



## Serbia Country Economic Memorandum: Productivity and Exports

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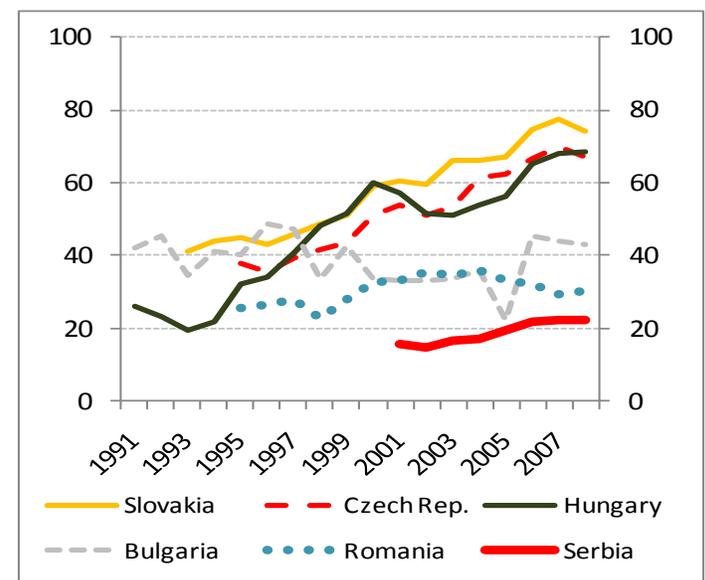
### Key Messages

- Serbia needs to redirect its growth strategy to a greater reliance on exports.
- There are many promising export products dispersed across different sectors, but numerous constraints to doing business in and exporting from Serbia remain.
- In addition to the weaknesses in the business environment, there are specific problems in the areas of labor skills, energy supply, land use, and trade facilitation.

### Introduction

In order to have both dynamic and better balanced growth, Serbia needs to rely more on exports. In the last decade, Serbia's growth has depended primarily on demand that was fueled by excessive debt finance. In the future, the Serbian economy would be better served by increasing its reliance on exports as a new, potentially powerful source of growth. Serbia's export share of GDP is currently 25 percent, but that figure should be closer to 50–75 percent, considering that all European Union (EU) comparator countries<sup>1</sup> have export shares of GDP of 60–80 percent (see Figure 1). A shift to a greater export orientation, which is necessary to propel economic growth to a much higher trajectory, requires major gains in productivity and improved competitiveness.

Figure 1: Export of Goods as Percent of GDP



Source: World Bank staff calculations.

Some sectors of the economy are already better positioned than others to export. For example, sectors in the traditional export base of Serbia, such as food and some chemical products, still have vast potential for growth. Others, such as the metals industry, emerged only more recently after a successful restructuring of the old socially owned enterprises. Still others, such as the automotive sector, are reemerging after decades of decline and already offer promise of the kind of export growth not seen in Serbia since the 1980s.

<sup>1</sup> For the purposes of this brief, the Czech Republic, Hungary, Slovakia, and Poland are used as comparator countries.

## Serbia's Potential Export Products

Relying on a Product Space analysis, done as part of the background work for this report, Serbia's promising product export clusters were identified.<sup>2</sup> All products that the country exported over the last 15 years were categorized as classics, emerging champions, marginals, and those disappearing, depending on whether these products had and/or maintained a comparative advantage. Products that had a comparative advantage in the past and have maintained that advantage today are "classics"; products that did not have a comparative advantage in the past but display one now are "emerging products"; products that are highly profitable even though there is no comparative advantage for the country are "marginals"; and finally, products that had a comparative advantage in the past but lost it over time are categorized as "disappearing."

Fully half of Serbia's exports fall into the "emerging champions" category. In addition, many Serbian products are close to the center of the product space, where the more sophisticated and profitable products can be found (Figure 2). The diagnostic suggests that there are many profitable opportunities to be seized, especially in food processing and metals manufactures. Serbia's current position in the automotive sector is considered weaker, but the recent investment in the country by Italian car manufacturer FIAT, along with a number of its suppliers, could significantly revitalize this industry.

