

KOPAONIK CONSENSUS: ELEVEN POLICY RECOMMENDATIONS FOR 2011
Conclusions of Kopaonik business forum
„Sustainable reforms for sustainable development“ held March 1-3, 2011

Over the last decade Serbia followed a transition strategy and economic policy largely based on neoliberal policies and broadly defined *Washington consensus*. As it turned out, this did not guarantee macroeconomic stability or sustainable development. Low and stable consumer price inflation (CPI) is necessary but not sufficient condition for growth. In the current growth model key drivers for economic growth came from strong consumer demand (for imported goods) financed through large capital inflows based on FDIs and privatization proceeds.

The current growth model started to show signs of increasing fatigue in the aftermath of the global economic crisis. In 2010 in Serbia the price stability gave in and CPI reached double digits. At the same time the real sector suffers from low competitiveness and falling asset prices despite the persistent output gap and record high unemployment rates. In the presence of high twin deficits (fiscal and current account) and reversals of large number of privatizations, there is clearly a need to revisit the status of economic reforms and the validity of the past growth and the economic policy model.

The initial discussion of the new growth model indicates that savings/investment, export orientation and improved competitiveness are essential ingredients of future long-run growth along with appropriate adjustments in the monetary and fiscal policy, public sector reform, as well as the adoption of a re-born general industrial policy. Clearly, sustainable development requires sustainable reforms and a combination of short-term policies (to address the immediate crisis concerns) and longer term policies aligned with the vision Serbia 2020 which seeks to make Serbia an attractive investment destination, good place to work in, and a pleasant place to live in.

To achieve this in only ten years Serbia must accelerate economic reforms and align economic policy with the long term development priorities (3-5) stated in Serbia 2020, based on a full political, economic and social consensus. Obviously, reaching wide “consensus” is opposite in meaning to the term “balkanize” which denotes divisions and the ultimate lack of agreement or consensus. Unfortunately, historically and again in recent decades tendencies to “balkanize” were an important albeit unsustainable part of our mentality. Serbia must seek a change in mindset which would enable synergies between its intellectual potential, political energy, technical and administrative capacity, entrepreneurial drive and management skills to reach consensus and advance its economic and social development. The 2011 Kopaonik forum generated a significant convergence of policy views presented in eleven papers published in the proceedings, four plenary sessions, and ten thematic panels. In the aftermath of the forum we could safely assume that a tangible *Kopaonik consensus* has emerged on the following eleven policy and reform issues:

First, this crisis brought an end to „great moderation,“ and neoliberal approach to economic policy based on free trade and unrestricted capital flows. The days of Washington consensus dominance in policy and reform design are over. A new legitimate role of the state is resurfacing in fiscal policy, regulatory area, and in public expenditures. The „visible hand“ of the state is needed to correct the failures of the market’s „invisible hand.“ As one of the forum distinguished participants remarked, „the invisible hand is invisible because it doesn’t really exist.“ However, the new enhanced role of the state should be exercised with restraint. Smart state should limit its interventions to few carefully selected areas. First and foremost, the state should allow the operation of automatic stabilizers whenever possible. This is particularly important in enabling the stabilizing role of public expenditures on aggregate demand. Second, the state should provide the necessary regulatory framework for the conduct of monetary, fiscal and social policy. The regulatory perimeter should be expanded to include the entire financial sector and the relevant segments of the real economy and, thus, limit the impact of destabilizing shocks, prevent systemic risks, and curb private sector greed based on moral hazard. The new institutional and policy framework calls for reformed and expanded regulatory setting, including effective micro and macro prudential regulation, and more effective risk management in the financial and real sector of the economy. Finally, the state must be able to effectively respond to important global (public good) initiatives related environment, gas emissions, biodiversification etc.

