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REINDUSTRIALIZATION STRATEGY OF SERBIA: HOW TO GET IT AND HOW TO USE IT

Strategija reindustrijalizacije u Srbiji:
kako je postići i kako je upotrebiti

Abstract

Serbia's economic crisis is not cyclical, but structural. Our starting point is that reindustrialization is the cornerstone of the anti-crisis program and the road map for coordinated response to the crisis. The article incorporates four sections, along with Introduction and Conclusion. The first part reviews the macroeconomic situation in the mid-2013. The analysis indicates that anti-crisis program is imperative due to large output gap resulting from deindustrialization. The second part of the article analyzes the concept and the main components of anti-crisis program. The third part provides economic policy proposals for reindustrialization. Finally, we identify priority sectors for reindustrialization.

For the most part, economics is not an exact science. This particularity allows that everybody thinks they know it, especially politicians. That is why economics often has no further scope than a gizmo science in the hands of politicians. Given that, this article represents an attempt to provide contribution from microeconomic (or business) perspective, while not ignoring macroeconomic one, to exit from profound and overwhelming crisis into which Serbia persistently sinks.

As business economics professionals, we share certain shame that a nation which can be proud of *Nikola Tesla* and *Mihajlo Pupin*, as well as of many great people from the field of theoretical and applied engineering, has not been able to create level playing field for development of industrial economy. Adequate institutional framework encourages technological development as well as commercial use of innovations in tradable sectors and, consequently, fosters an economic and social development which could make Serbia comparable with other European countries. The future of our future must be brighter than the time we are facing today. It will not be easy because we must simultaneously eliminate the burden from the past and adapt the economy to transformative global discontinuity challenges.

Key words: *transitional recession, deindustrialization, reindustrialization, industrial policies, automatic stabilizers, priority sectors, comparative advantage, competitive advantage, industrial economy*

Sažetak

Kriza u Srbiji nije ciklične, već strukturne prirode. Naša polazišna tačka je da je reindustrijalizacija okosnica antikriznog programa i izvodi putanja za koordinirani odgovor na krizu. Rad se sastoji iz četiri dela, pored uvoda i zaključka. Prvi deo daje pregled makroekonomske situacije na polovini 2013. godine. Analiza nedvosmisleno upućuje na neophodnost antikriznog programa zbog postojanja ogromnog output gopa kao posledice deindustrijalizacije. Drugi deo se bavi konceptualnim okvirom i osnovnim komponentama antikriznog programa. Treći deo sadrži predloge za ekonomske politike bitne za reindustrijalizaciju. U četvrtom delu identifikovani su prioritetni sektori koje treba obuhvatiti procesom reindustrijalizacije.

U najvećoj meri, ekonomija nije egzaktna nauka. Ova osobenost omogućuje da svi misle da je znaju, naročito političari. Upravo iz tog razloga ekonomija često ostaje samo igračka u rukama političara. Ovaj rad predstavlja pokušaj da se iz mikroekonomskog (ili poslovnog) ugla, ne zanemarujući makroekonomski, da doprinos izlasku iz duboke i prožimajuće krize u koju Srbija neprekidno tone.

Kao profesionalci u oblasti poslovne ekonomije, delimo izvestan stid što nacija koja može biti ponosna na Nikolu Teslu, Mihajla Pupina i mnoge druge velikane razvojnog i primenjenog inženjerstva nije bila u stanju da stvori stimulativan institucionalni ambijent za razvoj industrijske privrede. Odgovarajući institucionalni okvir ohrabruje razvoj novih tehnologija kao i komercijalnu primenu inovacija u sektorima razmenljivih proizvoda, i, na toj osnovi, ekonomski i socijalni razvoj koji bi Srbiju učinio uporedivom sa drugim evropskim državama. Budućnost naših pokolenja mora biti svetlija nego što je naša sadašnjost. To neće biti lako postići pošto istovremeno moramo eliminisati breme koje smo nasledili iz prošlosti i prilagoditi ekonomiju izazovima transformišućeg globalnog diskontinuiteta.

Ključne reči: *tranziciona recesija, deindustrijalizacija, reindustrijalizacija, industrijske politike, automatski stabilizatori, prioritetni sektori, komparativna prednost, konkurentska prednost, industrijska privreda*

Introduction

There are different sets of ideas concerning Serbia's crisis resolution. Neoliberal economy is full of predilections about anti-crisis program ("let the markets take care of themselves") treating industrial policies as marginal compared to market forces. This view is burdened with many misunderstandings about the industrial policies *per se*, and, more importantly, it is not connected to reality. Let us remember that solutions to the crisis need to be logical and feasible. As far as logical side of the problem is concerned, in our opinion reindustrialization is treated as an antidote for deindustrialization, which is definitely in place in Serbia. Feasibility of the concept stems from reality check, or the evaluation of effectiveness of policy measures, as is the case in prosperous economies. Namely, our proposal of the reindustrialization strategy is conceived bearing in mind a positive experience of the emerging economies with industrial policies like BRICS¹ and "next 11"² that have been recording above-average growth rates and respectable macroeconomic performance. According to the last World Bank's forecasts [13], the global economy is projected to grow at an average rate of 3% over the next three years, primarily due to 6% growth in the group of emerging economies. The same forecasts indicate that the world's most developed economies are expected to experience a sluggish growth of 1.5% in the analyzed period, while the EU is likely to face a decline. Interestingly, the last group of economies was usually considered as "champions of economic liberalism".

From a political perspective, there are certain contradictions. The principal contradiction comes from the fact that reindustrialization is a politically unprofitable venture not only because the effects are uncertain, but also because it occurs in the period that is longer than usual political cycle.

Reindustrialization should not be seen as an economic panacea. Nonetheless, it requires a shift from an orthodox approach towards heterodox one [1], focusing away from macroeconomic policies (predominantly monetary and

fiscal) toward industrial policies, and adjusting core macroeconomic policies in terms of implementation of automatic stabilizers. There are many how to do, how to get, and how to use. A quest for answers to the mentioned dilemmas is the purpose of this paper.

Diagnosis

In 2012 the Serbian economy experienced immense difficulties due to irreversible trends in both real and financial sectors. After GDP growth of 2% in 2011, a drop of 1.5% recorded in 2012 must be observed as a serious warning sign. Industrial production fell by 3.5%, while agricultural production declined by 8%. In the meantime, the attractiveness of the economy for investors has not significantly improved, owing to a delay in reforms typical of frequent election countries, as well as a standby in EU accession process linked to the Kosovo problem. Instead of a capital influx, 2013 has been marked by examples of capital outflows from the real sector (e.g. US Steel), as well as from the financial sector (e.g. KBC).

After the last elections in 2012, the new government has just had a near death experience. When fiscal consolidation was achieved in 4Q 2012, activities were redirected to strengthening existing strategic partnerships (in oil and gas sector) and introducing new partners into energy sector, air transportation, and agriculture. Unfortunately, the effects from government's efforts towards energizing the economy were postponed due to the complexity of projects and burdensome red tape characterising business climate.

Statistically, at the end of 2012 Serbia was in recession since negative growth rates were recorded for the last two consecutive quarters. In 1H 2013 the economy came out of recession thanks to a positive growth rate in two quarters, but the sustainability of that growth is being called into question because the main structural imbalances have not been eliminated yet. In fact, Serbia is still faced with negative consequences of transitional recession.

The crisis has serious political consequences due to high unemployment and difficulties in functioning of the state. The unemployment rate, which in pre-crisis 2008 accounted for 14%, reached 24% in 1H 2013. The youth unemployment (15-24 years) rate that stands at 60% is of

1 BRICS - Brazil, Russia, India, China and South Africa

2 Next 11 - Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, Turkey, South Korea and Vietnam

particular concern. According to forecasts, the unemployment rate is expected to skyrocket to 28% in the next three years. Namely, if the economy continued to grow on the basis of the existing development model, the output would actually be increased followed by a decrease in employment due to rightsizing. According to *J. Stiglitz* [11], this situation is marked as jobless recovery. Rising unemployment is constantly reducing consumption (final and investment) and reinforcing recessionary trends that threaten to turn into depression. The ratio of dependents to active population stands at 1.0:1.1, which has an adverse effect on economic functioning of the state (pensions, health care, education, science, culture, etc.) as well as on maintenance of liquidity (internal and external) of the system.

Moreover, the influence of 2008- crisis from the EU, manifested in a form of the double-dip recession, has further increased the negative impact of deeply embedded structural imbalances on macroeconomic fundamentals of Serbia's economy (appreciated FX rate, high cost of capital, prices disparities, etc.). Therefore, in 2012 the public sector and a larger part of the private sector were loss makers. Banking is still a profitable sector, but the sluggish performance of the public and private sectors and poverty in the household sector bring negative economic expectations, thereby creating new mini crisis. Financial performance of the insurance sector is also declining. However, in a poor country like Serbia, the insurance sector is small and does not have a considerable impact on the financial system and economic development.

