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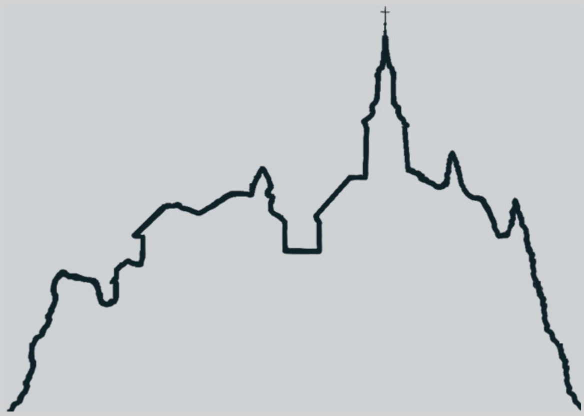
GODINA LVIII

SEPTEMBAR-OKTOBAR 2010

Ekonomika preduzeća

THE 2010 SOUTHEAST EUROPE MANAGEMENT FORUM
BLED-KOPAONIK



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In the aftermath of the crisis, five papers in this edition, each one from its own perspective, analyze the main problems, challenges, as well as possible solutions to exit the crisis permanently, both for Serbia's economy as well as in broader, global context.

Prof. D. Djuricin in his paper suggests the feasible road map, consisting of proactive strategic initiatives and passive tactical initiatives that lead Serbia's economy towards the end of combined crisis. The combined crisis in Serbia represents the result of interaction between local transitional crisis and global recession. The proposed anti-crisis program relies on the new economic model which stimulates investments that foster reindustrialization, new monetary model that is not only directed towards price stability, but also respects other tenets like elimination of output gap, composition of the output and behavior of asset prices (currency price, especially), as well as new institutional framework. The predominant idea is that clear vision, along with strong and constructive interaction among the government, business and academic elite, is a prerequisite if Serbia is to resolve its transition conundrum and embark on a path of sustainable growth.

Dr E. Jakopin gives another view of how the global economic crisis amplified the problems accumulated during period of transition in Serbia. In his paper he explains the influence that the crisis had on the reindustrialization process and performance of both public and private sectors in the form of different performance indicators. In 2009 the economy of Serbia was net loser. Namely, due to dramatic demand squeeze, restricted access to financial sources and drop in equity and foreign direct investments, as well as remittances, Serbian enterprises were pushed deeply into indebtedness, along with liquidity and solvency problems, and bankruptcy, in the worst case. The overall state of the economy is additionally deteriorated by traditionally poor-performing companies in state sector.

Prof. N. Savic offered an integral analysis of Serbia's future competitiveness strategy, its main objectives and likely restrains. The suggested strategy assumes creation of business environment that attracts foreign and domestic investment thus helping in raising the level of tradable goods. Also, active role of the government is necessary. That especially refers to cutting down excessive and unnecessary public spending and directing it towards investments in infrastructure, education and public governance reforms. Finally, Serbia's competitiveness strategy must be formulated in a way that provides smooth inclusion into Europe 2020 strategy implementation.

As the last global financial and economic crisis shook the world, the role of international financial institutions has been challenged once again. As noted in the paper written by Prof. D. Vujović, international financial institutions provided critical input in shaping a coherent and effective response to the crisis. It is expected that they will profoundly engage in designing the new international financial architecture in the following years as well as perform the new role in implementing it. It assumes a broad set of actions, from enhanced bilateral and multilateral surveillance and implementation of the new regulatory framework in financial sector to improved management of international reserves.

One of the most serious problems burdening Serbia's future economic growth refers to human capital mismatch. Hence, Dr M. Macura in his paper raises the question of continuing contraction in the pool of labor in the area of Southeastern Europe. Aside from low fertility rate and working-age population decline, Serbia, as well as most of its neighboring countries, currently suffers from under-utilization of human recourses. In the absence of suitable reaction these unfortunate facts can become a major constraint to economic growth. The author underlines that, in the long run, likely solutions to the problem will assume changes in the sensitive field of ethnic structure, meaning resorting to foreign labor.

THE 2010 SEE MANAGEMENT

ECONOMIC FUTURE AND MANAGEMENT CHALLENGES

Under the patronage of Minister Mitja Gaspari

Bled, September 16-17, 2010

Organized by IEDC Bled School of Management & Serbian Association of Economists

In 2010, the Serbian Association of Economists partnered with IEDC Bled School of Management to organise a regional management forum. Continuing the tradition of the Milocer Economic Forum, the event gathers renowned economic experts, highest government representatives, and business leaders and entrepreneurs from Southeast Europe.

Importantly, this year's forum ties the region's economic future closely to that of the European Union by actively involving the chief EU officials in charge of economic affairs into this top management convention. Symbolically, the forum is thus located at an academic institution close to the disappearing border of EU and its aspiring entrants.

The 2010 SEE Management Forum Bled-Kopaonik will centre on important issues of sustainable development, innovations, corporate governance and communication. Separate workshops will also examine sector-specific topics including energy, telecommunications, agribusiness, pharmaceuticals, and banking and insurance. The speakers will deliberate the position of Southeast Europe region in the global economy and the challenges facing business leaders and their governments, seeking synergies in the region and beyond, and aiming to understand and coalesce the business and government view on economic policies and business strategy.

AGENDA

THURSDAY, 16 SEPTEMBER 2010

08.30-09.00 **Registration**

09.00-09.15 **Welcome**

- **Danica Purg**, President IEDC - Bled School of Management, Slovenia

09.15-09.45 **Introductory address**

- **Mitja Gaspari,** Minister for Development and European Affairs, Government of Republic of Slovenia

09.45-10.45 **Plenary session 1: Searching for strategy after the crisis in the SEE region**

- **Dragan Đuričin,** President, Serbian Association of Economists, Serbia *"Anti-crisis program and sustainable development: An economic practitioner's perspective"*
- **Kemal Kozarić,** Governor, The Central Bank of Bosnia and Herzegovina

10.45-11.00 **Coffee break**

11.00-11.45 **Keynote speech**

- **Hermann Simon**, Chairman Simon – Kucher & Partners, Germany *"The business trends that shape the new decade – What they mean. What has to be done."*

11.45-12.45 **Plenary session 2: Revised development model**

- **Olivier Baudelet,** DG Regional Policy, European Commission
- **Dušan Vujović**, Lead economist, World Bank *"Stabilizing the role of international financial institutions in times of economic crises"*
- **Mladen Ivanić,** Delegate in the House of Peoples of the Parliamentary Assembly of BH

12.45-14.00 **Lunch**

14.00-15.00 **Panel 1: Innovation and learning (parallel track session)**

Moderator: **Iztok Seljak**, President of Management Board Hidria, Slovenia

Panelists:

- **Verica Hadzi Vasileva Markovska**, Partner AAG Skopje, Macedonia
- **Gordana Kovačević,** Managing Director Ericsson Nikola Tesla, Croatia
- **Hallil Kulluk,** Chairman Intecno Group of Companies, Turkey
- **Aleksandar Vlahović,** Partner EKI Investment, Serbia
- **Branislav Grujić**, Chairman PSP Farman, Serbia

14.00-15.00 **Panel 2: Improving operational performance (parallel track session)**

Moderator: **Branko Žibret,** Partner A.T. Kearney, Slovenia

Panelists:

- **Tomaž Berginc,** President of the Board Eti Elektroelement, Slovenia
- **Matjaž Čadež,** CEO Halcom, Slovenia
- **Slobodan Petrović,** CEO Imlek, Serbia
- **Vladimir Čupić,** President of the Executive Board Hypo Alpe Adria bank, Serbia

15.00-15.15 **Break**

15.15-16.15 **Panel 3: Growth and internationalization (parallel track session)**

Moderator: **Nenad Filipović**, Academic Director, IEDC – Bled School of Management

Panelists:

- **Toni Balažič,** President of the Management Board and CEO Žito, Slovenia
- **Franjo Bobinac**, Chairman and CEO Gorenje, Slovenia
- **Dragoljub Vukadinović,** Chairman Metalac, Serbia
- **Emil Tedeschi,** Chairman and CEO Atlantic Grupa, Croatia
- **Zoran Drakulić,** Chairman East Point Holding, Serbia

15.15-16.15 **Panel 4: Sustainability as a new megatrend (parallel track session)**

Moderator: **Goran Pitić,** President of the Board of Directors Societe Generale Bank Serbia

Panelists:

- **Renaud van der Elst,** Head of EU Juridical Affairs Alpiq Swisstrade, Switzerland
- **Nebojša Savić,** Faculty for Economics, Finance and Administration, Serbia
- **Nadya Zhexembayeva**, IEDC – Bled School of Management, Slovenia

16.15-16.45 **Coffee break**

16.45-18.00 **Industry group workshops (parallel track sessions):**

Energy:

Workshop host: Vuk Hamović, Chairman EFT, Serbia

Confirmed participants: Amer Jerlagić, CEO Elektroprivreda BH; **Branislava Milekić**, CEO Elektroprivreda Republic of Srpska; **Bojan Milković** CEO INA, Croatia; **Alojz Stana**, President of the Management Board Geoplin, Slovenia; **Ratko Bogdanović**, Assistant Manager, Head Department for Economic and Financial Affairs, Elektroprivreda Srbije

Telecommunication:

Workshop host: Ivica Kranjčević, CEO Telekom Slovenia

Confirmed participants: Jožek Gruškovnjak, Director Public Sector and Geo Lead, Internet Business Solutions Group, Cisco Systems, Slovenia; **Mladen Pejković**, CEO and CTO VIPnet Croatia

Pharmaceuticals:

Workshop host: Vojmir Urlep, President of the Board Lek, Slovenia

Confirmed participants: Smiljka Mileusnić, CEO Jugohemija, Serbia; **Manuel Neitsch**, Country Manager Bayer Schering Pharma, Serbia; **Gordana Šajić**, CFO Fresenius Medical Care, Serbia; **Dragan Šebrek**, Assistant General Manager, Economic Affairs Galenika, Serbia; **Ljubiša Mitof Višurski**, Country Manager Abbott Laboratories, Slovenia

Food processing and confectionery:

Workshop host: Slobodan Vučićević, Chairman Droga Kolinska, Slovenia

Confirmed participants: Drago Kavšek, CEO Fructal, Slovenia; **Miroslav Miletić**, Chairman Bambi concern, Serbia

Insurance:

Workshop host: Zvonko Ivanušič, Chairman of the Management Board Sava Re, Slovenia

Confirmed participants: Nebojša Divljan, CEO Delta Generali, Serbia; **Igor Stebernak**, Member of the Board Zavarovalnica Triglav, Slovenia

18.00-19.00 **Closing drink**

FRIDAY, 17 SEPTEMBER 2010

09.00-09.30 **1st Day panel reports**

09.30-10.30 **Plenary session 3: Beating crisis: Policy perspective**

- **Božidar Djelić,** Deputy Prime Minister for EU Integration and Minister of Science and Technological Development, Government of the Republic of Serbia
  "Competitiveness improvement and sustainable development"
- **Gregor Golobič,** Minister for Higher Education, Science and Technology, Government of Republic of Slovenia

10:30-11.30 **Plenary session 4: New vision for banks: Refocus, recapitalization and non performing loan management**

- **Draginja Djurić,** President of the Executive Board Banca Intesa, Serbia
- **Božo Jašovič,** President of the Management Board Nova Ljubljanska Banka, Slovenia
- **Wolfgang Edelmüller,** Deputy CEO Hypo Alpe Adria Bank International AG, Austria
- **Fikret Čaušević,** Member of the Governing Board of the Central Bank of BH

11.30-12.00 **Coffee break**

12.00-13.00 **Plenary session 5: Future of Europe: Leadership challenges**

- **Erhard Busek,** Chairman Institute for the Danube Region and Central Europe, Austria
- **Luca Gatti,** Founding Partner & CEO eLogus, Italy
  "Future of Strategic Leadership"
- **Miroslav Macura**, University of Geneva, Switzerland
  "Economic growth, immigration and ethnic structure change in Southeastern Europe: A look ahead"

13.00-14.00 **Panel 5: Future of Europe: Corporate governance perspective (parallel track session)**

Moderator: **Peter Kraljič**, IEDC – Bled School of Management, Slovenia

Panelists:

- **Žiga Debeljak,** CEO Mercator, Slovenia
- **Riccardo Illy,** Chairman Gruppo Illy, Italy
- **Irena Prijović,** Secretary General, Slovenian Directors' Association
- **Toplica Spasojević,** President, Serbian Association of Corporate Directors

13.00-14.00 **Panel 6: Future of Europe: Growth champions perspective (parallel track session)**

Moderator: **Derek Abell**, Professor Emeritus ESMT Germany and IEDC – Bled School of Management

Panelists:

- **Sandi Češko,** Founder and owner Studio Moderna, Slovenia
- **Mladen Fogec,** Chairman Siemens, Croatia
- **Nihad Imamović**, General Manager ASA Holding, BH

14.00-14.15 **2nd Day panel reports**

14.15-14.30 **Closing keynote**

- **Danica Purg**, President IEDC - Bled School of Management, Slovenia
- **Dragan Djuričin**, President Serbian Association of Economists, Serbia

14.30 **Lunch**


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ANTI-CRISIS PROGRAM AND SUSTAINABLE DEVELOPMENT: AN ECONOMIC PRACTITIONER'S PERSPECTIVE

Dragan Djuričin
School of Economics University of Belgrade
&
Deloitte

Abstract

It has become clear in recent years that Serbia's economy suffers from a structural crisis. This is the consequence of two different stressors: transitional stressors and the stressors triggered by global economic crisis. There are strong interactions among them. Namely, local transitional recession associated with a significant output gap and disproportionately high currency risk is compounded by the global recession manifested through credit crunch and demand squeeze. Consequently, Serbia's economy is in a combined crisis (transitional downturn + global recession).

Economists define a recession as two or more quarters of negative growth, so when growth turns positive, no matter how anemic, they declare the end of the recession. In 3Q 2010 Serbia's economy formally left recession, after two subsequent quarters of positive economic growth. This encouraging fact poses two related questions. First, is there a risk of recession reversibility? Second, do policy responses to combined crisis secure sustainable growth? Pondering over these questions one finds more hidden issues than answers.

For Serbia the end of recession is not the same as return to prosperity. The GDP growth rate for 2010 now projected at 1.5 percent is not nearly sufficient to compensate for the 3.0 percent reduction in GDP recorded in 2009 (2008 base) caused by the global economic crisis. Furthermore, the question is how will Serbia compensate for the loss of ⅓ of GDP and ⅗ of industrial production owed to transition downturn in the last two decades (1989 base)? The answer to both questions is through increased competitiveness. Even if we assume that competitiveness of the financial sector was fully restored during the last stage of transition, the problem with real sector competitiveness still remains.

In a crisis the government should address the root problems. But, adjustment to the new economic reality must be carefully crafted. In crisis, a full transparency of anti-crisis program and policy actions are crucial due to elevated social sensitivities. Transparency assumes complete clarity: identifying the problems, formulating the road map (or scenario), understanding the consequences of proposed initiatives (outcomes), and defining responsibilities in implementation. Without transparency, the core accountability of the government to key stakeholders could be lost, thereby increasing the risk of reform reversals under pressures from special interest groups pursuing individual gain at the expense of the country as a whole.

Finding root causes is like peeling back a cabbage, it takes time and must be done one layer at a time. Consequently, this paper suggests a two step approach combining proactive strategic and passive tactical initiatives. The strategic initiatives are geared towards adopting a new investment-driven economic model supported by appropriate monetary policy with multiple tenets and development of a new institutional framework fully compatible with the EU. Large investment efforts aimed at triggering competitiveness growth will be based on a three-pronged strategy: strategic sectors, food-processing and agriculture, and infrastructure from physical to social (education and health). In the post-crisis period, the monetary policy should continue to pursue the tenet of low and stable inflation. The crisis has made it abundantly clear, though, that policymakers have to monitor new tenets, including the output gap, asset prices and currency movements. Also, closing the institutional gap *vis-à-vis* the EU will help to eliminate the legacy of unfinished reforms during transition.

Improving competitiveness across tactical dimension assumes many initiatives such as the establishment of a development bank, a project management center, a science and technology advisory group, a relocation operations program, etc.

The proposed anti-crisis program is formulated from an economic practitioner's perspective. There is a difference between economic practitioners (including academic economists with practical experience, market leaders business executives and world class business advisors), who are deeply rooted in reality, and pure academic economists who are out of touch with reality. To make progress, economic practitioners need navigational guidelines and road maps anchored in economic theory as well as practical, albeit imperfect. Also, sense of timing is crucial. Majority of academic economists are good at identifying underlying forces that would eventually prevail, but are usually not very good at predicting precise sequencing and timing of events that may have a crucial role in shaping our reality today and in immediate future.

Key words: *Combined crisis, competitiveness, sustainable development, transition conundrum, anti-crisis program, strategic initiatives, tactical initiatives, reindustrialization, investments, new economic model, and multi-tenet monetary policy.*

The 2008 Global Economic Crisis: What Was the Problem?

Presently, the majority of national economies are at strategic inflection point in terms of *Kotler* [5, p. 75] caused by two past developments: one referring to systemic risk factors, which ultimately caused the 2008 crisis, and the other reflecting the new role of the state in crisis. From policy perspective *laissez-faire* was not enough. As the crisis gained momentum, the government became a major player in the post-crisis policy model. Crisis shift risk towards individuals and the government has an increasing responsibility to help pick up the pieces. The new reality reflects a paradigm shift, from macroeconomic stability toward dynamic management of change, both in public and private sectors. Crisis economics moves beyond static equilibrium, toward intelligent investments. The cumulative impact of new developments is hard to predict. The recovery started in 2009 is still under the threat of reversal in late 2010 (so-called "double dip"recession).

It is questionable whether the government actions shortened the recession or prolonged and deepened it. What underlies the crisis is the loss of confidence in the financial system. But the failure of the government to undertake an efficient and fair anti-crisis program leads to the loss of confidence in whole economy.

The current crisis is not an exception. Assets bubbles (commodity, financial, real estate, IT, etc.) and their aftermaths are as old as capitalism. In the last two decades there were four serious crises provoked by bursting bubbles (the 1978 oil crisis, the 1990 Wall Street crash, the 2002 dot-com bust, and the 2008 sub-prime and credit derivatives crash). The recession is an unavoidable consequence of bubble bursts. Ugly phenomena like excessive risk-taking, burgeoning conflicts of interest and pervasive moral hazard have repeatedly spun out of control as prosperity turns to bust.

The 2008 bubble became reality once financial deregulation took hold, while the central bank focused exclusively on inflation (low and stable). Financial innovations were so complex, that they had the effect of both increasing information asymmetries and amplifying risk. The bubble was supported by bad bank lending using assets whose value had been inflated by the bubble as collateral. Deregulated financial markets awash with liquidity and low interest rates, global real estate bubble, and expansion of sub-prime lending were a toxic combination. Underestimation of risk led to a massive loss of capital. Trust and confidence that underlie the financial system evaporated. Credit crunch and demand squeeze due to fall in economic expectations were the sources of so called "fear of fear".

All those things were the result of not understanding the fundamentals of the markets (risk of imperfect and asymmetric information and nature of the market risk itself). It was the consequence of forgetting and ignoring not only lessons from economic theory but also historical experience. Regulatory structure that the government adopted during the Great Depression 1929-33 served well, presiding over an unprecedented period of almost 50 years of sustainable growth. In that regulatory framework three elements were crucial: the government provided safeguard to depositors, the central bank played the role of lender of last resort for commercial banks, and the government prevented deposit-taking commercial banks from engaging in investment banking activities.

The last bubble burst in the U.S., but it took down most of the world economy with it, thanks to the interlocking fragility of global financial markets. There were several channels through which crisis become global. The U.S. as "world consumer of the last resort" [6, p. 20] was continuously spending well beyond its means. It was debt based consumption financed through "innovative" financial instruments such as sub-prime mortgages and credit derivatives. Toxic assets were exported quickly into the global financial markets, as nearly a quarter of the U.S. mortgages had gone abroad.

In global bubble capitalism aggregate demand (the total sum of goods and services demanded by households, companies, government, and foreigners) was weak, partly because of the growing income inequality which shifted the money from those who would have spent it to those who did not. From the other side, export led countries (commodities and human force rich predominantly) turned to a policy of keeping their exchange rates competitive. And this meant buying reserve currencies, selling their own currencies and accumulating reserves. Countries with un-competitive economy and financial deficits like Serbia suffered strongly from the crisis, as remittances fell and capital that had flowed into them through foreign direct investments has diminished.

There is no doubt that the 2008 crisis is a structural crisis of liberal capitalism. It opens the discussion about the future of the capitalism. As a system, capitalism can tolerate a reasonable level of inequality if it leads to prosperity. Moreover, inequality exists as a way to motivate people toward innovation and risk taking. But in the last crisis those who were rewarded so well, bursting sub-prime mortgages and credit derivatives bubbles, did not make economy more prosperous. Liberal capitalism is not sustainable if continuously contributes to misallocation of resources and if private rewards are unrelated to social returns.

Economic policy in liberal capitalism cannot address core problems imposed by the last global economic crisis. The fact that banks, investors and consumers are all jammed in the risk-confidence trap caused by fear of fear is a non-standard problem that calls for non-standard solutions. It is a part of rationale why new regulation was needed. It is no longer realistic to follow wait-and-see pattern in hope that the invisible hand of the market would trigger the trial-and-error mechanism that will return the economy back to balance. The crisis ends only when debt levels, asset prices, and factor incomes (wages, interests and profits) get back into balance, but this time thanks to the visible hand of the government. It is not trivial because in time of crisis the adjustments considering income from labor (salaries and pensions) could generate different sensitivities, including radical ones (social unrest).

Anti-Crisis Program: What Happens Next?