Second, to achieve sustainable development Serbia needs a new economic growth model based on vibrant investments financed increasingly through domestic private and public savings mobilized through more efficient financial sector intermediation. An increasing share of new investments will go to real sectors engaged in the production of competitive tradeable goods aimed both for exports and domestic market. The drivers of growth

in the new model will shift from strong consumer demand with import content and heavy reliance on foreign savings, to exports enabled by dynamic investment based on increased domestic savings, steady capital in-flows and productivity increases. Strong exports are the main source of sound external and exchange rate stability. The role of the public sector in the new development model evolves from passive provision of fiscal buffers to cushion social pressures towards a more active role in providing efficient regulation, promoting competition in the operation of domestic markets, and supporting improved micro and macro competitiveness vis-a-vis comparator countries. In its new role, the public sector should leverage its resources to crowd in private financing for infrastructure and attract new sources of financing from the emerging surplus economies at the global level. These new sources of financing capital investment in developing and transition economies have long surpassed the severely constrained lending potential of multilateral international financial institutions (IMF/WB/EBRD) traditionally focused on financing a narrow segment of domestic (fiscal) and external deficits.

Third, the central bank should be independent in the design and conduct of monetary policy, but it must coordinate policies with the government (ministry of finance primarily) to ensure that broader macroeconomic policy objectives are met. The fast emerging best practice in the post-crisis world, calls for an expanded set of monetary policy objectives which now include not only the stability of CPI measured consumer prices, but also the stability of asset prices and the exchange rate, as well as the level of GDP dynamics (output structure) and the level of unemployment. Therefore, the central bank must expand its policy instruments and closely coordinate its policies with the government to achieve multiple macroeconomic, structural and growth objectives. A typical case that requires policy coordination involves fiscal deficit financing through government bonds and its impact on private sector credit. With limited external credit rating, government sovereign debt instruments (denominated in dinars and euros alike) usually end up in the balance sheet of domestic commercial banks with an expected upward pressure on the interest rates and a strong crowding out effect on available private sector credit. On the positive side, this creates a short term stabilizing impact on prices and exchange rates, and contributes to financial deepening and helps develop a full yield curve for corporate bonds essential for financial sector growth. Unfortunately, in weak and shallow financial markets, this often creates strong contractionary effect channeled through reduced credit availability and increased cost of borrowing, which undermines investment and longer term growth prospects.

Fourth, fiscal policy should aim to be counter-cyclical within given fiscal capacity. In Serbia, the scope for fiscal stimulus during the recent crisis was very limited. Hence, the Government planned to at least maintain fiscal neutrality. In reality, however, we observed increased delays in government payments to suppliers. This exacerbated the liquidity crisis and the contractionary effects of a serious credit crunch. In addition, to compensate the shortfall in revenues, there was a widespread increase in local taxes which gave rise to increased tax evasion and provided incentives for a move to shadow economy, with negligible impact on revenues. Clearly, local governments should have been advised to act counter-cyclically and borrow short, rather than attempt to increase taxes in the midst of crisis. In that sense, the new legislation on municipality ownership is a prerequisite for municipality bond issue. In addition, structural deficits related to pensions and social expenditures should be financed from international financial institutions (IFIs) loans and other longer term sources until reformed funded systems are in fully place.

Fifth, new intelligent public and private sector investment are expected to pull the economy out of crisis. At this level of development, the investment is likely to be in resource intensive sectors and position rent based economic activities. Luckily, Serbia has significant comparative advantages in these sectors (i.e. energy, food, logistics, tourism) which presently enjoy strong demand and favorable price developments. Public sector investment in energy, agriculture, infrastructure and tourism would act as a trigger to kick-start the engines of economic growth and crowd in private investment. The sectors expected to attract future private investment would include logistics, food processing, construction as well as other processing industries (such as transport equipment, metal processing, pharmaceuticals, etc.) with already competitive companies that can form the core of industrial clusters and/or provide a viable technological platform for future competitive industries. Private sector growth requires investment and business environment similar to the EU or neighboring countries in terms of basic infrastructure services, tax burden, cost of financing, and provision of export guarantees.