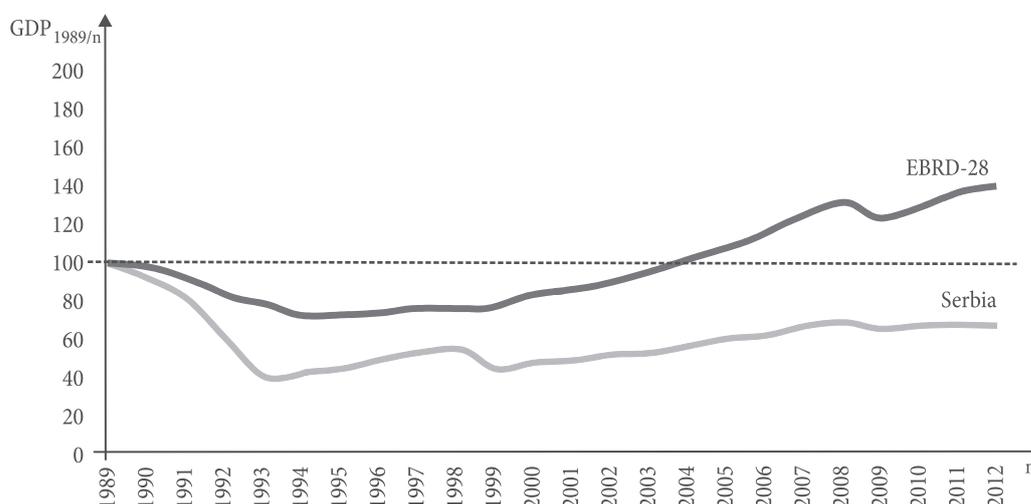
The key problem of the Serbian economy is output gap, i.e. the level of economic activity which is below its potential level. It is politically unjustified for a European country to have, for more than two decades, such a low level of economic activity that has brought about almost African level of poverty. The level of GDP in 2012 (at constant prices) compared to its level in 1989, i.e. the last year before the start of transition, is by 30% lower. In the same period, other economies in transition, denoted as EBRD-28³, experienced an increase of over 40% on average (see Figure 1).

In general, output gap is typically associated with the first stage of transition. In later stages, restructuring of the enterprises and banks and development of investor-friendly environment usually drive structural changes and investments, which leads to the annulation of transitional output gap. The countries from the EBRD-28 group managed to break even in 2004 on average. That situation indicates the end of transition and the start of catching up to more developed economies.

The essence of structural changes during transition lies in the growth of productivity and output increase in the tradable sectors as well as cost reduction in the non-tradable sectors, which, through a positive feedback loop, affects the competitive position of the tradable sectors

3 Albania, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Montenegro, Estonia, Georgia, Croatia, Armenia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Hungary, Macedonia, Moldova, Mongolia, Poland, Romania, Russia, Slovakia, Slovenia, Serbia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan

Figure 1: Transitional output gap, 1990-2012



Source: [2, p. 143]

and creation of a new level playing field attractive for investments.

Starting the process of catching up to more developed economies was a prerequisite for the political integration of former socialist economies of Central and Eastern Europe (CEE) into the EU. In addition to positive effects from political integration, certain development incentives also emerge from the effects of the institutional convergence.

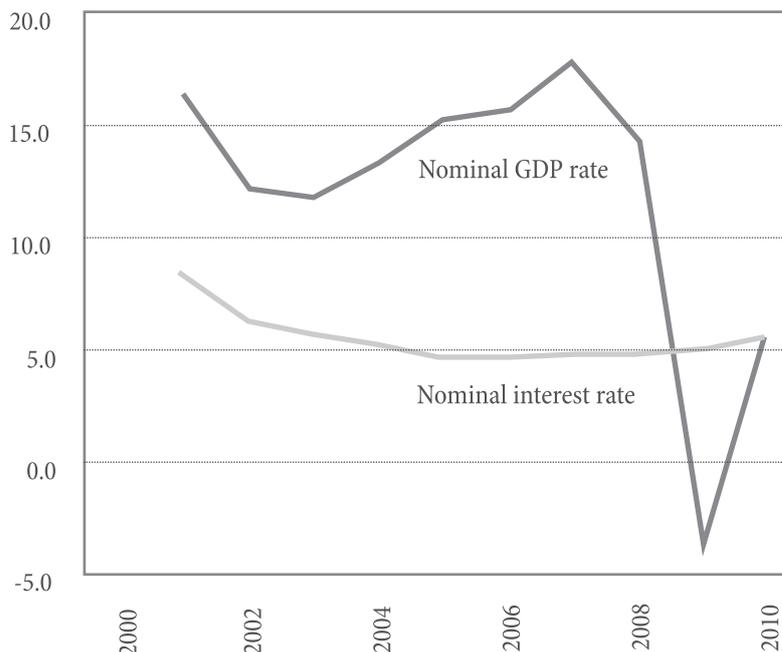
The whole period of transition in CEE (1990-2004) was marked by a significant economic optimism that probably contributed to its successful completion. Sufficiently low interest rates allowed economic expansion (see Figure 2). However, the growth was significantly fueled by foreign credits, which increased the vulnerability of these economies to the recession of 2008- due to high financial leverage. The crisis 2008- started with credit crunch and continued with demand squeeze. Government responded to credit crunch by introducing austerity measures, while the response of the corporate sector consisted of deleveraging (i.e. debt reduction by decreasing assets). In other words, credit crunch caused the contraction of production. Unfortunately, this was followed by a fall in revenue. As a result of the crisis, pessimism replaced initial optimism.

But, in the period of downturn the real economy (industry + agriculture) in post transitional countries showed the greatest vitality. Due to speculative bubbles experience, there were serious problems with investment in finance, real estate, and service sector. In the context dominated by “fear of fear”, investments are the segment that suffers most. Reduced level of investments particularly affects the economies with a high level of public debt because in new circumstances it is difficult to maintain fiscal balance.

In contrast to great majority of economies in transition from CEE, which in the past two decades achieved economic progress and started catching up to the economies from Western Europe, in the same period Serbia was lagging behind CEE economies experiencing economic regression. Primary cause is an incomplete transition.

The most dramatic decline in Serbia during transition was recorded in the real economy, especially in the segment of industrial production. The value of industrial production in the period 1990-2010 dropped by more than 60%, the share of industrial production in GDP fell from 31% to 15%, while the number of industrial workers declined from 1.03 million to 0.3 million. These trends are in stark contrast not only to regional trends, but also to the trends that were present in Serbia prior to transition period. Indeed, in the

Figure 2: Growth rate and cost of capital in Central and Eastern Europe, 2000-2010



Source: The Vienna Institute for International Economic Studies

period 1960-90 the industrial production grew at an average compound rate of 8% and the economy manifested a solid degree of industrialization given that all core industries figured in its structure (e.g. steel, automobiles, basic and fine chemistry, machinery, etc.). What followed in the period after 1990 may freely be called deindustrialization. Figure 3 depicts two periods in the development of Serbian economy: the period of industrialization (1960-1990), and the period of deindustrialization (1990-2010).

Figure 4 presents the level of industrial production in Serbia in comparison to the successful transition economies from the Visegrad group⁴. The figure shows that the transition process in this group of economies was characterized by an accelerated increase in industrial production, while in Serbia the trend was completely reversed.

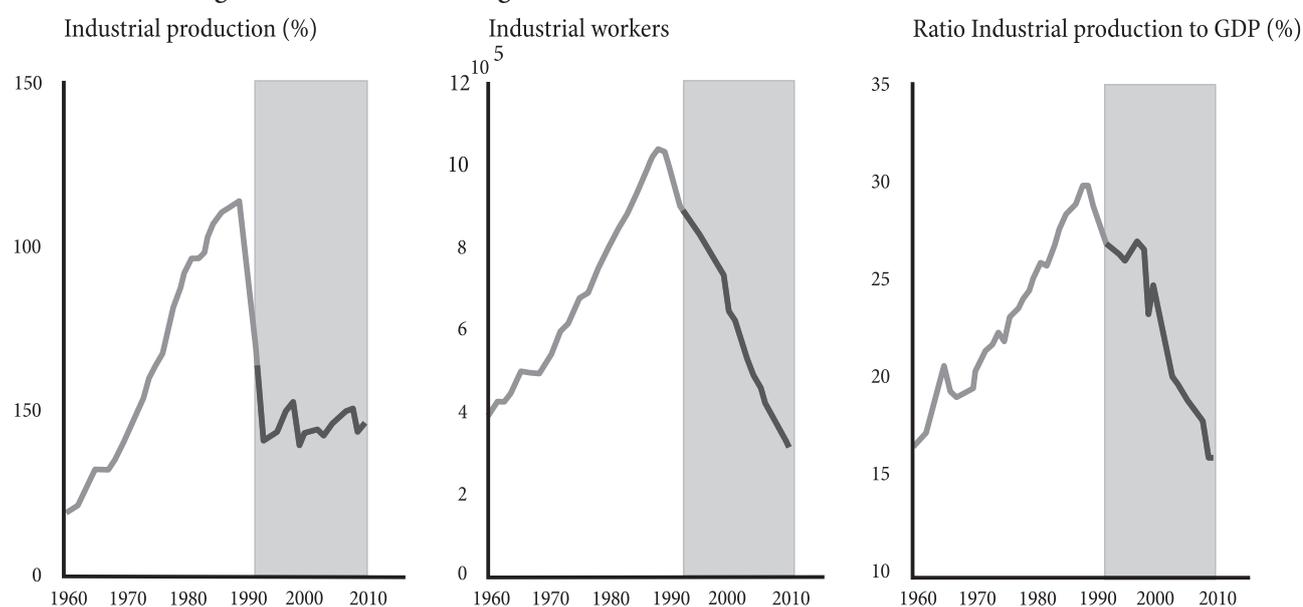
The composition of FDI is, also, one of the causes of further deepening of structural imbalances in Serbia. The structure of FDI in Serbia has been largely dominated by investments in financial intermediation (banks, insurance companies, etc.), real estate (primarily commercial), and retail. By contrast, in the countries from the Visegrad group investments in manufacturing and infrastructure have prevailed (see Figure 5). Specifically, with a share of 40% investments in manufacturing represent by far the largest component of FDI in this group.

