INVESTMENT FOR GROWTH

NEW GROWTH AGENDA

WORLD BANK GROUP

Acknowledgements

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Acronyms

BRA	Business Registry Agency
CAD	Current Account Deficit
CAGR	Compound Annual Growth Rate
CEE	Central and East European
ECA	Europe and Central Asia
EIB	European Investment Bank
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IFI	International Financial Institutions
IMF	International Monetary Fund
MSME	Micro, Small, and Medium Enterprises
NALED	National Alliance for Local Economic Development
PIM	Public Investment Management
PPP	Public-Private Partnership
SME	Small and Medium Enterprises
SOE	State-owned Enterprise
VAT	Value-Added Tax
WEO	World Economic Outlook

Executive Summary

Recognizing that the recent growth episode was disappointing, the question now is whether Serbia can shift to more pro-growth macroeconomic policies and structural reforms. This chapter looks at levels and structure of past investments—private vs. government, foreign vs. domestic—and how those were financed. The period covered is from the start of the transition to a market economy[1] in 2001 and compares developments in Serbia with those in other European transition economies. In addition, a special focus is put on savings, since that is important not only as a source of investment, but also as a determinant of external sustainability.

Serbia is a transition economy that has low investment and slow growth. Serbia earned the third lowest growth rate among 16 Central and East European (CEE) countries: real growth averaged 1.2 percent from 2009 to 2018. This is the result of low and declining investment over that period, among other things. Total investment slipped from a peak of 26.4 percent of GDP in 2008 to about 18–19 percent over the next 10 years. The Growth Commission[2] found that sustainable long-term growth requires investment levels of around 25 percent of GDP.

While foreign private investment performed well, domestic private investment was particularly low compared to other countries. Net foreign direct investment (FDI) averaged 5.6 percent of GDP annually since the start of the transition, which is about 0.7 percentage points higher than in other CEE countries. However, Serbian domestic businesses annually invested much less (3.3 percentage points less, on average) than their peers in other countries, with that gap widening recently.

In addition to low domestic private investment, government investments were low throughout this period, thus missing the opportunity to support the growth of the economy. In each year over the entire transition period (2001–2018), Serbian public investment was lower than in peer countries. On average, public investment was about 1.4 percentage points lower than rest of the CEE region. However, this gap has been closing over the past couple of years.

There are several reasons for low investment in Serbia. On a macro level, a particular feature of the Serbian economy is the low level of national savings. Among the transition economies, Serbia has the fourth lowest savings rate, although the situation has improved over the last couple of years: the level of national savings is now approaching those of neighboring countries. Domestic private investments are mainly constrained by the business environment and access to financing, while public sector investments are limited by the public investment management framework and delays in dealing with inefficiencies in the public sector.

Now Serbia must expand investment. Serbia's total investment rate is still below 20 percent of GDP,[3] one of the lowest among the transition economies. And within that, private sector investment is particularly low, at around 17 percent of GDP. Simulations for Serbia's long-term GDP growth to reach 7 percent annually suggest that total investment needs to be around 26 percent of GDP and to be sustained on that level for a long period of time.

1 While some market-oriented reforms started in early 1990s during the Socialist Federal Republic (SFR) Yugoslavia era, (for instance, liberalization of foreign trade, privatization, etc.) the real transition to a democratic society and a market-based economy started after the fall of Milosevic, in late 2000, and in particular with the appointment of the first democratic government in early 2001.
2 Growth Commission (2008). The Growth Report: Strategies for Sustained Growth and Inclusive Development. World Bank. Washington DC.
3 Average for 2015–18 was 19.4 percent of GDP.

The government has much to do to support a shift to higher investment that stimulates growth. To begin with, fiscal policy must be reoriented from high subsidies to higher spending on new infrastructure,[4] while keeping the fiscal deficit low. In addition, the government should restrain from crowding out private sector investment by borrowing extensively from the local banking sector to finance the deficit. In addition, the government needs to work on improving the business environment, such as by removing the remaining bottlenecks to private sector development and easing access to finance for private businesses.

4 In addition, not only the level of capital expenditure matters, but its structure is equally important. The focus of government capital expenditures should be on new infrastructure that helps the private sector to grow, such as in education, transport, energy, etc.

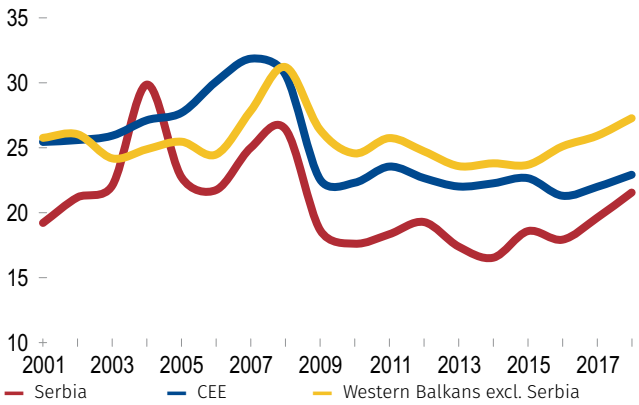
Introduction - Investment in Serbia

Because of its difficult starting position in transitioning to a market economy, so far macroeconomic policy in Serbia has mainly been concerned with achieving stability. At the start of its transition in 2001, Serbia was practically bankrupt, burdened with old overdue debt and huge arrears in budgetary payments, especially pensions. At the end of 2000, public debt was 175 percent of GDP and external debt was 128 percent. In both 2000 and 2001, inflation was over 80 percent. High inflation and external imbalances were the main concerns all the way through the global financial crisis (GFC). The GFC (as well as external shocks) brought multiple recessions between 2009 and 2014, and a major widening of the fiscal deficit. Since 2014, the focus has been on consolidating public finances, in addition to keeping inflation low.

While macroeconomic stability is a necessary precondition for growth, the question is whether Serbia can do more to create a pro-growth environment. Serbia has succeeded in keeping inflation low over recent years; the current account deficit (CAD) is now low enough to be manageable and is almost entirely financed by non-debt-creating flows; large fiscal deficits have been converted to a surplus; and public debt is heading downward. However, growth is still meager. To ensure that the Serbian economy grows more quickly,[5] the focus should be on increasing investment—both private and public.

