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Challenges for Serbia's New Government in the Face of Floods in the Balkans

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The new government's plans for rapid improvement in Serbia's economic situation have been shaken by the devastating floods in mid-May. The authorities have announced that areas affected by the disaster will be rebuilt, but the time and resources this will consume could result in less dynamic reforms elsewhere, and a deterioration of macroeconomic indicators. The EU should invest in the economic transformation of Serbia to ensure that this country maintains the pace of its progress towards European integration.

The Scale of the Natural Disaster. The biggest, yet unexpected challenge for Serbia's new government, occurring just two weeks after it was sworn in, has become the struggle with the effects of flooding. In western and central parts of the country, many towns were evacuated, some completely, including Obrenovac (population of 25,000). Much infrastructure has been damaged, with more than 3,500 kilometres of national and local roads being destroyed, as well as parts of the only railway connecting Serbia with Montenegro. About 300,000 households were left without electricity, agriculture (which provides employment for around 20% of Serbia's population) suffered heavy losses, and public facilities such as hospitals and schools were damaged.

A state of emergency was introduced throughout the country on 15 May, reduced a week later to an area covering 16 municipalities and two cities. These areas are also particularly vulnerable to epidemics as a result, among other things, of contamination of drinking water sources. Although it is difficult to assess the final balance of financial losses caused by the disaster, the Serbian authorities estimate it at more than €1 billion (total budget expenditure for 2014 is assumed at a little under €10 billion).

Counteracting the Effects of Flooding. The government will cover part of the losses from external sources, including EU support via the relocation of unused funds from the Instrument for Pre-Accession Assistance (a total of €65 million for Serbia and Bosnia). Further help is expected from the current budget planned for this purpose. Other funds will come from the EU Solidarity Mechanism, support from which will be available because the losses exceeded 0.6% of Serbian GDP. An additional €1.5 million of aid has been announced by the European Investment Bank. The governments of some countries have made voluntary donations (for example, the Netherlands, Norway and Algeria each gave hundreds of thousands of euros, and the authorities of the United Arab Emirates announced aid of $10 million). Some of the costs have been met by broad emergency technical assistance, particularly from the former Yugoslav republics.

Despite this, the Serbian government assumes that the state will have to cover about 80% of the losses. Some of the funds will come from World Bank and European Bank for Reconstruction and Development loans, but money will also be required from the national budget. In the first round of spending, the government plans to rebuild critical infrastructure, including a comprehensive renewal of energy infrastructure. The authorities have also implied support for farmers (such as provision of seeds, fertilisers and fuel). The government plans to complete housing reconstruction before winter.

The challenge for the authorities will be to refine the shortcomings that emerged during the anti-crisis measures. It was revealed that only 17 municipalities in Serbia were able to use the civil system for the coordination of activities during emergency situations effectively. The Ombudsman drew attention to cases of differences in the treatment of the Roma community during and after the evacuation. Moreover, the OSCE representative on freedom of the media drew attention to the government's attempts to influence the content of media reports in relation to the authorities' actions during and after the flood.

The Natural Disaster and Economic Reforms. The floods coincided with the government's intense efforts to remedy the economic situation in Serbia. In mid-May (just before the floods), after extensive consultation with banks, entrepreneurs and foreign investors, the authorities announced that a comprehensive package of reforms would be prepared in the coming weeks. A recent amendment to the law on privatisation aims to facilitate the privatisation of more than 150 companies, including Telekom Srbija, Belgrade Airport, and the largest insurance company, Dunav Osiguranje. Other reforms, such as changing the law on taxes, aim to reduce the "grey economy" (the government proposed that as of June 2014, for a period of two years, those entrepreneurs who employ new workers will be exempt from some taxes), and thus at reducing unemployment (currently 22%).

Moreover, the authorities have decided to introduce government guarantees for bank loans (up to a total of €1.2 billion) to small and medium-sized local enterprises and foreign investors, and for infrastructure projects. An important part of improving the investment climate is to be the continuation of the fight against corruption, as a result of which the former minister of telecommunications and a number of people managing the agency for foreign investment and export promotion were recently detained on charges of misappropriation of around €1 million. The government has plans to further reform the anti-corruption agency.

The authorities support the development of the investments already made, including one of the most evident, Air Serbia, which was established in October 2013, through the transformation of JAT airlines after an agreement was signed with Etihad airlines from the United Arab Emirates. Due to increased initial capital, the fleet was modernised and the network of connections expanded (a total of about 40 operated independently, and about 120 with partner airlines). With the opening of new routes in the spring of 2014, the government has confirmed its ambition to make Air Serbia the major airline in the region. Moreover, the authorities will continue supporting flagship foreign investment, such as the Fiat factory in Kragujevac (33% of shares belong to the Serbian government), which holds the largest share in Serbian export; in the first three months of 2014, it recorded sales of $375 million. Additionally, based on an agreement signed on 30 May with the Finnish company Sisu Auto, the car factory in Proboju will start production of new trucks in September.

The EC recommendations for the Serbian economy, published just before the floods, confirm that fiscal consolidation is the main challenge for the coming year, and that lack of reform may lead to a further increase in unemployment, and a rising budget deficit (currently 6%) and public debt (about 70%). The government has already announced a plan to correct the budget, which envisages wage cuts in public administration sector and the implementation of a loan agreement from the United Arab Emirates. These changes do not take into account the consequences of flooding.

Conclusions and Recommendations. Although most municipalities provided preliminary estimates of losses after the floods, some of them (including Obrenovac, the worst hit) are still calculating these costs. Thus, the final sum may be higher than that assumed by the government. Renewal of the country after a disaster on this scale will require long-term, prioritised work. So far, the authorities have not experienced visible criticism in relation to their handling of the effects of the floods, but the test of credibility will be whether they fulfil their promises to restore the situation to a pre-disaster state. Any insufficient or delayed cover for residents' losses, which happens in such situations, especially in developing countries, will certainly be criticised by the opposition, and may translate into weakening public support for the government.

Encouraged by the success of starting accession negotiations with the EU, and by a clear win in the election, the Serbian government has the ambition to place the country on a path of rapid reform. It is, however, difficult to analyse these plans in isolation from the losses caused by the floods. The state budget will require further changes, assuming that it is supplemented by funds from foreign aid, and that this assistance is deployed according to the requirements of the affected areas. The need for change in budgetary allocations and the time that it will take to deal with the effects of the floods could lead to the postponement of part of the government's plans (some parliamentary and committee debates related to the reform package have been already shifted). It may cause deterioration of macroeconomic indicators, including an increase in the budget deficit and a slowdown in Serbia's economic growth, projected at 1.1% for 2014.

The economic problems facing Serbia are typical for societies in transition and in negotiations with the EU. In this case, however, they were compounded due to the costly effects of a natural disaster. This makes it even more important that EU and Member States should invest in the economic development of Serbia, pointing out at the same time that, regardless of the circumstances, only solid reforms guarantee stabilisation of the economic situation. Those EU countries that invest less in development assistance in the region should consider increasing their contribution to projects related to the reconstruction of areas that suffered the greatest damage.

An expansion in privatisation is an opportunity for foreign investors, including Polish companies, to make acquisitions, for example in the telecommunication and insurance sectors. It is also worth making Serbian market more accessible to Polish entrepreneurs, through closer contacts at the political level, combined with economic missions. This is supported by the fact that in 2013 export to Serbia grew the fastest of all Polish exports, increasing by 77% compared to the previous year (up to about €640 million), but still constituting less than half a percent of total Polish exports.