There is no scientific basis for the presumption that the markets are always efficient. Also, there is no practical confirmation that market economy is self-correcting, at least in a relevant time frame. In some sectors the problems are larger than in others (financial sector and health care, for example). Last but not least, an individual making economic decisions in the market selection environment is not always rational (*homo economicus*) and acts sometimes in an irrational way. Irrationality due to cognitive biases is the real invisible hand that prevents people from making rational decisions and drives macroeconomic fluctuations. Irrational exuberance leads to bubbles and booms, irrational pessimism to downturns. Consequently, the government has an important role to play to correct market imperfections. First, eliminate market defects (asymmetric information, monopolistic behavior, externalities, etc.) in resource allocation and risk management. Second, prevent the exploitation of individual irrationalities. One of the key roles of the government is to set up the rules and provide referees. The rules govern the economy, the referees include the regulator and judges who help enforce and interpret the rules. Prosperous society has confidence that the rules are set fairly and that referees are fair. In order to achieve that, the government conducts monetary and tax policies as well as essential public services (defense, police, education, and safety net).

In crisis, intelligent state interventionism replaces naive liberalism. The government in the crisis is likely to play an ever larger role for at least three reasons. First, in time of discontinuity governments everywhere found themselves increasingly called upon to mitigate the sometimes negative effects on individuals. Second, the shift in power balance and deep market imperfections have reinforced much of the world bilateral and regional deal making which means that majority of local arrangements are "state-based" (energy, commodities, infrastructure, etc.). Third, the crisis itself prompted government intervention on a large scale to eliminate market imperfections as well as a call for new regulation.

Dealing with crisis and preventing future crises is as much a matter of politics as it is a matter of economics. Political paralysis is inevitable if the government does not make reforms given inconsistent demands of particular interests. Restoration of prosperity needs a new set of arrangements based on trust between all interest groups and between the generation in crisis and the following generations.

The policy model in crisis, however, does not automatically guarantee success. Success is conditioned upon the ability of the government to properly assess the nature of emerging economic trends and design (and implement) a viable, country specific anti-crisis program. Objectives of the anti-crisis program must address the core causes of the crisis and going-forward solutions. In other words, exit from the crisis must bring the economy to a sustainable growth path by balancing threats and opportunities. Sustainability is the new global trend. Its fuel is competitiveness. Sustainability includes economic, social and environmental perspectives (so-called "triple bottom line"). Sustainability assumes balance between maximizing the achievement of objectives for all stakeholders in the business ecosystem (business, social, and more broadly defined environment with open-minded clients) and certain set of limits.

Tensions between policy makers and business executives in a crisis are truly daunting. From one side, the government has been charged with driving prosperity by fostering economic growth. Most of business executives understand that this tenet requires primarily the market forces rather than the state. On the other side, the government must maintain a social safety net and education. Also, government takes on a large role, from setting the rules and enforcing them to providing infrastructure (physical and social) for recovery. Some parts of social infrastructure like education and healthcare have crucial roles in competitiveness improvement. In playing its role the government must eliminate short termism. The argument for the government to think with a long term view is even greater than for business executives, knowing that politicians predominantly think in short term. The space where the different stressors clash will serve as the crucibles where innovations will be generated. In the 21st century innovative economy the government may need to take a more central role in promoting the experiments on which the whole edifice rests. Thinking in long terms means having a vision (what kind of economic system we want in the end). Some breakthroughs in basic science, new technologies and social innovations can have ripple effects on the business ecosystem. The anti-crisis program without a vision could be qualified as tenet missing.

Expanded claims for the government actions in crisis will raise debt to GDP ratio. Today, in OECD countries the debt level, on average, is approaching 80 percent of GDP which is a looming time bomb. Moreover, in 2014 debt levels will likely rise to 120 percent of GDP. The developing world has an additional factor toward a bigger role of the government, growing demand for investments in physical and social infrastructure in order to catch up to the developed world.

Generally, the role of the government expands every time when society needs collective and long term actions. An anti-crisis program is the collection of interrelated initiatives with the purpose to eliminate the crisis distortions. It is a causal and chronological order of different initiatives reflecting certain set of principles. According to *J. Stiglitz* [6, pp: 59-62], a well designed anti-crisis program reflects the following principles: (1) it should be fast, (2) it should be effective, (3) it should address the country's long term problems, (4) it should focus on investments, (5) it should be fair, (6) it should deal with the short run exigencies created by the crisis, and (7) the stimulus should be targeted on areas of job losses.

Serbia: The Story in Short

Serbia's economic crisis is different in so many ways from any other. The economy entered the 2008 global crisis with the legacy of its own structural problems. Its root cause is related to incomplete transition reforms initiated two decades ago. The main consequence is a lingering transitional recession. The specific transition curve is a perverse triple J-shaped curve, which after typical fall never reaches its pretransitional level of GDP [2, pp: 6-7], which is untypical.

Progress in four transition sub-processes is not equal. For the most part, privatization has been completed. Macroeconomic stability (single digit inflation) has been maintained for almost a decade now. However, institutional reforms have not been completed yet and reindustrialization which hinges upon new investment has been seriously postponed. The global economic crisis amplified the consequences of preexisting structural problems in an essentially uncompetitive economy.

Let's now drill into the complications. The output gap is a crucial problem. The GDP in 2009 was at 69 percent of real GDP level recorded in 1989, the last pretransitional year. Moreover, the equivalent level of industrial production is below 40 percent. Furthermore, more than 40 percent of GDP is government related. The economy is not only impotent but also uncompetitive. The trust in local currency as a manifestation of the quality of domestic economy has evaporated. The lack of confidence in domestic currency feeds continued EUR indexation. More than 70 percent of all business transactions are denominated in EUR. This further increases demand for foreign exchange and tilts the equilibrium towards depreciation of the local currency. Currency risk is another big problem. It is a trigger for growing credit risk exposure or threat of default that is not manageable.

The output gap and high unemployment are Siamese twins. Advertised unemployment rate (ILO definition) for 2009 was 16.9 percent. It masked the real dimension of unemployment. Official unemployment rate does not include people who had dropped out of labor force too discouraged to even keep looking, people from grey economy and people who had to accept only part-time employment. Upward of a third of all unemployed are considered to be long term (or structurally) unemployed and thus unlikely to rejoin the workforce any time soon. Many of the unemployed chose to go on disability. Also, teenage unemployment soared to a record level. As the summer of 2010 rolled into autumn, the number of unemployed continued to grow to 20.1 percent.

In Serbia's economy financial and real sectors are not fine tuned. Transitional strategy neglected the real sector, financial sector was in focus. Previous particularly refers to industries producing tradable goods as well as strategic sectors, mostly energy and networks. Two facts provide support to these claims. Low competitiveness of the Serbian real sector is best illustrated by the low share of exports in GDP (18 percent in 2009). For a country of similar size sustainable level is more than 50 percent. In the same year, the share of public and private foreign debt in GDP was at dangerous 75 percent, quickly approaching the 80 percent level of high indebtedness.

With the weakening of the industrial base, middle class jobs in Serbia have been disappearing. Another defect of this strategy is growing income inequality. Service based economies tend to be less equal than manufacturing economies. The *Gini* coefficient as a measure of the difference between top and bottom earners is two thirds higher for the service sector than for manufacturing sectors.

Financial sector in Serbia is bank centric. Capital markets are shallow because they have played only the infrastructure role in privatization. After completion of privatization, capital markets are in retardation. In banking sector retail dominates the corporate business line. In the corporate line, lending is not based on small and medium-sized businesses, which are the basis for job creation in any economy, but instead concentrates on the state sector or investment banking. The central bank does not play the role of lender of last resort but it has jumped during the last crisis into the deposits guarantee function (limited to EUR 50 thousands). The prime rate is on a high 8.5 percent level. On the other side, commercial rates are influenced with high level of obligatory reserves (40 percent of deposits in foreign currency) as well as large country risk. Consequently, cumulative rate is very high. The central bank continually expresses high paternalism *vis-à-vis* commercial banks. The price of maintaining the high profitability expectation for commercial banks is the ballooned balance sheet of the central bank (triggered from liability side). It could be another inflation push factor. But as long as the unemployment rate remains high, the threat is as much deflation as inflation.

With the ballooned balance sheet all solutions for the central bank to stimulate investments are coming from an empty space. If it takes out liquidity rapidly, before recovery is firmly established, the economy could go into a deeper downturn. If it does so too slowly, there is a real risk of currency depreciation and so inflation, especially given the magnitude of excess liquidity through reducing obligatory reserves, for example.

Fight against inflation has always been an exclusive tenet of monetary policy. But it was expensive trial and error process. To achieve selected tenet, the central bank started from a simple role of monetarism mainstream, increasing money supply at the fixed rate, namely, at the rate of expansion of real output. It was complementary with another monetarism hypothesis, the expectation that when inflation is moderate and stable, wages are also stable (so-called wage-price rigidity hypothesis). Contrary to the expectations, empirical evidence shows that the ratio of money to GDP (so-called velocity of circulation) was not constant. In fact, over the period of intensive privatization it has varied greatly and influenced appreciation of domestic currency. Because the concept was not effective and efficient, the central bank refocused on another simple rule, inflation targeting. The main idea of the new concept was that if real inflation rate exceeds targeted rate, central bank raises the policy rate. One of the most telling a criticism on inflation targeting is that it pays insufficient attention to the sources of inflation. If, for example, high inflation is a consequence of soaring commodity prices, monetary policy which raises interest rates will do nothing to prevent inflation. Moreover, some measures were counterproductive. Namely, central bankers' naive belief that when inflation is low they could unleash a flood of liquidity creates bubbles (securities and real estate) in some periods. The last conceptual innovation was market currency rate. Unfortunately, this monetary policy mean was again ineffective and expensive.

Rapid privatization combined with monetary policy with an exclusive focus on inflation postponed reindustrialization and job creation. Employment level dropped from 2.1 million in 2001 to 1.8 million in 2010. Maintaining macroeconomic stability exclusively with monetary means is a very expensive experiment. Today (3Q 2010) external debt is EUR 23.6 billion. To compare this level of debt we go back to 2000, the year of political transition. In that time the foreign outstanding debt reached DEM 10.1 billion (only) even after a decade of geopolitical cataclysm triggered by the break up of former Yugoslavia and economic sanctions lasting for almost the whole period. After political transition in 2000 the election gift from the EU in the form of 70 percent write off of a major part of foreign outstanding debt reduced the level of indebtedness to approximately EUR 2 billion. In the meantime, earnings from privatization and foreign direct investments exceeded EUR 15.5 billion while remittances were at least EUR 30 billion. To maintain macroeconomic stability in the last decade Serbia has spent huge money. To complete the picture of indebtedness it is necessary to take into account the latest developments, the twin deficits. Projections for the end of 2010 are: current account deficit of 7.1 percent of GDP and budget deficit of 4.6 percent of GDP.

All these facts explain Serbia's transition conundrum (unsustainable growth or growth without development). The delay in transition means that catching up to the EU has been prolonged. According to EUROSTAT [7], in 2009 the GDP p.c. for EU27 was EUR 23,600 but in Serbia the same indicator was EUR 4,304 only. Namely, in Serbia the basic indicator of the power of national economy is 18 percent of the EU27. Another power indicator PPS (Purchasing Power Standard) seems slightly better, it reaches 37 percent of EU27.

To complete the position map for Serbia we combine indicators of the power of the economy (GDP p.c. and PPS), with indicators of competitiveness (GCI-*Global Competitiveness Index* from the World Economic Forum and EDB-*Ease of Doing Business* index from the World Bank), indicators of competence (R&D spending to GDP ratio and number of patents per million of inhabitants), and vulnerability indicators (unemployment rate and average age). The radar diagram presented in the Figure 1 expresses a benchmark of key indicators (in relative terms) between Serbia and EU27. The diagram shows tremendous gaps between the EU27 and Serbia with the exception of vulnerability indicators describing the population risk. It seems like a matter of economic alchemy to catch up to the EU with impotent and uncompetitive economy, huge debt burden, twin deficits, shrinking labor force and human capital mismatch.

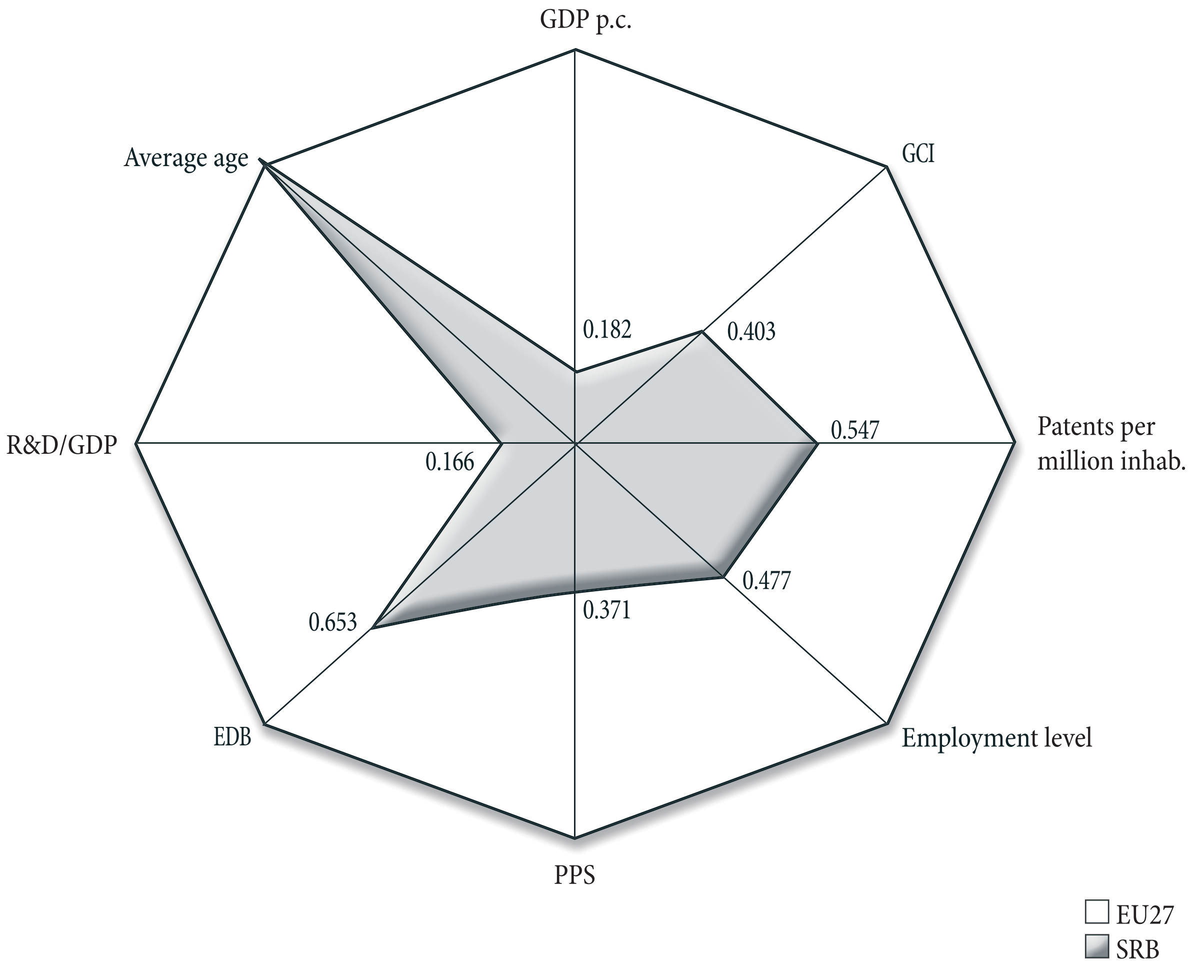
Serbia's Transition Conundrum

Today, economic practitioners in Serbia have two important concerns. The first relates to the effectiveness of the current economic model and within that monetary policy, the second regards the efficiency of macroeconomic policy in combined crisis.

The global economic crisis has definitely made clear that Serbia's economic model (with monetary policy) does not work. The monetary policy of "strong currency in a weak economy" sounds like an oxymoron. Appreciating exchange rate as a measure of local currency strength depends on the strength of the economy, not on policy tenet. The continuation of this model would impose a significant additional maintaining costs (spending currency reserves and/or rising policy rate to attract investments in state papers). This model is not sustainable for at least two reasons. First, due to the structure of foreign exchange reserves. With relatively low exports, remittances are the only reliable source of current financing because during the crisis privatization revenues and foreign direct investments declined sharply. Difficulties in sustaining this policy model are best confirmed by the sizeable IMF package approved in mid 2009 with an implicit tenet of maintaining exchange rate stability. Second, the differences between interest rates on inter-bank (and intra-bank) loans and state short term securities sometimes are spiked drastically. In a "normal" economy, the two interest rates differ little.

One of the issues that raised blood pressure of business executives in Serbia is the exchange rate policy. In the last period the central bank combined the policy of inflation targeting with the policy of market currency rate. The ultimate tenet of the present monetary policy is to maintain macroeconomic stability. Actually, macroeconomic stability is reduced to price stability (single digit inflation).

Figure 1. Key Performance Indicators Benchmark: EU27 vs. Serbia



Policy of market currency rate confirms that the exchange rate is not a tenet or mainly remains below the radar screen of the monetary policy. This policy keeps local currency too expensive to maintain competitiveness in export markets. It has led to a boomerang effect. Namely, it would not sustain in the long run when incomplete institutional reforms and delayed reindustrialization directly cause low level of economic activity and bad competitiveness. Lack of confidence in domestic economy (currency) feeds continued euro indexation. This further increases demand for foreign exchange and tilts the equilibrium towards depreciation of the local currency. At that point the exchange rate temporarily enters the radar screen of the monetary policy as local currency depreciation contributes to increasing inflationary pressures.

The monetary policy uses two means to stabilize the exchange rate in the time of growing pressures on depreciation. First, interventions in the foreign exchange market with currency reserves. For example, in the period mid May to mid Jun 2010, the central bank intervened by selling about EUR 1.3 billion. Second, changes in the policy rate. This instrument is used to increase the return on treasury and the central bank securities (so-called repo papers). As usual, this instrument is directed towards commercial banks to regulate the level of liquidity through open market operations. But, currency markets are rife with externalities in the sense that actions of one party adversely affect others. This probably best confirms the absence of any tuning between the real sector and the financial sector. It is somewhat puzzling that an economy operating significantly below potential GDP level continuously has excess liquidity in the banking sector. Currency market failed, and the presence of the large externalities is one important reason. But there are others, correlations for example. Until recently, policy rates were quite high and created an upward bias in commercial bank expectations from credits extended to real sector. Large and growing interest rate spreads are further eroding the competitiveness of the real sector due to extraordinary high cost of capital.

This monetary policy generates at least three paradoxes. First, short term orientation. Market may help with adjustment of demand and supply of foreign currency, but not necessarily in the way that promotes macroeconomic stability in the long run. If the central bank pays attention exclusively to inflation, long-term interest rate will rise, and this will dampen the economy both directly, because it will reduce the demand for investments, and indirectly, because commercial banks will be induced to hold treasury and central bank papers rather than to release credits. But, as we have seen frequently, there is little reason to believe that the central bank calibrates the response (volume of intervention and/or level of policy rate). Second, price stability is pursued for its own sake. If despite stable prices, investment, production, employment, and competitiveness of the real sector all continue to fall, what is the rationale for defending the stability of exchange rate by selling currency reserves and/or increasing the policy rate? Third, the central bank involved itself in risky open market operations. By doing so, the central bank went from being the banks' regulator to being the banks' deal maker. Does this pose a conflict of interest problem? Apparent consequences seem to suggest so. Repo operations are an important source of income for commercial banks. Thanks to that, the banks can make a reasonable profit margin by charging high interest rates even on limited lending. But this behavior discourages companies from investments and from hiring new employees. At the same time, the central bank is taking a substantial cost of defending the exchange rate which contributes to its operational losses, while the real sector is faced with growing risks (currency and credit). Interest rates in Serbia are significantly higher than in the EU and in the neighboring countries. This fact also increases risks in the financial sector caused by the volatility of speculative capital flows attracted by exceptionally high returns on state securities.

The confidence of this monetary model is maintained through high obligatory reserves, the requirements which, in turn, contribute to further increases in the interest rate spread. For business executives in Serbia foreign exchange risk has a paramount importance. The main source of discomfort comes from the fact that foreign exchange risk can instantaneously become a credit risk.

The previous analysis has described how monetary policy in Serbia misallocates capital, especially proceeds from privatization. But the real cost of that misconception may be greater. It led to misallocation of human capital as the scarcest resource in this geography. Too many youngsters believe that high pay reflected social contributions. The most popular (and expensive) graduate course not only in the School of Economics but also in the whole University of Belgrade is the course for portfolio managers. When I was an undergraduate, the best students went into engineering, basic science, and medicine. At that time they wanted to change the world by using their brains. Today, young people are money-oriented. Actually, they are the victims of pathology of the society who value maneuvering of financial markets more highly then entrepreneurship and science. Human capital mismatch is a logical consequence of the economic system which systematically encourages more young people to go into brokerage and rent-seeking activities instead of industrial ones. Human capital mismatch may be larger and even harder to correct than others deficits.

The efficiency of the government could also be monitored through performance of state owned companies and budget discipline. In the public sector reform objectives have not been met. Given the huge size (over 40 percent of GDP), inefficiency of public sector affects the private sector both through prices of goods and services provided and the fiscal burden. In the risky and fragile post-crisis environment, this additionally lowers investments, increases the necessary working capital and pushes private companies to downsize its business.

Public expenditures continue to exceed available revenues. Budget deficit is between 3 and 5 percent of GDP. Deficits are covered through future tax increases rather than through aligning expenditures with the revenue capacity (budget discipline). Hard budget constraint policy imposed to the private sector should be employed in the public sector as well.