4 Czech Republic, Poland, Slovakia and Hungary

The tradable sector is one of the biggest weaknesses of the Serbian economy. It has become especially obvious in the period of the global crisis 2008-, when the need for the foreign currency inflow based on export and substitution of import has become particularly emphasized under the pressure to reduce indebtedness (deleverage effect). However, in the case of Serbia the export is growing at nearly the same rate at which the import is declining (see Figure 6), unlike in the countries from the Visegrad group where there is a simultaneous increase in both export and import. Although at first glance this fact sounds like good news for Serbia, we have to take into account that the previous trend is happening in the conditions when the industrial production is contracting more strongly than GDP, which points to the continuation of deindustrialization. Furthermore, this situation leads to lower fiscal revenue.

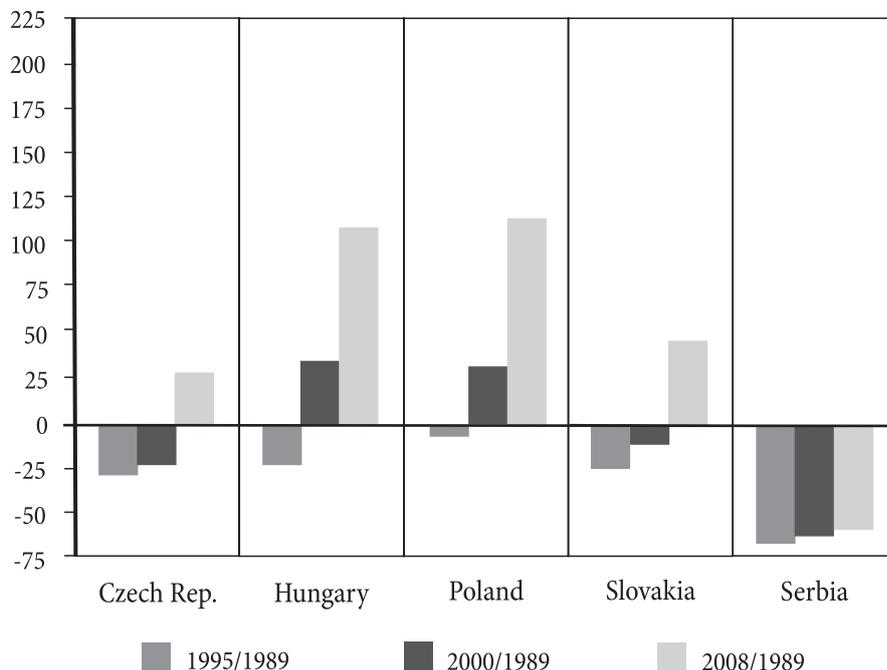
In addition to the transition strategy that has been based on capital markets development, one of the main reasons for the existing structure of the economy is also an inadequate economic policy focused on inflation (low and stable), rather than on output gap (low and stable). An exclusive reliance on monetary measures for maintaining price stability inevitably leads to sacrificing the real economy. Moreover, such an economic policy is counterproductive because it provokes artificial overheating

Figure 3: Two economic stages in Serbia: Industrialization and deindustrialization



Source: [8, p. 21]

Figure 4: Industrial production in 1995, 2000 and 2008 relative to 1989



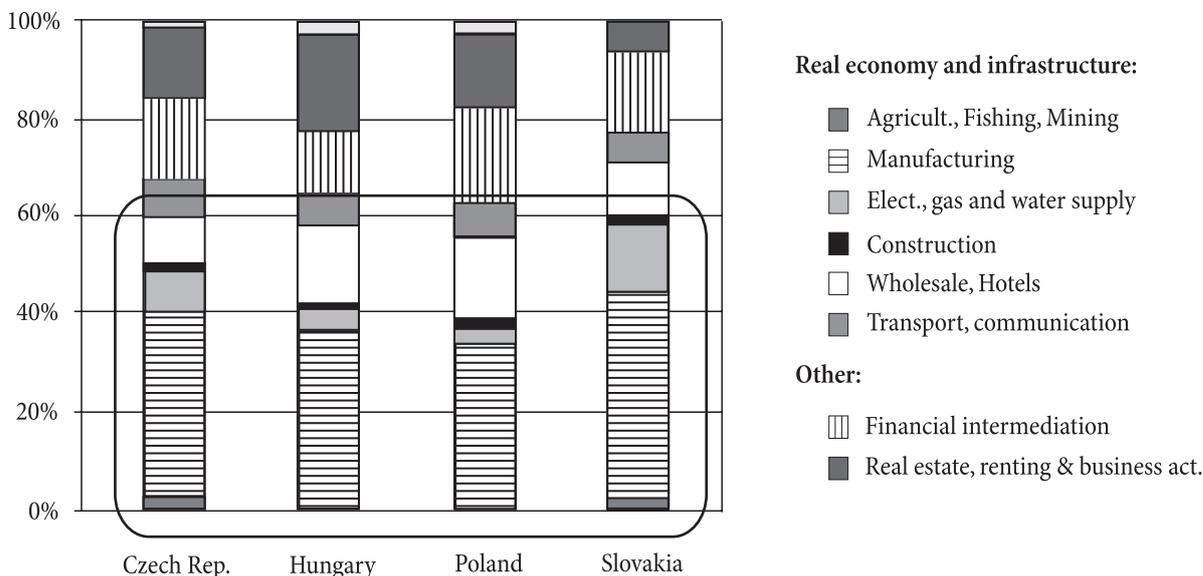
Source: The Vienna Institute for International Economic Studies

of the economy, given that capital inflows arising from privatization and FDI increase money supply. But, cooling down an artificially overheated economy using monetary measures is too expensive. In this respect, the National Bank of Serbia (NBS) has implemented measures such as raising obligatory reserves, increasing the policy rate, and intensifying open market operations (repo papers and foreign currency sales). Since all these measures increase cost of capital, it is absurd to apply them in an economy

with an outstanding output gap that could be eliminated only by energizing economy with investments. Also, such policy leads to the erosion of currency reserves which the NBS uses to relieve a pressure on FX rate in the periods when repo papers are due. Finally, there is additional negative effect of this behavior, an appreciated value of local currency (RSD) in real terms.

Previously described macroeconomic fundamentals of Serbia's economy constantly send out wrong signals

Figure 5: Structure of FDI in the countries of Visegrad group



Source: The Vienna Institute for International Economic Studies

to investors (attract portfolio investors and push away investors in the real economy). The space for investment in the real economy is completely squeezed, not only as a result of an insufficient level of retained earnings, but also due to lack of a fiscal space necessary for the implementation of neo-Keynesian instruments of deficit financing (infrastructure development, credit expansion to small and medium sized enterprises, social benefits for the unemployed, public procurement, etc.) which are traditionally used to stimulate supply during recession.

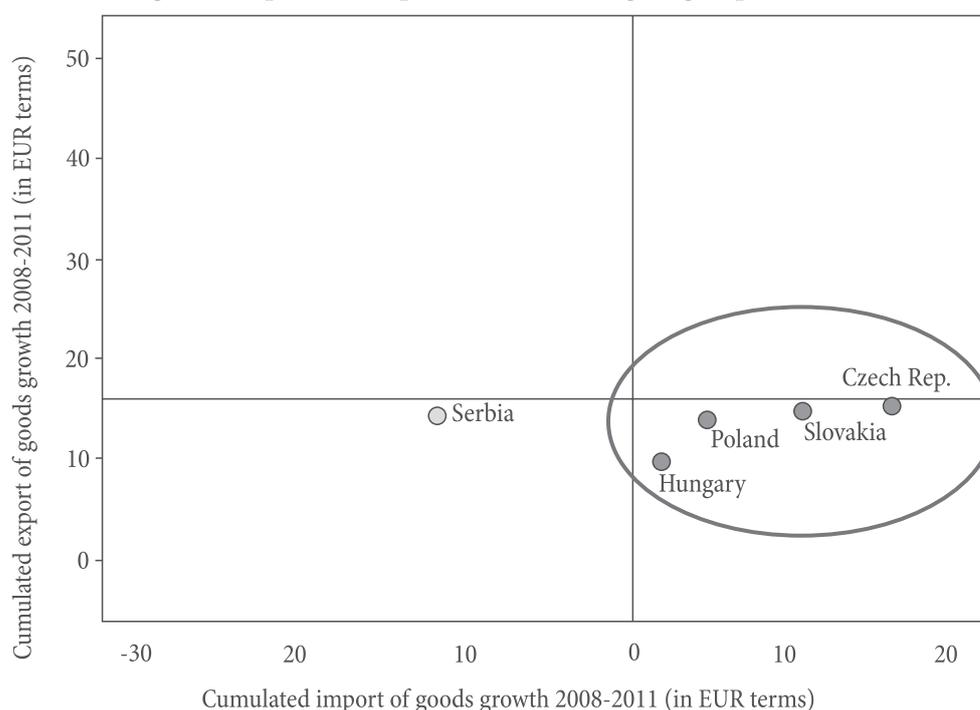
In the last decade the transition architects in Serbia have been explicitly guided by a neo-liberal economic doctrine and economic policy platform known as the “Washington Consensus”. Privatization, deregulation and liberalization, along with inflation targeting, are the main pillars of this platform that has been widely supported even by international financial organizations. Loans aimed at maintaining macroeconomic stability and enabling structural adjustment that are released by WB/IMF and EBRD bear out this fact. Unfortunately, there weren’t enough of politicians in Serbia capable of comprehending the irrelevance of this concept in local conditions. The concept was also adopted by the expert elite in regulatory bodies and non-governmental

