

»»» Serbia – on an ambitious path to EU membership

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Economic situation

Serbia returns to stronger growth after rather lean years

- Real growth
- Real private consumption expenditure (var. on prev. year)
- Inflation rate

In the years following the financial crisis, Serbia's economy grew at rates that were significantly below the average of the other economies in the Western Balkan region. But this year the growth rate has clearly risen, boosted by consumption as well as investment demand. In the course of the year 2018, inflation has gained momentum but remains below the central bank's target corridor of 1.5 to 4.5 %.

Growth financing

Direct investment is financing the structural current-account deficit

- Current account balance in per cent of GDP
- Gross government debt to GDP
- Budget balance to GDP

Serbia has a structural current-account deficit that fell sharply from 2012 (11.5 % of GDP) to 2016 (3.1 %) but has since widened again (Q1/2018: 6.5 %). It can cover this deficit in full by way of direct investment. Gross government debt increased from 32 % (2008) of GDP to 76 % (2015) but has since been decreasing (2017: 62.5 %). Today this successful consolidation course is also reflected in the budget balance, which was positive in 2017 for the first time since 2005. The country has stayed the course so far in 2018 (Q2/2018: 0.7 % of GDP).

Growth resources

More impetus sought from investment

- Share of services in GDP
- Labour market participation
- Investment ratio

The structure of Serbia's economy still rather resembles one of an emerging than an EU economy. The share of agriculture is relatively high (6 %) and that of services is relatively low (approx. 60 %). The labour market still shows weaknesses but progress has been made. Labour force participation has been increasing and the unemployment rate decreasing since the financial crisis. A higher investment ratio could help further. And at just under 20 % it is relatively low in comparison with both large emerging economies and the Western Balkan region.

Economic relations with Germany

Germany is extremely important for Serbia

- Germany's share of exports
- Germany's share of imports
- FDI inflows from Germany

Germany is Serbia's second most important export market. The share of exports and imports to and from Germany has been on a long-term upward trend since 2010. Conversely, Serbia ranks 52nd in Germany's export destinations. Among the Western Balkan countries, Serbia ranks highest for German trade after Slovenia and Croatia, which are already EU members. German FDI in Serbia is trending upwards and Germany is the fourth largest investor as measured by the existing FDI stock in Serbia.

Legend (see p. 5 for detailed explanation of methodology)

very good good neutral poor very poor

Investment climate – assessment by our local experts

What makes Serbia attractive to investors is the combination of low labour costs and political and economic stability. Moreover, its ongoing EU accession negotiations open up prospects for further improvements to location quality. Areas which Serbia still needs to work on are the rule of law and administrative efficiency.

Continued on p. 2

Focus topic: The prospect of joining the EU is a driver for necessary reforms but much remains to be done

Serbia is the driver and motor of the region on the way to joining the EU, along with Montenegro. Support for EU membership has recently grown again among the population. The country has also made progress in achieving EU conformity in key areas such as the education sector. Its attractiveness as a location and, hence, international competitiveness have improved significantly in recent years. The large informal sector, the rule of law and corruption prevention remain major challenges. A solution to the Kosovo question is also yet to be found.

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Investment climate – assessment by our local experts

Serbia convinces with stability and prospects. As an investment location, Serbia has so far presented itself primarily as a classic manufacturing location for suppliers to the automotive industry, for example, whose products are exported for final assembly. Here, Serbia benefits primarily from low wage costs, which enables it in some cases to even re-shore production from abroad (e.g. from China). But beyond the Serbian market the country is also becoming increasingly attractive as a location hub where businesses successfully combine development and production. Siemens, Continental, Leoni, ZF, Fiat and Stada are prominent examples of businesses operating in Serbia. The government is also working to establish Serbia as a location for the IT industry and the start-up community. The Western Balkan region's largest domestic market, with some 7 million inhabitants, and political stability are the location advantages that make Serbia interesting for investors in the future as well. President Aleksandar Vučić is regarded as a reformer and stands for economic and political stability. His centre-right party SNS has the absolute majority in parliament, although it is sharing power with a further party, the Socialist SPS. The non-partisan Prime Minister Ana Brnabić is regarded as pragmatic and competent and she enjoys a good reputation internationally as well. Serbia's attractiveness is also being boosted by ongoing improvements to local conditions as part of progress made in EU accession negotiations (see focus

topic). The economic policy focus in the past years was on fiscal consolidation, not least as a consequence of an IMF standby agreement. The standby agreement has now been superseded by a policy coordination instrument that will ensure a reform-driven agenda in collaboration with the IMF in future as well.