Faced with the global credit crunch, demand squeeze, volatile prices of commodities, high interest rates, and growing foreign exchange risks, private companies in Serbia find it increasingly difficult to maintain a sufficient level of liquidity and sometimes these factors push them out of business. It is especially the case when private companies are faced with large changes in regulations with retroactive effectiveness. Regulatory risk, thus, becomes a new reality amplified by the recent introduction of water and land usage fees. Despite public commitments to exercise fiscal restraint, in reality we observe fiscal expansion. Local governments became very active in this regard after the delay in implementing the regulatory *guillotine* initiative. The discretionary right of local governments to impose new taxes and fees on businesses and households reached absurd proportions.

Concept: What is the Road Map for Serbia?

The economic state of the country is not as good as it could have been. The current economic model is not sustainable for at least two reasons. First, it increases external liquidity risk. Significant twin deficits are a direct consequence of impotent economy and insufficient supply of competitive tradable goods. Second, this model increases political risk. The consumption levels are beyond means enabling the current generation to consume more than it otherwise would. That level of consumption erodes savings and generates public deficits, which are financed either through external borrowing, passed on to the next generation, or monetized and absorbed through inflation and/or currency appreciation.

From an economic practitioner's perspective there are two dilemmas. First, whether the government and the central bank in Serbia understand all the risks brought to the business ecosystem by the combined economic crisis? Second, what is their approach to defining an exit strategy that neutralizes the negative effects of the combined crisis and provides a basis for sustainable development? Systematic and reasonable people may differ in their answers to these questions (value judgment), but in the panic of responding to the crisis it is possible to make mistakes and overestimations.

Serbia's economy needs to be restructured in directions that are not perfectly clarified. There are many scenarios. Yet, there is little consensus over which road map will be adopted, much less how it will be enforced. What is clear is that any scenario will require significant resources (financial and human) and public spending. Resources will have to move from some sectors which are not competitive to others that have better prospects for sustainable growth. Also, some resources will come from external sources. Adjusting to this shift in the structure of the economy will not be simple. It is easier to lose jobs in areas where competitive advantage has been lost than to create new jobs in propulsive areas. Consequently, export and import substitution are the main tenets. Central part of restructuring the economy entails going from the service sector to the manufacturing, logistics, infrastructure and agriculture. During transition Serbia's economy lost its fundamentals, the real sector. During transition the center of the new economy was the service sector. But that raises a logical question of how could something that represents the end of the value chain become the center of the economy? Serbia needs a return back to the basics.

In any case, feasible vision for Serbia going forward must be articulated as part of a global vision. It is not easy to maintain macroeconomic stability (price and currency) when growing financial instability has become an increasing global problem. Also, when so many countries borrowed so much to finance their anti-crisis programs there is a risk of a substantial increase of interest rates. Consequently, highly indebted countries with limited ability to raise taxes may face a financial crisis. Investments are a typical remedy for that situation.

Also, new vision for Serbia must respect local specifics. Architects of anti-crisis program can and must foster homegrown solutions, be they conventional sources of comparative advantage (natural resources, qualified work force, position to market or geographic location) or new sources of competitive advantage (technology and social evolution). The long term problem in Serbia is the output gap. The productive capacity is being underutilized in the same time when huge unmet needs exist. Moreover, the most serious underutilization is the one of human capital. Thousands of people do not have education to use their potential fully, and even when they do, they do not do it at their full capability. The social loss due to absence of decent work is, maybe, far greater than the output gap.

Restoration of sustainable aggregate supply is the starting point of an anti-crisis program for Serbia. Recovery of manufacturing is the main challenge. That sector has the potential to reach both export and anti-import tenets. Employees in that sector are well paid and represent the backbone of the middle class. But, the sector has limited capacity for employment. Growth of productivity means that even as the sector grows, employment decreases. Diversification is the solution.

Serbia has, in addition, some further challenges. The most important one is demographic risk. A huge shift is underway due to diminished labor force growth. Low birth rates and graying workforce will make it enormously difficult to maintain sustainable growth in the future because labor is not a deflation but an inflation factor.

Serbia's economy also faces series of sectors problems. Finance as one of the best positioned sectors is based on unsustainable premises and is not backed up with solvent real sector, while much of another, energy sector, is not environmentally sustainable. Further, telecommunications suffer from profitability crisis, food-processing has inadequate branding and agriculture is in devastation. Last but not least, Serbia has an inefficient education sector. Students perform more poorly in science and mathematics than the average of most emerging market countries. Healthcare is another arena where do-it smarter will thrive.

Our vision is that only economic growth fully contributes to the benefits of all interest groups or leads to sustainable win-win-win proposal for the government, tax payers and private investors. An anti-crisis program inspired by an idea of redistribution may be politically appealing and leads to zero-sum game in the short run, precisely to the win-win-lose proposal (the government wins, tax payers win, if the program works for budget, and private investors lose). This populist approach is not sustainable in the long-run and it leads to negative sum game or lose-lose-lose proposal because when incentives to produce value for private investors disappear everybody loses, nobody wins. Also it is questionable whether large redistribution of income through progressive taxation (taxing those at the top of the social pyramid more heavily, reducing taxes at the bottom line) is feasible when new capitalists in Serbia have a tremendous debt burden in their companies. Hence, the primary role of the government in the crisis is to provide incentives to the economy to lead economic revival and growth.

As we think about the vision, it is natural to begin by thinking about what is Serbia's long-term competitive advantage, and how it can be achieved. Competitive advantage lies in the capitalization of comparative advantage that Serbia already has. Namely, Serbia must specialize in its comparative advantage, in those areas that reflect its relative strengths. Serbia has comparative advantage in energy sector, agriculture, food processing and logistics. After transition Serbia no longer has a comparative advantage in many areas of manufacturing. But, in some areas it still does. There are some niche players operating successfully on global market in many manufacturing sectors. It is well known that a country's comparative advantage can change. But what matters is competitive (dynamic or sustainable) advantage which also reflects the shifts in their sources, specifics of modern technology, the evolution of key competence and configuration of the value chain. Forty years ago Korea's comparative advantage was not in producing consumer electronics or automobiles, but in rice. But the Korean government has stressed the roots.

Achieving the new vision will require a new economic model. Sustainability will require less emphasis on services and a shift in the direction of manufacturing, infrastructure, logistics and agriculture. The government must inspire and energize new investment drive. Instead of focusing on redistribution of income and resources, it should support pro-investment logic as the right step in the right direction. Serbia's substantial transition deficits can only be eliminated through a higher level of economic activity, primarily in the sectors producing tradable goods, but also in sectors producing non-tradable goods enabling efficient import substitution.

It is a well known economic fact that value is created in the real sector and released through financial markets. If there is a gap between value created in the real sector and the value released in the financial sector, it leads to bubbles in macroeconomic fund flows. Bubbles tend to grow until they burst or get deflated. The government should scrupulously avoid re-inflating burst bubbles, either by incurring debt at the expense of future generations or by re-monetizing deficits creating inflationary pressures. It should seek an exit strategy by enhancing the level of investment activity, especially in sectors producing tradable goods, while at the same time vigorously implementing public and private sector reforms, and modernizing public administration to lower the fiscal burden on the economy. Also, it would make sense to give priority to investments that strengthen our future, high return investment in human capital and technology.

Investment drive improves macroeconomic stability, and eventually gives a meaning to industrial policy aimed at improving competitiveness. It supplements social and regional development policies by providing real sources of financing and creating added social cohesion. Taken together, investments lead to greater political stability, a necessary condition for survival and prosperity of any state. Only politically stable countries can implement their intentions.

To balance investments (or allocation of resources to specific projects) and financing (or resource mobilization), a country needs an appropriate financial system. Together, the financial system and monetary policy represent the financial side of the new economic model. The crisis has made clear that monetary policy must embrace many tenets. In addition to price stability, the new monetary policy must secure a predictable exchange rate and lower unemployment. A well functioning financial system (well regulated banking system in case of Serbia) with cheap money could lead to prosperity, as it did in other times and places.

In the period before the crisis central bankers all over the world have promulgated the doctrine that central bank should be fully independent. The argument for independence is used as the prerequisite for credibility, in a sense that central bank will not encourage populist intentions toward expansionary demand which means less inflation and greater macroeconomic stability. For many countries it is hard to take. Moreover, independence is not always a prerequisite for credibility. The issue is trade-off between inflation and unemployment [6, p.142]. In the long run, too high rate of unemployment gives rise to an ever increasing inflation. In the short run, sustainable growth rate (the non-accelerating rate of unemployment) as a rate bellow which inflation is set up is critical. In case of Serbia the gap between aggregate demand and the level of production is a structural cause of inflation. Consequently, rule based approaches to monetary policy like inflation targeting are neither efficient nor effective. From the other side, the free market mantra for currency rate meant doing nothing to address output gap and, consequently, high unemployment. It is not fair to forcefully, sometimes almost brutally, resist and ignore all initiatives to correct currency rate policy, especially when the central bank is using credit from the IMF to maintain currency stability. Also, such behavior worsened the problem of moral hazard, burdening future generations with the legacy of debt and strengthening doubts about fundamental fairness of that policy.

The proposals in the suggested scenario range from offensive strategic initiatives to defensive tactical initiatives. In the segment of strategic initiatives we will propose a new economic model. In the segment of defensive tactical initiatives the intention is to improve the existing level of competitiveness for current market players.

Initiatives: What is Feasible?

A flow diagram depicting the process of anti-crisis program formulation is presented in the Figure 2. The initiatives are the central part of the diagram. They correspond upward to the stressors from combined crisis and downward to the competitiveness tenets.

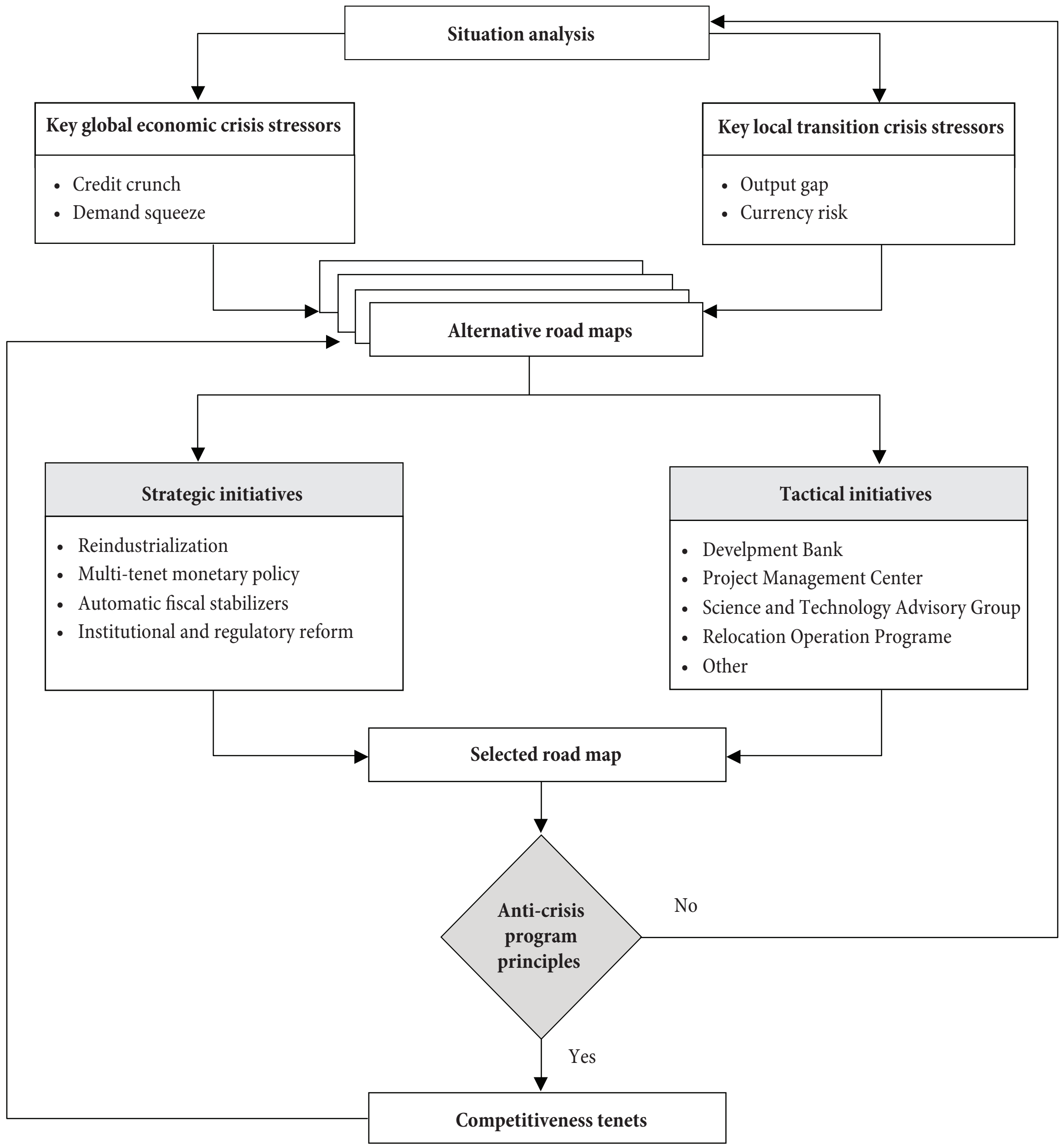
Reindustrialization, the new economic model (with multi-tenets monetary policy), automatic fiscal stabilizers and regulatory reform are the main strategic initiatives.

Reindustrialization is the zero stage in anti-crisis program. It is the legacy of unfinished transition. There are three triggers for reindustrialization. First, investments in strategic sectors based on network technologies (energy, telecommunications and logistics, most of all, but defense also). These sectors are for the most part still state owned („one can influence those that can be controlled"). Also, these investments would increase the supply of tradable goods and/or services which would have a positive impact on external liquidity and the stability of the exchange rate. In addition, these sectors are projected to face growing demand in the long run. Finally, these sectors require a large investment volume with strong multiplier effect on the growth of aggregate demand. In other words, these investments tend to create strong demand in related sectors, such as construction, electrical equipment, and ultimately increase demand for financial services. Given an overhang of debt, it is crucial to give more equity to state owned companies to recapitalize them. To follow this pattern, strategic partners will inject paid-in capital.

Second, investments in food-processing and selected sub-sectors in agriculture (organic food and fruit production, for example). These investments could generate new production of tradable goods, but their main tenet is either direct import substitution or production of non-tradable goods and services that serve as inputs for import substitution. Growth of this production is expected to close the gap in demand for food and agriculture and help reduce the deficit on the current account balance. These investments should be financed either from private sources or public private partnerships (PPPs) which both assume the existence of appropriate programs (one-stop-shop, tax incentives, etc.) aimed at attracting foreign investments.

Third, investments in infrastructure. Contrary to the previous investment trajectories which are based on comparative advantage, these investments are a prerequisite for doing business in other sectors. These investments usually have indirect effects that far exceed direct effects. It is a powerful magnet for ready made investments. There are some differences in financing physical and social infrastructure. Financing of the physical infrastructure can be done through concessions, including building-operating-transferring (BOT) and its versions, PPP, and debt financing. The main reason for diversifying sources of financing is to secure a sufficiently large volume of long term resources given the constraints imposed by the level of debt burden and the debt service schedule. A prerequisite for the success of investments in physical infrastructure is elimination of bureaucratic red tape and rapid creation of adequate administrative capacity of responsible ministries, especially in the area of project management. Social infrastructure includes education, science and technology, and healthcare. Investments in people and technology are high-return investments, but in the long run. Consequently, funds are coming from the government. History shows that majority of productivity growth (more than two thirds) comes from product and process innovation combined with social innovation. New jobs created

Figure 2. Anti-Crisis Program Flow Diagram



in the modern era require complex knowledge skills. The new leadership is anchored in new specializations such as project manager, chief information officer, risk analyst, actuary, internal auditor, logistics manager, etc. Some manifestations of brain power such as intellectual property, brand, know how etc., will be major value drivers in the 21st century economy.

Education programs play the role of bridge between university, science and industry. Good programs will eliminate the growing human capital mismatch. Adjusting the education system to the needs of leading edge technology is the primary issue. The shift from financing education institutions to financing education programs is necessary. Doing smarter business in healthcare will also thrive. The idea of dealing with the expansion of surgery centers instead of sending patients abroad makes sense.

Monetary policy is in the center of the new pro-investment economic model. According to *O. Blanchard, G. et. al* [1], the crisis clearly forces on us doubt that we know how to conduct monetary policy. Precisely, high positioned executives from the IMF concluded in cited article that the ultimate tenet of macroeconomic policy remains the same, low and stable inflation, but the economic crisis has revealed that policymakers have to watch new tenets, including elimination of the output gap, composition of the output, and behavior of asset prices, including currency price [1, p.16]. Currency price monitoring means at least exchange rate predictability or stability at last. Policymakers have potential to match more instruments than before the crisis. Combination of traditional monetary policy means (and regulation tools) and the design of efficient automatic stabilizers for fiscal policy are promising routes for macroeconomic policy in crisis.

Faced with imperative of sustainable economic growth in the aftermath of the global economic crisis, Serbia desperately needs a model of monetary policy which would pursue a broader concept of macroeconomic stability (including both price and foreign exchange stability) and expand its radar screen to monitor unemployment. Naturally, the IMF (as the guardian of international liquidity) is interested in price stability and sound financial sector parameters and performance. Likewise, the government should be concerned with the infrastructure, cost of capital, the competitiveness of the real sector, and investors perception of the economy as these factors define the investments volume, job creation and growth. In each society unemployment triggers not only economic problems but also social tensions.

Expectedly, in a non-competitive economy burdened with high indebtedness and structural problems, the exchange rate cannot be stable over longer periods of time until institutional reforms and intelligent investments restore competitiveness. Meanwhile, the monetary policy must be flexible in exercising occasional adjustments in the exchange rate but following transparent rule based procedure. Currency rate policy must be transparent and simple (for example, quarterly adjusting currency rate with inflation differential). Transparency means predictability. Predictability contributes to exchange rate stabilization.

The government should not assist (or boost) the existing private sector investment appetite by releasing special programs for them. Restoration of aggregate supply, supported through the three investment trajectories discussed above, is likely to induce greater private sector confidence leading to investments, job creation and growth in line with competitive market behavior. With revived aggregate demand, the main role of the government is to secure an institutional environment compatible with the EU, including its main manifestations like interest rate and taxes.

In creating the institutional (legal and regulatory) framework, Serbia should seek full compatibility with the concepts and specific solutions prevailing in the EU with zero defect in preparation and implementation. The fact that Serbia is a small economy does not mean that it should give up the great ideas adopted in the EU regulatory framework. The budget discipline, tax and monetary policies aligned with the EU practice are fully acceptable reform objectives for the economic practitioners. By contrast, domestic and foreign businesses operating in Serbia do not accept the concepts that are out of economics principles and without practical support as well as policies that are not explicitly stated, have retroactive and selective applicability, change the essential elements of the business environment, or contradict global economic trends. The role of the government in anti-recession policy is not only to attract new investors but also to retain the existing investors.

After solving the main structural problems (output gap, exchange rate transparency, and economic system compatibility) the reform architects will be in position to develop the strategy for competitiveness improvement. This is the next issue in anti-crisis program, defensive tactical measures. Actually, the strategy will be developed for many niche players from different real sector industries as a response to the growth of aggregate demand based on massive investment influx. Contrary to the previous investment trajectories, the strategy is based on capitalization of the competitive advantage. For example, Spain and Greece have well developed infrastructures and significant income from service sectors but they are in deep recession primarily due to the real sector with competitive disadvantage.

Easy financing is also an important prerequisite for investments rejuvenation in private sector. A specialized development bank can provide this kind of support. It could be formed by merging some existing state-owned financial institutions. Additional capital could be provided from privatization proceeds and/or from special purpose international loans. The main activities of the bank would be financing of the production of export and anti-import goods, provision of guarantees for companies taking part in international tenders, and financing new programs in high tech (ICT sector, primarily). In the era when microfinance for small and medium size companies has become a mainstream, allocation of funds to support state owned companies may seem elitist and inequitable.

Another proposal is the initiative to create a project management center. To manage large public and private sector projects throughout its lifecycle (initiating, planning, executing, monitoring and closing), country needs critical mass of expertise in the area of project management. Every member of the project team will have the necessary expertise (PMP-*Project Management Professional* certificate), experience, and professional growth potential. With a credible team of experts, good project documentation, and support in negotiations with subcontractors, supervision and control would be significantly improved generating shorter lead and implementation times, within agreed costs.

The next tactical initiative could be founding of a science and technology advisory group. The knowledge based economy is the mantra of governments everywhere. Achievement of this aspiration needs world class intellectual property. Serbia is a land locked country with relatively poor resource base (including labor force) and far from major markets. Consequently, the primary source of competitiveness is human capital. Serbia must combine different approaches including strong diaspora connections with knowledge, and/or capital and/or customers. There are many prominent high-achieving expatriates in the U.S. and Canada in the fields of ICT, computer science, electronics, engineering, and life science with Serbian origin. Taiwan is a good example of how the government with a vision transforms brain drain to a reverse, brain gain [4, p:44-6]. Taiwanese government in 1980s engaged in consulting with prominent experts in lead edge technology companies from the U.S. and established an ongoing forum to collect their inputs. The government built many programs based on suggestions of that forum. When the other expatriates realized how successfully projects were implemented, they returned home to occupy prominent policy positions or run new companies that were established. Between 1988 and 1990, around 40 thousands engineers returned home. Today this is the human capital backbone of Taiwan's ICT industry.

