ISSN: 2241-4851

Eurobank Research

GLOBAL & REGIONAL FOCUS NOTES

FOR THE EA PERIPHERY AND THE CESEE

Virtual Trip-Note from Serbia

Key notes from our recent virtual trip to Belgrade: February 9th – 18th

In mid-February, we held virtual discussions with high-level officials from the Fiscal Council, the European Bank for Reconstruction and Development (EBRD), the World Bank (WB) and the International Finance Corporation (IFC). The present note attempts to offer our readers a cohesive overview of the reasons behind 2020's economic over performance and the current conditions in the domestic economy as well as the outlook ahead.

- The economy registered the lowest recession in 2020, outperforming CESEE & EU peers
- A strong growth rebound is on the cards in 2021 provided that vaccination both in the country and trading partners remains on track
- A new program with the IMF will provide the country with a valuable policy anchor going forward
- The fiscal consolidation effort of the previous years allowed for a generous anti-Covid-19 support program. A more frugal –but still supportive- fiscal policy is envisaged in 2021
- Benign inflation trajectory has allowed the NBS to pursue an accommodative policy in 2018-2020. Room and need for further NBS policy rates cuts appear to be limited
- Balance of payments risks are capped in the short-term
- The acceleration of structural reforms in governance and competition issues could unlock the growth potential of the country in the medium-term
- Political landscape remains broadly unchanged: The recently elected government should ensure policy continuity in the next one and a half years but may stay in office until only late April 2022

Contributing Authors:

Ioannis Gkionis
Senior Economist
Eurobank Greece
igkionis@eurobank.gr

Maria Kasola
Economic Analyst
Eurobank Greece
mkasola@eurobank.gr

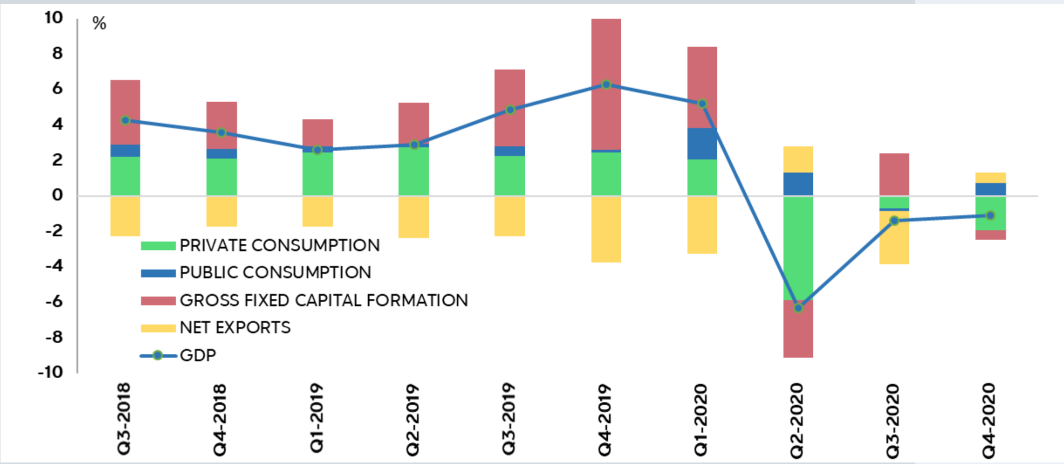
Ivan Radovic
Head, Strategy & Market Research Department
Eurobank Serbia
ivan.radovic@eurobank.rs

Special thanks to Mr. Ivan Radovic at Eurobank Serbia for organizing the virtual meetings with our discussants

How to survive the GDP roller coaster; from 12-year highs in Q4-2019 to more than 20-year lows in Q2-2020. Yet, Serbia finished the year with the mildest recession of -0.98% in the Western Balkans and the EU.

Serbia entered the Covid-19 crisis with significantly milder imbalances than a decade ago allowing the authorities to compile a supportive fiscal package of 12.7% of GDP, which remains up to date among the largest in the CESEE region. The Q4 GDP growth print released in early March set the economic recession in FY2020 at -0.98% and practically confirmed the flash estimate of late November. This performance, albeit negative, constitutes a positive development for the country taking into account that the EU experienced an economic recession of -6.4% according to the flash estimate. Since 2013, the economy has been continuously growing, with a short interval in 2014 when extreme weather conditions led to a mild recession of -1.6%. In 2018 and 2019 the economy took off posting GDP growth rates above +4.0% while the consensus for 2020 before the Covid-19 outbreak in Europe, i.e. exactly one year ago, stood at 3.5% with a continuing perspective at these levels up to 2024. Entering 2020, the economic activity kept expanding by 5.2% YoY in Q1 and then shrunk by -6.3% YoY, -1.4% YoY and -1.1% YoY in the following quarters. The decomposition of the GDP in terms of expenditure shows that had it not been for the public consumption and the gross fixed capital formation which contributed positively by 0.93pp and 0.81pp respectively to the headline -0.98% figure, the recession would have been deeper as private consumption and net exports declined by -1.61% YoY and -1.03% YoY respectively. The slowdown of imports by -2.3% YoY prevented net exports' contribution from decreasing further and dragging the GDP recession rate deeper.