Investments were low and generally declined throughout the transition period (2001–2018). Investment as a share of GDP declined from the peak of 26.4 percent of GDP in 2008 to about 18–19 percent over the next 10 years (Figure 1). In only one year (2004) did Serbia have a higher investment as a percent of GDP than other peer countries. And only in 2004 and 2008 was total investment above the previously mentioned threshold of 25 percent of GDP, which is set by the Growth Commission as a necessary level of investment to ensure a long-term sustainable growth. As a result of the post-GFC decline, the average annual contribution of total investment to GDP growth between 2009 and 2018 was negative 0.3 percentage points.

Figure 1. Total Investment as percent of GDP, 2001–18



Source: World Bank staff calculations based on Eurostat and data from national statistics offices.

To achieve the goal of 7 percent growth as set out in this document, Serbia's total investment would need to reach around 26 percent of GDP and remain on this higher level for a long period of time. Long-term simulations developed for this report[6] suggest that total investment should increase to around 25 percent of GDP over the next five years, and then remain between 25 and 26 percent of GDP over the following 15 years, in order to have a sustainable long-term growth of around 7 percent of GDP. It is also assumed that the government's investment would be around 5 percent of GDP annually—around the levels typical for other countries from the region—starting in 2020.

5 For instance, average real growth of GDP from 2009–2018 was 1.2 percent (CAGR). If the growth momentum is maintained, real GDP will at last exceed the 1990 level only this year.

6 These are projections covering a 20-year period starting in 2019. Projections are done using the expenditure side of GDP.

Private Sector Investment

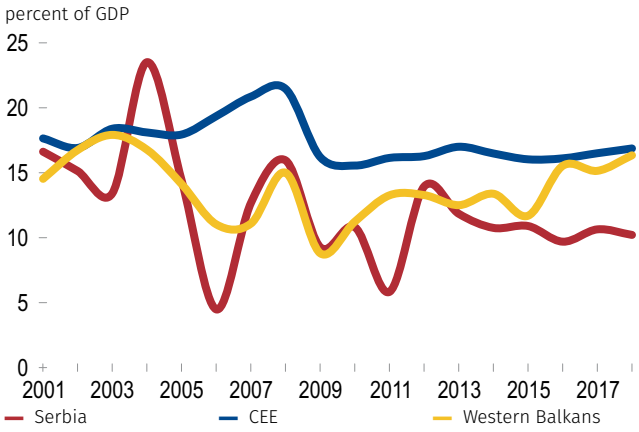
Level and Structure

Total investment in Serbia is low because both public and private investment are lower than in peer countries. Serbia's private sector investment averaged a mere 17.8 percent of GDP since the start of the transition in 2001, and the gap in total private investment between Serbia and peer transition countries averaged about 2.8 percent of GDP.

The gap with peer countries in private sector investment has widened since the GFC, as the drop in private investment in Serbia was more prominent. Total private investment (comprising both foreign and domestic investment) slipped by 7 percentage points in the early years of the GFC, from one of the peak levels of 22.9 percent in 2008 to 15.6 percent in 2009, a level which prevailed over the next ten years.

The Serbian private sector invests much less than the private sector in other transition economies. Since the transition started, private domestic investment[7] in Serbia has been significantly lower than in other Western Balkan countries, and strikingly lower than in the CEE countries (Figure 2). During the pre-GFC period, Serbia invested about 0.2 percent of GDP less than other Western Balkan countries, and 4.3 percent of GDP less than the CEE average (Table 1). After the GFC, when the growth of Serbia's economy plunged, the gaps widened even further, to 2.7 and 5.9 percent of GDP, respectively.

Figure 2. Domestic Private Investment



Source: World Bank staff calculations based on Eurostat and data from national statistics offices.

Table 1. Private Domestic Investment in Serbia Compared to the Western Balkans and the CEE, 2001–18

percent of GDP

Compared to:	*Average 2001–08*	*Average 2009–18*
Western Balkans	-0.2	-2.7
CEE	-4.3	-5.9

Source: Staff calculations based on the Eurostat and World Bank data.

The structure of private investment is also not favorable to growth. Overall, Serbian companies are increasingly investing in buildings and business premises, and less and less in equipment (Table 2). Considering the low level of competitiveness of Serbian businesses, in part because of underinvestment in the 1990s, one might expect that more of their investments would go to the purchase of new equipment and machinery,[8] which could help to increase productivity and competitiveness.

7 These calculations include change in inventories as part of domestic private investment.
8 Due to the revision of national accounts time series covers only this period (2013–18).

Table 2. Realized investment in fixed assets by technical structure

percent of total

	2013	2014	2015	2016	2017	2018
Total	100.0	100.0	100.0	100.0	100.0	100.0
Buildings and premises	38.8	38.2	38.2	39.5	43.3	42.7
Equipment	52.6	52.4	50.9	49.7	47.9	46.7
Other fixed assets	8.6	9.4	10.8	10.8	8.8	10.6

Source: Statistics Office.

Private investment has gone increasingly to non-tradeable sectors, and state-owned enterprises' (SOE) investments have increased as a share of the total. In recent years, private sector investment has increasingly gone to non-tradeable sectors (Table 3). This is mainly the result of a significant drop in private sector investment in manufacturing, which is the main tradeable sector (from 30.3 percent in 2013 to 23.2 percent in 2017). At the same time, there was a significant increase in SOE (including defense sector) investment as a share of total investment, (up from 6.2 to 15.3 percent, over the same period).