Also, a useful tactical initiative would be a program to attract international companies to relocate their headquarters in Serbia (Belgrade, Novi Sad and Kragujevac, for example). The implementation of this initiative is based on recent trends in relocating administrative activities and moving corporate governance thanks to the breakthroughs in modern ICT (near short information outsourcing, for example). This would increase utilization of idle business in these cities, as well as significant information and staff potential for large scale data processing and IT support. The implementation of such an initiative would require significant changes in the tax legislation, the introduction of a visa regime for foreign investors, and other enabling activities. Poland has recently created special tax breaks for companies relocating operations there. For example, *Hewlett Packard* and *IBM* have put centers in Wroclaw.

Completion of the regulatory *guillotine* and implementation of the proposals advised by the Competitiveness Council could also help to attract investors. These measures also include the NALED proposals to promote local economic development based on transfer of land ownership from the state to local government. If properly managed, this could be a basis for PPP projects and the issuance of local municipal bonds to raise revenues for financing local development.

Last but not least, helpful tactical initiative is involvement of media in the story. If the government intends to promote entrepreneurship, it can also take a soft approach. Start-up success stories broadcasted through the media quickly become part of a social dialog and raise awareness about opportunities and threats in doing business. The media can play an important role not just in celebrating wins but in changing attitudes. Today if some *empresario* (usually without economics and business management background and practical experience as well) self-proclaimed as "expert in the field" is being interviewed in the newspaper or on TV everybody respects his statements. His popularity is growing rapidly if he describes the negative image of local entrepreneurs as greedy exploiters and preaches for progressive taxation. The media could play a crucial role in transformation of the negative image which entrepreneurs have in crisis. The society needs entrepreneurs much more than the entrepreneurs need the society. Encouraging people to have entrepreneurial aspiration is a small step in good direction in the process of economic democratization of the society.

Instead of a Conclusion

It is the old sentence that near death experience forces one to reevaluate tenets and values. After geopolitical cataclysm in 1990s Serbia's economy has had a near death experience. Recent global economic crisis has made us more myopic. In the combined economic crisis economic practitioners, of course, face no shortage of challenges. It is not easy to accompany microeconomic adjustments with macroeconomic imbalances. Today Serbia's economy is at strategic inflection point. We should take this moment of thinking about the society we would like to have for asking ourselves: are we creating an economic model that is helping us to achieve that?

At the start of the global economic crisis, the government and the central bank in Serbia were excessively optimistic. As the crisis unfolded they hoped that main problem was "irrational pessimism" coming from some economic practitioners. It is a paradox to blame the messenger for bringing the bad news. But it is far better than killing them as it was the practice in the Ancient Rome. We have lost the sense of urgency and what has happened so far is not good enough to seize the opportunity for reaching sustainable balance between tenets and means, between the market and the state, between the individual and the society, and between short run and long run.

This article offers two things in order to promote real optimism. First, clear picture of why today so many economic practitioners in Serbia feel disillusioned. The first step for exit strategy is problem identification. Second, the forward looking road map on how we can exit from the current combined crisis and develop a feasible approach to restructure economy.

Figuring out what to do in an economy in the combined crisis is not easy. The government response with an anti-crisis program could set the economy on the path to recovery. It is far better than the opposite tactic, doing nothing, which the government can also take. Realizing that every recession comes to an end thanks to an invisible hand of the market provides little comfort for policy makers especially if you take into account the fact that after two decades of transition Serbia's economy has almost 1/3 of GDP transitional deficit, high costs of maintaining price stability, many structural problems, and large debt burden. During time of combined crisis where the global crisis and local crisis exacerbate each other, failure to act can be as dangerous as wrong policy moves. This adds political uncertainty to the economic uncertainty because that course might push the economy into depression and society into social unrest.

In fighting with the combined crisis the government was able to make a turnaround. Positive growth rates in the last two quarters confirm that the recession is formally (or statistically) over. The best that could be said is that the economy is at the end of a freefall or decline without an end in sight. The rate of decline in near environment has only slowed down. Technically speaking the second derivative had turned positive. But the end of the free-fall does not automatically mean a return to prosperity. However, GDP growth rate projection in 2010 at 1.5 percent based on latest announcements is not nearly sufficient to compensate for the 3 percent short term reduction in GDP recorded in 2009. Furthermore, the question is when will Serbia implement a new economic model that would help compensate huge transition deficit in GDP and embark on a path of sustainable growth?

We cannot wait until after the crisis. Indeed, the way we are dealing with the crisis can not avoid the government. In formulating anti-crisis program every successful economy needs both market and the government. There needs to be a balanced role. It is a matter not just of "how much" but also of "what" and "when". Finding root causes is like peeling back a cabbage. Consequently, prescribed road map contains some proactive strategic initiatives and some passive tactical initiatives. The proactive strategic initiatives are geared towards adopting a new economic model based on strong pro-investment drive, new monetary and fiscal policies, and a new institutional framework fully compatible with the EU. The benchmark analysis of competitiveness strategies for respectable national economies is the input for tactical initiatives formulation.

Serbia needs a new vision not just because the current economic model failed but because the world economy is changing. Prescribed scenario is an attempt to figure out a pragmatic and realistic compromise with leading trends, even a sensible approach to restructuring the economy and society as well. There is no exact formula for achieving sustainable growth. There are only practical, even if imperfect, road maps. But to formulate some feasible scenario, you must respect conventional economic principles, the best practice and new principles in time of crisis.

Aside from the expert elite in the government, and the business and academic elites, the exit from the combined crisis also requires political elite that understands the lead trends, has a clear vision how to exit the crisis, and uses all available resources to achieve this target by catalyzing positive and sustainable change. Politicians are continually pressured by the anti-business backlash. They must work well with business leaders as the best way to resolve their biggest political dilemmas. This is a time to lead through interaction with the elites (including business one), not to follow populist demands, in order to create the society that is both prosperous and sustainable.

Business leaders will do well if they acknowledge problems coming from the environment and work with the government to help solving them. The risk of populist anti-business backlash is tremendous in Serbia but companies and banks have the "right to operate" in a pro-business environment. Just as business leaders need to recognize challenges facing the government, the government must recognize the legitimate role they play to formulate and enforce solutions. Only a strong and growing private sector can provide funds required to meet expanding government's needs.

If Serbia is going to succeed in reforming its economy, it may have to begin by reforming the economic profession at first. I was more surprised with the surprise of local expert circles when a similar document was presented to society two months ago [3]. The rules of prevailing paradigm were that the economy is doing relatively well, the market is efficient and self correcting, and just wait and see and the economy will recover. Even though the economy plunged into recession, some expert circles gave surprising advice, do nothing. Similar advices were: the government that governs best is the government that governs least; the only feasible tenet of monetary policy is price control, multiple tenets are like "wooden iron"; the lower the tax rate, the higher the growth rate; increase expenditure to stimulate the economy meant increasing deficits; putting output gap on the list of tenets for monetary policy means money printing; etc.

Successful economies have not been bogged down by certain ideological predilections, such as that market is always efficient and the government is always inefficient. As professionals, we need a "war of ideas", variety of road maps instead of nihilism. As manifestation of specific value judgment, each road map must reflect economic principles confirmed in reality as well as comprehensive anti-crisis program principles (*J. Stiglitz* principles, for example) to eliminate the main imbalances and restore economy. Once the main balances are achieved and the economy restores to full employment and sustainable growth, and standard of living starts growing again we could return to the marvels of the free market economy. Until than, we must follow an anti-crisis program solutions.

National economies succeed not only because their leaders are always right, but because they are positive. When you are positive, even if you are wrong, correction and improvement of wrong decisions lead step-by-step to success. This encouraging thought should, maybe, inspire Serbia's leaders (both in business and politics). Is this approach feasible? Rwanda is a good example. According to [4, p.41], in the latest *Ease of Doing Business* ranking from the World Bank, Rwanda made a spectacular leap, from 143rd to 67th place. Considering sub-index of ease of opening a new business, Rwanda ranked 11th worldwide. The GDP p.c. has almost quadrupled since 1995. To remember, it is the same country whose institutions were decimated by genocide two decades ago. As the first step in turnaround strategy the government has formulated key steps for competitiveness improvement identifying three local industries that had proven potential for investments. Serbia today takes 88th place in the same ranking. Will we seize the opportunity to define our priorities and restore competitiveness? Eyes open, optimism is awarded!

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TRANSITION BALANCE OF SERBIAN ECONOMY

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Republic Development Bureau

'Today, competitve advantage heavy like butterflay dream'
(Kjel Nordstrom)

Abstract

The global economic crisis hampered the realization of structural reforms and was manifested as a combination of the crisis of solvency and productivity of the real sector. The initiated reform processes, in spite of some positive trends registered, have not managed to wipe out long-standing, accumulated problems nor negative effects of key limitations, which led to inefficient economy and deprivation of capacities to boost its productivity and competitiveness. A large decrease in domestic and foreign demand, a limited and more complicated access to financial sources, diminished foreign investment and the inflow of funds from donations and remittances, and a drop in purchasing power of citizens led to increased indebtedness, lower liquidity and solvency, and initiation of bankruptcy procedures for a large number of enterprises.

The process of transformation of social and state enterprises is not complete. Large industrial loss-makers increasingly burden macroeconomic balances. Transformation of state public enterprises is in its early days. A new model of economic growth needs to be based on strategic planning of economic development.

Key words: *Transition business scores, financial indicators economic structure, indebtedness, liquidity, solvency, annulled privatizations.*

JEL: D21, G31, P21, O11

Introduction

Economic reforms which were launched in 2000 have induced many changes to the environment in which Serbian companies operate. One of the reform targets has been to strengthen market discipline and improve competitiveness, which has been supported by programmes aimed at endorsing productivity growth, upgrading competitiveness at the level of companies, reinforcing export-oriented operating, internationalization, etc. Privatization and foreign direct investment, and the inflow of private capital through investment funds have enabled joint undertakings with multinational companies, import of new technologies and capital goods, and expansion of production range.

The global economic crisis hampered the realization of structural reforms in 2008 and 2009 and was manifested as a combination of the crisis of solvency and productivity of the real sector. The global economic crisis affected operations of companies in that their volume of work decreased, payment of liabilities was more difficult because of a decline in liquidity of economic entities and, in particular, realization of revenues from legal entities undergoing bankruptcy was lower.

Transition Business Scores in Economy 2002-2009

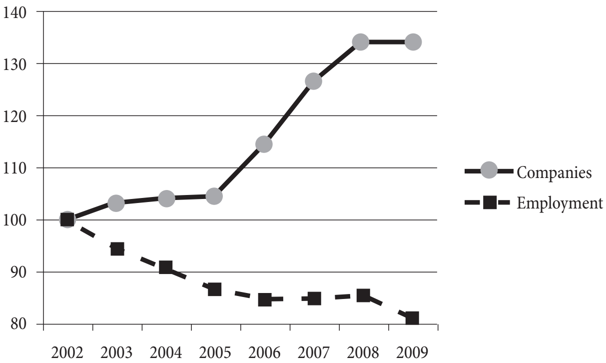
Positive effects of the transition period 2002-2009 can be tracked through the growth of the following parameters: the number of companies (33.9%), total revenues (86.0%), profit (230.0%), and GVA of the corporate sector (113.4%). On the other hand, the process of transition further aggravated by business conditions imposed by the global crisis deepened the problems that had existed during the pre-transition period: liabilities increased 2.3 times, a loss 2.5 times, and accumulated losses 1.3 times. Non-liquidity, accumulated losses, and increased indebtedness burden all companies equally irrespective of whether they operate with positive or negative financial outcome. Large industrial enterprises pose yet another problem – they are lame ducks that are struggling with obsolete equipment, uncompetitive production programmes and excessive employment, and are still undergoing the process of restructuring whose outcome is uncertain. The initiated reform processes, in spite of some positive trends registered, have not managed to wipe out long-standing, accumulated problems nor negative effects of key limitations, which led to inefficient economy and deprivation of capacities to boost its productivity and competitiveness.

Table 1. Transition Effects 2002-2009

	Growth rate (%)
No of companies	+33,9
Employment	-19,0
Revenues	+86.0
Liabilities	+133.9
Profit	+230.0
Loss	+154.3
Accumulated loss	+33.2

Source: author's calculations on the basis of the RDB and BRA data

Figure 1. Growth Rates of the Number of Companies and Employment (2002=100)



Source: (RDB)

The number of workers in 2009 in relation to 2002 went down by 248,002 (by 19.0%). The trend of declining employment was interrupted in 2007 and 2008 but operating problems caused by the crisis led to a repeated decline in the number of employees in 2009.

Total revenues generated in 2009 (EUR 66.3bn) were two times the value of revenues of 2002 (at EUR 35.6bn). Total expenditure exceeded total revenues in all the years except for 2006 and 2007 when for the first time we had positive effects of the realized economic restructuring.

Net profit in 2009 amounted to EUR 2.9bn, 3.3 times higher than in 2002. The profit had a rising tendency during the period 2002-2007 when it had reached the highest value (of EUR 4.1bn). The tendency of increasing loss was interrupted in 2006 and owing to viable operations of public enterprises of interest for the state, primarily PE Electric Power Industry of Serbia, the loss of economy decreased by 17% in relation to 2005. However, since 2007 we had had a rise of the loss again and in 2009 it reached 2.5 times the value of 2002.

Figure 2. Ratio of Total Revenues and Expenditure

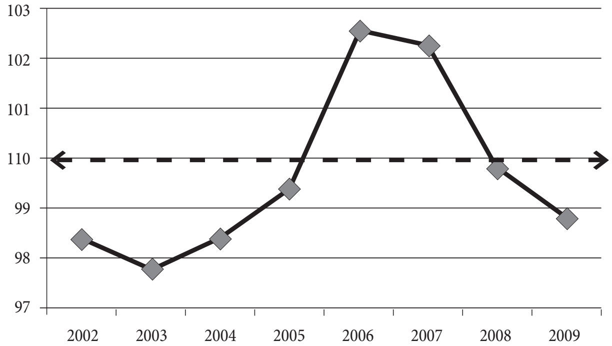
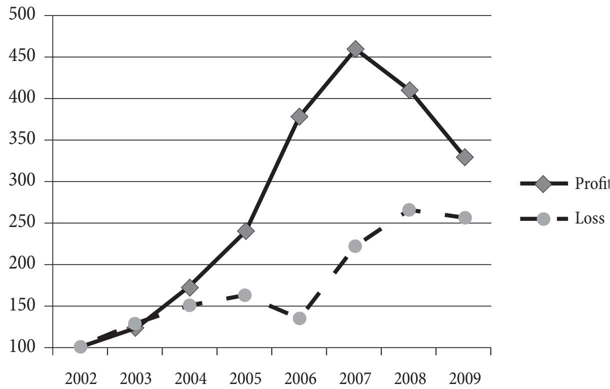


Figure 3. Growth Rates of Profit and Loss (2002=100)



Source: author's calculations on the basis of the RDB and BRA data

During the period 2002-2009 the economy of Serbia only in two years was net profit-maker. Negative net financial results characterized operations in economy in 2002-2005 despite the fact that in this period annual growth rates of profit were much higher than growth rates of the loss.

In 2006 and 2007, after more than a decade during which the economy of Serbia had constantly been recording negative net financial results, the economy reported a positive net financial performance.

Slower structural reforms, incomplete privatization and restructuring, inadequate post-privatization restructuring, the global crisis, and diminished business activity stopped positive tendencies. In 2009 the value of the loss exceeded the value of reported profit 1.3 times (1.7 times in 2002), while net financial balance reached EUR 1.0bn (EUR 668m in 2002).

High and rising indebtedness and the accumulated loss burdened the operating of Serbian economy in 2002-2009. In 2009 total liabilities were 2.3 times larger than at the beginning of the transition period and they exceeded the value of assets by 34.4% (in 2002 total liabilities accounted for 64.7% of the value of assets). A high level of accumulated loss led to a lower level of capital – the rate of lost capital of economy in 2009 stood at 31.6%.

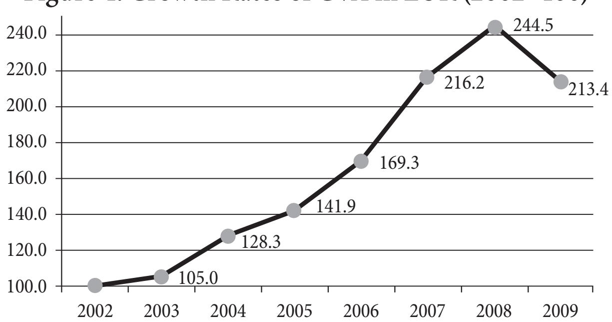
The loss of above the value of capital at the level of all companies and cooperatives was rising permanently and in 2009 amounted to EUR 5.2bn. This item shows that liabilities of some legal entities were higher than their assets and at the same time shows that the financial position of some economic entities is seriously threatened.

Table 2. Indebtedness and Accumulated Loss, 2002-2009

	Total liabilities (chain index)	Accumulated loss (chain index)	Rate of lost capital %
2002	100,0	100,0	34.0
2003	102.4	89.2	30.5
2004	119.8	80.4	24.6
2005	107.0	105.0	24.0
2006	113.9	111.4	23.3
2007	131.5	126.9	23.7
2008	124.4	122.2	27.5
2009	95.6	102.4	31.6

Source: RDB on the basis of the BRA data

Figure 4. Growth Rates of GVA in EUR (2002=100)



Source: RDB

Accumulated loss per employee exceeded profit per employee several times and in the years of reference had a rising trend.

Developments of gross value added indicate a rise in overall business activity of Serbian companies. The corporate sector of Serbian economy in 2009 generated EUR 13.2bn of gross value added – 2.1 times more than in 2002.

Transition Effects of Privatized Companies

According to data released by the Privatization Agency, over the period 2002-2010 whole 2,453 companies were privatized; 106 through tender privatization, 1,631 through auction privatization, and 716 companies through the sale of minority share packages from the Share Fund portfolio.

How efficient privatization is can be measured by means of the degree of improvement of major business performances of companies and their impact on economic development. Main positive effects are a smaller share of privatized companies in total liabilities, the loss and accumulated loss, and a higher share in economic profit in comparison with 2002.

Table 3. Financial Indicators of the Operating of Privatized Companies

	2002	2008	2009	Real growth in %	
	% of economy	% of economy	% of economy	2002-2009	2008-2009
No of employees	30.0	19.0	17.1	-53.7	-14.5
Fixed assets	19.5	13.0	13.2	73.6	6.0
Capital	20.0	14.4	14.4	-40.3	-7.8
Total revenues	21.0	15.2	14.2	-7.7	-22.7
Total expenditure	21.2	14.9	14.1	-9.1	-20.4
Total liabilities	21.6	14.5	13.8	10.0	-4.4
Profit	15.6	18.6	18.0	179.8	-18.5
GVA	29.6	18.7	16.2	-14.2	-20.9
Loss	22.8	11.6	16.5	35.6	44.1
Accumulated loss	21.0	11.9	12.6	-41.1	13.9

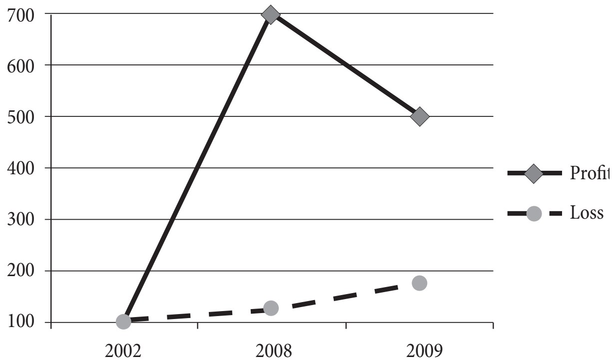
Source: author's calculations on the basis of the Privatization Agency (PA) and BRA data

In 2009 privatized companies employed 181,426 people. In comparison with 2002 the number of employees fell by 210,322 workers. Due to dynamic decline in the number of employees in privatized companies (53.7% vs. 19.0% in economy), their share in employment of economy also decreased, by 12.8 structural points.

Positive effects of the sale of social assets were mirrored in the rise in the share of privatized companies in generated net profit of economy, and that from 15.4% in 2002 to 18.0%, and a lower share in reported loss, from 22.8% to 16.5% in 2009. The share of profit generated by privatized companies in GDP rose from 0.9% in 2002 to 1.7%

in 2009 (2.0% in 2008), and the share of the loss in GDP fell from 2.2% to 2.1% (1.4% in 2008).

Figure 5. Profit and Loss of Privatized Companies (2002=100)



Best performances were registered with companies in which privatization was for the largest part efficiently completed in initial transition years, and the privatized companies managed to exit the zone of loss makers in 2002 to the zone of viable operations in 2009.

On the other hand, privatized enterprises that are not able to rapidly and efficiently adapt to market conditions pose yet another problem. Due to inadequate post-privatization restructuring and, primarily, an absence of intensive investment in modernization of equipment and enhancement of production process technology these enterprises have not managed to shift from the zone of non-viability and thus pose a social threat for the state (29,519 employees in these companies).

Privatized companies are to a large extent burdened with development problems and an incomplete process of post-privatization restructuring, which affected business activity: total revenues in 2009 in comparison with 2002 decreased in real terms by 7.7% (by 22.7% in comparison with 2008).

Privatized companies generated 12.6% of accumulated loss (EUR 2.2bn) and 13.8% of liabilities of economy (EUR 8.0bn). In 2009 total liabilities exceeded the value of assets by 29.3% whereas accumulated loss accounted for 35.0% of assets (in 2002 - liabilities accounted for 70.1% and accumulated loss 35.5% of the value of assets).

Most indebted were 374 companies that operated without assets, while 915 companies reported larger total liabilities than what the value of the capital is. Accumulated loss in 2009 was reported by 70% of analyzed companies.

The crisis had negative effects on operations of privatized companies to a far greater extent than on overall economy:

- employment went down by 14.5%; in economy by 5.4%,
- total revenues went down by 22.7%; in economy by 17.1%
- profit went down by 18.5%; in economy by 15.5%
- loss increased by 44.1%; in economy by 1.2%
- GVA went down by 20.9%; in economy by 8.5%.