Figure 1: Public consumption and investments supported GDP from shrinking further in 2020



Sources: Statistical Office of the Republic of Serbia, Eurobank Research

The increased public consumption materialised in the shape of extensive fiscal stimuli which were primarily focused on mitigating the rapidly rising unemployment risks since the beginning and throughout the period of the pandemic, which is still at play. So far, the labour market appears properly ring-fenced as unemployment in Q4-2020 stood at 9.9%, which is higher only by 0.2pp compared to the same period last year, despite the restrictive measures that supressed demand. The hit on both the domestic and the external demand through the channels of the pandemic was more than evident both in the subdued private consumption and the reduced exports throughout the year. While increasing private consumption used to contribute more than half of the total GDP growth since 2016, the course was interrupted with a -1.61% YoY contraction in FY2020, milder than the -5.9% YoY contraction in Q2, which was the strongest of the year. On the same footing, exports declined by -3.3% YoY in FY2020, bottoming out by -11.6% YoY in Q2, reflecting the stringency measures in the EU and other trading partners that caused external demand and consumption to sink.

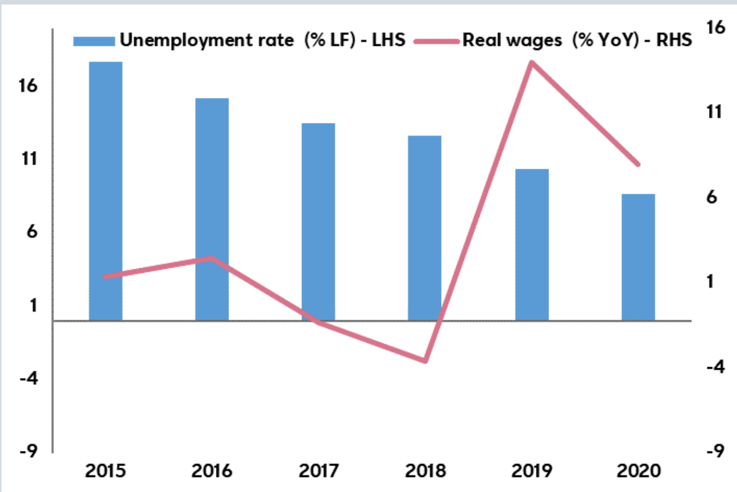
Taking into account that the CPI ended the year at 1.3% YoY while it averaged a notch higher, at 1.4% throughout the same period, the key policy rate, currently standing at 1.00%, in real terms is practically negative in an effort to stimulate, inter alia, lending and investments. In this respect, monetary policy easing stood supportive to the economic activity and kept it from shrinking further. Indeed, lending to corporates and individuals continued to increase, albeit at a smaller pace. According to data from the National Bank of Serbia (NBS), in December 2020, total domestic loans, for a third year in a row, recorded an almost double digit growth rate – 9.9% YoY – shaping a favourable landscape in terms of the contribution to economic recovery. In our view, credit growth is expected to remain relatively resilient helped by the existing low level of NPLs, the comfortable liquidity position of the banking sector along with the prospect of the economic rebound in the aftermath of the pandemic. In support of the above, as of end of December, total NPLs ratio stood at 3.7%, which is close to the average of the CESEE region[1]. As already mentioned, fiscal support has been focused on the protection of employment. Therefore, since the extent of layoffs which is highly correlated to payment defaults is anticipated to remain contained, NPLs volume is not expected to pick up sizeably in the near term. In any case, a clearer view on whether the end of loan moratoria since October 2020 will have a more pronounced negative impact on the NPLs volume will be seen at the end of Q1. Additionally, investment has contributed positively in the economic activity in FY2020, mostly consisting of infrastructure projects, specifically roads. The positive impact lasted in Q1 (+4.6% YoY) and Q3 (+2.4% YoY) but retreated in Q2 (-3.25% YoY) and Q4 (-0.53% YoY).

Since the beginning of the transition from a centrally planned economy to a free market, Serbia has been phasing out an ambitious reforms agenda collaborating with international institutions, including the IMF, the World Bank, the International Finance Club and the EBRD. In January, the Policy Coordination Instrument (PCI) fostered by the IMF was completed and the two parties have already agreed to renew their collaboration on a new program which could start in mid-2021. The PCI begun in July 2018 and was completed in January. The key goals of the programs were to foster inclusive growth, maintain financial stability, and help the authorities with the implementation of ambitious structural reforms, including to sustain the earlier improvement in the fiscal position. While the positive spill over from the implementation

[1] https://vienna-initiative.com/assets/Uploads/2020/334602ac2d/NPL-Monitor-2020-H2.pdf

of reforms cannot be captured instantly on the national accounts, the recently completed PCI is considered a successful programme. Indeed, reforms may have not rolled out as rapidly as initially planned, but the IMF, through the tactical reviews conducted in the country, monitored closely the negative repercussions of the pandemic and advised the country wherever required. As Mr.Jan Kees Martijn, the IMF's mission chief for Serbia stated in an interview in the IMF Country Focus in early January, ''the program was broadly on track when Covid-19 hit, but the program's objectives had to be adjusted to reflect additional challenges posed by the pandemic. Last spring, the focus of the PCI shifted to supporting the economy through the crisis and managing risks''. The government will negotiate with the IMF representatives anytime soon the content of the new program with the key target remaining the continuation of structural reforms in the areas of the public sector salaries, the state owned enterprises (SOEs) and the capital market. Nevertheless, just before the burst out of the pandemic in Europe, i.e. in late January, the government decided to proceed with the sale of Komercijalna Banka to the Slovenian Nova Ljubljanska Banka (NLB) with the transaction being completed in the end of 2020. It is reminded that in December 2019, the NLB placed the best bid in the sale of Komercijalna Banka and entered talks with the government over the purchase of 83.23% of the bank's ordinary shares while the under sale bank is the third bank in terms of total assets in Serbia.