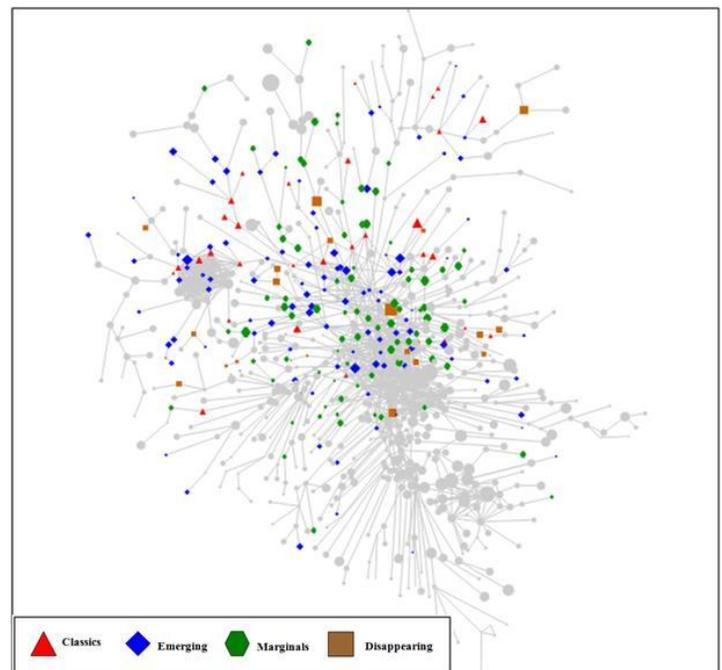
In a nutshell, an optimal export strategy for Serbia would give priority to scaling up the most profitable emerging champions (vegetables and fruits, meat, milk, and steel, iron, or aluminum manufactures), while exploring ways to build linkages for marginal products (i.e., promote a

shift toward products with higher value added) in order to expand their production as well.

## Manufacturing

Value-chain analysis of the metals and auto industries suggests that there continues to be a comparative productivity and competitiveness problem in the manufacturing sector in Serbia. Low productivity is a particular problem for medium-sized enterprises. Yet there is also considerable potential for synergies, not only to generate export growth but also to expand domestic value chains, which could boost the growth of small and medium-sized enterprises.

Figure 2: Product Space



Source: World Bank staff, based on Hidalgo et al. (2007).

The FIAT investment promises to be transformational for Serbia's auto industry. To take full advantage of it, the industry will have to work aggressively to boost productivity, cut and control costs, and overcome such constraints as slow customs and logistics and the inadequate pool of possible domestic suppliers.

Three policies are recommended to build the capacity of the auto and metals sectors for dynamic export and growth:

- Target high value-added foreign direct investment (FDI).
- Promote private sector partnerships and research and development (R&D) within academia.

<sup>2</sup> Product Space analysis offers a fact-based, data-driven evaluation of the feasibility and desirability of alternative sectoral and product-level transformation options. Product Space analysis uses a concept of revealed comparative advantage combined with new (metrics) measures that consider how different products may be interrelated (this is termed "density") and what incomes are associated with the export of particular products (PRODY). Combined, these metrics make it possible to estimate and compare across countries the sophistication of a country's exports by calculating the composite measure termed EXPY. See R. Hausmann, J. Hwang, and D. Rodrik, "What You Export Matters," *Journal of Economic Growth* 12 (2007): 1–25; R. Hausmann and B. Klinger, "South Africa's Export Predicament," *The Economics of Transition* 16, no. 4 (2006): 609–37; and C. A. Hidalgo et al., "The Product Space Conditions the Development of Nations," *Science* 317, no. 5837 (2007): 482–87.

- Ensure that the relevant institutions align quality standards with those of the EU.

### Agriculture

Agriculture is widely considered to have significant potential for improvement. Although Serbia has recently become a net food exporter, these exports could be substantially higher. There are various reasons for the suboptimal performance of this sector. Extension services, which are essentially a transfer of know-how to farmers, could be much more effective, for example, and some segments of the supply chains do not function well or are missing altogether. Moreover, trade liberalization is not fully completed, the costs of trade (customs, logistics) are still relatively high, and the budget's structure does not reflect the sector's priorities. Finally, unpredictable policies and a lack of attention to structural reforms are making it difficult for farmers, processors, and traders to plan ahead.

The key recommendations for the agriculture sector to:

- Establish a more predictable agriculture policy process.
- Build an effective extension service.
- Continue with and expand trade liberalization.
- Rethink the agricultural budget by reallocating resources away from ineffective support measures and gradually increasing the budget envelope.