Transition Changes of Economic Structure by Size

Table 4. Enterprises and Employment by Size in %, 2009

	Enterprise	Employees
Micro	84.9	14.3
Small	10.1	20.3
Medium	3.9	22.9
Large	1.1	42.5
Economy	100	100

Source: RDB

In 2009 Serbian economy comprised 89,658 economic entities[1] with 1,058,539 employees. The sector of SME dominated – 88,697 small and medium-sized enterprises with 608,353 employees (98.9% of economic entities, i.e. 57.5% of employment of economy). Large enterprises (961) accounted for only 1.1% of the structure of enterprises; still, they had a key role in the forming of financial business indicators (55.0% of total revenues, 55.3% of total expenditure, 49.5% of profit, 56.8% of the loss, and 58.4% of GVA).

Positive effects of structural reforms of the real sector were manifested as a continual rise in the number of economic entities. Apart from a more stable macroeconomic environment, very significant were realized regulatory reforms and, particularly, new legal practices in the area of registration, bankruptcy, and execution proceedings.

In 2009 in comparison with 2002 the number of economic entities increased by 22,697 enterprises. The number of SME rose by 22,478, primarily owing to the rise in micro enterprises (19,434). In addition, there were 219 functional large enterprises more than in 2002 (742 in 2002; 924 in 2008, and 961 in 2009).

1 Out of total 112,160 enterprises 96,919 to submitted a report, but treated 89,658 enterprises.

Figure 6. Rates of Rise/Fall of Employment 2002-2009

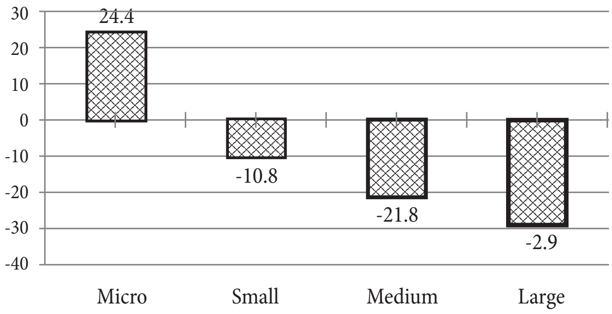


Table 5. Transition Growth Rates of Economic Operations by Size 2002-2009 (in EUR)

	Micro	Small	Medium	Large
Companies	34.3	24.2	57.4	29.5
Fixed assets	127.8	-22.5	56.0	11.9
Capital	69.1	-30.3	0.5	-25.2
Total revenues	9.7	15.1	60.4	43.7
Total expenditure	9.2	10.9	59.0	44.1
Total liabilities	129.8	164.4	244.5	115.2
Profit	117.7	87.3	69.2	42.0
GVA	102.6	37.2	185.7	45.9
Loss	83.1	-7.8	113.7	98.9
Accumulated loss	161.5	-9.5	84.4	-24.0

Restructuring of large economic systems, privatization of social enterprises, and a rise in the number of companies undergoing bankruptcy and liquidation impacted on a fall in the number of employees.

The total number of employees in economy decreased from 1,306,541 in 2002 to 1,058,539 in 2009 (by 248,000). In 2009 large enterprises employed 184,240 workers less than in 2002. A decrease in the number of employees in the SME sector by 63,760 people largely resulted from a drop in employment in medium-sized enterprises to which, because of organization restructuring of large enterprises, the burden of separated companies shifted. Only micro enterprises managed to raise the number of employees (by 29,686 workers or 24%).

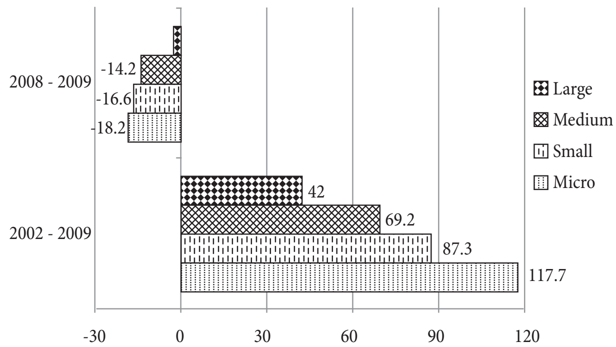
Effects of the realized structural reforms, privatization, and restructuring of economy were additionally burdened with effects of the crisis. In comparison with 2008 all companies, irrespective of their size, had fewer employees (large enterprises 22,080 or 4.7%; the SME sector 37,765 employees or 5.8%).

The analysis of financial indicators showed that large enterprises in the years of reference propelled growth but also generated loss. An increased share of the loss of large enterprises in 2009 in relation to 2002 was a consequence of incomplete restructuring of large systems in manufacturing industry. A drop in the share of accumulated loss of large enterprises of 18 structural points resulted from generated profit after efficiently completed privatization processes. Nevertheless, although accumulated loss in economy decreased by 2% (with large enterprises by 24%), unresolved problems that had accumulated over the years and non-viable operations still burdened equally all enterprises, regardless of their size.

Although reported profit of large enterprises increased 2.1 times in comparison with 2002, their share in realized profit of the economy of Serbia decreased. Greater profit of micro, small and medium-sized enterprises at higher rates than large systems led to the SME sector generating 50.5% of profit in economy in 2009, by 6.3 structural points more than in 2002. In addition, the sector of SME increased its contribution to the creation of GVA of the corporate sector of economy (35.5% in 2002 and 41.6% in 2009), which is indicative of an ever greater significance of this sector for growth and development.

In comparison with 2002, in 2009 total revenues, GVA, profit, and the loss of economy rose in real terms. The sector of SME recorded above average real growth rates of profit and GVA; however, this sector to a large extent absorbed accumulated structural problems manifested through the rise in accumulated loss (1.8 times), while a high growth rate of the SME loss (73%) was in the first place determined by non-viable operations of medium-sized enterprises. Large enterprises did not stop to be propellers of non-viable operations as they accounted for 56.8% of the loss of economy and an above average growth rate of loss.

Figure 7. Real Growth Rates of GVA by the Size of Enterprise



Large enterprises increased their GVA at a lower rate than micro, small and medium-sized enterprises, which made an impact on the change of the GVA structure of the corporate sector to the favour of SME.

Comparisons of financial indicators of companies' operations in 2009 and 2008 indicate a real rise in the loss, accumulated loss, and total liabilities, whereas total revenues, profit and GVA recorded a real drop, which attests to negative effects of the global economic and financial crisis, and the national structural problems.

The economy of Serbia in 2002, 2008, and 2009 suffered an adverse net financial result. The SME sector had positive business results only in 2008 whereas large enterprises were unviable in all years of reference.

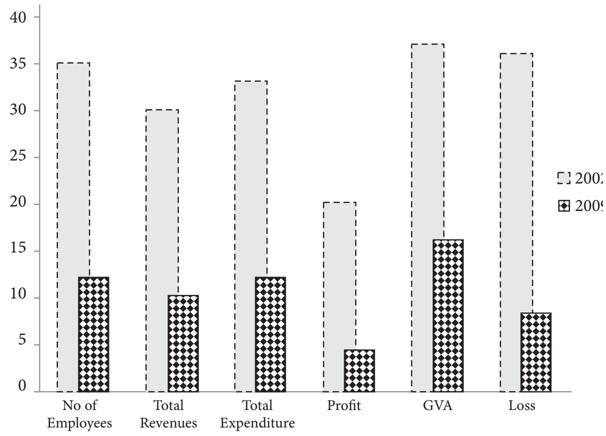
Profit of the SME sector in 2009 amounted to 140.4bn dinars and the loss 161.6bn dinars (the net loss exceeded the value of net profit by 21.2bn dinars). Large enterprises also reported a negative net financial performance (74.5bn dinars). Only small enterprises reported a positive net financial outcome – profit (36.3bn dinars) was 1.7 times larger than the loss (21.6bn dinars).

Economic Structure by Type of Organization

Limited liability companies (89.8% companies) dominated the structure of the corporate sector of Serbian economy in 2009 and made a key influence on the level of all financial indicators of economic operations. LLC employed 61.2% of employment in economy.

In comparison with 2002 the number of limited liability companies rose by 33,276 while companies of this type of organization increased their share in total revenues, profit, loss, and GVA by more than 30 structural points.

Figure 8. Operations of Social&Public Companies (% Economy)



The influence of social and public enterprises was heavily diminished after privatization of social capital, i.e. after reorganization and financial and organizational restructuring of state-owned companies of strategic interest.

Partnership companies, limited partnership companies, and LLC reported positive net financial performance in 2009. The loss in social companies exceeded profit 22.5 times, in public companies 1.6 times, and in cooperatives 2 times, which is indicative of how essential it is to finalize privatization of the remaining social assets, resolve the ownership status of cooperatives, and resume the process of restructuring and privatization of public companies (republic and local).

Table 6. Indicators of Economic Operations, 2009, by Type of Organization (% Economy)

	Partnership	Limited partnership	JSC	LLC	Social	Public	Cooperatives	Other
No of companies	3.0	0.5	2.6	89.8	0.7	0.5	2.4	0.5
No of employees	0.6	0.1	25.1	61.2	1.1	11.0	0.8	0.1
Fixed assets	0.1	0.03	22.5	51.3	0.8	24.8	0.4	0.2
Capital	0.1	0.04	20.9	51.4	0.9	26.1	0.5	0.0
Total revenues	0.3	0.06	20.1	71.0	0.3	7.1	0.8	0.2
Total expenditure	0.3	0.06	21.2	69.8	0.5	7.1	0.9	0.2
Total liabilities	0.2	0.05	24.3	63.3	1.8	9.4	0.7	0.4
Profit	0.3	0.05	21.0	73.9	0.2	4.2	0.3	0.1
GVA	0.3	0.06	25.3	62.1	0.5	11.0	0.6	0.1
Loss	0.1	0.03	37.9	52.8	3.2	5.1	0.5	0.4
Accumulated loss	0.1	0.02	31.9	44.8	4.2	17.9	0.5	0.6

Source: author's calculations on the basis of the RDB and BRA data

Economic Structure by Activities

The analysis of sector breakdown in 2009 showed that the largest number of companies in Serbia operated in sectors of *Wholesale and retail trade, repairs* (39%), *Manufacturing industry* (20.8), and *Real estate activities, renting* (15.1%).

In comparison with 2003 the number of economic entities rose in all sectors, and most in the sector of *Real estate activities, renting*. An increase in the number of employees compared to 2003 was also generated only in the sector of *Wholesale and retail trade, repairs*. In addition, a contribution of service sectors (*Trade, Real estate activities, Construction) to the creation of* GVA also increased.

Unfinished structural changes undertaken in *Manufacturing industry* have placed it among sectors whose shares in employment and generated GVA of economy in the given period decreased. However, despite reduction of employment by more than 170,000 workers, *Manufacturing industry* in 2009 created the largest portion of GVA of the corporate sector of economy (28%) and employed over 1/3 of employees in companies.

Most dynamic business activity in the given period was registered with service activities (*Trade, Real estate activities, Construction, Transport*), having had the highest growth rates of total revenues and expenditure. However, a dominant impact was made by Trade – it generated 38% of total revenues and 37% of total expenditure, which was 7.9, i.e. 7.8 structural points more than in 2003. Trade managed to increase its revenues at a three times higher rate than Manufacturing industry.

Negative growth rates of revenues and expenditure in comparison with 2008 only attest to the crisis and its impact on a decline in economic activity.

Structura reforms did not bring significant changes to the sector reallocation of generated profit and loss. A key influence on the level of generated profit and reported loss in 2003-2009 was made by sectors *Manufacturing industry* and *Wholesale and retail trade*.

Measured by the level of loss, largest development problems exist in Manufacturing industry as the process of restructuring and privatization of large companies which face major development problems is still not over.

In 2009 the economy of Serbia was net loser. Net loss of economy rose 2.6 times in relation to 2008, i.e. 1.6 times in relation to 2003. *Manufacturing industry and Mining and quarrying* generated the largest portion of the loss in economy.

As different from 2008, in 2009 *Manufacturing industry* reported negative net financial outcome. Profit of this sector in comparison with 2008 fell by 22%, while the loss rose by 15%, whereas in the sector of *Mining and quarrying* the loss was 23 times larger while profit was by 41.7% lower.

Positive net financial performance in 2009 was reported by the following sectors: *Construction, Trade, Transport, and Real estate activities.*

Regional Transition Effects

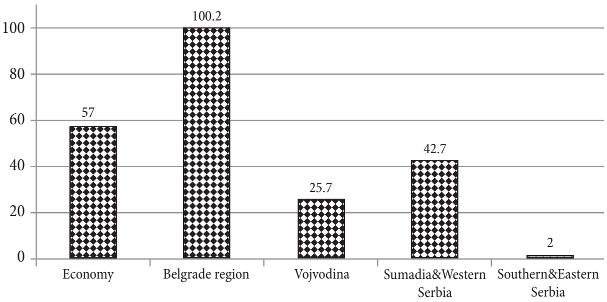
Structural reforms in the real sector undertaken during the period 2002-2009 failed to reduce regional dispropor-

Table 7. Profit and Loss 2003-2009, by Sectors

	Profit			Loss		
	in %	real rise in % 2003-2009	real rise in % 2008-2009	in %	real rise in % 2003-2009	real rise in % 2008-2009
Economy-total	100.0	107.9	-15.5	100.0	52.5	1.2
Agriculture, forestry and water management	3.1	237.3	-25.1	5.9	10.6	15.0
Mining and quarrying	0.3	-93.9	-41.7	12.0	1480.8	225.3
Manufacturing industry	32.5	88.1	-21.5	34.4	12.6	14.8
Electricity, gas and water supply	0.6	377.8	14.0	4.2	6.3	-62.6
Construction	8.2	163.4	-25.1	4.3	117.2	19.4
Wholesale and retail trade, repairs	26.7	190.9	-20.2	17.2	120.7	-5.1
Transport, storage and communications	12.5	59.9	25.9	8.5	2.9	-37.5
Real estate activities	13.7	514.4	-7.5	9.7	90.3	-3.6
Other sectors	2.6	-5.6	-8.0	3.8	103.0	8.2

Source: RDB on the basis of the BRA data tions between development levels. As in the early days of the transition period, in 2009 as well economic activity was concentrated in most developed regions – Vojvodina and Belgrade. On the territory of these two regions in 2009 67.5% of the total number of enterprises operated, they employed 65.9% of the total number of employees, generated 77.6% of revenues, 77.1% of expenditure, 79.7% of profit, and 70.9% and 78.2% of GVA. Within the region of Vojvodina the most developed part was South Backa District as it employed 42.8% of all the employed and created 54.6% of GVA of the region.

Figure 9: Growth Rates of GVA by the Regions 2002-2009



On the other hand, if we exclude the least developed region of Kosovo and Metohija, we would infer that the region of South and East Serbia had the largest development problems. Economic development based on traditional industrial branches despite an above average rate of profit and a below average rate of loss failed to foster a more expansive growth and support the degree of lagging behind of more developed regions to go down – in 2002 the ratio between this region and Belgrade when it comes to creation of GVA was 1:3 and in 2009 it reached 1:6. The analysis of regional breakdown of enterprises and employees in economy in 2009 suggests that 67.5% of the total number of enterprises in Serbia operated in two regions: Belgrade (41.2%) and Vojvodina (26.3%). At the same time these two regions provided jobs for almost 2/3 of employees in the non-financial sector (441,400 and 256,000, respectively).

During the transition period 2002-2009 significant changes to the structure of economy took place. The number of enterprises in Serbia rose by a third. Most dynamic changes were registered in Belgrade (the number of enterprises rose 50.2% of the total increase) and Vojvodina (33.8%). Through improvement of conditions for investment and establishment of new economic entities entrepreneurship developed and so the number of enterprises per 1,000 inhabitants rose from 8.9 (in 2002) to 12.2 (in 2009) – in Vojvodina from 8.7 to 12.0 and in Belgrade from 15.6 to 22.7.

The process of economic restructuring, particularly of large enterprises, led to a drop in the total number of employees by a fifth (by 248,000). A rise in the number of employees in Belgrade (by 32,000) was not sufficient to offset the loss of jobs in other regions – Southern and Eastern Serbia (111,700), Sumadija and Western Serbia (102,700), and Vojvodina (68,000).

In addition, setting up of new companies and creation of new jobs in the sector of small and medium-sized enterprises did not offset the loss of jobs suffered by large companies during their restructuring, most often in mono-industrial areas. This is particularly characteristic of the beginning of the period of reference (2002-2005) as well as for the first year of the global economic crisis (2009).

The intensity of economic activity in Serbia is not evenly distributed by regions. An average rise in total revenues of the economy of Serbia during the period 2002-2009 was 36.8% and expenditure 36.2%. Only Belgrade had an above average rise in revenues and expenditure (75.0% and 73.1%, respectively).

That main performances of business operations of

Table 8. Regional Breakdown of Profit and Loss in Economy 2002-2009

Region	Profit			Loss		
	2009 in %	rise in % 2002-2009	rise in % 2008-2009	2009 in %	rise in % 2002-2009	rise in % 2008-2009
ECONOMY TOTAL	100.0	142.7	-15.5	100.0	87.0	1.2
Belgrade Region	53.8	136.4	-12.0	40.9	91.6	-21.4
Vojvodina	25.9	97.3	-15.7	30.0	147.8	37.5
Sumadija and Western Serbia	13.8	360.8	-13.5	15.4	33.4	7.4
Southern and Eastern Serbia	6.4	178.1	-38.6	13.0	53.3	37.5
Kosovo and Metohija	0.1	308.6	-23.1	0.8	3280.7	-39.5

Source: RDB on the basis of the BRA data enterprises in the region of Vojvodina during the transition period deteriorated is demonstrated by the fact that only these enterprises saw a below average rise in profit and an above average rise in loss. A below average rise in the loss of regions Southern and Eastern Serbia (53.3%) and Sumadija and Western Serbia (33.4%) resulted from positive effects of restructuring of large enterprises concentrated in these two regions. Economic activity was also uneven within regions, by districts. Within Vojvodina the most dynamic rise was that of Srem and North Backa District whereas South Backa District, despite a dominant impact on the forming of total revenues and expenditure of the region (56%) saw a below average growth.

In Sumadija and Western Serbia the activity in economy was rising much slower compared to the average of economy. Sumadija and Kolubara Districts stand out while Pomoravlje and Rasina Districts had the worst results. In Southern and Eastern Serbia a rise in economic activity was registered in Podunavlje District whereas severely negative tendencies were registered in Zajecar, Toplica, Pcinja, and Jablanica District.

Conclusion: Key Business Problems

Adverse effects of the global economic crisis led to a decline in economic activity, multiplication of business problems and, consequently, impacted on business results of Serbian economy in 2009. A large decrease in domestic and foreign demand, a limited and more complicated access to financial sources, diminished foreign investment and the inflow of funds from donations and remittances, and a drop in purchasing power of citizens led to increased indebtedness, lower liquidity and solvency, and initiation of bankruptcy procedures for a large number of enterprises.

Indebtedness. The major development problem is the functioning of Serbian economy that relies on borrowed funds. Because of a constant lack of own funds, indebtedness of economy was rising continually and the economic crisis only aggravated this. Total liabilities in 2009 1.3 times exceeded the value of assets and 1.5 times the value of working assets (1.2 times and 1.4 times in 2008, respectively). The value of total liabilities in relation to 2008 went up in real terms by 0.2% while the value of assets went down in real terms by 7.9%. Due to less favourable business conditions, the total value of sources of funds (liabilities) in 2009 went down in real terms by 3.5%. An unfavourable structure of sources of funds (borrowed funds accounted for 57.0% and assets 42.4%) is yet another indicator of how dependant economy is on borrowed funds, especially having in mind that short-term liabilities accounted for 69.2% and long-term liabilities 29.8% of borrowed funds. The share of long-term loans of 70.6% in long-term liabilities has not changed compared to 2008.

Liquidity. The economy is working in an environment of *non-liquidity*[2], i.e. enterprises are not able to defray their matured liabilities in time:

- A general liquidity ratio[3] stood at 0.97 (0.98 in 2008);
- A reduced ratio of liquidity[4] stood at 0.68 (0.67 in 2008) and suggests that enterprises on having neglected stocks were not able to defray 32% of short-term liabilities.

Non-liquidity is one of the largest problems of Serbian companies. As they are unable to defray their liabilities, the number of blocked companies was up by 14.4% and debt was up by 19.5% in relation to 2008. At the end of 2009 accounts of 66,438 enterprises and entrepreneurs were blocked (15.6% of registered legal entities, 425,000 in total – 105,000 legal entities and 320,000 entrepreneurs) that owed 261bn dinars. Among firms and entrepreneurial shops whose accounts were blocked 1/3 had been blocked for more than three years. Only in 2009 almost 21,617 accounts were blocked (25% of overall debt), which shows that for a number of enterprises and entrepreneurs non-liquidity is a long-term problem.

Solvency. The coefficient of solvency in 2009 equaled 36.7% (by 3.5 percentage points lower than in 2008) and it showed that economy was operating in an environment of *insolvency*[5]. Insolvency of enterprises means that they

2 Liquidity is a ratio between short-term payment abilities and short-term liabilities.

3 A general ratio of liquidity shows how much working assets cover one dinar of short-term liabilities. The recommended value is 2 while the value below 1.5 shows that companies have liquidity problems.

4 A reduced (accelerated) ratio of liquidity shows whether a company can cover its current short-term liabilities if it does not use (sell) its stocks to cover these liabilities. It recommended value is 1.