Table 3. Structure of Investment by sectors (tradeable vs. non-tradeable)

percent of total

	2013	2014	2015	2016	2017	2018
Tradeable	66.2	62.7	60.7	60.8	57.9	58.5
Non-tradeable	33.8	37.3	39.3	39.2	42.1	41.5

Source: Staff calculations based on the Statistics Office and the National Bank of Serbia data using the Amador and Soares (2012) methodology for the split into tradeable and non-tradeable sectors.[9]

How to Unleash Private Investment

To achieve the desired growth, which will ensure convergence with income in the EU, Serbia needs much higher private investment. The previously mentioned long-term growth simulations suggest that Serbia needs about 5-6 percent of GDP of additional private sector investment each year over the medium- to long-term. While a continued effort to attract foreign investment is needed, the focus of policy makers should be on a shift toward attracting FDI in high value-added sectors.[10] In the case of domestic private investment, the factors keeping domestic businesses from investing are much more diverse. A coordinated and decisive push by the government is needed to address them.

Multiple factors lead to low private sector investment in Serbia. Two broad groups of factors are the business environment, including the quality of governance, and access to finance. Both of these issues are discussed in greater detail in separate notes under this report. This section covers some of the main issues related to the business environment.

Despite recent improvements, important bottlenecks to private sector investment in Serbia remain. While Serbia improved its rating in the World Bank's Doing Business index, moving from 93rd position in 2013 to 44th in 2019, some important obstacles to private sector development remain. Several business associations[11] regularly publish findings from surveys of managers regarding the bottlenecks, which include issues like: property rights, paying and investing across the border, quality

9 As per https://www.gee.gov.pt/RePEc/WorkingPapers/GEE_PAPERS_60.pdf
10 See the more detailed discussion on this issue in two additional notes under this report, on productivity and FDI spillovers.
11 For instance: the Foreign Investors Council; NALED; AmCham; Chamber of Commerce; etc.

of infrastructure, access to finance,[12] paying taxes, uniformity of administrative procedures and requirements across municipalities, parafiscal charges and fees, and management of agriculture land.

The government has made some attempts to address the obstacles, but it has not always been successful. Reforms are often partial and not in sync with different initiatives across ministries. For instance, the effort to shift to digital services was not implemented equally across ministries and levels of government, which limited the benefits. Reforms sometimes take a long time to be formulated and implemented, as in the case of regulations dealing with foreign exchange operations.

In addition, there are some broader issues and concerns which point to deeper structural and institutional weaknesses. For example, World Governance Indicators, which look at a country's broader institutional and governance performance, point to weaknesses in Serbia's institutional framework. In particular, Serbia performs poorly on issues of voice and accountability, rule of law, and control of corruption.

12 This is discussed in greater detail in a separate note under this report.

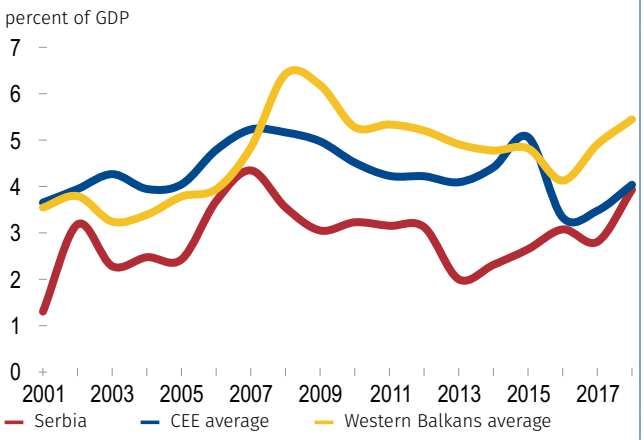
Public Investment

Evolution of Public Investment

Low public investment has long been a serious concern in Serbia, and only recently began to grow. As Figure 3 shows, each year between 2001 and 2018, the Serbian government invested about 2 percent of GDP less than other Western Balkan countries, and about 1.3 percent of GDP less than CEE governments. Only in two years (2006 and 2007) over the observed period did the Serbian government invest on par with neighboring countries.

If the Serbian government had invested as much as other transition economies, while taking into consideration debt sustainability concerns, the quality of the infrastructure and growth outcomes would be much better. The stock of capital today would be EUR 3.5–9.9 billion[13] higher, which is the equivalent of 700–2,000 kilometers of new highways or 1,100–3,300 new schools. Moreover, if the Serbian government had invested at the Western Balkan and CEE country levels, the economy would now be 16–29 percent larger (in euro terms)[14]. As Figure 4 shows, nominal GDP in 2018 could have been EUR 6.8–11.9 billion higher than it actually was.[15]

Figure 3. Share of Public Investment in GDP, 2001–18



Source: Staff calculations based on data from the Serbian Ministry of Finance; Eurostat and ministries of finance of the Western Balkan countries.

Evolution of public investment is to some extent a reflection of the fact that Serbian fiscal policy has gone through three major phases since 2001: expansionary (2001–08), fiscal crisis (2009–14), and consolidation (2015–18). Before the GFC,[16] total budgetary spending rose continuously, mainly because of high and increasing government consumption (the wage bill and spending on goods and services) and the expansion of spending on pensions. Between 2001 and 2008, the wage bill jumped from 8 to 11.8 percent of GDP, and spending on pensions rose from 9.7 to 11.4 percent. During that period, fiscal deficits averaged 1.7 percent of GDP (Table 4).

Table 4. Government Finances by Phase, 2001–18

percent of GDP

	2001–08	*2009–14*	*2015–18*
Total revenues	39.6	38.6	40.8
Total expenditures	41.3	43.8	41.5
Wage bill	10.1	11.3	9.3
Pensions	11.3	12.2	10.9
Capital expenditures	2.9	2.8	3.1
Deficit	-1.7	-5.2	-0.7

Source: Staff calculations based on data from the Ministry of Finance.