organizations, among which there were some advocates of the platform of the complete state’s withdrawal from the economy. Through their involvement in drafting systemic laws, campaigns in professional organizations and *ad hoc* bodies, and media appearances these circles significantly contributed to the promotion of the market fundamentalism mindset.

In this way, following the principle “the free market is the best regulator, the state is a bad master” the previous governments were provided with an alibi for many omissions. An exclusive focus on inflation control by using monetary measures makes sense only when the economy does not suffer from major structural imbalances that lead into recession or deflation and/or when there is demand-pull inflation. However, under conditions of significant output gap and cost-push inflation, keeping inflation under control is not guarantee for macroeconomic stability, especially when it is accompanied by liberalization (in the commercial and financial markets).

It is interesting to notice that the Serbian reformers have dealt only with the reforms in the commercial sector while the public sector has been untouched (with exception of oil and gas) and, actually, under the ownership of political parties.

Figure 6: Export and import: Serbia vs. Visegrad group, 2008-2011



Source: Eurostat and authors' calculations

Wrong economic policy had unavoidable negative consequences. The key macroeconomic indicators of the Serbian economy for the last eleven years are presented in Table 1. Undoubtedly, the achieved growth was not sufficient to eliminate transitional output gap. Also, the whole period was marked by the twin deficits (current account and budget) which, along with losses in the public sector (mainly due to price disparities) and pension fund deficit, represent the main structural imbalances that are covered by increasing debt (public and private).

It is fair to say that Serbian economy is unbalanced, impotent, and out of tune. Deindustrialization during transition has created many black holes in the structure of the economy. The fact that colorfully illustrates impotence of the economy is that in the whole period of transition only in one year (2006) the level of FDI (privatization + green field investments) attained the level of remittances⁵. When it comes to the attractiveness of the Serbian economy to foreign investors, the situation is extremely alarming given that the inflow of FDI in 2012 amounted to just EUR 0.2 billion. The data on inflation and FX rate movements confirm that the system is completely out of tune. To be specific, in the period 2001-2011 cumulative inflation was 174%, while RSD depreciated by 78%, which points to a significant level of real appreciation of RSD relative to reserve currencies. Nominal appreciation of RSD for 1H 2013/1H 2012 is 1.4%, and real 10.5%.

In addition to conclusion that in the last eleven years structural unbalances remain unabated, another evidence of bad financial health of the Serbian economy is an absence of reserves that could be used in case that new stressors start to operate. Table 2 provides a view of

⁵ In analyzed period remittances fluctuate from EUR 2.5 to EUR 4.0 billion per annum.

vulnerability indicators. The data gives insight into the capacity of the economy to mitigate the negative effects of stress factors. Risk exposure of economy is enormous. Specifically, operational performance falls below the reference point, financial performance gravitates below or near the limit of reference point, and competitiveness is far below the level of the SEE countries.

The institutional setting (regulation + institutions + prevailing strategies of economic entities) in which the economic policy is being implemented is not satisfactory. This is particularly true for the regulatory bodies, but also refers to the mindset of emerging nomenclatura involved in the so-called "privatization" of privatization and related forms of corruption. For instance, the legal provisions in the field of privatization and financial system enacted after 2001 prescribed the change in character of shares of the corporations that had been privatized under the previous legislation and, by means of the laws with retroactive effect, enabled the change in legal status (closed joint-stock companies were transformed to open ones). This practice cleared the ground for the re-privatization in which the government acted as a catalyst while the system institutions (the Privatization Agency, the Security Commission and the Stock Exchange) provided necessary infrastructure. The argument that this practice is necessary for the development of capital market held up only until the takeovers of appropriate companies by new owners had been completed, as the same companies immediately left the stock exchange through going private transaction. Today, the capital market is still shallow and full of imperfections. For example, market capitalization for numerous companies listed on Belgrade Stock Exchange is lower than their book value, which means that their expected return on equity is lower than a factual rate of return.

Table 1: Macroeconomic indicators in Serbia, 2002-2013

Indicators	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	1H 2013
Real GDP growth rate	4.3	2.5	9.3	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.7	0,7
Consumer price inflation, in %	14.8	7.8	13.7	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	9.8
Unemployment rate	13.3	14.6	18.5	20.8	20.9	18.1	13.6	16.1	19.2	23	23.9	24.1
Current account balance, in % of GDP	-4.2	-7.8	-13.8	-8.8	-10.1	-17.7	-21.6	-6.6	-6.7	-9.1	-10.5	-3.4
Budget deficit, in %	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.7	-3.4	-3.7	-4.2	-5.7	-5.2
Public debt, in %	72.9	66.9	55.3	52.2	37.7	31.5	29.2	34.7	44.5	48.2	59.3	60.6
External debt, in %	58.7	55.9	49.8	60.1	60.9	60.2	64.6	77.7	84.9	76.7	85.9	83.1
RSD/EUR FX rate (period average)	60.69	65.12	72.69	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	112.15

Source: NBS

Table 2: Vulnerability indicators in Serbia, 1H 2013

Indicators	Value	Reference point	Type of vulnerability
Transitional output gap	32%	0%	Operational
Okun index (inflation + unemployment)	33.9%	<12%	
Twin deficits			
▪ Current account	3.4%	<5%	Operational
▪ Budget	5.2%	<3%	
Indebtedness			Financial
▪ Public debt/GDP	60.6	<45%	
▪ Foreign debt/GDP	83.1	<90%	
▪ Foreign debt/Export	202.8	<220%	Financial
Credit rating			
▪ S&P	BB-/negative	investment ranking > BB	Financial
▪ Fitch	BB-/negative	investment ranking > BB	
Export (goods)/GDP	30.3%	>50%	Competitive
Currency change (1H2013/1H2012)			
▪ Nominal	-0.9%	<-5%	
▪ Real	8.5%	<-3%	Competitive
Global competitiveness index	101 th of 148	65-SEE average	
Corruption perception index	80 th of 176	59-SEE average	
Ease of doing business	86 th of 185	60-SEE average	
Economic freedom index	94 th of 177	62-SEE average	Competitive

Source: NBS and authors' calculations

In the meantime, under the pretext of sticking to the principles of independence, the NBS is still conducting the policy of inflation targeting, relying on a partially floating FX rate as its main tool. By definition, in an economy in which import is greater than export, FX rate serves as an important tool of price control. However, the problem with this policy is the absence of an economic anchor in determining FX rate (inflation differential relative to the Eurozone, for example). Besides, interventions in the foreign exchange market are the manifestation of the voluntarism of the NBS in using currency reserves, which leads to really appreciated RSD.

During the global crisis 2008- the policy of inflation targeting has drawn fierce theoretical criticism in the countries in which it was launched. After more than two decades in use, this policy is practically being abandoned despite the fact that in these economies there are still prerequisites for its implementation (low and stable output gap and demand-pull inflation). In the case of Serbia, this policy has not been a right choice from the very beginning. In addition, by adopting such a policy the NBS fell into the trap of acting as an employer of commercial banks, rather than as a regulator, thus contributing to further deindustrialization of the economy instead to reindustrialization. As a consequence, it left room for the market cornering in relation to the yield of financial market

participants. Operations with repo papers issued by the NBS provide the best illustration of the previous point. There were periods when annual rate of return on repo papers amounted to 24% (for example, in 2006) and at the same time RSD appreciated by 1% against EUR. In other words, speculative investors were able to achieve a yield of 25% in foreign currency in the economy that practically has no industry. At the beginning, repo papers were primarily used to sterilize increased money supply from privatization and FDI. When the privatization proceeds declined, repo papers changed the purpose becoming a tool for maintaining banks' positive expectations in order to prevent escape of capital from branches operating in Serbia to their headquarters. Let us recall that repo papers issued by the NBS, along with state bonds, which were used in maintaining external liquidity and budget liquidity, not only attract hot money, but also increase the cost of capital for corporate sector and households causing crowding out. For instance, in 2012 the average interest rate in Serbia in EUR amounted to around 12%.