5 Insolvency is inability to defray matured liabilities within their maturity deadlines, i.e. it stands for a situation in which company's debts are higher than the value of its assets.

are not able to defray the debt to their suppliers, creditors, shareholders, employees, the state, and other entities and should it not be overcome shortly, it leads to liquidation and bankruptcy of enterprises. Reasons for huge non-liquidity of economy lie in an absence of financial discipline of all economic entities and the state but also in structural and long-term problems that burden the economy. Inefficient legal instruments only foster such conduct of enterprises and the state and only make this wave of insolvency to spread fast within economy.

Bankruptcy. The destiny of over 66,000 enterprises whose accounts are blocked depends on the initiation of the bankruptcy procedure by creditors. However, in spite of legal options, creditors are reluctant to start bankruptcy procedures:

- *Tax Administration* – the last option to collect debt; debts usually get reprogrammed and one can even see the writing off of interests or the freezing of taxes;
- *Individual creditors* – estimates that they will not have funds to repay the debt; creditors must deposit money for the costs of initiating the bankruptcy procedure and sometimes these costs can exceed the level of debt itself (the level of advance payment is from 50,000 to 500,000 dinars);
- *Banks* – for the most part do not know what to do with the assets of debtors as it is hard to sell it and only poses a burden; the account blockage annuls the option to pay other credit installments.

Annulled privatizations. Of 2,285 signed contracts on the sale by the method of tender and auction privatization, sales contracts were broken for 548 companies (26 tenders, 521 auctions) or 24%. Most frequent reasons for the breaking of contracts with new owners of companies were unfulfilled liabilities relating to investment and abiding by the social programme, disrupted production, unpaid selling price, and the sale of company's assets.

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EXPORT, COMPETITIVENESS AND GROWTH – CHALLENGING QUESTIONS FOR SERBIA

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Abstract

At the moment, the decline in the world economy is at a standstill, but the further dynamics of GDP is still uncertain. There is no doubt that the recovery of the Serbian economy is closely linked to the dynamics of the world economy and is already lagging behind that of the world economy and economies in transition. Serbia must conduct competitiveness-led strategy, which is based on the competitiveness framework model and is broader and more comprehensive than export-led development strategy.

The key to the success of this strategy lies in the creation of an attractive business environment across all dimensions, which will attract greater FDI than has hitherto been the case. This will create better conditions for the growth of GDP and will contribute to export increases. On one side, this will enable Serbia to get included in the implementation of the Europe 2020 strategy in a satisfactory manner in its territory and, on the other side, to avoid the middle-income trap into which some countries, which used to promote only export activities, have fallen.

The successful implementation of this strategy also anticipates an active role for the government in all segments in which its presence is necessary. Therefore, it is necessary to anticipate the government's fiscal responsibility in order to restrain excessive and unnecessary public spending, while at the same time redirecting it to investments in the improvement of competitiveness. This refers especially to government investments in the improvement of infrastructure, education and the functioning of government, thus providing the greatest possible scope for the development of the private sector, especially SMEs, and a decrease in corruption. Serbia needs an increase in its public spending in order to boost demand and GDP, but that must be achieved by increasing public investment in infrastructure and high-quality education and science, as well as by encouraging private capital investment.

Key words: *Competitiveness, export, competitiveness framework, productivity, Serbia*

The world economy passed through recession during 2008 and 2009. Subsequent growth was modest and there are already signs that the world economy may plunge into a new recession or a third great depression. Similar dynamism was also followed by the Serbian economy for whose further development it is very important to adequately formulate economic policy and respond to the current challenges.

In order to intensify the process of European integration, Serbia must adopt its development strategy until 2020, which should be in compliance with the EU strategy presented in the document entitled "Europe 2020". This document essentially deals with the improvement of competitiveness and the building of a knowledge society.

In order to improve its competitiveness, Serbia must have its national competitiveness strategy, which will conceive its development strategy on the basis of the competitiveness framework model developed by Porter. It should be based on the improvement of the business environment in order to attract as much foreign direct investment (FDI) as possible, as well as on a rise in exports.

This paper consists of three parts. The first part presents an analysis of the current situation; the second part points to the elements of the Europe 2020 strategy from Serbia's perspective and the third part deals with the competitiveness strategy that should be conducted by Serbia.

Just a Recession or a New World Depression!?!

Have we entered into the third world depression? – From the current viewpoint, August 2010, it can be stated that the world economy came out of recession and is now recording a mild recovery. However, there are numerous early warning signs that it is entering the period of a new slowdown in growth and, probably, a new decline. This could be indication of the entry into a new recession or a third world depression, which would probably be similar to the Long Depression, and its cost will be huge, reflected primarily in the form of high unemployment.[1]

Is it possible to avoid a new depression and how should Serbia's conduct its economic policy?

At the June G20 Summit Meeting in Canada, global leaders expressed their concern over a rise in inflation and thus advocated austerity measures and cuts in spending. The danger of deflation was not addressed separately.

The economic policies conducted in 2008 and 2009 have confirmed that the current leaders learned the lessons of history and did not repeat the crucial mistakes of their predecessors. By lowering interest rates in conditions of low inflation, the Fed and ECB supported the functioning of the market, while by increasing fiscal deficits and public spending, they avoided the collapse. The recession was successfully stopped in the summer of 2009.

The question that imposes itself is what to do next? Unfortunately, we will know the exact answer only in the future. Let us recall that growth during 1933 did not mark the end of the Great Depression. Therefore, the current growth does not have to mark the end of the current crisis. There are numerous warning signs that the United States and Europe are on the brink of falling into the deflation trap in which Japan has been since the 1998 crisis. Grounds for concern are linked to the fact that the level of unemployment is increasing even during the period when a rise in GDP is being recorded.[2] It will be primarily caused by economic policy failures because, as could be seen at the G20 Summit in June, the governments are obsessed with the fear of inflation and thus propose belt tightening, although the real danger is posed by deflation and the associated problem of insufficient spending.

In our opinion, it is indisputable that the introduction of long-term fiscal responsibility is necessary. This means, above all else, that during periods of prosperity a surplus is created, while public debt is reduced so as to provide room for increasing public debt in times of crisis and recession. What is currently the subject of debate is whether now is the moment for cutting public spending and which spending items should be cut, or whether it is necessary to increase public spending, that is, taxes in order to reduce public deficits? Krugman argues that, if orthodox solutions are accepted, to which Europe is very close, while the US Administration has not yet made up its mind, the price that will be paid is enormous. Moreover, it will be paid by those who are already bearing the highest cost of the crisis, and those are permanently or currently unemployed.

Serbia's modest growth within the countries in transition (CIT). – CITs are recording economic revival, but they differ significantly among themselves due primarily to the deteriorated external environment, caused by strict fiscal austerity measures in developed economies, which also affected the export demand of CITs (EBRD, 2010).

The largest countries (Russia, Turkey and Ukraine) managed to renew capital inflows and growth, while the countries of South-Eastern Europe (SEE), including Slovenia and Croatia, recorded a slightly positive growth. A rise in exports from these countries was mostly offset by low domestic demand.

According to this EBRD projection, the average growth of CITs in 2010 will amount to 3.5%. After Belarus, the highest growth will be recorded by Turkey (5.9%), Russia (4.4%) and Ukraine (4.0%); SEE will have the negative growth of -1.5%, while Serbia's growth will be 1.9%. This shows that Serbia's growth will be modest despite the fact that the growth of CITs will be significantly higher (it is not consoling that Serbia will record the highest growth in SEE).

FDI and Serbia. – The level of FDI in the world is slowly increasing. The UNCTAD expects that FDI inflows in 2010 will amount to 1,200 billion, after their decline to USD 1,114

1 In economic history two periods are treated as periods of economic depression: the period of the Long Depression in the 19th century, following the panic of 1873, and the period of the Great Depression in the 20th century, characterized by mass unemployment and following after the financial crisis of 1929-1931. Both depressions were characterized by alternating periods of economic decline and growth, but the decline in the previous period was never compensated in the period of growth.

2 Among numerous economists who point to this possibility, we single out Krugman. See: Krugman, P. 2010. "The Third Depression". *The New York Times*. 27 July 2010.

billion in 2009, and that they will further increase to USD 1,300-1,500 billion in 2011 and to USD 1,600-2,000 billion in 2012 (when the 2007 level amounting to USD 2,100 billion could be reached) (UNCTAD, 2010). Developing countries and CITs attract one half of FDI inflows and invest one-fourth of global FDI outflows. They are leading the FDI recovery and will remain a favourable destination.

As for FDI in Serbia, it should be noted that the removal of barriers to its attraction and the creation of an attractive business environment pose the crucial challenges. The world's FDI is undergoing recovery and its level has reached such proportions that, despite the world crisis, there is still considerable room for Serbia to secure the necessary amount of USD 3-4 billion each year.

Europe 2020

Since Serbia opted for the European path and European integration, it is necessary to consider in what way Europe intends to develop during the next decade. Europe responded to the crisis in two ways. On one side, it adopted economic policy measures, which were implemented by the ECB and member countries, and, on the other side, it launched the strategic document "Europe 2020".

European economic policies and the crisis. – In analyzing the European economic policy measures, Grauwe (2010) emphasizes that:

(i) Central banks (Fed, ECB) provided ample liquidity by conducting expansionary monetary policies and lowering interest rates, so that they did not repeat the mistakes of the 1930s (Bernanke, B. & H. James, 1991, 33-6; Eichengreen, B. 1992; and: Eichengreen, B. and P. Temin 2000: 183-207),

(ii) Governments did not try to balance the budget when economic activity collapsed, so that they did not repeat the mistakes of the 1930s, and

(iii) The mistake of the 1930s – when a number of continental European countries, the so-called "gold bloc" countries (France, Italy, Belgium, the Netherlands and Switzerland) kept their currencies pegged to gold – was repeated. Namely, when in the early 1930s the United Kingdom and the United States went off gold and devalued their currencies, the gold bloc found their currencies to be significantly overvalued. This had the effect of depressing exports and prolonging the economic depression in these countries. A similar mistake has now been made in the eurozone whose currency, the euro, has become strongly overvalued. The answer why Europe is employing this policy today is economic orthodoxy, which is derived from the view of the ECB that the foreign exchange market is better placed than the ECB to decide the appropriate level of the exchange rate, since it should only be concerned with keeping inflation low and not with meddling in the foreign exchange market. Wolf (2010) expects that, as in the 1930s, the eurozone countries will pay a heavy price for this orthodoxy. The price will be a much slower and more protracted recovery from the recession. This will also make it more difficult to deal with the internal disequilibria within the eurozone between the deficit and the surplus countries.

The objection that the central bank is powerless to affect the exchange rate is not correct, since it can drive down the value of its currency by an increase in its supply. And that is exactly what the United States and the United Kingdom have done with their policies of quantitative easing, enabling their money markets to have high liquidity relative to the eurozone. Since the start of the crisis, the ECB has injected plenty of liquidity into the system in support of the banking system, but it was much more timid in creating liquidity compared to the Federal Reserve and the Bank of England (since October 2008, these two central banks have doubled their money supply, while the ECB has increased the size of its balance sheet by less than 50%).

Such an imbalance in the expansion of central bank money has spilled over into the foreign exchange markets. The massive supply of dollars and pounds created by the US and UK monetary authorities has been transmitted to other financial markets in search of higher yields, thus putting upward pressure on the value of the euro. Thus, the greater timidity of the ECB in providing liquidity is an important factor in explaining why the euro has been so overvalued.

Finally, the ECB has to make choices. The Federal Reserve and the Bank of England chose massive programmes of liquidity creation, attaching a low weight to the possible inflationary consequences of their actions. The ECB has been much more conservative in its liquidity creation, attaching a low weight to the consequences for the exchange rate and to the chances of a fast recovery. Only time will tell us which of these two choices was right.

Europe 2020 and competitiveness. – An analysis of the implementation of the Lisbon criteria has shown that among the five best countries there are three Nordic ones – Sweden, Denmark and Finland, in addition to Austria and the Netherlands. As for the new members, the best results have been achieved by the Czech Republic and Slovenia, which hold the 10th and 11th place (Tilford, S. and P. Whyte, 2010, 5).

Tilford and Whyte (2010, 63-5) point out that it is necessary to increase manufacturing and that the government's role should not again to be to support so-called "national champions". Instead, it is necessary to conduct a much more refined strategy that will enable the development of Europe's competitive advantages.

In that sense, the notions of industry and industrialization are also undergoing change; today, they include all parts of the value chain linked to the physical production of a good. To illustrate this, we will take Apple as a very good example. Namely, it has practically no factory, but its products – due to engineering, design and applications – are the symbol of the highest quality.

Apart from these so-called "virtual manufacturers", there are also "service manufacturers", companies that generate a large portion of their revenues from the services they provide to manufacturing (e.g. Rolls-Royce generates half of its revenues from maintaining and supervising the airplane engines manufactured by it).

The third broader category, so-called "touch manufacturers", includes companies within specialized sectors in which there is great demand for manual processes, coupled with handicraft skills (this is especially pronounced in machine and auto parts building).

This strategy is closely linked to fostering technological development in academic institutions and the strengthening of training programmes for developing the commercial way of thinking in science and technology, as well as the R&D grant programme to support small and medium-sized enterprises.

The development so conceived has an enormous simulative potential for economic growth over the next decade, which the experience of the United States and Asia has already shown ((Tilford, S. and P. Whyte, 2010, 59-61)).

In summing up the results of competitiveness improvement during the last decade, Europe launched a new strategy, called "Europe 2020" (Europe 2020, 2010). It should enable Europe's long-term development based on (i) smart, (ii) sustainable and (iii) inclusive growth, which will ensure high levels of employment, productivity and social cohesion.

The smart growth of the European economy will be based on a knowledge society and innovation. In this connection, it is necessary to increase the quality of education, strengthen the research potentials and promote innovation and knowledge transfer. Smart growth will be achieved by increasing: (i) innovativeness and R&D expenditures; (ii) improving education, training and lifelong learning and (iii) developing a digital society.

Sustainable growth should promote a more resource efficient, greener and more competitive economy, coupled with the strong development of SMEs and improvement of the position of consumers. To achieve sustainable growth it is necessary to improve: (i) competitiveness by raising productivity so as to successfully combat competition on export markets, (ii) position relative to climate change and (iii) energy efficiency.

Inclusive growth is directed towards creating a high employment society, coupled with the strengthening of social and territorial cohesion.

In evaluating the Europe 2020 project, Zuleeg (2010) points out that the proposals are intended to improve the situation that existed during the implementation of the Lisbon Agenda, but that this is still insufficient for ultimate success. In his specific SWOT analysis, he points out that:

(i) Its strengths are as follows: proposals are more concrete; there are seven flagship initiatives that should be developed at the EU level, and the educational, environmental and social targets have been included in a number of activities; at the same time,
(ii) Its weaknesses are an unclear rationale for targets; excessive dependence on member states' political will and policies and, naturally, an unintegrated public finance system, so that the overall delivery system is weak.

The further process of Serbia's European integration will depend directly on whether Serbia will catch up with the pace of realization of this crucial European project in the next decade. The project of a European Serbia 2020 is also decisively linked to it.

Competitivenesses and The Role of Exports

A comprehensive approach, which links competitiveness, exports and economic growth, has been developed by Porter (1990, 1998) proceeding from the view that competitiveness essentially means productivity, because it is the critical driver of long-term sustainable prosperity, and long-term sustainable prosperity is the ultimate objective of economic policy.

Competitiveness framework. – Raising competitiveness is the process of improving the business environment that should enable foreign and domestic investment inflows, exports, imports, etc. Competitiveness means the level of productivity that companies can achieve in a location, including all elements of the business environment that influence their activities. It is the structured approach towards creating the best possible business environment and is called competitiveness framework (CF). Empirical work has confirmed the high correlation between strong performance in improving the business environment and prosperity levels across countries (Porter, Delgado et al, 2008a).

Insofar as the improvement of competitiveness is concerned, it should be noted that there is no zero-sum game in the world economy. That enables every country to increase its prosperity if it increases its productivity and competitiveness, regardless of a rise or decline in the competitiveness level of other countries. In recent times, this has been especially contributed by the globalization process. On one side, it has enabled the prosperity of those increasing their competitiveness but, on the other side, it has relatively increased the costs to those with low productivity (Porter and Ketels, 2007).

Therefore, Porter points out that in the competitive struggle for national prosperity it is much more important for a country how it competes than with what industries; modern theory of competitiveness is actually the competition of different locations (Porter, 2008b). The primary aims are not the size of a country's economy, level of foreign exchange reserves or exports and the like, but the creation of the best possible business environment that will result in a high standard of living, that is, the prosperity of the nation.

Indicators and enablers of competitiveness. – The process of improving competitoveness takes place within the CF, which ensures a rise in productivity. Exports have a dual role, as is the case with imports, FDI, investment and innovativeness (Ketels, 2010, 6-7):

- Exports are intermediate indicators – the more productive you are, the more you will be able to sell on the world markets, but
- Exports are also the enablers of competitiveness – the more you export, the more you are exposed to foreign competition and ideas that improve both your ideas and your products.

Inherited and created prosperity. – Insofar as prosperity is concerned, it is very important to make a distinction between inherited and created prosperity. In analyzing the competitive position of Russia, as a resource-rich country, Porter, Ketels et al. (2008c) emphasize that the inherited natural resources and wealth may have a positive effect on national prosperity, but their availability per se does not guarantee prosperity. At times, it may even make wealth creation more difficult. Inherited wealth is derived from natural sources, such as: minerals, oil, land, good locations… Created prosperity means wealth creation based on the capability to achieve the high productivity of goods and services, which are profitably sold on foreign and domestic markets. Consequently, created prosperity is only restricted in its ability to innovate and dynamize firms. Wealth can be created only by firms. The government cannot create wealth, but it plays a significant role in providing favourable conditions for the creation of prosperity.

If the model of inherited prosperity is adopted, the strategy is based on the maximum use and sale of available inherited natural resources; the key player in this model is the government as the owner and distributor of resources, with a marked propensity to redistribute value according stakeholders' requests.

In the model of created prosperity the key lies in the creation of as valuable products and services as possible, coupled with a rise in efficiency. This kind of prosperity is only created by firms. Based on innovativeness and productivity, such prosperity is essentially unlimited. Here the government play a very important role, because it is directly responsible for the provision of healthy competitive conditions, thus enabling a rise in productivity for the creation of a sufficiently attractive business environment for the successful development of the private sector.

In order to substantiate this thesis we can give numerous examples of countries with a much lower competitiveness ranking in 2009 compared to their GDPpc ppp ranking, which shows that there is vast scope for the relatively rapid and successful improvement of their competitiveness; in this group of countries Serbia shares the 8th to 10th position with Croatia and Italy, whereby its competitiveness ranking is 27 places lower than the level of GDPpc ppp. Venezuela, Trinidad and Tobago, Greece, Libya and Bosnia and Herzegovina are at the top of the list. At the other end we have the countries – agents of prosperity, whose competitiveness ranking is considerably higher than their GDPpc ppp ranking, which ensures high growth in the future. This group of countries is led by India, China, Thailand, Tunisia, Indonesia...

Growth and exports. – The world today is trying to revive economic growth. Export-led growth (ELG) is traditionally treated as one of the most promising pathways. The experience of the Asian countries, which have achieved high-level sustainable growth due to ELG, provides an empirical basis for that approach.

ELG policies can be confined to the ability to sell on the global market, which represents so-called export competitiveness. In this case, exports are the aim and purpose of economic policy.

This is very significant, since ELG has been motivated by intermediary objectives like generating jobs, or increasing export revenues to cover import costs, or servicing foreign debt obligations. However, this is a necessary condition, but it is not sufficient for prosperity growth.

As an alternative, Ketels (2010) presents the concept of increasing competitiveness in which exports are a diagnostic instrument or, more precisely, indicators and enablers, representing only one dimension of competitiveness and growth strategy. The main idea of this approach is that the focus of debate needs to be on the improvement of competitiveness in all dimensions and not only on exports.

The view that exports are an engine of economic growth has been present in economics for a long time. The theoretical arguments focus traditionally on the ability of exploiting export gains, especially those leading to higher productivity by exploiting comparative advantages. However, the introduction of market imperfections into analysis raised the question of specialization in the "wrong" activities, those with lower levels of positive externalities, since their growth prospects are smaller (Grossman and Helpman, 1991). Exports then might not be beneficial per se, but only if they occur in the "right" activities.

The findings from empirical studies are widely varied. Many researchers have found a stable relationship between openness and prosperity growth (Baldwin, 2003; Dollar and Kraay, 2002; Frankel and Romer, 1999; Sachs and Warner, 1995), or have highlighted the role of trade as a means to tap into foreign knowledge and raise productivity (Coe and Helpman, 1995; Alcala and Ciccone, 2004).

Other researchers have been more skeptical and attributed these findings to the specific data and applied methodologies (Rodriguez and Rodrik, 2000; Medina-Smith, 2001).

It can be concluded that neither the theoretical nor the empirical work provided equivocal support for targeting exports, but it can also be said that there are the examples of the successful Asian economies with their significant export increases, which have inspired economic policy makers to look for ways to enhance growth through ELG.

Also, Felipe (2003) raised the question as to whether ELG is still feasible if it is being pursued by a large number of countries in parallel. What if exports focus on the same industries? This might lead to unsustainable macroeconomic imbalances with countries running large current account deficits/surpluses.

The question that also imposes itself is whether export orientation is feasible in the current economic climate. On the demand side, the sluggish growth in advanced economies and the excess capacity globally might leave insufficient room for countries to achieve a rise in exports (Rodrik, 2009; Blecker and Razmi, 2009).

Competitiveness framework and exports. – The crucial difference between CF and ELG lies in the fact that CF is more comprehensive, since it upgrades performance across the entire economy, not just the export-oriented sectors. Export-oriented sectors are of critical significance, but without an efficient transmission system towards local industries, there is a danger that their value generation does not translate into a rise in GDPpc, that is, a higher standard of living of the population.