Figure 3: Labor market has stood firm in the pandemic so far



Sources: Statistical Office of the Republic of Serbia, Bloomberg, Eurobank Research

Serbia's continuous reform endeavours have borne fruits and are deemed to continue to do so in a broader economic perspective of the economy. That said, there are official estimates by the National Statistics Office and the NBS[2] that the GDP growth acceleration in 2017-2018 was mainly driven by faster growth of the Total Factor Productivity (TFP). Moreover, in FY2019, both TFP and capital's contributions increased further to 2ppts and 1.4ppt respectively in the 4.2% GDP growth headline figure, due to structural reforms, unleashing hidden potential of the economy and leading to income convergence with developed economies.

[2] https://www.nbs.rs/export/sites/NBS_site/documents-eng/finansijska-stabilnost/presentation_invest.pdf

Taking into account all the above, we reach to the conclusion that a plethora of timely and targeted decisions at the economic policy level prevented the economy from experiencing a severe economic recession, as is the case for the majority of the developed and developing economies around the world. Additionally, though the tertiary sector of services diachronically comprises more than half of GDP, the country's lower exposure than other regional peers to sectors hit the hardest by the crisis[3] and the relatively short duration[4]of the most stringent containment measures back in spring also underpinned its over performance in 2020 and are expected to give a lead in 2021 as well.

What to expect in 2021? Growth landscape, opportunities and challenges.

The government has set an ambitious range of economic growth for 2021 between +5% and +6%. Our discussants recognised the looming economic rebound as the pandemic will start to fade away but they also pointed out that their forecast lies somewhere lower, .i.e. around +3.5% to +4.0%. Their views for the growth outlook of 2021 coincides with the official government forecast in fiscal strategy for 2021-2023 over the long-term potential GDP growth rate for 2021 at 3.6%. The target of +6% was widely viewed as rather optimistic, waking pleasant memories of 2007 when such an economic result was achieved for the last time. The second quarter of 2021 will be crucial with respect to the real capabilities of the economy as supportive measures will be phased out after Q1 and corporates and individuals will face any challenges without the state shield from that point onwards. We anticipate investments to take centre stage in the economic growth trajectory due to the low base effect that 2020 inherited to 2021. Public consumption is expected to continue contributing positively, albeit to a lesser extent, and private consumption is anticipated to kick off, given the bounce back in domestic demand after the relaxation and even maybe the cessation of stringent social distancing measures. That said, all three components of domestic demand will positively contribute to the economic growth, with investment and private consumption contributing ca. 2pps each to the headline GDP growth forecast. In our assumptions we take into account the firm labour market and the expectations that wages in the public sector will most probably continue to increase, ahead of the parliamentary elections scheduled for early 2022. We anticipate the recovery of the services sector which was most affected by the pandemic in 2020 to assist the private consumption rebound while the ambitious pipeline of infrastructure projects that is estimated to reach 5.5% of the projected GDP will further give a boost to the component of the gross fixed capital formation The net exports component is considered the most difficult to predict, with its dynamics being broadly determined, inter alia, by the domestic and external demand and the high uncertainties around them. For the foregoing reasons, we have pencilled in a GDP growth forecast of +4.5% in 2021 with risks, however, tilted to the downside and broadly stemming from the vaccination roll out in 2021 in the EU, which is the main trade partner of Serbia. Following the ample economic policy stimuli in flux in 2020, it is highly probable that expansive policies may have reached their limits in the year ahead. As such, the speed of the vaccination will determine to a great extent the economic route of 2021 as along with the herd immunity, the cessation of social distancing measures will come and domestic demand will be able to fledge again. So far Serbia appears to have timely noticed the

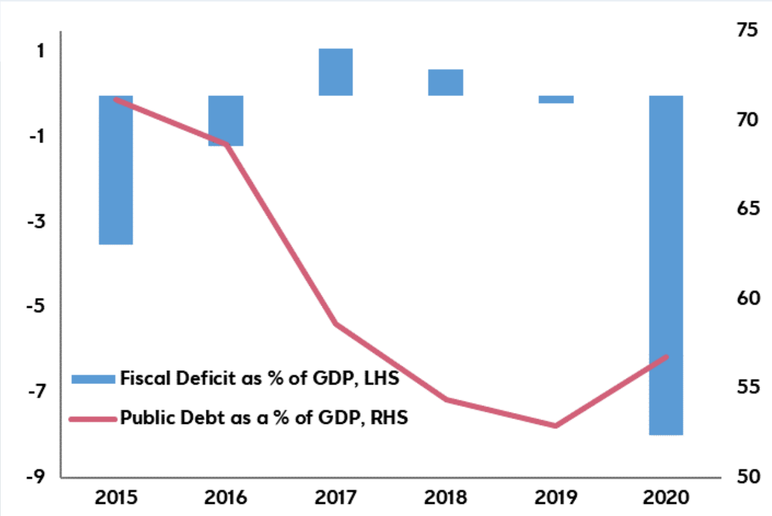
[3] According to data from WTCC, tourism industry consists of 5.9% of GDP and 6.2% of total employment, which is lower compared to regional peers such as Croatia, Greece, Albania and the EU average.
[4] The most stringent measures were in effect between March 15 and May 6, when Serbia was declared in a state of emergency. Ever since, the measures have been gradually relaxed compared to other EU and CESEE countries

respective challenge as it is marking a stellar performance regarding the speed with which vaccines are reaching to the country and being jabbed to its citizens. Still, as a small and open economy, it is dependent on the immunity of its major trading partners.