In addition to the direct consequences of the government's missteps in transition, there are certain problems arising from its failure to act. There are several omissions in this respect. First, delay in the restructuring of state-owned companies operating in the fields of natural monopoly and network technologies (electricity, gas,

telecommunications, railways, air transport, etc.) and the emergence of new nomenclatura as a consequence of implementation of party property criteria in formation of management bodies of those entities. Second, allowing companies undergoing restructuring (with more than 50 thousand employees) to stay on the budget for an unlimited period of time due to political reasons. Third, low level of investments in infrastructure as a consequence of an unskilled administration and/or red tape. Consequently, an inadequate infrastructure keeps burdening the private sector of the economy with its inefficiency and does not sufficiently contribute to budget stability and job creation.

The appetite for investment in the real sector has been reduced as a result of appreciated FX rate and inadequate infrastructure, but also due to high cost of capital. The NBS impacts on the cost of capital, *inter alia*, through the policy rate. Since the onset of the global crisis of 2008, the policy rate in Serbia has been extremely high (up to seven times in some periods) in comparison to the economies that served as role models when opting for the policy of inflation targeting.

The policy of inflation targeting without a nominal anchor leads to the new contradiction of “strong currency in a weak economy” which is the main reason for a limited development of the tradable sector. Appreciated FX rate encourages import and discourages export, thereby acting in favor of further deindustrialization. Owing to deteriorating macroeconomic fundamentals of the system, the return on investment of the companies from the real sector could turn out to be unfavorable despite an adequate level of value creation. Inadequate profitability leads to the indebtedness growth in case of a maintaining activity level or to the effect of lost growth due to abstaining from investment. The growth of private debt adversely affects current account position as well as overall debt level (public + private). When debt is growing faster than income, the situation becomes unsustainable.

Issuing debt instruments cannot eternally compensate for the misconceptions of economic policy and gap between consumption and production. Also, it is politically unacceptable that the deficits made by one generation are constantly debt-financed and thus transferred to the next

generations and/or re-inflated, i.e. lead to redistribution in the same generation between those who save and those who spend.

Anti-crisis program requires radical conceptual changes in conducting economic policy. Specifically, in order to ensure recovery it is necessary to match income and expenditure (the principle of hard budget constraints) by implementing austerity measures on the expenditure side, at the same time eliminating output gap by increasing investment spending, which, in turn, fuels the growth of revenue. These processes are interrelated. Namely, in maintaining liquidity (external and internal), apart from cost reduction, the expansion of the production of tradable goods and services is the best way to reduce import and increase export, and consequently, to achieve net positive effect on current account.

Anti-crisis program

Structural crisis cannot be overcome without an anti-crisis program. Those who believe in built-in self-restoring mechanism of the invisible hand of the market in an economy that doesn't abound in natural resources, which is small, uncompetitive and with diminishing population, with highly liberalized trade, without reserves which could be used to mitigate new stressors, in the period of double-dip recession in the EU as its immediate surroundings, are condemned to failure.

The anti-crisis program implies involvement of the government's visible hand. Serbia cannot make a turnaround in macroeconomic performance and achieve sustainable development without a proactive government that is capable of aligning new level playing field with reindustrialization goals, investing and/or attracting investors. Besides, the upward global trend in the prices of commodities and energy will constantly intensify inflationary pressure, further deepening the existing fractures of the system. Naturally, the new role of the government does not suppose going to the opposite extreme, i.e. towards the annulment of the market.

Reindustrialization should enable the elimination of structural imbalances, which leads to visible signs of recovery in the medium term and sustainable development in the

long term. It triggers rather radical shift in the economy, affecting both its anatomy and physiology. In order to realize the aforementioned, it is important to synchronize industrial development, as a principal factor of sustainable development, with two other core processes, i.e. fiscal consolidation and elimination of output gap. The first step in the right direction (or zero step) includes activities that should be undertaken in the short run, but which are also in accordance with the vision of long-term development.

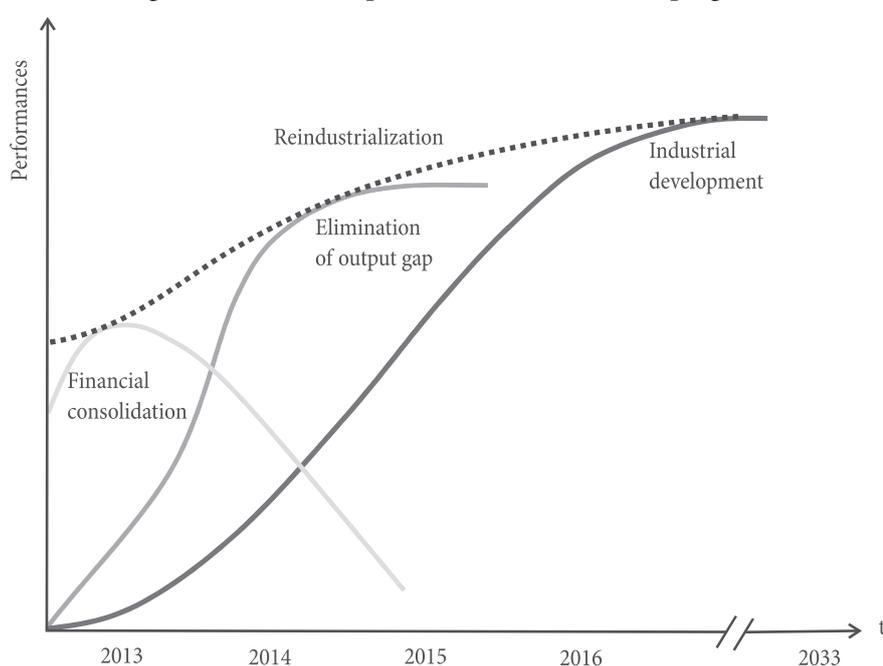
In fact, the anti-crisis program synchronizes three processes: (i) fiscal consolidation, (ii) elimination of output gap, and (iii) industrial development. All three processes of the anti-crisis program start at the same time, but have different durations and various scopes of impact on the growth of economic performance (see Figure 7). Fiscal consolidation will take effect in 1-2 years and output gap elimination in 2-5 years. The full effects of the industrial development will be felt in the period up to 20 years. The aforementioned processes must begin as soon as possible. All processes take place simultaneously. Cumulative effects of the anti-crisis program can be observed at the envelope of curves portraying performances of its core processes. Narrowing down the focus of anti-crisis program exclusively to financial consolidation, while neglecting elimination of output gap or industrial development, leads straight to bankruptcy.

Fiscal consolidation produces effects in the short run, especially in terms of initializing an increase in economic expectations. The new Government has managed to avoid bankruptcy mainly due to the program of fiscal consolidation implemented so far. Even though the fiscal consolidation is a necessary condition, it is just one of the steps on the path to sustainable development. Macroeconomic balance will be established only when the transitional output gap has been eliminated. Also, this process clears the way for the industrial development based on new technological platforms that will boost competitiveness and ensure sustainable economic development in the long run.

It is realistic to expect that the implementation of fiscal consolidation will for some time rely on the issuance of debt, including the sale of government bonds and/or taking loans from international financial organizations for maintaining macroeconomic stability and supporting structural adjustments. However, in addition to further borrowing, it is advisable to refinance the existing debt. The main reason for this is low cost of capital from international sources during the crisis 2008-.

Debt issuance can stop only when the transitional output gap has been eliminated as a result of the growth in the tradable sectors in which Serbia has comparative advantage. Sectors with comparative advantage include the sectors whose potential for growth lies in available resources

Figure 7: Three main processes of the anti-crisis program



(minerals, fertile land, skilled labor force), accessible and favorable sources of financing and position rent, all of which have potential to drive the output expansion. The tradable sectors have positive impact on external liquidity, which consequently leads to fiscal balance. Countries similar in size to Serbia are considered to be on the path of sustainable development if they export 50-70% of their production or if their export is greater than import. Today Serbia exports less than 30% of its GDP, while its import exceeds export.

In the case of Serbia, sectors with comparative advantages are: energy sector, agriculture, food processing linked with agriculture, and metallurgy. The government can take an active part in expansion of these sectors thanks to the fact that in these sectors the state is an exclusive owner, co-owner or could easily become an co-owner (for example, by conversion of debt into equity in the case of state-owned banks that have collaterals of privately-owned companies which are insolvent). In parallel with the expansion of these sectors, it is reasonable to count on the growth of the sectors based on position rent (telecommunications, infrastructure, logistics, and tourism).

However, the growth of export cannot be permanently based on the expansion of production in the sectors with comparative advantages, since it rests upon extensive development. For the time being, intensive development strategies are not feasible in Serbia. Unfortunately, the output gap cannot be eliminated by pursuing the most lucrative activities, but by doing what currently can be done. However, the expansion of the sectors with comparative advantages enables buying time before further reorientation (as soon as the output gap has been eliminated) towards other sources of competitiveness growth, primarily based on technological development and innovation. Competitiveness improvement can be achieved through an intensive industrial development based on new technological platforms.