The export and domestic sectors also face different dynamics. In export-oriented sectors companies compete directly with foreign peers, thus facing different business environments. In the local sectors, companies face only the local business environment. Economic policy makers must take into account the specifics of the locations in which export-oriented industries are present.

This shows that competitiveness strategies are highly country-specific and focused on the specific barriers to growth a country is facing at a given point in time. While the general principles apply across all countries, the key barriers to growth differ significantly depending on local circumstances.

Therefore, CF, which includes an analysis of the diamond of national competitiveness and Harvard Country Competitiveness Model (HCCM), the new competitiveness index, provides an analytical method for identifying the crucial barriers on the basis of country-specific data, including the analysis of a country's export portfolio.

Such competitiveness strategies are extremely complex due to the high interdependence of a number of competitiveness components; for example, the programme of strengthening education and skills, in particular, must be closely linked to simultaneous investments in infrastructure and the implementation of regulatory reforms. This concept implies the precise identification of policies being of utmost significance at a given point in time and the correct sequencing, because it is not possible to do everything simultaneously.

Therefore, competitiveness strategy combines efforts to upgrade general conditions in an economy with the efforts that are targeted at the specific conditions affecting some activities. These groups of activities, covering the industries related to each other in the value creation process, are geographically co-located in clusters. Competitiveness strategy must be closely linked to clusters in order to contribute more effectively to the improvement of competitiveness. If the government only addresses the challenges affecting all companies, a large part of what matters to companies in modern business remains left out. This cluster-based approach is fundamentally different from the old industrial policies that targeted industries by trying to profile the market in their favour. Instead, clusters focus on upgrading productivity and are open to all industries that are willing to engage in collaborative efforts to upgrade competitiveness (Ketels, 2010a).

For Serbia it is very important that it should start to implement the CF-based competitiveness strategy as soon as possible, without neglecting the significance of exports, which are attractive as a priority over the short term. In this connection, one must bear in mind the following two case studies – the role of China in the de-industrialization of developing countries and the avoidance of the middle-income trap based on Vietnam's experience.

The role of China in the de-industrialization of other countries. – China's opening has increased its supply of labour-intensive manufactures and its demand for primary products. For other developing countries this meant exclusion from the production of manufactures based on abundant workforce. On the other hand, China has increased its demand for primary products. In can be expected that, in the foreseeable future, China will enter a higher stage in which it will engage more skillful workforce, leaving the cheapest manufactures to its current competitors, which is especially evidenced by salary increases in China due to the engagement of increasingly higher quality human capital.

A world-scale shift concerning endowments has been reflected in the expansion of China's exports, which have been concentrated on labour-intensive manufacturing, where it has a comparative advantage, and of its imports, which have been concentrated on primary products and processed manufactures requiring the skills being scarce in China. The depth of these changes has been such that they have resulted in changes in the relative prices of factors and goods on the world market (Wood, and Mayer. 2010).

Rodrik's analysis of Chinese exports has shown that China's exports have been more sophisticated than one would expect considering the country's development level (Rodrik, 2006).

Avoiding the middle-income trap (Okno, 2009). – During the period 1991-2008, Vietnam was recording the annual growth rate of GDP of 7.6% on the average, which enabled it to leave the group of least developed countries, with GDPpc of USD 98 in 1990, and joint low middle income countries with GDPpc of USD 1,024. Vietnam's development has been driven by the liberalization effects, but local firms are still uncompetitive and institutions are weak. During that period, its growth was based on FDI inflow and ELG. Productivity and prosperity were increasing, while the poverty level was dramatically reduced. However, if it fails to improve its competitiveness now, Vietnam will remain stuck at the level of prosperity given by low value added. Consequently, Vietnam is now facing a very delicate choice: in the short run it is much easier to continue pursuing export-led growth than face much more complex issues concerning competitiveness improvement such as, for example, inefficient state-owned enterprises, inadequate regulatory framework, etc.

The next challenge is the internalization of skills and knowledge accumulated by industrial human capital. Local personnel must replace foreigners in all areas of production, including management, technology, design, operations, logistics, quality control and marketing. As foreign dependence is reduced, internal value rises. The country emerges as a dynamic exporter of high-quality manufactured products reshaping the global industrial landscape. Korea and Taiwan are now in this stage.

The economic take-off of a low developed country may start with a significant FDI flow into manufacturing engaging in simple assembly work, or processing light industrial products for export such as garment, footwear, foodstuff… In the early stage of modern industrialization, design, technology, marketing and production are all directed by foreigners; key materials and spares are imported and the host country's contributes labour and industrial land. So far, Vietnam's situation has mostly corresponded to this stage.

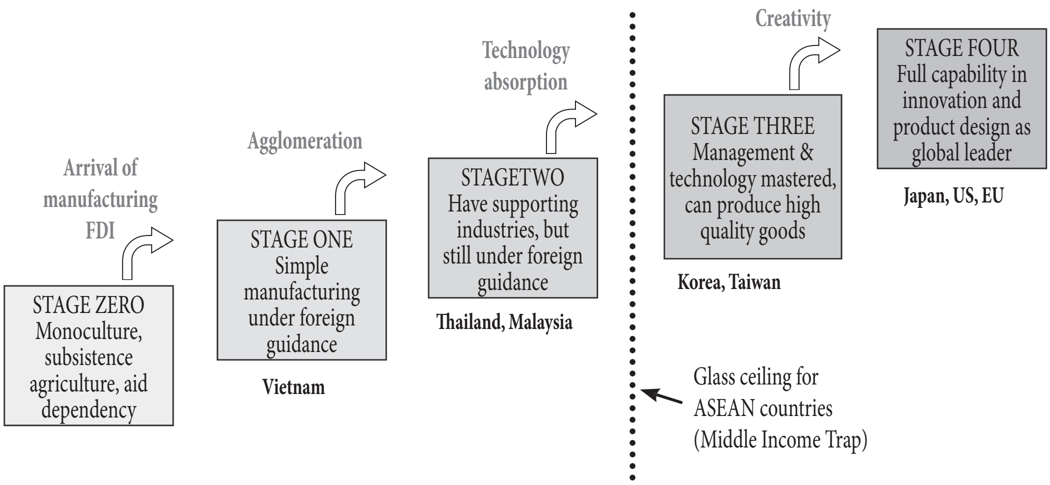
In the second stage, as FDI stock increases and production mix expands, the domestic supply of components and spares begins to increase. This is realized partly by the inflow of FDI suppliers and partly by the emergence of local suppliers. In this process, assembly firms become more competitive. Internal value increases moderately, but production remains basically under foreign management. Local salaries and income cannot rise more significantly. Thailand and Malaysia are now in this stage.

In the final stage, the country acquires the capability to create new products and lead global market trends. Japan, the United States and some EU countries are such industrial innovators.

Ohno emphasizes that a transition to higher stages is not guaranteed for all. A large number of countries with small FDI inflows stay at stage zero. Even after reaching the first stage, climbing up the ladder becomes increasingly difficult. Here the crucial trap involves a country's inability to upgrade human capital, in which the education system has a crucial role. None of the ASEAN countries, including Thailand and Malaysia, have succeeded in breaking through the invisible "glass ceiling" between the second and third stage (see Figure 1).

Most Latin American countries remain middle income ones, even though they had achieved relatively high levels of income as early as the 19th century. This phenomenon is known as the "middle-income trap".

Figure 1. Stages of Catching-up Industrialization



Source: Ohno, K.2 8.

To escape the middle-income trap, it is necessary to conduct an appropriate competitiveness and growth strategy. Deregulation, privatization, integration and a healthy business environment are necessary for reaching the second stage, but are not sufficient for further progress. An important role is played by the promotion of supporting industries and industrial human resources, which is not contrary to the WTO rules, while the measures devised to strengthen infrastructure, logistics, industrial clusters, technology transfer, education and training, marketing aimed at attracting FDI, incentive financing of SMEs, industrial estates and the like are acceptable under the existing international regimes.

An important lesson that can be derived is that Serbia must increase the levels of human capital skills and technology, instead of offering just space for plants and cheap labour.

In order to maintain the level of competitiveness, a rise in productivity must be higher than a rise in salaries. Under the pressure of salaries, Malaysia and China have already stopped attracting labour-intensive FDI and have switched to high-tech investors. Vietnam has also experienced a salary increase as the result of a high concentration of labour-intensive FDI in some industries.

The "manufacturing plus plus" concept, applied by Malaysia during the period 1996-2005, is instructive because it was an attempt to climb up to the third stage. This was the two-dimensional wish for domestic industries to expand along the value chain in order to encompass higher value-added activities and uplift the whole value chain by increasing productivity. They selected eight industrial clusters to be thus strengthened: electronics, textiles and apparel, chemicals, resource-based industries, food processing, transport equipment, materials and machinery. However, despite all these efforts, Malaysia has not yet succeeded in achieving this aim (Ohno, 2009).

Recommendations for Serbia

At the moment, the decline in the world economy is at a standstill, but the further dynamics of GDP is still uncertain. There is no doubt that the recovery of Serbia's economy is closely linked to the dynamics of the world economy and is already lagging behind the dynamics of the recovery of the world economy and economies in transition.

Serbia must implement competitiveness-led strategy, which is based on the competitiveness framework model and is broader and more comprehensive than export-led development strategy.

The key to the success of this strategy lies in the creation of an attractive business environment across all dimensions that will attract greater FDI and contribute to a rise in exports. On one side, this will enable Serbia to get included in the implementation of the Europe 2020 strategy in a satisfactory manner in its territory and, on the other side, to avoid the middle-income tramp into which some countries, which used to promote only export activities, have fallen.

The successful implementation of this strategy also implies an active role for the government in all segments in which its presence is necessary. Therefore, it is necessary to anticipate the government's fiscal responsibility in order to restrain excessive and unnecessary public spending, while at the same time redirecting it to investments in the improvement of competitiveness. This refers especially to government investments in the improvement of infrastructure, education and the functioning of the government, thus providing the greatest possible scope for the development of the private sector, especially SMEs, and a decrease in corruption.

Serbia needs to increase in its public spending in order to boost its demand and GDP, but that must be achieved by increasing public investment in infrastructure and high-quality education and science, as well as by encouraging private capital investment.

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THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS IN ECONOMIC CRISIS

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Abstract

Only a decade ago international financial institutions were being squeezed out of global financial flows and out of hearts and minds of political and business leaders. In their plans, the role of IFIs was being reduced to administering concessional aid and providing routine balance of payments and similar financial support. Everything else was supposed to be taken over either by the galloping private capital flows and omnipotent leading governments, or by private charities and NGOs, and by key bilateral aid agencies.

As the IMF and other IFIs completed their scaling down plans and exit strategies, global financial and economic crisis shook the world and changed all of that. Within two months from the collapse of Loehman Brothers, IFIs provided critical input into shaping a coherent G-20 response to the crisis. Strauss-Khan's early call for a combination of fiscal stimulus and monetary expansion to fend of deflation and prevent the march of the destructive financial and economic crisis marked a water-shed in policy thinking. It provided IFIs and the economic teams in leading governments with confidence to follow a pragmatic approach to policy interventions. Within a year, IFIs have contributed substantial analytical support to G-20 deliberations as well as record levels of resources to help most vulnerable countries respond to the crisis, revive economic activities, and restore trade flows. By April 2009 IFI's have been allocated more than one trillion US Dollars of additional resources to fund anti-crisis activities and provide support to global economy. More importantly, the crisis has revealed serious weaknesses in the global financial sector, especially in the regulatory and supervisory frameworks, as well as problem policy areas that required serious reform effort lead by seasoned international experts. The emerging role of IFIs includes both fixing the problem and discharging the new functions.

More specifically, in the post-crisis world IFIs will be expected to: (1) conduct enhanced bilateral and multilateral surveillance, and facilitate a global policy coordination framework; (2) improve the design and performance of the global financial sector focusing on four reform pillars - the global and national regulatory framework including micro-prudential and macro-prudential regulation, financial supervision, cross-border resolutions, and financial sector assessments; (3) establish and implement a global financial safety net system; (4) improve the management of international reserves and reduce the level of global imbalances; and (5) implement global governance reform of the IMF, World Bank and other IFIs.

Key words: *Global economic crisis, global financial crisis, International Financial Institutions (IFI), International Monetary Fund (IMF), World Bank, international monetary system, capital flows, lender of last resort, G-20, surveillance, policy coordination, regulatory framework, financial supervision, micro-prudential regulation, macro-prudential regulation, financial sector.*

Introduction

Defining the role of IFIs in the rapidly changing world is not easy. Potential scope for IFI activities is defined by actual market failures in the global arena, be it lack of markets and/or information, market imperfections, or weak regulatory frameworks. Within this potential scope, the actual mandate for IFIs must be obtained through an adequately defined authorizing environment, operating through an established international economic governance structure. Despite recent improvements, the present governance structure is essentially based on the old Bretton Woods formula which combined exact rules (quotas or fixed vote shares) with politically agreed and accepted leadership rules.

Historically, initiatives for the initial design of IFIs and their subsequent changes usually came from a smaller subset of political and professional leaders among IFI stakeholders. The original Bretton Woods Institutions (BWI) were formed with substantial US leadership and important intellectual (Keynes) and political support from the UK. Decades after the break-up of the original BW system in

1971, the political leadership came from the G-7. After the Asian crisis it became clear that a wider leadership body with better representation of emerging powers in the changing world economy would be needed to sustain quality dialogue on burning issues of global stability and sustained economic growth.

Several years later, the financial crisis launched the G-20 as the premier forum[1] to discuss global economic issues on the world stage. Its legitimacy rests on broad representation and economic weight (G-20 member countries represent two-thirds of world's population, around 90 per cent of global GDP and 80 per cent of world trade). The G20 presents a unique opportunity to reflect their views in shaping the global economic agenda and informing the short-term reform actions by clear long-term vision.

And the time for change is now. Crises create a window of opportunity for enhanced government learning, and for mobilizing support for change. According to Stern (30), political psychologists are markedly skeptical about the learning capacity of policy-makers and governmental organizations and argue that governments learn poorly or slowly at best. However, conditions associated with policy crises, and their aftermath, may facilitate learning and change and contribute to overcoming the governmental inertia and political dynamics which often inhibit learning under 'normal' conditions. The experience of crises may contribute to a posture of cognitive openness conducive to individual and collective learning. Crisis experiences tend to re-order the political agenda, stimulate an appetite for change, and create unique political windows of opportunity. We believe that this applies equally or even stronger to supra-governmental structures such as G-20 or IFIs.

This opportunity was missed in the wake of the Asian crisis. The support for change during this crisis was the strongest within the first year. With consolidation of financial giants and economic recovery under way, the support is waning and may soon fall below the political radar screen.

Since the outset of the crisis in September 2008, the G-20 met four times[2] and progressively moved towards defining, implementing, and monitoring a comprehensive agenda defining the global framework for strong, sustainable and balanced growth and, within that, a set of priority areas that required immediate action. These included the issues of:

- global financial sector reform (with particular attention paid to international financial regulatory system, supervision, resolution of cross-border financial institutions, and addressing systemically important financial institutions);
- redefining the mission, mandate and governance of IFIs (i.e. the IMF and multilateral development banks);
- sustaining open global economy (by fighting protectionism, promoting trade and investment); and
- energy security, climate change, support for the poor and most vulnerable groups, and job creation during recovery.

The above four sets of issues define the broader role of IFIs in the post-crisis world. Before addressing a subset of these issues in the latter part of the paper, we first provide a brief account of the developments that led to the biggest financial and economic crises since the Great Depression. In doing that, we focus in particular on the changing role of IFIs during that process, and on the emergence of institutional and policy risks that ultimately triggered this crisis and continue to represent a threat to global economic and financial stability. That would define the scope of the problem, the framework for redefining the role of IFIs and reforming the international financial system for strong, sustainable and balanced growth: To make the international finance safe for the world economy, not the other

1 G-20 or the Group of Twenty was established in 1999 as a response to the financial crises of the late 1990s and the need to more adequately include key emerging economies in the discussion of global economic issues. G-20 aims to strengthen the international financial architecture and support growth and development across the globe, discuss national policies, international co-operation, and international financial institutions. The G-20 is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Korea, Turkey, UK, and USA. The European Union, represented by the rotating Council presidency and the European Central Bank, is the 20th member of the G-20. The Managing Director of the IMF, the President of the World Bank, and the chairs of the International Monetary and Financial Committee and Development Committee attend G-20 meetings on an ex-officio basis.

2 Washington D.C. in November 2008, London in April 2009, Pittsburg in September 2009, and Toronto in June 2010. Next meeting is planned for September 2010 in Seoul, Korea.

way around (see Rodrik's contribution, pp. 15-16 in Eichengreen and Baldwin 14).

The Receding Role of IFIs in the World of Private Capital Flows: 1990-2007

Until late 1980's, private financial flows to developing countries were relatively limited in size and heavily dominated by commercial bank loans extended to governments or with government guarantees. Even when they exceeded official sources in value terms, private flows were driven more by supply side factors then by demand or creditworthiness of recipient countries. A typical example was the boom in commercial bank lending to Latin America during the 1974-1981 period associated with the need to recycle "petrodollars" that have built up after the oil price increases of the early 1970s. Despite its sizeable impact on the composition of net financial flows to Latin America and developing countries as a whole,[3] it was clear that loans from (mostly US) commercial banks were not sustainable in the longer run and could not displace the official sources of long term finance. Indeed, with the introduction of tighter monetary policy in the US and the ensuing slowdown in the world economy, this credit expansion to Latin America and other developing countries could not be sustained. An attempt by US commercial banks to collect early on their loans triggered a default response by Mexico and started a full-fledged debt crisis that affected almost all developing countries.[4] In the following five years net private financial flows to developing countries were reduced from around US$90 billion in 1981 to less than US$25 billion in 1986. Net flows from official sources also declined (by about US$10 m\billion) leading to a 50 percent reduction in total financial flows to developing countries (from US$160 billion in 1981 to about US$80 billion in 1986).

The situation changed dramatically in the 1990s. Many developing countries implemented reforms enabling efficient private sector development and liberalized their trade regimes and financial systems. Together with globalization of world commodity and financial markets, this generated renewed interest in supplying private equity capital to emerging market economies. Initially, private capital flows predominantly took the form of foreign direct investment (FDI), but soon expanded into commercial bonds, classical portfolio investments, and other non-guaranteed debt flows.

Unlike the credit boom of the 1970's, this change was seen as permanent and sustainable. As a consequence, private capital flows started to displace official flows in many middle income countries. At the aggregate level, the share of official (public) capital flows was continuously declining throughout the 1990's. In 1990, official flows were twice as big (US$60 billion) as private flows (US$30 billion). By 1997, just before the Asian financial crisis, private flows (US$300 billion) were seven times bigger than official flows (US$45 billion). This was taken as a sign that official capital flows to middle income coun-

3 During the 1975-1982 period private flows exceeded official flows by around US$170 billion.

4 See de Larosiere 11, page 5.

Table 1. Net Capital Flows to Developing Countries: 2001-2008

	2001	2002	2003	2004	2005	2006	2007	2008
	(in billions of US Dollars)							
NET FINANCIAL FLOWS	**224.2**	**162.4**	**258.6**	**370.7**	**498.7**	**668.3**	**1157.7**	**727.0**
Net official flows	26.9	5.6	-10.5	-25.8	-71.0	-70.9	0.2	20.4
of which:								
World Bank	7.5	-0.3	-0.5	1.6	2.8	-0.4	4.9	7.1
IMF	19.5	14.1	2.5	-14.7	-40.1	-26.7	-5.1	10.9
Net private inflows	**197.3**	**156.8**	**269.1**	**396.5**	**569.7**	**739.2**	**1157.5**	**706.6**
Net private equity flows	172.3	161.5	181.0	254.7	347.2	462.7	658.6	598.7
FDI	166.0	152.5	155.5	216.0	279.1	358.4	520.0	583.0
Net portfolio	6.3	9.0	25.5	38.7	68.1	104.3	138.6	15.7
Net private debt flows	25.0	-4.7	88.1	141.8	222.5	276.5	498.9	107.9

Source: Global Development Finance 2008, World Bank.

tries are no longer needed, despite the fact that the brunt of private sector flows went to only 12 emerging markets and remained increasingly volatile.

The Asian crisis put a temporary hold on private capital flows but the trend continued in the 2000s. The contribution of official flows further declined and became negative in the 2003-2006 period as the IMF substantially scaled down its loans.

Additionally, the Bretton Woods institutions were losing out to multilateral competitors in the "market for aid" in Kline-Harford terminology. More specifically, the World Bank Group (WBG), which includes IBRD, IDA, IFC, and MIGA, has been losing market share since the mid-1980's and IBRD has been declining in absolute terms since 1985.[5]

In response to changing global financial conditions and increased private capital flows to developing countries, G-7 requested a review of financing procedures used by the IMF and the roles of the World Bank and the regional development banks. The International Financial Institution Advisory Commission (IFIAC) submitted a report to the U.S. Congress in early 2000. The Meltzer report, as it later was named, reviewed the IMF, the World Bank, the Inter-American Development Bank (IADB), the Asian Development Bank (ADB), the African Development Bank (AfDB), the World Trade Organization (WTO), and the Bank for International Settlements (BIS).

The Meltzer report called for clearer delineation of the respective roles of the international financial institutions, conditional debt relief, and well-targeted support for successful development in the poorest countries. Its specific recommendations demanded complete elimination of overlaps in roles and responsibilities, and of competition among IFIs and with the private capital flows and financial market operations. To achieve this, the report recommended that: (a) the IMF lending be restricted to the provision of short-term liquidity to countries in financial difficulties; (b) IFC and MIGA be abolished; (c) World Bank's operations be restricted to low-income countries that lack access to capital markets; (d) IADB and ADB be given exclusive responsibilities in Latin America and Asia, respectively.