Fiscal developments: The previous years' consolidation effort allows for a generous anti-Covid-19 support program.

Following a firm fiscal consolidation effort in the period between 2015 and -2018, Serbia reduced its public debt to GDP ratio, from 70.0% in FY2015, to 52.0% in FY2019. This practically allowed for a hefty Covid-19 support program, worth ca. 12.7% of GDP in 2020, which is one of the most generous packages in the CESEE region. The completed fiscal consolidation consisted of two parts. On the expense side, the bulk of the burden was carried by retirees with above average pensions, and public sector employees, whose benefits had been reduced and/or fro-zen for a period of three years. Also, the pension reform which gradually increased the retirement age limits resulted in reducing expenses. Finally, parts of the "unintended" savings came from inefficient public investments, a trend that is however being reversed in the recent period. On the income side, revenues had been boosted by consistent GDP growth, accompanied by higher VAT, excise proceeds and steady rise in formal employment (higher benefits collection). One more technical reason for the drop in the debt to GDP ratio was the real appreciation of the local currency, which led to increased local currency collections along with a relative decline in foreign denominated debt. Overall, the consolidated fiscal expenses came down, from 42.7% of GDP in 2015 to 42.3% in 2019, while revenues grew from 39.3% to 42.1% in the period. As a result, Serbia entered the pandemic with the public debt reaching 52% of GDP, a near investment grade credit rating and ample room for fiscal intervention. Shortly after the outbreak of the Covid-19 spread locally, the government imposed the toughest of measures, including a state of emergency that lasted between March 15th and May 6th. During the course of the year, as the crisis evolved, the administration sequentially introduced a set of counter crisis measures that were amongst the most generous in the CESEE region, accounting ca. 12.7% of GDP, with a direct expense to the budget amounting around 6.6% of GDP. The program was deemed generally appropriate. Firstly, the deferral of the withholding tax payments and corporate tax for most of the private sector reached an amount equivalent to 3.4% of GDP. Then, there was the direct support measures to the private sector worth 2.5% by subsidizing minimum wages directly from the budget to all non-large corporates for three months and half of the minimum wage for LCs, followed by another two months of subsidies worth 60% of minimum wage for all. These initial measures mitigated to a great extent the imminent threat of layoffs, resulting in unemployment levels deteriorating just mildly from a pre-Covid rate of 9.9% as of Q4-2020. The lending boosting scheme worth EUR2.0bn was introduced in May, whereas the state of Serbia took up 80% of the risk per each ticket. Around EUR1.6bn has been utilized thus so far, granting 23ths loans in total. Apparently, around 40% of the total amount granted was issued to refinance old debt, which raised questions as to whether this particular measure fulfilled its purpose. The administration announced a renewal of the program in the spring of 2021, worth EUR0.5 bn. Finally, to stimulate domestic demand, each citizen above 18 were paid EUR100, for a total cost of ca. EUR600mn. This particular measure was deemed as the least appropriate, as it did not address the issue of inequality, nor did it strongly boost demand, costing some 1.3% of GDP.

Figure 4: Supportive measures weighted on the fiscal balance and the public debt



Sources: Ministry of Finance, Eurobank Research

The fiscal supportive measures led to a budget shortfall of 8.0%, which is higher than that in most CEE countries, but lower than that expected earlier in the year, as earlier more pessimistic forecasts led to expectations over a higher budget gap. The crisis came to expose some of the structural weaknesses, such as the inadequate support in the healthcare system in the previous period (healthcare expenses came in at 0.6% of GDP higher than the CEE average in 2020), as well as a reminder of inefficient public enterprises such as EPS, JAT, Railroads and municipal public enterprises, which altogether routinely cost near 1.0% of GDP to the taxpayers every year. That said, the government needs to resist the temptation to raise public sector wages above the inflation level. While it is more than appropriate to reward medical staff for their formidable effort during the Covid-19 crisis, salaries of public servants with administrative duties should be firmly in check. Concluding on this issue, a comprehensive public sector wage grade system needs to be implemented at last, after years of dubious hesitation.

As already mentioned, the record high budget gap heightened the public debt to 56.8% of GDP at the end of 2020, which calls for a cautious approach in projecting medium term fiscal policies. The budget bill for 2021 projects a shortfall of 3.0%, which, with the moderate estimate of the output rise of 4.0 to 4.5%, leaves the public debt in the neighbourhood of 57% to 58% of GDP. On both the revenue and expenditure sides, risks lay mostly on the overly ambitious fore-casted growth of 6.0% upon which the budget is built. Payroll contributions appear exceptionally overstated with a full 0.6 pp vs. the pre-crisis levels of 2019 (13.1% of GDP), while other revenues such as VAT and corporate taxes are oddly lower compared to 2019 aggregates. On the expense side, the public sector employees bill is 0.5 pp higher than in 2019, which amounts to a difference of ca. 700mn EUR in total. Despite the expected improvement in the Covid-19 situation, both in Serbia and its major trading partner, i.e. the EU, the risks remain large, therefore targets could have been set a bit less ambitiously.