The proposed strategy leads to the structural changes that produce effects in the long run. In the meantime, we should undertake some actions that will prepare a conceptual framework for the implementation of the strategy (the zero step). This step is rather urgent and consists of activities which the Government and the NBS

could carry out in an ultra-short term in order to adapt the economic environment to suit the needs of interested investors and start as soon as possible with the elimination of output gap, which should be done in accordance with the reindustrialization strategy.

In order to do that, the Government is to take following activities: (i) to establish the Fast Response Office aimed at providing reliable assistance reliable real-time assistance to potential investors, (ii) to enact the Law on Planning and Construction, (iii) to enact the Labor Law, (iv) to fully implement the concept of corporate governance in state-owned companies, and (v) to establish the constituencies that will take charge of reindustrialization (a sector within the Ministry of Economy or the Ministry for Reindustrialization). On the other hand, the NBS has to implement following measures: (vi) to reduce obligatory reserves for the commercial banks which means more credits for tradable sectors, and (vii) to prepare the framework for new monetary model and stable FX rate policy that will favor investment in the real economy.

Last but not least, reindustrialization does not imply the revival of bankrupt companies. Reindustrialization triggers three processes at a time. First, the expansion of vital companies from tradable sectors. Second, the revitalization of state-owned companies and companies undergoing restructuring (or business controversial companies) that could help eliminate output gap. Third, introduction of start-ups in private and public sectors based on new technology platforms.

Economic policy proposals

Today, there is a universal acknowledgement in the world's most developed economies that the crisis 2008- could not be overcome by undertaking the measures and activities that were its direct causes (deregulation, securitization, privatization, and outsourcing) and that the time has come to conceptualize new economic policy platform. When market forces fail, government will come in to pick up the pieces. In the meantime, prosperous economies from developing part of the world have pursued a different economic policy platform for long time, which has enabled them to be more resilient to the effects of the

global crisis, which actually emerged as a consequence of the misconceptions from the developed part of the world.

As far as Serbia is concerned, the standard approach that suggests continuation with neoliberal approach by focusing on inflation, pro-cyclical conditionality (budget cuts and tightening of interest rates), and labor market flexibility could be counterproductive since they led to further deepening of output gap, fiscal instability, and difficulties in functioning of the state. Inflation in Serbia was double-digit in six of the last ten years. In the whole period, neither the targeted levels were reached, nor the inflation corridor was respected. For example, inflation target in 2012 was 4% with tolerance band of + 1.5% and -1.5%, while actual inflation (CPI base) was 12%. Besides, inflation targets have never been defined according to theoretical level of 2%. Also, using certain austerity measures makes sense only for prosperity stage of business cycle to keep the economy from overheating, but not in downturn when the economy is, in fact, in an under-heated mode. Finally, labor market flexibility is difficult to achieve in Serbia due to high switching costs and high level of unemployment.

New conceptual platform of economic policy should have other priorities: (i) real economy (instead of finance and services), (ii) investments (instead of consumption), (iii) savings (instead of credits), and (iv) deployment of local capacities in order to trigger production growth (instead of relying on imports). The shift in mindset is at the heart of the new policy framework in terms of replacing a brokerage mindset with an entrepreneurial one.

There is firm evidence [9] that progressive economies direct investments towards the tradable sectors, capitalizing on comparative advantage (in the early stages of economic development) or competitive advantage (in the later stages of economic development). Instead of inflation (low and stable) as a dominant goal of economic policy, some other goals should also be taken into consideration including: output gap (low and stable), sustainable employment, GDP structure (emphasis on the real economy), price parity of other types of assets (first of all, FX rate), and establishment of dynamic equilibrium between the real economy and financial sector (instead of insisting exclusively on financial system stability). In order to successfully achieve

the extended list of goals, the central bank will have to renounce a part of its independence. Namely, the new structure of goals requires a close cooperation between the monetary power and the government. Also, new conceptual platform of economic policy is conceived as a combination of industrial policies and new macroeconomic policies that are based on automatic stabilizers, especially in monetary and fiscal spheres. As a result, industrial policies lead, and macroeconomic policies follow.

In industrial policy FDI are not considered as a basis for sustainable development, since in the medium term they adversely affect the growth due to the effects of transfer prices, profit repatriation, and potential gap in case of exit. New financial arrangements should enable investment without further increase in debt. The arrangements that meet the previous criterion are: (i) joint ventures up to 50% ownership for foreign partner (no casting vote JV), primarily in the sectors where Serbia has comparative advantage (energy sector, food processing, and telecommunications), (ii) concessions, with a special emphasis on the types of arrangements such as Build-Operate-Transfer (BOT) in infrastructure, metallurgy, transportation, logistics, and tourism, and (iii) Private-Public Partnerships (PPP) in utility companies and public services. A particular focus should be put on financing by sovereign wealth funds (SWF) from the countries with immense foreign currency reserves (Russian Federation, People's Republic of China, Gulf countries, Norway, Indonesia, etc.). Today's global investment arena is marked by a dominant role of SWF over FDI.

Regardless of the orientation to finance industrial development predominantly from capital raising by introducing strategic partners, it is not realistic to expect that, at least in the medium term, Serbia will be able to implement its anti-crisis program without having funds provided by international financial organizations. When considering these funds, it is necessary to draw a distinction between financing counter-cyclical macroeconomic policies and capital investments financing, having in mind that importance of the latter stems from their counter-cyclical nature. According to the new vision of development based on reindustrialization, supporting development projects with financing provided by the lenders such as WB, EBRD,

KFW DEG, etc., and by SWFs will allow easier access to IMF funds for counter-cyclical macroeconomic policies. Economies that are solvent, thanks to expansion of tradable sectors, can easily raise funds for maintaining short-term liquidity. Economies lacking dynamic development are forced to issue debt to maintain liquidity (external and internal). But, rising indebtedness increases the country risk and cost of capital, slowing down the rhythm of development.

Also, new economic policy platform has to be consistent with the development trends in the global economy. The changes are significant and relate to: (i) new model of capitalism, (ii) changing role of industrial policies, and (iii) new priorities of technological development.

As for the model of capitalism, it has now become evident that the model of liberal capitalism has been mostly abandoned in the emerging economies. In order to streamline their progress in catching up to the most developed economies, the developing economies have assigned a special role to the government in their economic policy platforms, especially in the field of industrial policies. The countries from BRICS and “next 11” are cited as typical cases. They have adopted a model of the “managed capitalism” in terms of *R. Rajan* [9, p. 58]. The active role of the state in industrial development does not imply protectionism, but a subtle support to tradable sectors and infant industries, without intention of eliminating the market forces.

However, competitiveness requires an adequate technology. Export of competitive products (usually low-end) and import of modern technology (usually expensive) needed for their manufacturing create current account deficit that is financed by more debt, which leads to capital account deficit. As a result, such development model could be unsustainable, generating deficits in balance of payments, current account and capital account. The only way to avoid a development trap caused by the terms of trade is to develop own technology. But, the development of cutting edge technology requires time and intelligent government. By expanding production in the sectors with comparative advantage and position rent, intelligent government is buying the time and creating the ground for switch towards investments in the development of new technologies.

The modern capitalism is characterized by a change in attitude towards business elite, particularly in terms of adjusting tax and banking systems in order to encourage entrepreneurial instead of rent-seeking mindset. Also, when it comes to cross-border investments, FDI are losing primacy over the investments of SWF, which results in a growing importance of geopolitical factor to the allocation of investments, especially in basic resources (food, energy, water, etc.). In modern times, it is more important to whom you are connected than who you are.

Nowadays industrial policies have a central place in emerging economies, but they are gaining importance in the developed economies in crises. In both group, the main focuses of industrial policies are: basic resources, on the one hand, and high-end products, on the other. Massive production of durables is no longer on the radar of industrial policies because of hyper competition and the China syndrome.

Today, technology is a major driver of competitive advantage and environmental sustainability. In new context the main challenges of technological development include: (i) climate change, (ii) food safety, (iii) sustainable energy, (iv) integrated transport, and (v) the economic consequences of pro-ageing. Another problem associated with the previous challenges relates to the economic consequences of possible solutions, again due to well-known market imperfections (asymmetric information and external effects). In search for solutions to the previous challenges, the EU defined 36 technological platforms that should provide the base for its future competitiveness and the seeds of industrial policies.

The government-led industrial policies, mainly focused on the tradable sectors (with export and anti-import goals), are at the core of the new concept of conducting economic policies for Serbia. Industrial policies are formulated for the priority sectors. The priority sectors include: sectors with comparative advantages and sectors with competitive advantages.

According to the new economic policy platform, industrial policies lead while “hard” policies (monetary and fiscal, primarily) follow. Industrial policies and macroeconomic policies are synchronized with other policies such as regional development policy, population

policy, and competitiveness policy. The reindustrialization accounts for dominant position of the real economy and dynamic equilibrium between the real economy and financial sector, and it is also directed at achieving the goals of three main anti-crisis processes (see Figure 8).

Therefore, industrial policies are the backbone of the new economic policy framework. Their primary strategic goal is to enable the growth in the tradable sectors, which leads to import substitution and export expansion, i.e. to sustainable positions of current account and capital account.