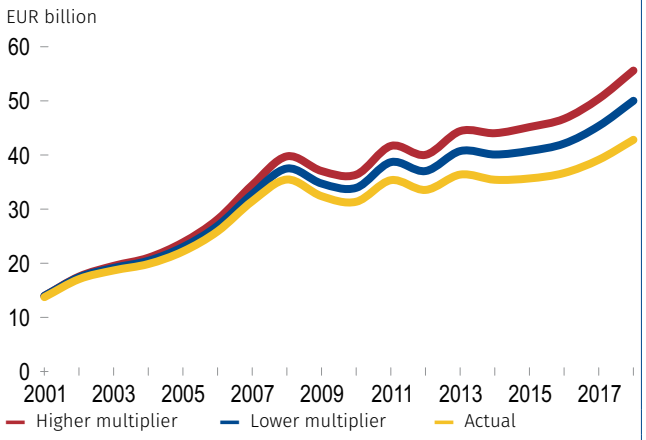
13 There are differences in estimations of fiscal multipliers for Serbia. For instance, the IMF Debt Sustainability Analysis (DSA) assumes a medium fiscal multiplier of 0.5 (public investment multiplier 1; tax multiplier −0.5 to −0.6). Škrbić and Šimović (2015) obtain a spending multiplier of 0.4 and a negative value of −1.5 for the tax multiplier. Nicolae-Bogdan Ianc and Camélia Turcu estimate the expenditure multiplier at 0.35 and a negative value of −0.92 for the tax multiplier. For these illustrative scenarios, the team used two alternative multipliers: 0.5 and 1.0.

14 To illustrate the loss in possible GDP, it is useful to create alternative scenarios showing the potential amount of nominal GDP if public investment were at the level of Western Balkan or CEE countries.

15 These calculations are for illustrative purposes only.

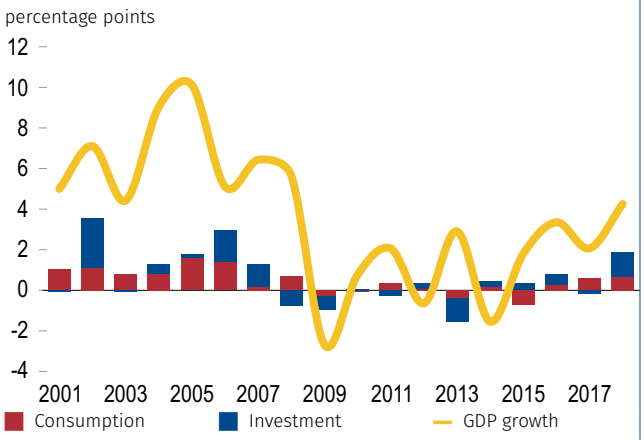
16 Data for 2001–04 are less reliable and not always comparable to those after 2005 because of the changes in the functioning of that time, such as the state union with Montenegro and financing of joint functions (primarily defense and foreign affairs).

Figure 4. Nominal GDP in Euro Terms, Actual and Possible Public Investment Scenarios, 2001–18



Source: Staff calculations based on data from the Serbian Ministry of Finance; Eurostat and the ministries of finance of the Western Balkan countries.

Figure 5. Contribution to Growth by the Government Sector, 2001–18



Source: Staff calculations based on data from the Statistics Office.

When the GFC started, revenues began to shrink rapidly, and controlling expenditures became even more difficult. Revenues dropped from about 41 percent of GDP to as low as 37.3 percent just before the austerity package was introduced. As consumption declined, so did revenues from the VAT, down by 1.2 percent of GDP, and customs, down by 1.4 percent. Moreover, as the incomes of individuals fell, personal income tax proceeds declined by another 0.9 percent. Meanwhile, spending on interest payments, pensions, and subsidies accelerated, and total public spending went up from 43 percent in 2008 to about 45 percent when fiscal consolidation began.

Since the start of the fiscal consolidation, revenues have revived significantly and spending has come under control. As Table 4 shows, over the four years of fiscal consolidation, the government managed to increase its revenues by 2.2 percentage points of GDP and spending was cut by 2.3 percentage points. Expenditures were reduced mainly by cuts in public wages and pensions, which together saved 3.3 percent of GDP. At the same time, the government managed to gradually increase spending on capital projects.

The volatility of fiscal policy had a profound effect on the growth of the economy. Growth accounting (Figure 5) shows that the government's expenditure policy was in most cases procyclical. Here it is important to emphasize that in the five years since the start of the transition in 2001, the government sector had a negative contribution to growth. Even more striking is the fact that public investment made a negative contribution to growth in seven years over the same period.

How to Sustain a High Level of Good Quality Public Investment?

Two main reform efforts are needed by the government in order to ensure a higher level and better quality of public investment. First, the government should continue improving the public investment management, legislative, and institutional framework. Second, Serbia needs a change in focus from inefficient spending (mainly related to subsidies) toward capital expenditures. Addressing public investment management challenges requires finding a solution for three fundamental and interrelated challenges: parallel systems; quality control, and information management.

Serbia's public investment management (PIM) suffers from parallel and uncoordinated sets of procedures. There are separate procedures depending on the source of project financing (EU, International Financial Institutions (a), or national budget), whether the investment is in construction

or non-construction, and at which level of government. These disagreements trap the government in institutional fragmentation, duplication, and lack of clarity on procedures and governing regulations.

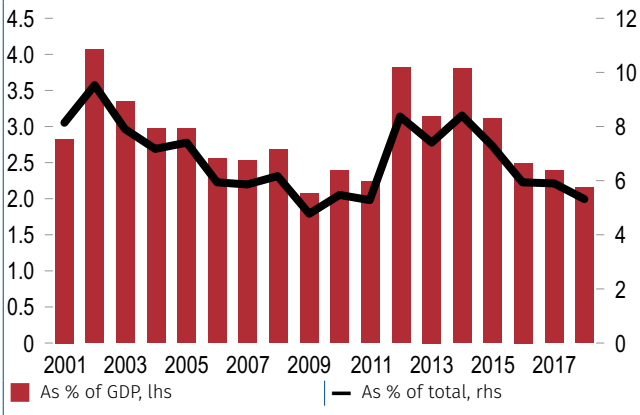
Several quality control points of a modern PIM system are not institutionalized and, as a result, clear responsibilities have not been allocated for proposing, reviewing, and deciding on project proposals at various stages. This prevents the Serbian PIM system from assuring the quality of all projects selected for financing based on their strategic relevance and potential for furthering social and economic development. As has often been seen in other countries, some external donors set their own rules and procedures for project preparation and implementation, which differ from, and often exceed, those applied to projects financed by domestic budget sources.