Inflationary pressures have declined in recent years creating a more stable and predictable macroeconomic environment.

Inflationary pressures have overall declined and remained relatively subdued in the past six years. The average annual inflation declined visibly from 8.5% YoY in 2008-2013 to 2.0% YoY in 2014-2019 and further down to 1.6% YoY in 2020 converging to the levels of advanced economies. Since late 2013, headline inflation has not exceeded the upper limit of the Central Bank (NBS) band. In contrast, there have been discrete periods of time during which inflation has remained firmly below the NBS tolerance band. Both domestic and external factors have been at play behind the steep disinflation trend. Among the key factors behind this trend stand the relatively low food and world energy prices which carry a significant weight in the consumption basket. Overall, once hit by hyper-inflation, high inflationary pressures by any metric are no longer a concern for the country making the economic environment more stable and predictable which is a prerequisite for promoting a growth enhancing agenda.

Moving on to the more recent inflation developments, January's inflation print surprised to the downside. The most recent data showed that inflation decelerated further to 1.1% YoY in Janu-ary 2021 down from 1.3% YoY in December 2019 and 2.0% YoY in January 2020 coming below the Bloomberg consensus expectations of 1.5% YoY. Inflation hit its lowest level since last May remaining below the lower end of the NBS target tolerance band for the second consecutive month. Transportation was the category which registered the biggest decrease (reflecting the crash in the world energy prices due to the Covid-19 pandemic) switching from 1.6% YoY in January 2020 to -5.4% YoY in December and -4.5% YoY in January 2021. Food & non-alcoholic beverages was the CPI component with the largest decrease on an annual basis from 2.3% YoY in January 2020 to 1.4% YoY in December 2020 and further down to 0.9% YoY in January 2021. On a monthly basis inflation expanded by +0.4% MoM in January up from +0.1% MoM in December.

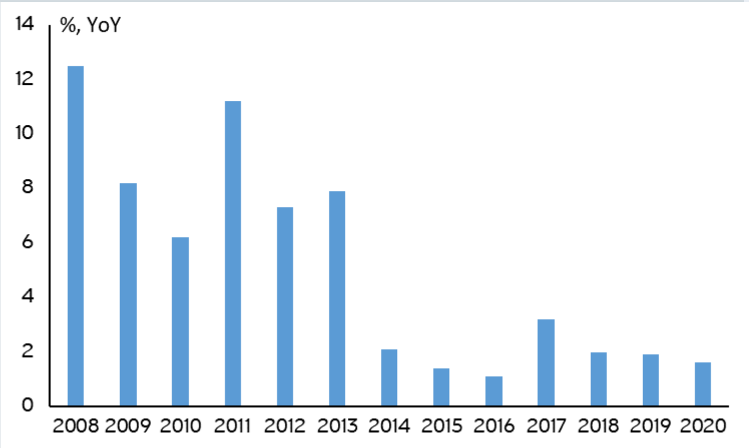
Having plummeted below 1% YoY (0.9% in July 2018) core inflation (CPI excluding food, energy, alcohol and tobacco) has been trending higher in recent months to reach 2.1% YoY in December 2020 and remain flat on an annual basis in January 2021. According to the relevant sur-vey of the NBS, the short & medium-term inflation expectations of the financial and corporate sectors moved within the target band (3±1.5%) in a manifestation that they remain well anchored. The short and medium term inflation expectations of the financial sector stood close to 2.0%, while those of the corporate sector stood a bit lower at the level of 1.5% and 1.9% respectively.

Looking ahead, we anticipate inflation to trend higher in the following months on the back of higher global energy prices and domestic regulated electricity prices. Firstly, the deflationary impact from low energy prices will gradually dissipate from Q2 but also the administered prices hike will weigh on inflation driven by higher electricity prices for households and alignment of excise duties for tobacco products with EU levels. To that end, NBS has recently revised the CPI projection for 2021 to 2.5% (from 1.9% previously).

Benign inflation trajectory has allowed the NBS to pursue an accommodative policy in 2018-2020. Room and need for further NBS policy rates cuts appear to be limited.

Monetary policy has been supportive even before the onset of Covid-19. Motivated by a number of favorable factors, the NBS has followed an expansionary monetary policy since early 2019. The improvement in the macroeconomic fundamentals, a negative output gap, well anchored inflation expectations, relative stability of the domestic currency in recent years and the dovish stance of major central banks are among the factors which allowed the NBS to maintain its easing bias throughout the previous period. The onset of the Covid-19 crisis, which substantiated the need to provide additional support to credit and economic activity accelerated the trend. Thus, the NBS delivered a cumulative 300bps of rate cuts in six moves (two of them in 2019 and four of them in 2020 with the last one taking place in November 2020) bringing the key policy rate (KPR) from 3.0% to 1.0%, which is the lowest level since the inception of the inflation targeting regime of the Central Bank. At the same time, real policy rate stands close to zero at the moment but is less negative than regional peers. Moreover, the inflation trajectory has allowed the NBS to narrow the interest rate corridor initially from +/-1.5ppts to +/-1.25ppts in March2020 and further down to 0.9ppts in December 2020, aiming to strengthen the monetary policy transmission through the interest rate channel. Looking ahead, it appears that the trough of the monetary policy easing cycle has been reached. Provided that the epidemiological situation improves in the 2H, the need to provide additional monetary policy stimulus will subside. Moreover, even though inflation is only expected to increase slightly, risks to the forecast are tilted to the upside thus leaving no room for further rate cuts. As a result, baseline scenario assumes NBS adopts a wait and see stance until there is more visibility in the post-Covid-19 landscape.