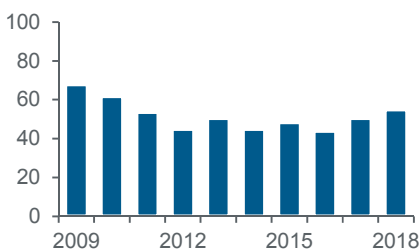
Serbia has much to catch up on, particularly in the public sector and implementing the rule of law. Approval procedures are often complicated (even if gradual improvements have been achieved here) and there is not always evidence that the rule of law is being followed. According to the EU, corruption and political influence on the justice system remain serious problems. The government is aware of this. It is currently working on reforming tax law and tax administration and it aims to make public administration more effective through the introduction of e-governance systems. Also worth highlighting is the Trieste Summit of 2017 at which a Western Balkan integrated economic region was agreed.

In summary, Serbia can be said to have good location quality. Looking ahead, the advantages clearly dominate, especially with the envisaged accession to the EU, since important issues such as the rule of law and the justice system are now being tackled on the way to joining the union.

Based on an interview conducted with Arne Gooss (KfW Belgrade Office Director) on 17 October 2018. ■

Figure 1: 'Sunday question' on the EU

'If there was a referendum tomorrow with the question: "Do you support the accession of our country to the European Union", how would you vote? In percentage of votes in favour



Source: Serbian Ministry for European Integration

Focus topic: EU accession negotiations are making good progress but much remains to be done

Serbia has been an official EU accession candidate since March 2012 already with, actual negotiations commencing on 21 January 2014. It is thus one of three current accession candidates along with Montenegro and Turkey. Of the 35 chapters to be negotiated, 14 have been opened and two (No. 25 'Science and research' and No. 26 'Education and culture') are closed until further notice. Most topics are therefore yet to be addressed by the negotiating partners.

Progress has been made: For Serbia, joining the EU is an extremely important prospect. Being part of the huge internal market and having access to EU funding programmes can boost Serbia's development and make the country attractive for new investors. Public support for EU accession was relatively steady at around 50 % in the past years but even higher at the beginning of the decade (Figure 1). The rate of support rose again lately, however. Negotiations with Serbia have been making promising progress in some areas. The EU has therefore acknowledged that the country has achieved a high level of preparation for EU accession in investment-relevant fields such as company law, protection of intellectual property and education. In the education sector, for example, the enrolment rate is above the average of the group of upper middle income countries to which Serbia belongs and even above the average of high-income countries (Figure 2). In addition, from 2018 Serbia will participate in the OECD's PISA programme, which typically sets new incentives for improving a country's educational quality. Serbia's international competitiveness has

Figure 2: School enrolment rates

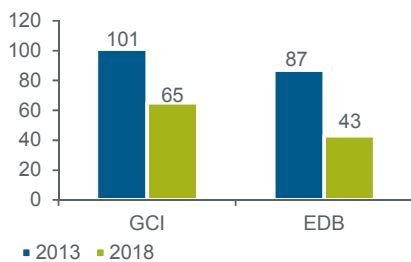
Primary schools, in per cent



Source: World Bank

Figure 3: Global Competitiveness (GCI) and Ease of Doing Business (EDB) Index

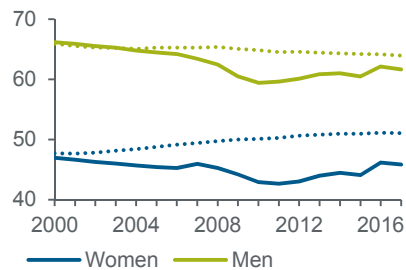
Rank on the relevant list



Sources: World Economic Forum, World Bank

Figure 4: Participation rate

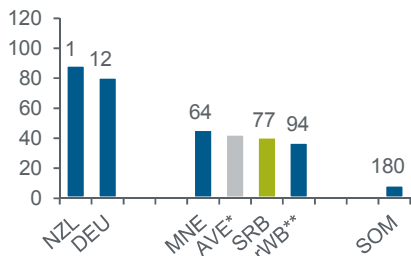
In per cent, dotted line: EU average



Source: World Bank

Figure 5: Corruption perception

Index 2017 (0=very corrupt, 100=not corrupt), values above the bars: rank (of 180 countries)



NZL=New Zealand, GER=Germany, MNE=Montenegro, SRB=Serbia, SOM=Somalia

*Average overall, **average of remaining Western Balkans: Albania, Bosnia and Herzegovina, Kosovo, FYR of Macedonia

Sources: Transparency International, KfW Research

increased not least as a result of these advances and the investment environment has improved significantly. This is also illustrated by the corresponding competitiveness indicators (Figure 3) and by the noticeable drop in the unemployment rate from 24 % in 2012 to 14 % in 2016. Further evidence of Serbia's fundamental attractiveness as an investment location is foreign direct investment, which has been able to fully finance the chronic current-account deficit since 2014.