Sixth, to trigger the reindustrialization process in Serbia, public sector investment must be well designed and efficient both in terms of economic and financial rates of return. Most likely, investment in energy and agriculture would take the form of recapitalization of existing companies by attracting global strategic partners. Investment in food industry, logistics and tourism could exploit the benefits of public-private partnerships. Investment in basic infrastructure would likely take the form of concessions, while secondary infrastructure could best be financed from loans provided by IFIs.

Seventh, public sector reform is critical in this process. It includes both the large state owned enterprise sector (SOES) and the public administration. SOES has enormous growth potential, especially in energy, which can be unleashed only through large scale investments. Although these investments would trigger demand in connected sectors and have large positive multiplier effects on employment, GDP growth and exports, they could only be undertaken after the initial restructuring of SOES and a change of the management model. New management of the SOES must exert technical and management competence equivalent to the private corporate sector and be free from the undue influence of political parties which presently act as quasi owners of the SOES and interfere in the management process. Gradual removal of price controls is an important dimension of efficient SOES operation and reform. In the first step prices should be aligned with the neighboring countries and in the medium run approach world market prices to secure efficient allocation of resources. Public administration reform can best be restarted by simplifying the maze of administrative rules and procedures that presently inhibit efficiency and stall economic growth. Legal, administrative and regulatory simplification proposed under the “legal guillotine” years ago should be completed as soon as possible. In addition, zero tolerance vis-a-vis relevant EU legislation and regulatory norms should be strictly adhered to in the future. Next steps would include civil service reform and a range of budget system reforms including the introduction of performance budgeting in the context medium term expenditure framework, and improved public financial and resource management.

Eight, regulatory risks must be kept to a minimum. A new regulatory framework should strive to improve the investment and business climate, eliminate sources of risks and uncertainty, and expand rather than constrain the operating space for present and future investors. Restrictions should be kept to a minimum, announced well ahead of effectiveness, and introduced gradually over a number of years. Regulatory discretion and arbitrage should be scrupulously avoided, as well as abrupt changes in the business environment, including the introduction of draconian penalties. Transparent methods based on accepted world data and analytical standards should be followed in all regulatory deliberations. This particularly applies to activities related to the protection of competition. The construction industry and the quality of the business environment in general have been adversely affected by the complicated and lengthy procedures for obtaining construction permits under the new legislation introduced few years ago. Much simpler procedures and one-stop-shop application process must be introduced soonest to avoid lasting negative impact on new investment, job creation and future economic growth.

Ninth, the public perception of private entrepreneurship and private sector should be re-affirmed, thus sending clear message considering biases from the past. Society needs entrepreneurs more than they need society. Small and medium enterprises in Serbia will slowly disappear unless media and politicians stop referring to leaders from a big business with bad intentions and prejudices. Proper understanding of the role of private entrepreneurship as a fundamental value of capitalism requires not only education, but also a new mindset of constructive criticism and respect undoubtedly prominent in public life.

Tenth, the above proposals should be supplemented by a swift implementation of short-term initiatives aimed at specific dimensions of the anti-crisis program. The initiatives include a proposal to boost the budget support to agriculture (including specific subsidies), faster utilization (disbursement) of financial resources made available through loans (credits) from IFIs and other sources, the introduction of mandatory insurance from natural disasters, the introduction of social protection programs (“social cards”) for most vulnerable social groups etc. Another short term priority is the finalization of the regulatory framework needed to effectively utilize alternative energy sources (with „green component“) including the gradual adjustment in the price of electricity necessary to justify energy efficiency improvements.

Eleventh, it is worth emphasizing that the forum reached a full consensus regarding the need to draw lessons from the last global crisis, particularly regarding the change in the conduct of fiscal and monetary policy, and the enhanced role of regulation and prudential control. These lessons would be essential for the design of short term policies and longer term reforms that would enable the implementation of the development vision contained in Serbia 2020 document. A change in policies and attitudes is needed to embark on a sustainable growth path and narrow the performance gap with the EU. When the catch up to advanced economies starts, integration with the EU will be feasible.

Signed (in alphabetical order):

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