Figure 5: Inflationary pressures have declined between 2008 and 2020



Sources: National Bank of Serbia, Eurobank Research

Short-term balance of payment risks appear to be capped.

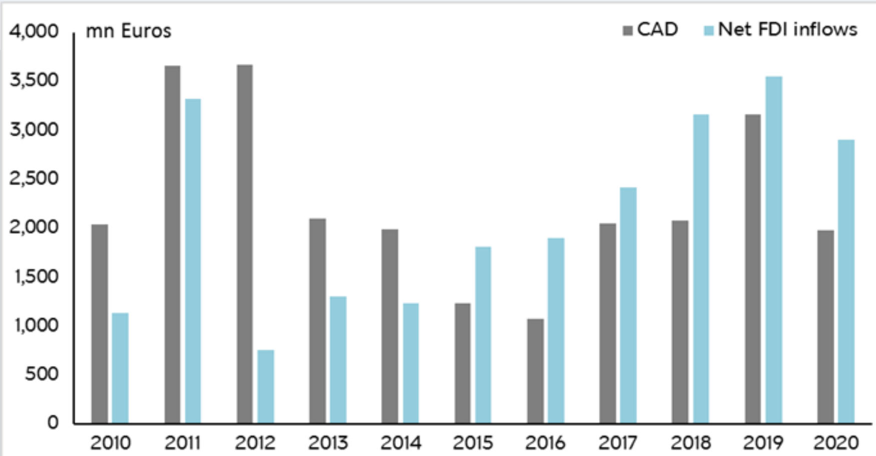
The external position of the country has been on an improving trend in recent years. The gross external debt has declined gradually from 76.1% of GDP in 2012, which is a multi-year high be-tween 2005 and 2020, to 61.5% in 2019 and climbed to 66.4% of GDP in 2020. Moreover, underpinned by its expanding export base, the country has managed to maintain current ac-count deficits (CAD) under control in recent years. The average annual CAD/GDP declined from -9.9% in 2008-2013 to -4.8% in 2014-2019. In the period 2010-2019, total exports more than doubled, from €9.5bn, to €23.3bn. The rise in terms of GDP is even more impressive: total exports as a percentage of GDP expanded from 30.2% in 2010 to 50.8% in 2019.

The role of FDI has been instrumental in improving economic fundamentals of Serbia. The country has been a recipient of €15.5bn in net FDI inflows in 2014-2019 with their amount increasing every year. On the positive side, those have not been limited to non-tradable sectors. From a sectorial point of view, manufacturing has taken the lead in attracting approximately one third of the total amount (30.0%) and construction & real estate received one fifth (20.6%). Financial services and retail & wholesale trade accounted for 13.9% and 9.4% of net FDI inflows in the same period. Net FDI inflows have been incentivized by the country's proximity and ac-cess to EU markets, recent improvements in the domestic business environment, a still cost-effective labor pool but as well as a generous subsidies scheme offered to foreign investors. The subsidies scheme provides coverage of a percentage of the eligible expenses depending on the type of project, the level of development of the investment location and the number of new jobs created.

Net FDI inflows account on average for around 5-8% of GDP in 2015-2019 (on average 6.3%), twice than 3.1% of GDP in 2012-2014, a ratio high by both regional and emerging markets standards, providing more than full coverage to the current account deficits. Finally, the NBS maintains adequate FX reserves despite its interventions in the past year. The FX reserves of the NBS stood at €13.5bn in December 2020, almost unchanged compared to a year ago, while at the same time the FX reserves of the banks had climbed by €500mn to €2bn. NBS FX reserves accounted for 28.8% of GDP, standing at the average level of the last five years and covered around 6 months of good & services imports (5.9 as of Q3-2020) and 200% of the short-term external debt (205.2% as of Q3-2020). The reserve capacity of the country is rein-forced by the €1bn precautionary repo line arrangement, which the ECB and the NBS have agreed to extend for nine months until March 2022, to provide euro liquidity to domestic financial institutions.

Macroeconomic imbalances shrunk in the past year as well. According to the latest NBS data, the current account deficit narrowed by 37.2% YoY down to €1,981.5mn in 2020, compared to a deficit of €3,160.9mn in 2019. As a percentage of GDP, the current account deficit reached 4.2% in 2020, lower than the latest NBS projection of 5.5%, compared to 6.9% in 2019 and 4.8% in 2018. The decline in the current account deficit was mainly driven by a lower primary income (-43.4% YoY) due to lower dividend pay-outs and lower repatriation of reinvested earnings, as well as a lower trade deficit (-7.1% YoY) reflecting reduced economic activity amid the Covid-19 pandemic. Finally, net FDI inflows declined by -18.3% YoY to €2.9bn down from a record high of €3.5bn recorded in 2019.

Figure 6: Net FDI inflows provided more than full coverage to CADs in 2015-2020



Sources: National Bank of Serbia, Eurobank Research

The acceleration of structural reforms in governance and competition issues could unlock the growth potential of the country in the medium-term.

