

INVESTMENT AND BUSINESS CLIMATE

The overriding feature impacting the business during the past year is the financial and economic crisis that shook the whole world. The crisis also hit Serbia. It was unavoidable, particularly considering the fragility of the Serbian business environment which is still in the process of transition.

Like in most countries the GDP fell rather dramatically. From a growth of over 5%, the GDP index will end up with a 3 to 5 percent fall in the course of 2009. Industrial production in the first half of 2009 is 18% smaller than in the first half of 2008. The foreign trade sector also registers a dramatic fall in activity, 37% in the first half of the year. Both exports and imports are falling, thus reducing the absolute size of the trade deficit. Exports fell by 34% and imports fell by 39%, with the effect of a slight improvement of the balance of trade. Exports now cover just over 50% of imports while last year, in the same period, the ratio was 47%.

The recession contributed to the reduction of inflationary pressures in the first half of 2009. Still, Serbia has one of the highest inflation rates in Europe. The biggest contributor to the high inflation rate is the segment of prices which are under Government control. These prices grew by 50% more than the prices formed on the market.

Unemployment, which was high to begin with, is increasing and will probably continue to increase, at least until the end of 2009, and possibly in the first half of 2010 as well. Total employment fell by over 100,000 year-on-year thus bringing the unemployment rate up by two percentage points, from 14.4% to 16.4%. The interesting feature is that companies did not react automatically, by firing workers in accordance to the fall in the volume of their output. As a consequence the unit costs of labour increased, thus contributing to reducing the already poor competitiveness of Serbia in the global market.

The volume of foreign investment is also falling compared to previous years, both in terms of acquisition of firms through privatization, as well as direct foreign investment.

Relations with the European Union are at a stand still since the Stabilization and Association Agreement was signed and then its implementation immediately frozen. Political relations seem to be improving, but this so far did not translate into steps which would unblock Serbia's integration into the EU. The state

of affairs with EU integration has negative consequences on the flow of foreign investment as well as on the credit rating of Serbia, thus making credit more expensive.

Serbia decided to implement the SAA unilaterally since January 1st 2009. The effect of unilateral implementation is, first of all, in the abolition of tariffs for a number of goods and a phased reduction of tariffs for those goods that are still subject to custom duties. This makes imported goods cheaper on the domestic market which is good news for companies that depend on imported inputs. The other significant effect is that cheaper imports contribute to competition on the domestic market.

Other than the European Union, Serbia has mounted a "diplomatic offensive" on other key players in the world with a view of converting diplomatic success into business deals. China, Russia and, to a lesser extent, the Non-Aligned countries are the subjects of this "offensive". It is too early to assess the full benefits of this initiative but some results are visible already, such as China's involvement in building a bridge near Belgrade, Russia's involvement in the energy sector and financial support to Serbia (credit lines) by both countries.

The monetary and financial sector fared a little better than in those countries that captured the headlines on news in the banking crisis. The banking sector maintained adequate liquidity because of the previous restrictive policy of the National Bank on reserves. The withdrawal of close to a billion euros by deposit holders did not create a banking crisis. And with the Government's decision to increase the guarantee of deposits up to EUR 50,000 the banking sector regained the confidence of the population and savings started increasing once again.

However, the liquidity of the banks did not translate into liquidity of the economy. The number of illiquid companies increased by over 15% in a period of six months. So far, no formula has emerged which would increase the liquidity of companies. In fact, it could be said that the Government acted to decrease the liquidity by emitting short term bonds. These bonds were much more attractive and secure than credits to companies so the banking sector preferred to invest into Government bonds rather than the economy.

Starting in March of 2009 the Government attempted to boost credit activity of banks by subsidizing the interest rate. Banks

that were a part of the subsidization scheme received over a billion euros of requests and granted just over 600 million in credits. The bulk of the granted credits were for working capital, i.e. improving liquidity. Only three investment credits were granted, totaling only EUR 500,000.

The dinar exchange rate has remained reasonably stable, albeit at a somewhat higher level than last year. The agreement with the IMF, and the funds available from this institution, are an important factor in maintaining the exchange rate stability. Also, the sale of the national oil company Naftagas brought in around half a million euros which helped to offset the effect of lower inflow of remittances from workers abroad.

The government expenditure remains the biggest source of instability and inflationary pressures. The budget is not only showing a deficit but the deficit, until recently, had a tendency of increasing. Currently, the projection for the next year is a deficit of 4% which has also been accepted by the IMF. The collection of revenues is falling far behind the projected for two reasons. First, the fall in GDP brought about by the recession. Second, the shifting of companies from the legal to the gray market to evade taxes.

Business climate did not undergo major changes for the better. It could be argued that the business climate deteriorated. If we consider that there is a high correlation between

competitiveness and the business climate, than the competitiveness index of the World Economic Forum shows that things in Serbia have deteriorated. In last years Report Serbia was ranked 85th among 134 countries analyzed. In this years Report Serbia slipped to the 93rd position.

In some key aspects which form the complex competitiveness index Serbia is even below the composite ranking. For example, in intellectual property protection Serbia has the rank of 101, in burden of Government regulation the rank of 129, efficiency of corporate boards ranks 120th, effects of antimonopoly policy 131st, procedure to start a business 99th, business impact of rules on FDI 106th, financial market sophistication 111th, firm-level technology absorption 125th, production process sophistication 109th, company spending on R&D ranks Serbia 110th, extent of staff training 120th and so on.

Among the positive developments which contribute to the quality of the business environment are: the enactment of a Law on State Aid which will take effect on January 1st 2010, the simplification of customs procedures and the consolidation of services at border crossings, the new Law on Cadastre, the shortening of procedure for obtaining construction permits, amendments to the Law on Investment Funds, amendments to the Law on Corporate Income Tax, a new Law on Foreigners. All of these and other positive developments are elaborated in greater detail in the text that follows.

FIC RECOMMENDATIONS

We will repeat some of the key recommendations from last year due to the fact that little or no improvement has been registered in the past year:

- Accelerate the rate of transition reforms which will improve business conditions and also bring Serbia closer to the European Union;
- Creation of conditions for market competition in a regulated market, by providing equal rights for all competitors, and proper regulation of monopolies;
- Reform of education system in Serbia and its harmonization with requirements of the economy;
- Stimulation of applied science development through appropriate financial support and more intense relations with

R&D institutions, domestic and foreign.

To these we add new recommendations:

- To pass through the Parliament and implement the „Regulatory Guillotine“ as soon as possible;
- Improve the organization and increase the efficiency of all preparatory and administrative work connected to the withdrawal of approved credits from international financial institutions;
- All Government enterprises and other recipients of budgetary funds should pay for goods and services no later than 60 days after the purchase to prevent them from being the largest generator of illiquidity;
- Consider making an Action plan for increasing the credit rating of Serbia.