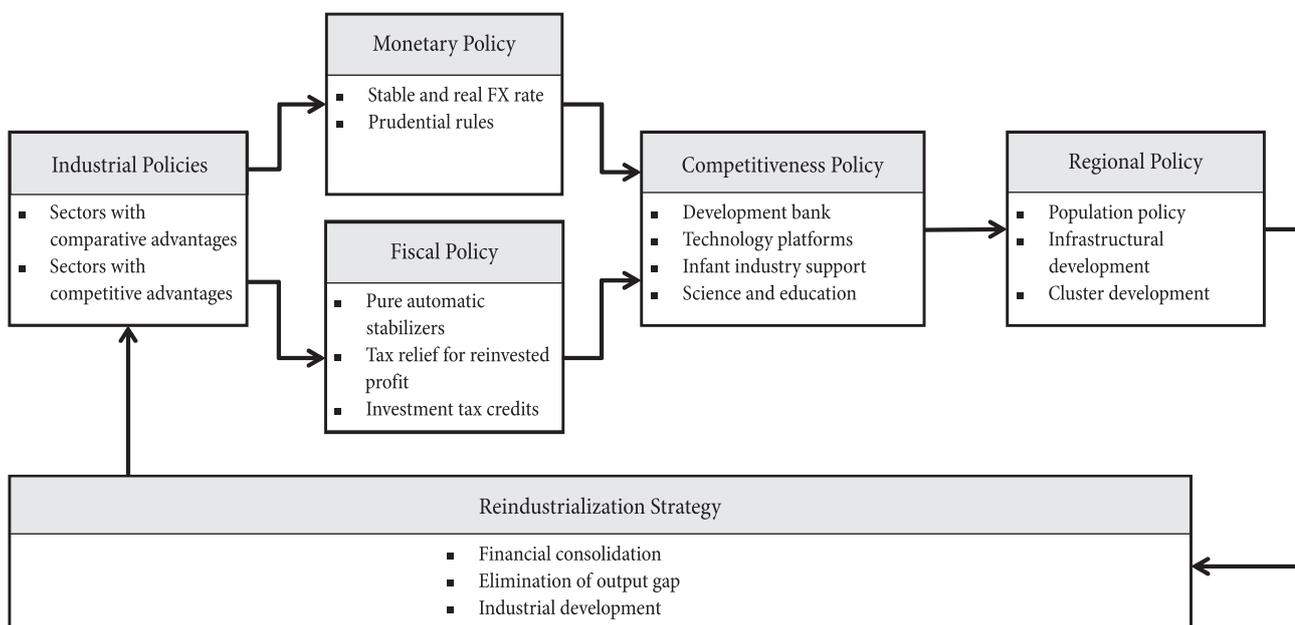
In order to achieve the above-mentioned goal, it is necessary to define appropriate industrial policy measures. For instance, the key measures in the energy sector are as follows: full-cost pricing, feed-in tariffs corrections, selection of strategic partners, establishing corporate governance in state-owned companies, and introduction of stimuli for the development of new energy and efficiency technologies. As far as pricing policy is concerned, the convergence of the electricity price towards the EU average would automatically cause an increase in value of state-owned company Electric Power Industry of Serbia (EPS) of at least EUR 1 billion. This situation would encourage strategic partners to invest more in this sector, which would further intensify the impact of the investment multiplier on other sectors. The experience of Turkey, which a few years ago replaced non-economic prices of electricity with economic prices, has shown a positive impact on

investment, production growth, export and budget stability (given that electricity is considered commodity). Feed-in tariffs should create positive expectations in the renewable energy sector. Selection of strategic partners is associated with geopolitical repositioning of the country. Corporate governance should ensure efficient and ethical management practices in state-owned companies. Economic stimuli for the development of adequate technologies strongly encourage the development of other industries.

Within the new economic policy framework, macroeconomic policies are based on automatic stabilizers, especially in monetary and fiscal spheres.

In monetary policy, FX rate plays the role of a key automatic stabilizer. The current policy of regulated floating FX rate does not encourage reindustrialization. To recall, the policy that relies on targeted inflation as the main tool for achieving macroeconomic stability is not effective under conditions of serious structural imbalances causing recession or deflation, as well as under conditions of cost-push inflation, which precisely characterize the case of Serbia. Furthermore, this policy turned out to be counter-productive because of the treatment of capital inflows in the periods of massive privatization that were increasing money supply, thereby leading to an artificial overheating of the economy. Status of privatization proceeds as a form of export rather than divestment triggers increase in money supply and undermines the level of output. It

Figure 8: Policy platform for reindustrialization



is even more interesting to notice that these substantial funds did not re-enter the economy through investments (for example, by the agency of the Development Bank), but instead, by increasing money supply, they created inflationary pressure and, consequently, the need for restrictive monetary policy measures. By means of the sterilization of a part of money supply and maintaining FX rate stable through selling currency reserves exactly to the buyers of securities that the NBS had issued, privatization proceeds ended up in the banking sector (the largest part) and abroad (a considerable part). Also, the monetary policy, escaping from the inflation caused by its own mistakes, led not only to decapitalization of financial sector, but also to really appreciated RSD and cost of capital increase, i.e. to the outcomes that unequivocally act against the real economy.

As far as FX rate policy is concerned, there are several options. Fixed FX rate is best suited to reindustrialization. Fixed FX rate encourages the expansion of real economy since it includes predictability in the calculation of the effects of capital investments, providing a clear framework for assessing the profitability of alternative investment strategies and corresponding business plans. Finally, a country that aspires to integrate into the EU must have a fixed FX rate⁶.

When determining the level at which FX rate is to be fixed, one should take into consideration the purchasing power parity of a domestic currency in relation to reserve currencies, i.e. the alignment of FX rate, as a price of domestic currency, with the competitiveness of the national economy. It can be concluded that the current level of RSD relative to reserve currencies is in stark contrast to the level of competitiveness. Namely, there is an obvious competitiveness gap between the Serbian economy and the economies whose currencies serve as benchmark for determining FX rate. In an economy that has a competitive disadvantage, the parity of the price of domestic currency with the level of competitiveness can be established only by the devaluation of currency. Namely, fixed FX rate must reflect the reality. Real FX rate acts as a macroeconomic automatic stabilizer because it stimulates export and discourages import, thereby enhancing the current account

and budget stability. On the other hand, opting for fixed and really appreciated FX rate may be hazardous, as it may cause serious problems in current account (for example, the case of Croatia) given that it simulates import and discourages export.

A monetary model that advocates the policy of fixed FX rate is a currency board. The currency board has been widely used. So far this monetary model has been implemented in about 70 countries, including some neighboring countries (Bosnia and Herzegovina and Bulgaria, for example).

Another possible FX rate policy aligned with reindustrialization comprises a FX rate that is favorable to export activity (depreciated value of local currency), but that at the same time ensures macroeconomic balance. For instance, China has applied this kind of FX rate regime for a long time. However, such FX rate policy is based on a superior calculation of cost components (the cost of natural resources and labor, primarily), which is difficult to achieve in most countries, including Serbia. The third option would be adopting a FX rate adjusted for inflation differential in the EU.

Each of the aforementioned FX rate policies could be implemented in order to enable the macroeconomic policy to function at its full capacity, i.e. to focus on conventional monetary instruments (reserve requirements, policy rate and open market operations).

The change in FX rate policy does not imply giving up inflation control as one of the main targets of economic policy. Anti-inflation policies should always serve to set up barriers against price increases, adhering to the principle of full employment. The elimination of output gap through expanding the real economy leads to a balance between aggregate supply and aggregate demand. In addition, anti-inflation policies require appropriate adjustments in incomes policy (wages and pensions) to prevent additional imbalances (demand inflation or deflation). One of the barriers to growing inflationary pressure may consist of determining the public-sector wages in accordance with output and productivity.

New monetary policy must take into account both price control and growth. In this respect, it is necessary for the NBS and the Government to make joint efforts

⁶ Among others, the "father" of Euro and Nobel Prize laureate *R. Mundell* and eminent monetary economist *S. Hanke* [5], [6], [7] support this view.

to reduce the policy rate and country risk, respectively. The cost of capital can be reduced to an acceptable level provided that the policy rate drops considerably.

Also, we should not neglect the political consequences resulting from the change in FX rate regime and adoption of the policy of real value of RSD having in mind a foreign currency clause in the existing retail and corporate loans, as well as some feasible solutions for mitigating the negative effects of policy shift. In addition to appropriate accompanying measures, the change in FX rate regime also requires good timing (e.g. introduction of strategic partners in natural monopolies and network technologies).

The fiscal policy should also be based on automatic stabilizers. Today, a general consensus has emerged that “clean” fiscal stabilizers such as unemployment compensation and benefits play a key role during recession. In the fiscal sphere, some other measures can also be implemented to boost the spirit of reindustrialization including tax holiday for investors in the priority sectors or tax relief on reinvested profits.

However, the truth is that the success of macroeconomic policy depends more on monetary measures than on fiscal ones, as it is well-known that when monetary and fiscal policies are in contradiction, the economy will follow monetary policy measures (*M. Freedman’s rule*). In a word, the critical success factors of the growth in the real economy come from monetary side (money supply, cost of capital and FX rate).