An ambitious reform agenda is essential to remove competitiveness bottlenecks in order to unlock the growth potential of the country. Despite reintegration in the world economy, there is huge room for improvement in the overall level of competitiveness in Serbia, which despite the convergence towards the regional average, is still low by EU and international comparison. Despite significant progress in recent years, reforms in a number of areas still remain incomplete. Legacies of the delayed transition from central planning to a market based economy in late 2000 still weigh on the economy twenty years later. According to World Bank estimates, even after the recent consolidation, Serbia still spends 5–6% of its total budgetary resources on subsidies (2.2% of GDP), mostly to loss-making state-owned enterprises.

Over the past four years, the country has improved its scores and its rankings in the relevant World Bank (WB) and World Economic Forum (WEF) country rankings. In the latest World Bank Doing Business 2020 report, Serbia ranks in the 44th place among 190 countries, compared to 93th place among 189 countries in the relevant 2014 report. In the so-called Distance to Frontier (DTF), which captures the gap between the country's performance in every area and the best practice, Serbia's score has improved from 70.0 points in 2016 to 75.7 in 2020 catching up with other regional economies. Among the areas in which the country has made remarkable progress stand "Dealing with Construction Permits" (from 37.6 in 2015 to 85.3 in 2020, ranking 9th) and "Resolving Insolvencies" (from 57.9 in 2015 to 67.0 in 2020, ranking 41th). Yet there are areas in which no progress or even backtracking has been recorded thus preventing the country from realizing its full potential. Serbia's score has not improved in in the area of "enforcing contracts" (from 64.0 in 2016 to 63.1 in 2020-ranking 65th) and "getting electricity" remains problematic (from 75.9 in 2015 to 73.2 in 2020, ranking 94th). In the WEF Global Competitiveness Index (GCI) ranking, Serbia's relative position has improved from 101st (out of 144 countries) in 2013 to 72nd (out of 141 countries) in 2019.

Although the country has achieved to some extent to improve the business environment and streamline business conditions with its regional peers, a lot still needs to be done to catch up in governance, institutional and competition issues. In a manifestation of the above, the country's scores in the World Bank Governance Indicators, which reflect the views of a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, by comparison to regional standards and progress overtime still look poor. On a more alarming note, Serbia's scores on the dimensions of voice and accountability and control of corruption have deteriorated in 2010-2019. Scores on rule of law and political stability and absence of violence-terrorism have partially improved in the same period. Moreover, indicators on government effectiveness and regulatory quality appear stagnant. Finally, from a price competitiveness point of view, the Real Effective Exchange Rate (REER) has become less volatile in the past ten years. The REER in CPI terms appears to have appreciated modestly by 9.0% in 2010-2020 with the bulk of appreciation taking place in the last four years. At the same period, the Nominal Effective Exchange Rate (NEER) has depreciated by 15.2% with the NEER being relatively stable in the last three years.

The recently elected government should ensure policy continuity in the next one and a half years but may stay in office until only late April 2022. Access to foreign vaccines enables the country to speed up the process of reaching herd immunity.

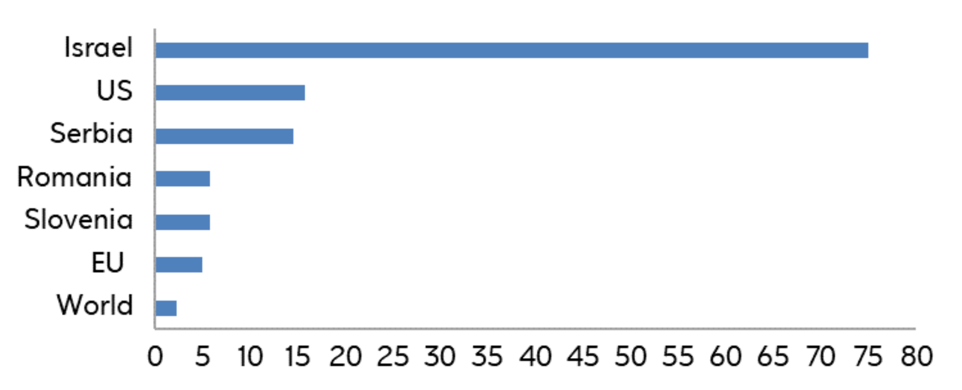
The domestic political landscape has remained largely unchanged in the past five years. It is marked by a standstill in the accession process towards the EU, broadly attributed to the status quo of Kosovo issue. The recognition issue and the territorial dispute appears to be constantly stalled due to election cycles in both regions. Additional factor for the standstill in the EU accession process is also the breeding and strengthening of strategic alliances with Russia, China and the US.

President Vucic and the Serbian Progressive Party (SNS) have been firmly in control for almost a decade now. After being postponed by two months due to the outbreak of Covid-19, elections were held on 21 June 2020, yielding an expected outcome with little change. The overwhelming majority of 61% of the people voted for the Progressives, while only two more parties apart from the minorities surpassed the recently reduced 3% threshold- the ruling Socialists, and the opposition SPAS. The newly formed coalition government includes SPAS and some of the minorities, leaving virtually no room for opposition in the Assembly and diminishing political pluralism. A number of opposition parties continued their boycott of the election process –resulting in a low voters' turnout of 49% -and thus putting in question the legitimacy of the administration. In the midst of the second wave of the Covid-19 cases, and while the President introduced a strict lockdown curfew, violent protests broke out in Belgrade and other cities. This led to the administration easing restrictions, which in turn led to the resurgence of Covid-19 cases. Aware of the disputed legitimacy of the government, President Vucic cut short the lifespan of the new administration at birth, to a year and a half at most, by stating that new parliamentary elections will be called for early 2022, at the latest. In order to appease the opposition, the Ministry of Dialogue and Human and Minority rights was resurrected and granted to Ms. Comic, a well-known ex Vice President of the Democratic Party, who was put in charge of coordinating the dialogue between the government and the boycott opposition on election conditions and attempting to dent the inflammatory rhetoric among the two sides.