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### Impediments to Export-Led Growth

The Serbian government's number one task is to accelerate reforms to create an environment that is highly conducive to export-led growth. The report identifies four main constraints to private sector growth, citing problems with available labor skills, the electric power supply, access to land and property rights, and trade facilitation. In all these areas, there are many remaining obstacles that hamper prospects for private businesses and discourage more significant inflows of FDI.

### Skills

In Serbia, the skills produced by the educational system are often not those most in demand by the economy. The mismatch results simultaneously in high unemployment and shortages of specific skills. Over the long run, solving the skills problem will take a set of comprehensive reforms across the board. In addition,

Serbia needs to rethink the scale and nature of its active labor market programs (ALMPs). At 0.1 percent of GDP, Serbia spends much less on ALMPs than most neighboring countries and EU member states. If the country were to reach the Organization for Economic Co-operation and Development (OECD) average of just 0.4 percent of GDP, it would allow 100,000–180,000 more people to receive training annually.

With regard to education policy, it is recommended that Serbia:

- Continue to implement a comprehensive reform of the education system, starting with the expansion of early childhood education all the way through to the introduction of an appropriate life-long learning system.
- Reduce dropout rates in secondary and tertiary education and equip students with more relevant labor market skills.
- Evaluate both current and planned activities of its ALMPs in order to improve their outcomes. Eventually, budgets for these programs could be scaled up.

### Energy

A power sector crisis looms in Serbia. Generating capacity already cannot meet the peak demand, and projections of consumption and new capacity show the problem worsening after 2015. Serbia consumes considerable amounts of energy, and the country's energy intensity is substantially higher than in other Balkan and EU countries. The high energy intensity reflects the consequences of policies over the last several decades that directly and indirectly promoted energy consumption by subsidizing prices and tolerating nonpayment. The energy sector also needs to reduce commercial losses, build new capacity, and rehabilitate the transmission and distribution network.

To implement the needed reforms in this sector, the following measures are recommended:

- Adjust tariffs, cut unjustifiable costs, and improve the poor payment discipline.
- Take measures to protect the poor from the adverse effects of price increases.
- Improve energy efficiency, particularly in exporting industries.
- Reinvigorate energy sector reform by implementing fully the new energy law.

## Land

Serbia has significant land policy issues that include insecure property rights, poor land management, and institutional inefficiencies. Specific hindrances to the efficient use of land and thus economic growth include bottlenecks in the issuance of permits, the complexity of the process of regularizing illegally built buildings, and land fragmentation. Institutional inefficiencies, such as the poor management of state assets and tax collection, also lower government revenue.

To address these issues, Serbia should consider the following measures:

- **Property Rights:** continue with the restitution process of properties that were nationalized after World War II and train local governments to deal with applications for the conversion of use rights to ownership rights over urban land.
- **Land Management:** streamline the process for the issuance of construction permits and assign a team to monitor the implementation of the new construction law. In addition, complete the cadastre in which every building is recorded and its status (legal or illegal) identified.
- **Institutions:** improve the management of state-owned property by creating an up-to-date inventory of state properties. In addition, train local tax administrations in the proper valuation of properties.

## Trade Facilitation: Customs and Logistics

Serbia is ranked 83rd out of 155 countries in the World Bank's Logistics Performance Index (LPI), and it ranks even worse on timeliness (137th). Thus, improvements in the targeted areas of transport and trade facilitation could yield substantial gains in terms of more efficient economic activity in Serbia. While the Customs Administration had at one point become significantly more productive, in recent years progress has slowed. International comparisons of the quality of Serbia's transport infrastructure also confirm significant shortcomings.

Recommendations to enhance trade facilitation include:

- Give the Customs Administration a greater role in customs policy design.
- Rethink Integrated Border Management that calls for close inter-agency integration and cooperation, compatible IT systems, and strong compliance.
- Consider juxtaposed border facilities with neighboring countries.
- Finish the development of an inland customs clearance process.
- Improve product quality standards and the tariff system so that they are consistent with those of the EU member states.

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## Conclusion

Serbia will need to fundamentally alter its growth model in order to compete effectively in world markets. The past model of relying on excessive inflows of capital and credit coupled with a consumption boom has run its course in all European countries, including Serbia. The country should now shift to a greater export orientation so that it can attain the significant gains in productivity and competitiveness necessary to advance economic growth to a much higher level. This cannot occur without an explicit export strategy that attracts commitment and coordination at the highest political level and promotes reforms to remove constraints and bottlenecks in a number of areas, including those outlined in this brief.

## About the Authors

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