Serbia needs a consolidated overview of the public investment portfolio and an integrated information system to support various stakeholders in project- and portfolio-level management. Project information is scattered across a number of databases. The lion's share of investment projects for the government as a whole are financed by IFIs and bilateral donors and managed and monitored separately from budget-financed projects. In addition, a new channel of information is being formed for public-private partnerships (PPPs). Information support systems are weak and do not allow tracking projects across fiscal years and throughout the various stages of their life cycles.

Besides improved PIM, a change in the structure of public expenditures must be a priority. Low public investment over the previous period could be to some extent explained by the high share of subsidies in total public spending. From 2001 until the GFC, subsidies averaged 3 percent of GDP, and after the GFC this figure went down only slightly, to 2.8 percent (Figure 6). On average, Serbia spends close to seven percent of its total budgetary resources on subsidies. Most of the subsidies go to loss-making SOEs[17] and eventually spill over to consumption, since subsidies received are usually spent on the wages of SOE employees. Subsidy policies have to a large extent delayed the necessary restructuring of public expenditures, from high spending on subsidies to higher capital expenditures, which in many cases drags down economic growth[18].

Figure 6. Government Subsidies, 2001–18

percent of GDP and share in total spending



Source: World Bank staff calculations based on Ministry of Finance data.

17 The SOE sector constitutes a major loss-maker in Serbia. Based on the latest report by the Business Registry Agency (BRA), among the top five loss-makers in 2018, four are SOEs: the power generation company EPS; natural gas supplier Srbijagas; the railways company, and furniture maker Simpo.

18 See the chapters of this report on state aid and productivity which provides more details on performance of SOEs.

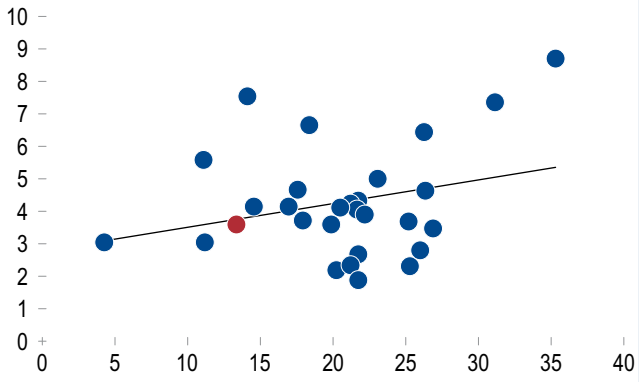
Financing Investment for Growth

Macroeconomic Challenges: Why Savings Matter

Savings are important for financing investment, which leads to growth, and for ensuring that the growth is sustainable.[19] First, national saving is a source of investment financing, and the higher the investment, the higher the growth of the economy. Data for Europe and Central Asia (ECA) countries confirm the positive relation between savings rates and growth (Figure 7). Second, low savings means that the savings-investment balance will deteriorate—that is, the CAD will expand—and the country will have to borrow more from abroad to finance the external deficit (and investment). An increase in external indebtedness can jeopardize the sustainability of growth.

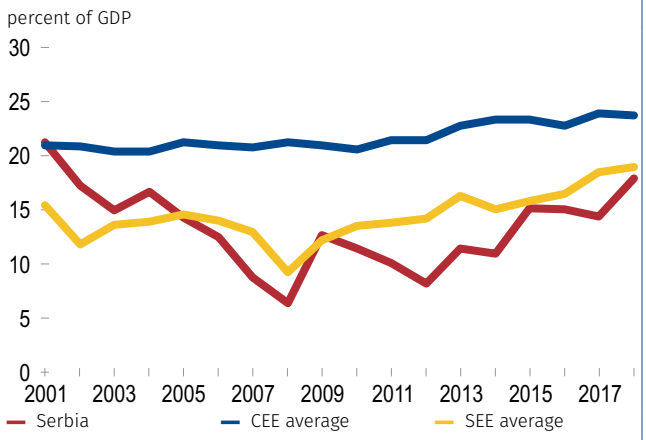
Serbia has low national savings and slow growth. Compared to countries with similar income levels and similar structural challenges (post-communist transition economies) Serbia has the fourth lowest savings rate,[20] at 12.7 percent of GDP (Figure 7), and the fourth lowest growth rate: real growth for 2010–18 averaged 1.7 percent. Going forward, the goal for Serbia should be to shift from the lower left corner of Figure 7to the upper right part, where countries with higher savings and higher growth belong.

Figure 7. Savings rates and average GDP Growth in ECA, 2001–18



Source: Staff Calculations based on IMF World Economic Outlook (WEO), April 2019.

Figure 8. National Savings by Country Groups and Serbia, 2001–18



Source: Staff calculations based on IMF WEO, April 2019.

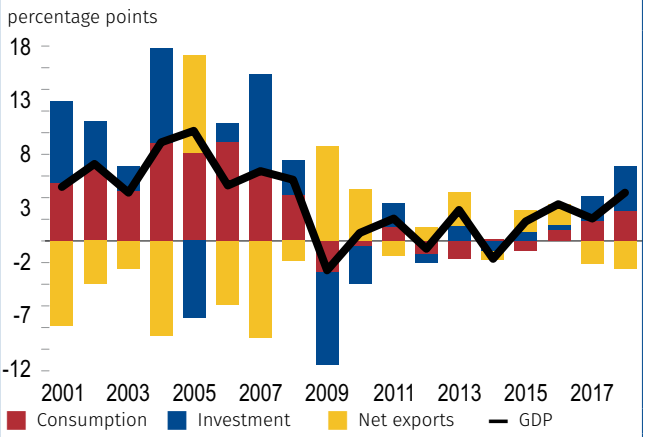
National savings have been low since Serbia's transition began. Ever since 2001, Serbia's national savings have been below those of other countries in the CEE and the Western Balkans (Figure 8). This gap with the CEE countries was widening even before the GFC, and in 2008 peaked at 14.5 percent of GDP. Between 2009 and 2018, Serbia's national savings were nearly 10 percentage points of GDP less than those in the CEE, on average, although in recent years the gap with other Western Balkan countries has practically closed.