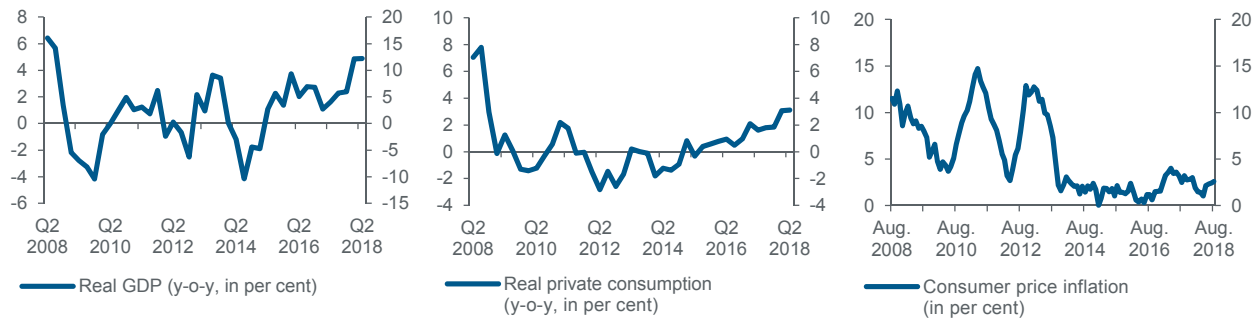
The informal sector is still too large. The deficits revealed in the context of the accession negotiations include the area of public administration. Public institutions are still deemed weak – a problem addressed not just by the EU but also by the IMF. Weak institutions inevitably mean a large informal sector. The labour market participation rate is thus significantly lower than in the EU, particularly among women (Figure 4). At the same time, Serbia's efforts at strengthening the formal labour market are also becoming apparent here. The participation rate has grown in the past years, with the gap to the EU average among men in particular decreasing noticeably. But the problem of informality in the Serbian economy remains and is highlighted by the high volume of cash in circulation. The weight of cash in circulation in Serbia is around 8.5 % of the consolidated balance sheet of the banking system, nearly twice as high as in the euro area. The euro is estimated to represent around 60 % of cash in circulation. Not least, a large informal sector also means a high degree of corruption. The EU has criticised that corruption is still a serious problem despite some improvements. The sluggish establishment of the anti-corruption agency is a particular point of criticism. In the Corruption Perceptions Index of Transparency International, Serbia is in 77th place (of 180 countries), together with China, Suriname and Trinidad and Tobago, and thus below the worldwide average – as are almost all other Western Balkan countries. Only Montenegro is above the average.

One of the stickiest points in the accession negotiations is a political issue that affects location attractiveness only indirectly for the time being: normalising relations with Kosovo. Serbia is aware of the importance of this point in the negotiations. This process is being hampered by Serbia's general refusal so far to officially recognise Kosovo. But progress is being made in implementing the normalisation agreement of 2013, although in April 2018 the EU expressed dissatisfaction with the implementation of the supplementary four-point agreement of 2015 between the two countries. Part of the delay has also been caused by Kosovo, which has not yet presented the final wording of the autonomy status for the Serbian minority in Kosovo. Settling the Serbia-Kosovo conflict should move the accession negotiations a decisive step forward.

Conclusion: EU accession is still a long way off for Serbia but progress is undeniable. This is having a very positive impact on the country's competitiveness. Nonetheless, investors cannot yet expect the standards that are customary in the EU territory, for example with respect to governance and institutional quality. Still, ongoing preparations for EU membership will make gradual but noticeable improvements to Serbia's location quality. ■