Priority sectors for reindustrialization

As we already identified, the key sectors for reindustrialization are: (i) sectors with comparative advantage, and (ii) sectors with competitive advantage.

(i) *Sectors with comparative advantage*. The expansion of sectors with comparative advantage is primarily aimed at eliminating output gap, ensuring fiscal stability and buying time before the industrial development based on new technological platforms happens. For Serbia, the main sectors with comparative advantages are as follows:

1. Energy
2. Agriculture
3. Food processing

4. Dairy
5. Metallurgy
6. Infrastructure
7. Transport and logistics
8. ICT
9. Tourism

(ii) *Sectors with competitive advantage*. The sectors with competitive advantage are the most important engine of future industrial development that will be based principally on the use of advanced technology. In the sectors with competitive advantage, there is the largest difference between the level of value added and costs. In the case of Serbia, this group of sectors includes:

10. Construction
11. Metals processing
12. Vehicles
13. Pharmaceutical
14. Agricultural machinery
15. Military
16. Pro-ageing

Industrial policies are conceived having in mind the characteristics of each priority sector (sector-specific policies). Macroeconomic policies (monetary and fiscal, above all) actually tend to lubricate the industrial policies in the priority sectors. Macroeconomic policies function by means of automatic stabilizers.

The development of regulatory framework (regulation + institutions) must have a “zero tolerance” in terms of compatibility with the relevant regulatory framework and specific guidelines in the EU. Once this condition has been met, the strategies of economic entities will become compatible with the EU regulations as well as with the economic development goals of the national economy.

The first step in the elimination of output gap through expanding production in the sectors with comparative advantage consists of finding strategic partners that would be interested to buy equity in the state-owned companies from energy sector, agriculture, food processing, logistics and infrastructure. On the other hand, the industrial development and build-up of the sectors with competitive advantage highly depend on the development of conceptual infrastructure and Serbia’s integration into the EU and its techno-economic space (36 European technology platforms).

Despite the fact that Serbia is a small and underdeveloped country whose economy is unbalanced, impotent and out of tune, it does not mean that we have to give up the big ideas like, for example, the development of technology platforms that are the building blocks of future competitiveness. In this respect, the effects of economies of scale and scope should be taken into account. For instance, the development of nuclear medicine as part of pro-ageing industry energizes the development of pharmacy, health tourism, transportation, etc. Furthermore, the previous orientation puts emphasis on the role of science in the economy and creates opportunities for an active involvement of the technocratic elite in economic development, which has been completely off the radar of policy makers in the last period. The aforementioned should ensure the development of the tacit knowledge, especially in the domain of new technologies, which is considered nowadays as a critical success factor in creating competitive advantage of each national economy. Moreover, tacit knowledge opens up the possibilities of self-employment through the development of business incubators, as well as small and medium-sized enterprises that capitalize on technological breakthroughs and their commercialization. *H. Simon's* empirical studies [10] indicate that such enterprises are seen as the hidden champions of competitiveness, which is particularly true in the most competitive economies like Germany.

A government that places a high priority on technological development by strengthening the role of University, scientific institutes and R&D units in companies, is actually carrying out the scientification of society. In that way, the government is preventing the spread of populism, largely promoted by media that today represent a real threat to sustainable economic and social development, since they lead people (especially young generation) in the wrong direction, causing the feelings of alienation and defeatism, as well as decadence.

The economy that formulates its anti-crisis program on the basis of pro-investment mindset should have enough specialists in the field of project management. Experts in this field must have a certified expertise (e.g. PMP certificate), experience and potential for advancement. The first step in the right direction would be to form a group of credible experts at the level of the Government within

the Fast Response Office. The Office will be in charge of the following tasks: communication with potential investors, project documentation preparation, providing assistance in negotiations, drafting financial proposals, issuing temporary orders to speed up investments before the enactment of appropriate legislation, monitoring and follow-up of the project in the public and private sectors, etc.

Conclusion

In the last decade of the past century, sometimes designated as “decade of transition”, Serbia actually was in confusion. Economic transition was slowed down due to geopolitical *status quo* and its economic consequences (dissolution of Yugoslavia's market, wars for former state heritage, economic sanctions, and physical destruction of infrastructure and production capacities). In the period after political changes in 2000, the economic transition accelerated but it was burdened with consequences of deindustrialization and severe political consequences of excommunication from the EU mainstream. Besides, the previous decade was also marked by certain missteps and oversights in strategy of economic transition by itself. As consequence, output gap has remained the main problem of the economy. It causes inflationary pressure, twin deficits (current account and budget), high level of unemployment, and related inconveniences.

In searching for solution, first we must face reality. The very essence of our reindustrialization proposal lies in the elimination of output gap. The main challenge raised by transitional recession in Serbia is to design a framework and road map for coordinated response to deindustrialization that recognizes the different constraints faced by individual sectors and industries. In order to do this, the reindustrialization has to accomplish three objectives. First, it should be conceptual platform for anti-crisis program and a strategy of sustainable economic development. Development of industrial economy is guiding idea for the structural changes, aimed at enabling the change in the existing institutional setting, which leads to the improvement of macroeconomic fundamentals of the system and elimination of deeply rooted structural imbalances. Second, reindustrialization should prevent

depopulation of the country, which logically goes hand in hand with deindustrialization. Third, reindustrialization is a prerequisite for political stability of the state that, having left several transitional entities in the recent history, finally has started its own geopolitical and economic transition but with economic burden and without allies.

Sustainable growth, low and stable output gap, and increase in competitiveness of the national economy are preconditions for political stability of Serbia and the completion of the EU accession process. In order to achieve these goals, it is necessary to take the following steps. First, the economic policy platform should be defined taking into account not only macroeconomic perspective, but also microeconomic (or business) one. Clear development priorities supported by appropriate industrial policies, stable and realistic FX rate, competitive cost of capital, comprehensive infrastructure, and explicit and codified tax system are the prerequisites for an investor-friendly business environment. Second, it is of paramount importance to carry out the restructuring of state-owned companies, especially in tradable sectors and services, and to ensure their operation on the principles that apply to the private sector, so that they can contribute to infrastructure development, improvement of current account position, and job creation. State-owned companies in network technologies and natural monopoly need to be governed by professional managers, guided by business plan and capital investments, all in compliance with the principles of corporate governance. Third, build up the infrastructure (conceptual and physical) from all disposable resources to enable the achievement of the previous goals.

Naturally, the implementation of reindustrialization requires a more complex economic policy platform that would create new level playing field enabling handshake between the government's visible hand (automatic stabilizers in monetary and fiscal spheres and industrial policies for tradable sectors) and invisible hand of the market providing selection environment for all economic agents. Our proposal is an attempt to restore balance between market and government with greater transparency and accountability, with short run actions consistent with long run vision, without irreversibility and asymmetries. Reindustrialization is a more dynamic and more sanguine way of moving the economy in that direction.

Our proposals are not based on redistribution of wealth and factors of production, but rather on value creation. Even with economically effective and socially fair mechanisms of redistribution in place, the economic development of Serbia could not have been established in a sustainable manner at least due to an insufficient level of wealth for redistribution. Moreover, the cornerstones of our proposal include investments in the tradable sectors and intelligent state that directs development towards tradable sectors through regulatory rules and/or acts as an investor. Such a state sticks to the principle of hard budget constraint in terms of adjusting expenditures to revenues. Delay in the implementation of the reindustrialization does not diminish its relevance, but actually increases switching costs and postpones positive effects.

The proposed strategy of reindustrialization is not only a framework for resolution of transitional recession and a road map for sustainable development, but also a prerequisite for the geopolitical survival of Serbia. Moreover, this strategy should be a conceptual platform if Serbia wants to be a part of the EU club. Serbia will be able to join the EU only if it increases output by using its comparative advantages that enhance investment and trade with the EU partners, imposes hard budget constraint (both macro and micro), creates stable currency and financial system, and develops an explicit and codified tax system, all attractive to investors (in the tradable and non-tradable sectors). Without these, the burden remains intact and capacity for quick response will wane. The previous is of paramount importance because the age we are witnessing is the age of transformative global discontinuity.

Our proposals do not analyze the political dimension of the problem, which, of course, constitutes an essential element of a complex equation of reindustrialization. Reindustrialization should start immediately with a synchronization of three complex, mutually interdependent and subtle processes which, in fact, require investment of an immense political capital, whose effects are uncertain and can be expected in the time period that is longer than the duration of a usual political cycle.

However, reindustrialization must be seen as critical not only from economic, but also from political perspective. The economy is the foundation of a society. Experience

shows that sustainable economic development and political stability at this level of economic development are based on tradable goods and services, i.e. on the real economy (industry and agriculture). Reindustrialization could solve the crisis of confidence, enabling Serbia to return to industrial economy development model. It largely depends on the statesmen, not politicians, and their readiness to first and foremost consider the economic consequences of the political decisions, giving priority to the return on investment over the return of voters, and taking the lead. Other alternatives seem like moving chairs on the Titanic.

Statesmen know when to take advises from knowledgeable people in order to find logical and feasible solutions. You cannot change personal feelings influenced by the national culture mindset, but you can change mind setting by developing new level playing field and, thereby, start to change this mindset.

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