Low savings in Serbia are primarily a result of the high consumption that was for some time the main driver of economic growth, especially before 2008. Serbia's growth was largely consumption-led over the pre-GFC period (2001–08). In the years immediately after the wars and after the international trade sanctions were lifted, households seized the opportunity to carry out

19 While there are academic disputes about the relationship between savings and investment leading to growth, extensive World Bank research on this issue is reported in other CEMs, such as "Turkey Country Economic Memorandum: Sustaining High Growth—The Role of Domestic Savings," 2011.
20 Average for 2010–18.

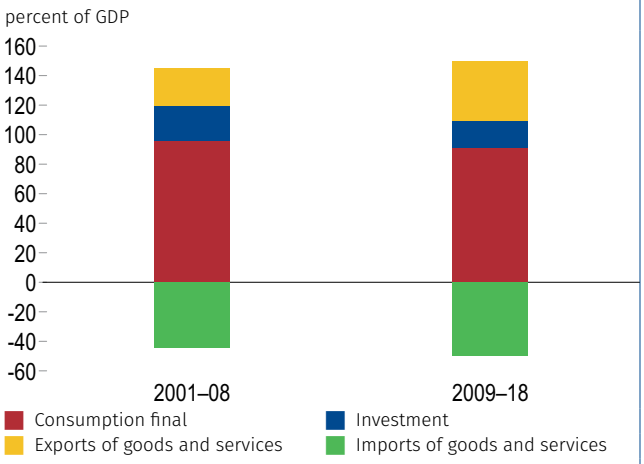
deferred consumption. Fiscal policy supported these developments as the government increased its consumption from 15 to 19 percent of GDP, while at the same time tax policy promoted household consumption. In that period, consumption on average contributed 6.6 percentage points to annual GDP growth and investment contributed 3.8 percentage points (Figure 9). During that time, the contribution of net exports to growth was negative, as soaring consumption (and investment) to a large extent spilled over to imports.

Figure 9. Contribution to GDP Growth, 2001–18



Source: World Bank staff calculations based on Serbian Statistics Office data.

Figure 10. Components of GDP, Expenditure Side, 2001–18



Source: World Bank staff calculations based on Serbian Statistics Office data.

Some rebalancing occurred after the GFC. Since 2009, consumption has been gradually declining as a share of GDP as wages (both in private and public sector) and employment have decreased, nominal pensions have been reduced, and financing options for consumption have become scarcer. Consumption fell from about 96 percent of GDP (the average for 2001–08) to a record low of 86.8 percent in 2018 (Figure 10). Households were responsible for two-thirds of the consumption drop: private consumption went down from 75.2 to 70.2 percent and government consumption from 19.5 to 16.7 percent in that time period. This decline in consumption led to an increase in savings over the last couple of years. Unfortunately, private and public investment decreased as well, but there was a significant increase in the share of exports in GDP, from about 25 percent before the GFC to over 50 percent in 2018. Figure 10 shows the structural changes in the Serbian economy before and after the GFC.

Box 1. Savings-Investment Balance, 2001–18

With national savings low, the CAD was high and Serbia had to rely on foreign savings to finance investment. The CAD shifted from a small surplus in 2001 to a deficit of over 20 percent of GDP in 2008 (Figure 11). High consumption, and to some extent investment, spilled over to imports; this led to a major increase in the deficit on trade in goods and services, which peaked at 25 percent of GDP. Before the GFC, financing the high deficits was relatively easy, but afterward, access to financing became more difficult as the growth of the economy slowed.

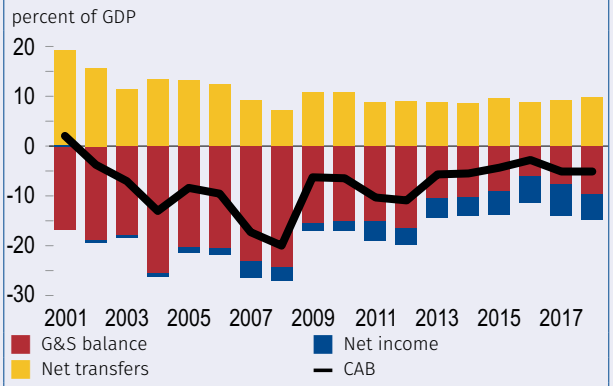
Serbia's private sector external debt mirrored the evolution of the CAD. Financing the high CAD meant heavier reliance on foreign savings, which pushed up external debt. During the period of high consumption and low savings that caused the high saving-investment deficit (the phase before the GFC), there was a rapid increase in external debt. During that period, private external

Box 1 continued

debt soared from 7 percent of GDP at the start of the transition to over 40 percent just before the GFC. After 2009, as national savings went up and the CAD went down, external debt began to decline.

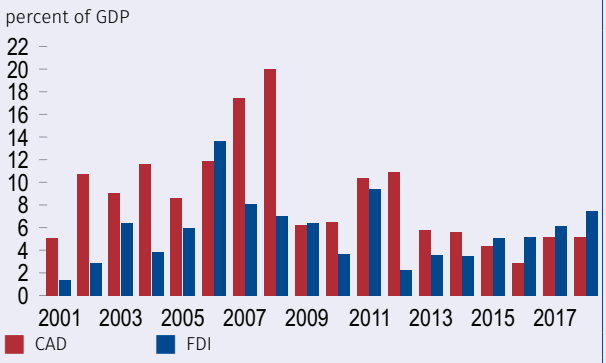
Fortunately for Serbia, it could rely on significant non-debt-creating inflows to finance the widening saving-investment deficit. Before the GFC, net FDI inflow, as a non-debt-creating source of financing the CAD, averaged a relatively high 6.1 percent of GDP (Figure 12). If it had been lower, external indebtedness would have been even higher. In recent years, with the CAD much lower than before the GFC, net FDI has continuously been higher than the CAD, although its share of GDP has been somewhat lower than it was before the GFC.