On the international politics front, the process of accession to the EU is practically at a stand-still, as already inferred. No new chapters in the accession negotiations were open in 2020, for the first time since the beginning of the process in 2014. While both Serbian and EU officials continue to declare Serbia's EU accession as a strategic objective, neither seem too eager to push hard towards the goal. Out of 35 negotiating chapters over the European acquis communautaire, so far only 18 have opened and 2 are provisionally closed, which are considered among the soft ones. Solving the dispute over the Kosovo renegade province remains the stumbling block, and for the time being, no light in the tunnel is at sight. Nevertheless, Serbia is in a much better negotiating position than it was 5, 10, or 20 years ago, as about a dozen states derecognized Kosovo's independence in the last few years, suggesting that the current trend is shifting towards strict compliance with the rule of law. In this context, it looks as if Serbia is strengthening the already warm relations with Russia and China, the country's allies in the Kosovo diplomatic row. At the same time, president has signed an economic normalization agreement with Kosovo officials in October of 2020, under the auspices of US, stipulating a "suspension" of efforts in further derecognitions in exchange for Kosovo not applying for membership in any international institutions for a period of one year. What is more important, however, in our view, is the fact that it was also agreed that the US International Development Finance Corporation, the DFC (newly formed US federal institution created by the merger of OPIC and DCA), under the auspices of USAID, will open a representing office in Belgrade. The move is seen as a major step towards the improvement of the diplomatic relations with the US, and an important milestone in the endeavour to establish Serbia as the prime hub for US investments in the region.

The Covid-19 pandemic brought into surface the EU-scepticism, both within the ranks of state officials and the people. In the wake of the crisis, Serbia found itself confronting with a serious lack of resources at every level, i.e. in terms of hygiene equipment, medical devices, testing and data processing capacities, and above all medical staff. Timely, China and Russia stepped in by providing with significant medical equipment, at a time of extreme scarcity. Chinese teams of medical experts spent months in training Serbian colleagues and helping them organize the defensive strategy in the fight against Covid-19. Finally, Serbia decided early to be procured with Chinese and Russian vaccines when most prospective manufacturers were just in phase 2 of the clinical trials, insightfully not counting on the WHO and European Commission sponsored COVAX program. China and Russia both were happy to facilitate the request, aligning their strategic interests with proven long standing friendship with Serbia. By early February, Serbia, a country of 7m people has received more than 2m vaccine doses; 1.5m doses of Chinese Sinopharm, ca. 250ths doses of Sputnik, and around 150ths doses of Pfizer/Biotech and AstraZeneca each. As of February 24th, Serbia ranks second in Europe and stands behind the UK in terms of administered doses per capita. This practically is translated into 1.3m people have been vaccinated, 0.5m of whom have taken both doses.

Figure 7: Total vaccinations per 100 people as of February 20



Sources: Our world in data, Eurobank Research

So far, the COVAX program has not been activated, while at the same time, despite the flamboyant rhetoric, EU's assistance has been more than modest (EUR15m donations to Serbia for vaccine purchases). The political implications of the Covid-19 course of actions are deemed to strengthen the EU-sceptic parties and the pro-Eastern (Russia/China) oriented government members.

Eurobank

Eurobank Research

Research Team

Dr. Tasos Anastasatos | Group Chief Economist
tanastasatos@eurobank.gr | + 30 214 40 59 706

Anna Dimitriadou
Economic Analyst
andimitriadou@eurobank.gr
+ 30 210 37 18 793

Ioannis Gkionis
Senior Economist
igkionis@eurobank.gr
+ 30 214 40 59 707

Dr. Stylianos Gogos
Economic Analyst
sgogos@eurobank.gr
+ 30 210 37 18 733

Maria Kasola
Economic Analyst
mkasola@eurobank.gr
+ 30 210 33 18 708

Olga Kosma
Research Economist
okosma@eurobank.gr
+ 30 210 37 18 728

Paraskevi Petropoulou
Senior Economist
ppetropoulou@eurobank.gr
+ 30 210 37 18 991

Dr. Theodoros Rapanos
Economic Analyst
v-trapanos@eurobank.gr
+ 30 214 40 59 711

Dr. Theodoros Stamatiou
Senior Economist
tstamatiou@eurobank.gr
+ 30 214 40 59 708

Elia Tsiampaou
Economic Analyst
etsiampaou@eurobank.gr
+ 30 214 40 59 712

Περισσότερες εκδόσεις μας διαθέσιμες στην ηλεκτρονική διεύθυνση που ακολουθεί: https://www.eurobank.gr/en/group/economic-research
Εγγραφείτε ηλεκτρονικά, σε: https://www.eurobank.gr/el/omilos/oikonomikes-analuseis/forma-ekdilosis-endiaferontos
Ακολουθήστε μας στο twitter: https://twitter.com/Eurobank_Group
Ακολουθήστε μας στο LinkedIn: https://www.linkedin.com/company/eurobank