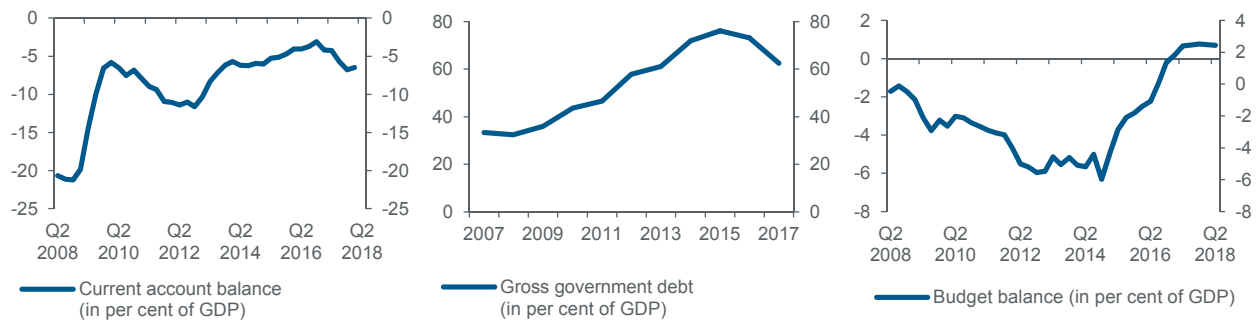
Charts

Economic situation



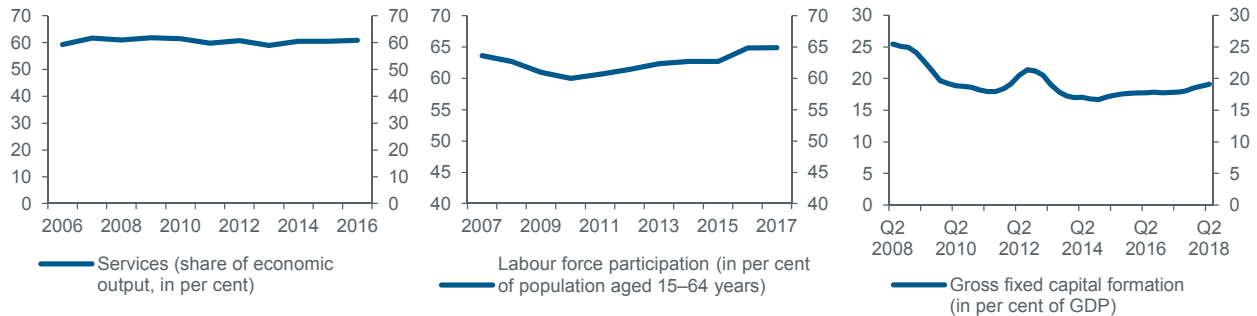
Sources: Datastream; IMF, World Bank; own calculations

Growth financing



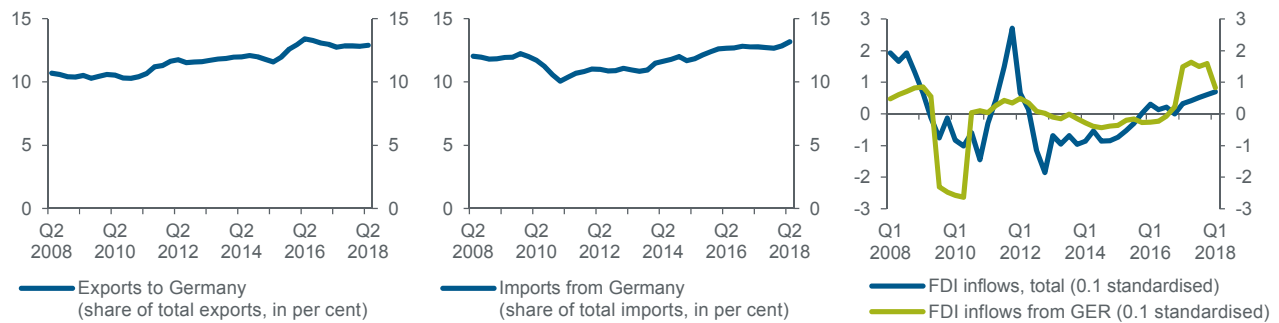
Sources: Datastream; IMF, World Bank; own calculations

Growth resources



Sources: Datastream; World Bank

Economic relations with Germany








Sources: Deutsche Bundesbank; Datastream; IMF; UNCTAD; own calculations

KfW Research

Emerging Markets Spotlight

Method

The Emerging Markets Spotlight examines a selected country on the basis of various macro-economic indicators. These indicators are summarised into the following four blocks: economic situation, growth financing, growth resources and economic relations with Germany

 Quantile 1	On the basis of the indicators, we analyse how well the country performs within a comparison group. The comparison group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The examined country is situated within the country group on the basis of the quantile rank. The distribution quantiles are distinguished by different colours (see colour scheme).
 Quantile 2	
 Quantile 3	
 Quantile 4	The country is assigned to a quintile of the country group for each indicator observed. The identification of the best quintile may vary depending on the indicator. For example, higher growth rates are better, so here the top quintile is coloured dark green, while higher debt ratios are worse, so here the top quintile is coloured dark magenta.
 Quantile 5	

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