Figure 11. Components of the Current Account Balance, 2001–18



Source: World Bank staff calculations based on data from the national Bank of Serbia and Serbian Statistics Office.

Figure 12. Current Account Deficit and Net FDI, 2001–18



Source: World Bank staff calculations based on data from the National Bank of Serbia and Serbian Statistics Office.

Private Sector Financing

Access to finance remains an issue for the private sector.[21] The Serbian BRA provides detailed data from balance sheets of companies, and based on that data, only 13 percent of micro firms relied on debt financing in 2017 (compared to 58 percent of large firms). One quarter of SMEs finds access to finance as a limiting factor to their growth[22] in addition to 36 percent of micro firms. A recent study conducted by the European Investment Bank (EIB) confirmed that micro enterprises have the highest unmet demand for financing.[23] The study found that access to bank financing is limited for micro enterprises, as banks' lending standards are strict, requiring good credit history, sufficient collateral, and large turnovers.

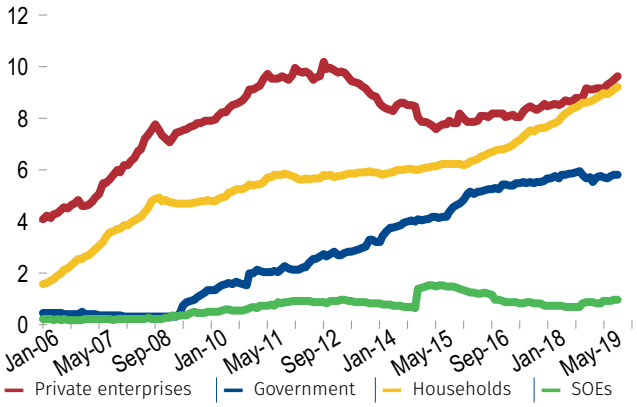
While total credit activity has expanded, it is mainly driven by increased lending to households and the government, rather than businesses. Loans to private sector businesses reached a peak in 2012 and have never returned to that level. Over the same period, loans to the government more than doubled (an increase in euro terms of 112 percent) and loans to households increased by 58 percent between 2012 and 2019.[24]

21 A more granular analysis is provided in the separate note under this report dealing with the financial sector performance, led by Gunhild Berg.
22 Based on Serbia 2013 Enterprise Surveys, www.enterprisesurveys.org, The World Bank.
23 EIB, 2017. *Ex-ante* study to assess the potential future use of Financial Instruments to deploy IPA resources in support of Small and Medium Sized Enterprises (SMEs) in Serbia - Final Report.
24 Based on September 2019 data.

One of the reasons why access to finance is a constraint to private businesses is low diversification of Serbia's financial sector. Serbia's financial sector continues to be bank-dominated, with limited alternatives to bank financing if firms want to grow and expand. Factoring and leasing are alternatives to bank financing, but are underutilized by micro, small, and medium enterprises (MSMEs) and have been stagnating over the last several years. The leasing sector could play a stronger role in financing MSMEs if the sector's regulations are changed to lower the costs of operations, better regulate leasing operations, and improve legal protections for leasing providers.

Figure 13. Stock of Loans by sector

in euro billion



Source: National Bank of Serbia.

Finally, Serbia needs better regulation of foreign exchange operations that currently not only limit foreign investment in Serbia, but prevent local Serbian companies from expanding abroad. The current Foreign Exchange Operations Law and its bylaws practically prevent various financing instruments and cause significant costs to the private sector. The restrictiveness of this law makes access to finance from abroad (including through intra-company loans) and obtaining guarantees complicated, uncertain, and expensive.

Government Financing

Between 2009 and 2014, the Serbian government's financing requirements increased dramatically. Until the GFC, the Serbian government had run small deficits or even surpluses and benefited from debt forgiveness or restructuring, which brought the public debt down from 97.7 percent of GDP in 2001 to 24.7 percent in 2008. Thereafter, the financing requirements of the general government remained low, at about 3–4 percent of GDP (see Table 5). When the GFC began, Serbia started running high deficits and was forced to borrow on unfavorable terms. As a consequence, within a period of only four years, its financing needs quadrupled.

Table 5. General Government Financing Operations, 2005–18

in EUR million

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Debt Service	604	1,045	701	691	2,005	2,786	3,384	3,394	4,507	4,287	5,227	5,259	5,362	4,858
as % of revenues	6.6	9.7	5.4	4.7	15.7	22.5	25.3	26.1	33.2	31.0	37.2	35.1	33.0	27.3
Financing Needs	141	1,053	1,040	1,443	3,120	3,833	4,597	5,115	5,548	5,622	5,531	4,644	3,940	3,753
as % GDP	0.7	4.3	3.5	4.3	10.2	12.9	13.8	16.1	16.2	15.9	15.5	12.6	10.1	8.7

Source: Staff calculations based on the Ministry of Finance data.

Thanks to a shift from high deficits to a surplus, government financing requirements are now much lower. After the fiscal consolidation package was adopted in late 2014 and the deficit brought under control, financing requirements started declining. By 2018, financing needs were down to 8.7 percent of GDP, about half what they had been in 2013, when they peaked at 16.2 percent (see Table 5).

Table 6. Change in stock of loans outstanding, by borrower and share in total stock of loans outstanding

in EUR million and percent

	Change in stock of loans, EUR million		*Share in total stock of loans*[25]	
	2001–2008	***2009–2018***	***average 2001–2008***	***average 2009–2018***
Private enterprises	3,690	1,938	66.8	48.0
Government	-138	3,485	6.6	13.0
Households	4,750	3,775	21.8	34.0
SOEs	-347	621	4.8	5.1
Total	**7,955**	**9,818**	**100.0**	**100.0**

Source: Staff calculations based on National Bank of Serbia data.

