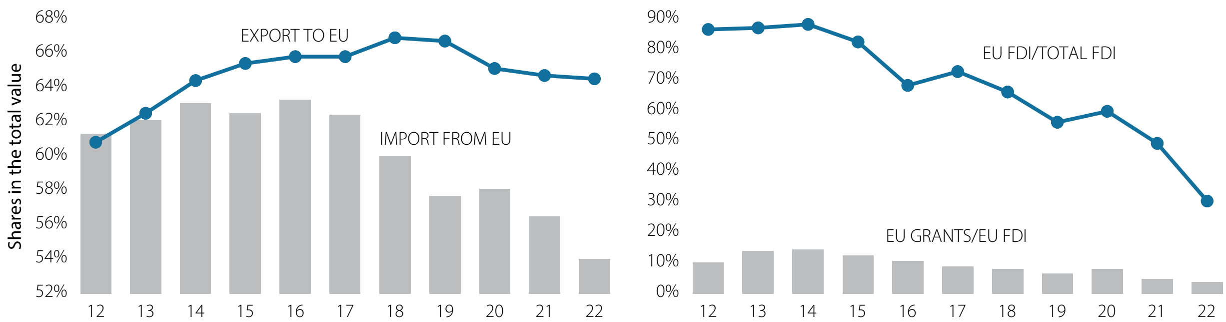
In the recovery period, consumption promotion played a significant positive role, while net exports appeared to reduce economic growth. That did not happen because of a slowdown in exports but because of a significant increase (increase in price) in imports. Net exports continued to have a positive effect on the rate of real GDP growth this year as well, but more due to a decrease in imports rather than an increase in exports. Figure 5 shows that growth depends much more on external factors (exports and imports) than internal factors (public and private consumption and investment).

Regarding Serbia's exposure to the EU, it is surprising that it has visibly decreased in recent years, although it is still dominant. That led the London Times in August 2023 to write, "Beijing is now investing as much in Serbia as the entire EU. This is bad news for Western diplomats". This conclusion is not entirely correct, but according to the NBS data, which we have listed on the right graph in Figure 6, the share of FDI from the EU drastically decreases. Also, EU grants are decreasing. That corresponds to the decline in relative exports to the EU (exports to the EU divided by total exports) over the last four years, shown in the left graph of Figure 6. On the other hand, relative imports from the EU have been falling even more and for longer[1]. Although the EU is still the dominant trade and investment partner for Serbia's economy (the fund of FDI from the EU is five times larger than from China), the trends above are worrying.

These trends correspond to the declining marginal progress

1 The data of the EU Delegation to Serbia do not agree in everything with the data of the Bureau of Statistics and the NBS.

FIGURE 6: SERBIA'S EXPOSURE TO THE EU

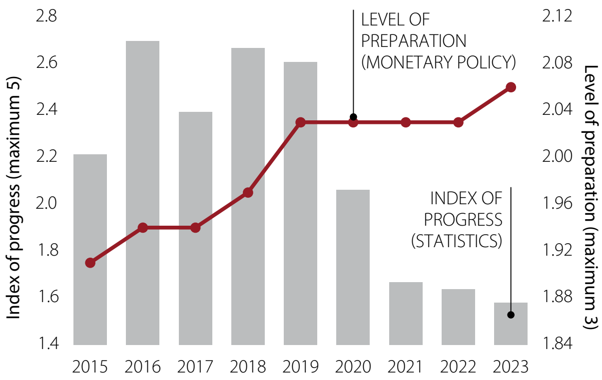


Source: SORS

Source: NBS, Belox

in Serbia's accession to the EU. Based on the assessments of the EU Commission, we compiled numerical progress scores in the negotiations and presented them in Figure 7. Also, the preparation stage is reported. What is the central message of Figure 7? There is a public misconception, which is spreading on both sides of Europe, that Serbia's biggest problem lies in its non-aligned foreign policy with the EU. It is an old wisdom that one should distinguish what is essential from what is important. Serbia's foreign policy is an important factor, especially today under the circumstances of the wars in Ukraine and Middle East. However, that is not the essential factor driving the accession of Serbia to the EU. The crucial obstacle is the institutional mismatch and the absence of necessary reforms in Serbia. The index of progress towards the EU achieved a historic low point in 2023 (1.58), despite an excellent score of statistics, while the level of preparation for the membership gained a small increase (due to efficient monetary policy).

FIGURE 7: SERBIA'S PROGRESS IN JOINING THE EU



Source: EU, FIC

FIC RECOMMENDATIONS

The recommendations of the Foreign Investors Council address the main challenges for investments: Serbia's distance from the EU, keeping inflation at the same time as interest rates rise, the increase in the tax burden and the sustainability of the public debt. Individual recommendations are:

- Intensify negotiations with the EU on membership to harmonize domestic regulations with European standards and reduce geopolitical risk for investments and foreign trade,
- Bring inflation back within the target corridor,
- Optimize the fiscal burden to encourage investments and economic growth and
- Reduce public expenditures and complete the restructuring of infrastructure companies, especially in the energy field, to sustain the fiscal deficit and public debt.