On average, three-quarters of the government's financing requirements (2005–18) have been covered by domestic borrowing, thus crowding out the private sector.[26] In addition, SOEs have mainly borrowed domestically. This means that private businesses have had to compete with the government for access to finance. Table 6 shows that before the GFC, the government sector, including SOEs, was deleveraging so that all the new loans by local banks went to private businesses and households. Rather abruptly, after 2009, the government and SOEs accounted for about 42 percent of all new loans from domestic banks, and the rise in the stock of loans to private businesses was only half what it was for 2001–08. As a result, private enterprises now account for as little as 40 percent of all loans provided by banks.

The government opted to borrow locally to lower the cost of financing deficits. The spillover of the GFC for Serbia was significant, so the cost of borrowing abroad was high. In addition, local banks were liquid and deposits were high, so they readily lent to the government, which led to a significant decline in interest rates charged to the government. Interest rates in 2018 were more than 500 basis points lower than at the peak. (Table 7 gives currency and maturity details for government debt instruments.)

Table 7. Weighted Average Interest Rates, Republic of Serbia Government Securities, 2009–18

percent

Bond Maturity	*Denominated in Dinars*									*Denominated in Euros*						
	3M	***6M***	***12M***	***18M***	***2Y***	***3Y***	***5Y***	***7Y***	***10Y***	***12M***	***18M***	***2Y***	***3Y***	***5Y***	***10Y***	***15Y***
2009	13.51	11.95	11.86													
2010	10.84	11.19	10.60	10.70	13.32											
2011	12.69	12.44	12.90	12.92	13.06	14.38				4.48	5.40		5.00			
2012	12.39	11.94	13.04	13.67	13.33	15.21	14.74			6.00	6.03	5.67	-			
2013	9.52	9.38	9.98	-	10.70	11.01	12.13	12.49		3.58	-	4.52	4.80	5.22		
2014	7.35	7.54	8.49	-	9.21	10.15	10.93	11.98	12.99	3.04	-	3.91	4.71	4.99		5.50
2015	4.95	4.41	5.92	-	7.04	8.56	6.50	11.97	-	1.83	-	2.67	4.00	4.49		4.48
2016	2.78	3.13	3.87	-	4.78	5.29	-	5.82	-	0.92	-	1.30	2.80	3.13		4.20
2017	-	2.64	3.48	-	4.56	4.83	-	5.40	-	0.63	-	1.04	1.80	2.62		4.00
2018	-	-	-	-	-	3.83	4.11	-	5.17	0.46	-	0.88	1.25	1.89	2.50	3.50

Source: National Bank of Serbia.

25 Average for the period.
26 Over the period 2005–2018.

However, financing of government investment in most cases was financed by borrowing from abroad. Successive Serbian governments decided to finance important infrastructure projects by borrowing from abroad (either from IFIs or from bilateral creditors). Therefore, the crowding out effect was smaller, if any, when it came to borrowing to finance government investment.

Going Forward

The question now becomes: How can Serbia reform macroeconomic policies and design structural reforms to be more effective in supporting growth? There are a number of options, starting from establishing the right macroeconomic policies; then implementing actions to support private sector investment, and finally, carrying out measures aimed at increasing public investment.

On a macroeconomic level, Serbia needs to increase savings. The trend of increasing savings that started in 2012 needs to be sustained in order to provide sources for increased investment. This is also important to prevent further widening of the CAD, and higher external debt thereafter. A priority is to limit reliance on consumption as a driver of growth through the right mix of fiscal policy (as in, budgetary spending on wages and goods and services) and taxation of income and consumption. Serbia is now close to the same level of savings as other Western Balkan countries, but the gap with CEE countries is still about 10 percent of GDP. This to large extent explains the fact that Serbia is one of the countries with the lowest investment rates among the European ECA countries,[27] at around 19 percent of GDP.

The private sector needs an improved business environment and easier access to finance in order to invest more. Various government measures and policies still limit private investment, a lot of them coming from the tax policies, which are often outdated[28] and expensive for those affected, requiring many interactions with the tax administration, and often complicated by the lack of uniform rules across the country. Another deterrent to private investment in the field of tax policy is the presumptive taxation system, which disproportionally burdens new businesses and entrepreneurs with lower income. Other reforms—in the field of land ownership and management; red tape; trade facilitation and other identified under different business surveys would help to improve the business environment.

Access to finance remains a major concern for private companies, especially the small ones. The financial sector is characterized by low diversification, and international transactions are restricted by the Law on Foreign Exchange Operations. The regulation covering foreign exchange operations limits both foreign investment in Serbia and the growth of domestic business abroad. Serbia is a clear example of how the private sector can be crowded out of the financial market: when the government became the main borrower from local banks, it left little room for the private sector to grow. Reforms aimed at increased diversification of the financial sector; better regulation of foreign exchange transactions and the work of leasing companies would help to provide more financing opportunities to the private sector.

The government can play a significant role in promoting growth through budgetary policy. The government needs to significantly increase capital expenditures and to sustain them on a high level for a long period of time. To succeed in this endeavor, the government needs to continue rebalancing away from consumption (that is, reduce the high wage bill and spending on goods and services) and direct resources toward higher and good quality capital spending.

The government also needs to resolve remaining PIM bottlenecks. The existing PIM system is characterized by fragmentation, a lack of strategic vision, and poor delineation of responsibilities between different institutions. Implementation of the new, improved PIM framework would not only

27 European ECA countries include Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czechia, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Serbia, Slovakia and Slovenia.

28 There were some changes in the tax legislation that are aimed at increasing investment by local businesses introduced in December 2018. Effects of these changes are too early to assess.

help to speed up the implementation of infrastructure projects, but would allow prioritization of projects of greater importance for growth and improved standards of living.

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This note is part of the Serbia Country Economic Memorandum (CEM) 2.0, "Serbia's New Growth Agenda."

The report and associated papers outline a strategy that could seize the opportunity provided by the country's successful macroeconomic stabilization to boost growth to 7 percent a year, nearly double its current rate of 3-4 percent. Serbia is well-positioned to turn itself into a fast-growing, sophisticated, modern economy, that, driven by its private sector, catches up rapidly with peers in Central and Eastern Europe and converges with the EU. With an ambitious new growth strategy, this vision of Serbia is entirely within reach.

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