5 For details see Kline and Harford (15, p.14).

Although its recommendations were somewhat excessive, the Meltzer report triggered a serious discussion in development circles about the changing role of the IFIs in the world dominated by private capital flows. The Bretton Woods institutions were the prime targets of attacks behind the slogan "60 years is enough" supported openly by the political conservative tide and, albeit indirectly but very persistently, by the economic heavyweights of the democratic US federal government (Greenspan, Rubin, Summers – see Johnson and Kwak 18, p.9).

As a result of proposed reforms, the Bank would work only with poorest countries (IDA) and the Fund would only do (limited) surveillance and provide emergency financing. Modalities of Bank's continued lending presence in middle income countries were being discussed with a likely outcome closer to Meltzer report recommendations than to a continuation of "business as usual." This colossal change in the mandate of two pivotal international financial institutions could have been justified and made to work if it wasn't done in politically (and interest) inspired haste, and if an adequate international financial architecture complementing the new private capital role had been designed and implemented.

But it was not. The main source of expertise and brainpower for the task that resided in the IMF and, to some extent, in the World Bank, hasn't been tapped at all. More than that. In the run-up to the global crisis the economic gurus in the US and most G-7 governments simply ignored explicit warnings about the weaknesses in the regulatory and supervisory framework, growing global imbalances, inadequate (monetary) policy responses (especially by the US) in the wake of the dot-com stock collapse of 2000, lack of early warning systems, to mention just a few.

Testing the New International Financial System During Global Economic Crisis: 2008-2009

The new international financial system grew at unprecedented rates. Financial deepening reached record proportions. According to McKinsey Global Institute data, by 2005, the mountain of financial assets reached US$140 trillion at the global world level. In that, equity accounted for US$44 trillion, private securities US$35 trillion, government (public) securities US$23 trillion and bank deposits US$38 trillion. At the world shifted to more direct forms of financial intermediation during the past 25 years, the share of bank deposits declined from 42 percent in 1980 to 27 percent in 2005. This lowered the cost of financing investment but increased the importance of trust, promises contained in the pyramids of complex financial instruments built over the years. In the US alone the pyramid of financial assets exceeded US$64 trillion in 2005, or more 400 percent of GDP for that year. Comparable levels of monetization were around 360 percent for the UK and over 300 percent for the Eurozone.

Compared to these volumes, net capital flows to developing countries of around half a trillion of US dollars recorded in 2005 look like a rounding error and, certainly, do not attract much economic or political attention. Likewise, their growing volatility did not generate any major concerns even when private capital "surges" and "sudden stops" produced financial/banking crises or recessions in developing countries. Growing number of financial and banking crisis that took place in individual countries during the early 1990s (Brazil 1990, Hungary, Poland 1991, Mexico 1994, Argentina 1995 – see Reinhart and Rogoff 26, pp. 87-88) were entirely ascribed to weak and incomplete institutional and regulatory systems, or inappropriate policy responses.

The first sobering moment came with the "almost global" crises of 1997-1998 that first hit Asian economies, and then Russia and connected FSU countries. The worldwide contagion spread through panic and pre-emptive capital withdrawals called by global cross-border giants rather than by tangible financial and real economy linkages between country and regional markets. The large pre-emptive withdrawal of private capital (in the form of loans, FDI, and portfolio investment) was enabled by amply funded crisis response packages in Korea, Thailand and other affected Asian countries supported by the IMF and World Bank (with active participation of the US Treasury). The brunt of adjustment cost was absorbed by domestic taxpayers through sizeable devaluations, loss of reserves, and increased public debt. Direct impact on international capital markets was fairly limited, and capital flow reversals were based for the most part on over-reaction. The behavioral and management weaknesses of large cross-border financial institutions exposed during the 1997-1998 crises did not receive enough attention and, most certainly, did not result in necessary corrective action or reforms of then national and international financial systems.

A plethora of proposals to take these warnings seriously and draw lessons for the reform of the international financial architecture were basically ignored (see Vujovic 36). But the fact remains that after the Asian crises we already knew that there were serious weaknesses in the operation of financial markets (especially in the growing unsupervised and unregulated parts – related to non-banking financial institutions and many new complex instruments), that domestic regulation was far from perfect, that international regulation did not exist, that IMF's capacity to act as the lender of last resort was now sufficient (in mandate, in staff capacity, and, most of all, in resources)

But "greed" of the financial sector gurus riding on inflated optimism of world institutional and other investors (i.e. from large pension, insurance and other funds to common folks) kept on pushing the limit. On the macro side this was complemented and enabled by growing global imbalances. As detailed later in the paper, the pre crises imbalances grew close to 2.5 percent of world GDP. The US financed its deficits through Government bonds (and other instruments). In addition, to support economic revival after the 2000 stock crash and counter the recessionary impact of external deficit, the US continuously followed an expansionary monetary policy.[6]

The side effect of low short-term policy rates was two-fold: it supported growing prices of nominal asset (such as high grade bonds) and lowered the cost of US external deficits. Along with structural factors, it helped push down long-term lending rates (especially for mortgages) to record low levels gave and provide another boost to already high housing prices.

Prospect of recapitalizing businesses and refinancing real estate at very low cost generated enormous demand for financing. Private financial markets were more than

6 Expansionary monetary policy was implemented through very low policy interest rates. Taylor (35) showed that the US Fed grossly violated his famous prime rate formula during 2001-2006 period resulting

happy to oblige by providing ample and creative financing (such as sub-prime mortgages). Following a well established mechanisms, these were then pooled, polished and substantially upgraded to create asset backed AAA securities demanded by eager institutional investors in the US and abroad (Germany, Russia, Ukraine, and many other countries).

With no international regulators and whistle blowers (IMF had ostensibly been silenced and sent to contemplate its own downsizing and deal with poor countries along with the World Bank), ... and domestic policy makers and regulators engulfed in deep conflict of interest relationship with the Wall Street as vividly demonstrated by Simon Johnson, former IMF chief economist (see Johnson and Kwak 18), the world financial system was spinning out of control.

This was all seen and predicted by many insiders (including for example Edward Gramlich, a member of the Fed Board) and well known independent analysts with moral integrity (Nouriel Roubini, Joe Stiglitz, Paul Krugman, Raghuram Rajan, William White, Maurice Obstfeld, Kenneth Rogoff, to name just a few most prominent names). But the vested interests protected by policy vision of Alan Greenspan and other economic heavyweights in Washington prevailed. They shut down every dissenting voice one and continued with a lethal combination of opaque innovative instruments issued by unsupervised non-banking institutions, fueled by expansionary monetary policy.

When toxic assets based on sub-prime loans could not be contained anymore the sub-prime crisis started to brew in early 2007. This was only the beginning of a huge financial and economic crisis that erupted eighteen months later with the Loehman Brothers failure in September 2008.

How IFIs Responded to the Crisis

This crisis was different in the way it impacted the world economy and in the way governments and international community mobilized their response. The IFIs responded promptly and became a central part of the coordinated global response to the financial and economic crisis, both in terms of mobilizing critical financing and in terms of providing the necessary professional and analytical support for G-20 deliberations and decision making. The resources approached one trillion US Dollars including $750 billion raised by the IMF and $235 billion raised by the Multilateral Development Banks (MDBs). In addition, $350 billion in capital increases for the MDBs would allow them to nearly double their lending.

Joint and coordinated efforts by IFIs helped advance the reform agenda for the reform of the financial sector and the international monetary system. The IMF has taken the lead in the debate by proposing tougher and better regulation, supporting complementary financial taxation, and asking for greater collaboration among countries. Despite much opposition and criticism, the financial sector tax is being introduced by some major economies to tame erratic speculative capital movements. Progress is also being made on the regulation front, even if some of the key parameters—including the quantity and quality of capital—are still under discussion. I hope that these issues will be resolved shortly.

Voice reforms in the World Bank and the Fund, open, transparent and merit-based selection processes for the heads and senior leadership of all the IFIs, the 2008 IMF Quota changes and substantial expansion of the New Arrangements to Borrow (NAB) are well aligned with and substantially complement these efforts. Organizational and governance reforms and stronger replenishment of IDA and ADF resources will better position MDBs to discharge their roles in a transparent, accountable and effective manner, strengthen their focus on improving the lives of the poor, supporting sustained growth, and addressing challenges related to climate change and food security.

According to Strauss-Khan, the collaboration among IFIs and with participating governments established during the crisis continues to this date within the *Mutual Assessment Process*, which aims to deliver stronger, more balanced, and more sustainable, global growth. Cooperative action is expected to boost world growth by 2½ percent over five years, create 30 million new jobs, and lift 33 million people out of poverty. "Global cooperation" inspired by G20 and facilitated by IFIs is central and essential tool that can positively impact the lives of millions of people.. Despite some diverse views, leaders remain committed to both fiscal adjustment *and* growth, with the pace of adjustment reflecting country circumstances.

The IMF played a lead in policy coordination. Strauss-Khan was among the first to call for a globally coordinated fiscal stimulus effort to boost demand and help the world avoid a second Great Depression. The commitment by the G-20 leaders to triple IMF resources played a major role in restoring confidence. The Fund committed over $200 billion and injected an additional $283 billion in Special Drawing Rights (SDRs). Flexible Credit Line (FCL) provided a strong safety net for countries with a good track record, albeit the demand turned out to be weaker than expected due to possible negative signaling associated with the instrument. IMF also tripled its commitments in concessional lending for low-income countries, charged zero interest through 2012 and enhanced country ownership through more flexible programs and streamlined policy conditions. Last but not least, the IMF played a very active role in responding to Greek crisis, much more in sharing knowledge and expertise than in resources.

The multilateral development banks responded both through significantly increased policy and investment lending to most affected member countries, as well as through targeted analytic work and policy advice. An ongoing IEG[7] evaluation of the World Bank response indicates that the initial response to the crisis was focused on increasing lending, especially to middle income countries. In response to an enormous scale of demand caused by the global credit crunch and "sudden stops" in private capital flows in late 2008 and early 2009, the Bank took a three-prong approach: it rationed relatively limited IBRD resources; front-loaded IDA three-year allocations using a new Fast Track Facility; and sought to better leverage MIGA and IFC resources and mobilize additional funds (in case of IFC). Overall, IFIs responded strongly to the financial crisis and enabled record financial flows to developing countries. From the start of the crisis till mid-2010 IMF committed almost US$220 billion and disbursed US$67 billion due to contingent nature of its new financial support. During the same time the World Bank committed almost US$130 billion and disbursed a record US$80.6 billion.

7 IEG stands for Independent Evaluation Group of the World Bank.

Much of the increased lending was delivered through quick disbursing investment loans and development policy loans that provided the necessary budget support and, thus, enabled a more flexible response to the crisis.

The Role of IFIs in Managing the Post-Crisis Global Economy

This crisis has strongly confirmed the need for continued strong presence of IFIs in the modern global economy within their existing mandates, as well as suggested possible new areas for expanded responsibility within the reformed international monetary system and development finance. This section provides a brief overview of these areas with strong emphasis on the necessary reforms and enhancements, the introduction of new elements and roles, and the ongoing debates on some unresolved issues of critical importance for the stability and efficient performance of the post-crisis global economy.

In doing this we will follow IMF's definition of international monetary system (IMS)[8] and a five-prong approach to systemic reform of the IMS including:

(1) Enhanced surveillance and global policy coordination framework;
(2) Improved financial sector performance based on four reform pillars (regulatory framework, financial supervision, cross-border resolutions, and financial sector assessment);
(3) Global financial safety net system
(4) Management of international reserves (and global imbalances); and
(5) Global governance reform of the IMF, World Bank and other IFIs.

We discuss the first three aspects here. The issue of

8 IMF Articles of Agreement define IMS as policies and official arrangements related to the balance of payments including exchange rates, international reserves, current payments, and capital flows. The main objective of the IMS is to facilitate balanced growth of international trade, promote and maintain high levels of employment, real income, and development of the productive resources of all member countries through adequate economic policy. In addition, IMS should promote exchange stability, maintain orderly exchange arrangements among members, avoid competitive exchange rate depreciations, and facilitate the orderly adjustment to shocks.

international reserves and global imbalances was covered in our previous paper (see Vujovic 40), and the global governance reform was mentioned earlier in this paper.

1. Enhanced surveillance and global policy coordination framework: The traditional IMF surveillance system emerged after the breakdown of the Bretton Woods system in 1971. The so called bilateral surveillance was focused entirely on individual countries and had a dual role: first, to provide countries with (often unpleasant) diagnostic of their economic situation; and second, to render quality policy advice and propose the best course of action. The assessment of policy spillovers was rare and multilateral surveillance did not exist. Global economic developments, the emergence of systemic risks and other issues were dealt with almost entirely through IMF's analytic work and policy messages sent to world finance ministers and central bank governors during the IMF/World Bank meetings (held twice a year -- in April and October). Usually this was done as part of deliberations of the International Monetary and Finance Committee of the IMF and the Development Committee of the World Bank attended by a subset of member countries following the representation structure observed in their respective Boards. In recent years the IMF was delivering its global policy messages much more frequently through various international conferences and regular press releases, but the nature of the policy advice remained purely informative.

Multilateral surveillance becomes a necessity in today's world where inter-country linkages underlie the global financial system and shocks can be transmitted rapidly through high level of interconnectedness between financial entities relying on complex asset and liability structures. But it will take years to build such a system. In the meantime there are two initiatives worth mentioning. One is IMF's interim proposal to move one step closer towards a full multilateral surveillance by looking at the impact of domestic policies in systemically-important countries on the rest of the world. A new series of "spillover reports" will be introduced in the next 18 months focusing initially on China, the euro area, Japan, the United Kingdom, and the United States and the impact of their policies on regional and global stability.

The second initiative is the so called Mutual Assessment Process that takes place in the context of the G20 effort to secure a Framework for Strong, Sustainable and Balanced Growth on a global scale. The indispensible and very demanding technical support (including global economic modeling and analysis of alternative policy scenarios) has been provided by IFIs under the IMF leadership. Based on progress demonstrated in Toronto in June 2010, it is possible that a comprehensive action plan may be adopted at the next G-20 summit in Seoul in November 2010. This is a promising initiative which may result in a basis for future multilateral surveillance system.

In terms policy content, this crisis has spurred a huge policy debate on the nature of policies entering a pragmatic mix geared to respond to economic crisis under real life circumstances. Some the long held views on macroeconomic policy have been seriously challenged and some unorthodox views legitimized on the basis on "new pragmatism" entirely focused the real impact of policies on the ground within the relevant time horizon, rather than the theoretical norm. The policies under review are[9] the relationship between macroeconomic stability and growth (output gap), desirable low level inflation limits in deflationary (post-crisis) situations, the use of countercyclical fiscal policy, the role financial intermediation in macroeconomic policy, and the non-neutrality of regulation from the macroeconomic point of view.

In short, the enhanced bilateral and multilateral surveillance of the international monetary system should be the IMF's responsibility. In that capacity the IMF should provide, as Lipski (21) recently put it, "analytically sound advice on achieving balanced and sustained growth in a context of global economic and financial stability, and it should facilitate effective multilateral collaboration. Moreover, it should incorporate monitoring and assessment of economic and financial interconnections, while providing insights regarding international policy spillovers."

2. Improved financial sector performance and greater resilience to shocks: Pittsburg G-20 Summit held in November 2009, produced a broad consensus

9 For details see Blanchard et. al. (6) and Vujovic (40).

that the regulatory and supervisory failures created fragilities, enabled excessive risk taking, and significantly contributed to the financial crisis. To enhance the stability of the sector and prevent future crisis, improvements are needed in areas of: micro-prudential and macro-prudential oversight, risk management, transparency, market integrity, collaboration through supervisory colleges, and stronger international cooperation.[10]

Redesigned, enhanced and expanded scope of regulation and oversight is expected to impose tougher conditions on over-the-counter (OTC) derivatives, securitization markets, credit rating agencies, and hedge funds. Coordinated actions at both national and international levels are needed to implement global standards consistently, ensure a level playing field, avoid fragmentation of markets, protectionism, and regulatory arbitrage.

Predictably, there was a strong push back against tighter financial regulation claiming that it would substantially increase the operating cost and provide no tangible benefits. Two leading international institutions in this area, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision have recently completed studies which show that tighter regulatory rules (stronger capital and liquidity requirements) bring substantial benefits very modest costs. This is the basis for internationally agreed financial reforms that push the banks increase and improve their capital base, introduce a simple risk-based capital framework, adopt counter-cyclical capital buffers that can be drawn down in periods of stress, and manage their maturity and currency mismatches in a prudent manner. Proposed reforms also aim to strengthen the FSB mandate (Charter), promote high quality standards, better protect investors and depositors against abusive market practices, and lower the risks of global crisis of the kind and scope we have seen in 2007.

10 G-20 recommendations from the Pittsburg and Toronto Summits stress that it is important to ensure an adequate balance between macro-prudential and micro-prudential regulation to control risks, and to develop the tools necessary to monitor and assess the buildup of macro-prudential risks in the financial system.

In addition to stronger regulatory and supervisory pillars, the success of financial sector reforms will crucially depend on the introduction of: (a) effective national, regional, and global resolution mechanisms for cross-border institutions and improved treatment of systemically important financial institutions; and (b) the regular conduct of enhanced financial sector assessments (so called FSAPs), including transparent stress tests for key banks or entire national banking systems.

International financial groups channel large volumes of capital and provide financial services across national borders, support economic growth and financial stability. But when they face insolvency problems, the opposite is true: they can stall growth and undermine global financial stability. To preserve systemic stability it is important to agree on an orderly and effective resolution of insolvency problems faced by large international banks or financial groups. The Toronto Summit affirmed that the costs of resolution should be borne by the financial system itself rather than financed by scarce public funds. But that is not enough to overcome the limitations of existing legal framework in resolving problems of major financial firms that live globally but die locally, particularly when the objective is to preserves financial stability and minimizes the cost to the public.

According to Lipski (21), there are many possible solutions to this problem. A multilateral treaty on coordinated international resolution process does not appear to be a feasible option, except maybe among formally-integrated groups of countries, such as the European Union. Forced de-globalization of financial institutions to align them with national resolution mechanisms is equally controversial since it would undo much of the efficiency gains from financial globalization. The IMF proposed a solution based on coordination among national authorities within an agreed international framework which would provide clear incentives for countries to participate, but it would not create a binding treaty obligation.

This approach recognizes a fundamental reality that national authorities will be willing to cooperate fully only if they trust each other. The trust is built on three pillars: (i) participating authorities maintain similar high standards of regulation and supervision; (ii) the national regimes provides the tools to deal effectively with insolvent institutions at an early stage; and, (iii) participating authorities have developed effective working relations and capacity to cooperating effectively.

The framework assumes that: (a) domestic legislation is amended to permit international resolution; (b) national supervisory and insolvency frameworks are sufficiently robust and "core coordination standards" are adhered to; (c) criteria and parameters to guide the burden sharing process have been agreed; and (d) procedures for coordinating resolution measures across borders have been adopted (see Lipski 21 for detailed discussion of the proposed resolution system).

By contrast, the latest Geneva Report on the World Economy (by Claessens et. al.12), advocates a two-tier solution to the problem of cross-border resolutions – a universal approach for closely integrated countries such as EU member states and a modified universal approach for other countries.

The authors start from a policy problem faced by the national authorities dealing with financial failure: their natural inclination is to focus on domestic financial system and ignore the wider impact on the global financial system, i.e. the cross-border externalities. This happens for two reasons: first, the direct costs of resolution are borne by domestic taxpayers; and second, insolvencies and bankruptcies are dealt with by national courts and resolution agencies derive their powers from national legislation. This combination leads to coordination failure – a situation where national authority looks after its own national interest with little regard for the global interest. Authorities are faced with "financial trilemma" -- three policy objectives (preserving national autonomy, fostering cross-border banking, and maintaining global financial stability) that are not always mutually consistent. Viable solutions to the trilemma can be found through trade-offs, by giving up some fiscal and legal sovereignty, or imposing some restrictions on cross-border banking in the event of crises.

3. Global financial safety net system: Well functioning financial systems, international monetary system included, must have instruments that permit an effective response to large economic and financial shocks, restrict the spread (propagation) of shocks across countries, while at the same time controlling for moral hard and similar behavioral distortions. At the level of national financial/monetary systems, insurance-like facilities are provided by the central banks in their role of lender-of-last-resort with the exclusive power to issue local currency to secure liquidity. At the level of international monetary system this issue has never been properly addressed as the problem of sudden stops and liquidity shocks has never been acute at the global level until the breakout of the global financial crisis. The insurance-like short-term facilities to fulfill the (liquidity) crisis prevention function have never been created despite the fast growing cross-border capital flows during the past two decades and the long perceived need to design and implementation such instruments.

The creation of IMF's new Flexible Credit Line (FCL) in March 2009 was the first step in the direction of creating an instrument to counter financial countries in countries with strong track record. Only few days ago, on August 30, 2010 the IMF Board softened the FCL eligibility criteria, increased the cap to ten times the members quota and doubled the duration of the FCL instrument. In addition, the IMF Board approved a new Precautionary Credit Line (PCL) in an effort enhance its lending tools aimed at containing the financial crises in a broader spectrum of countries with sound policies that still did not meet the stringent FCL criteria. In other words, the new PCL instrument would carry somewhat softer qualification criteria and streamlined ex post policy conditionality.

The precautionary credit facility allows the Fund to provide contingent funding to members that follow strong policies but still face possible vulnerabilities from external market volatility. "The goal is to avoid the emergence of perceived risk asymmetries deriving from external developments that could create systemically destabilizing capital flight from countries or economies that in fact are following sound policies. The Fund's membership made the application of such contingent facilities credible by agreeing to provide substantial amounts of contingent funding through the expanded New Arrangement to Borrow (NAB). While these changes allowed the Fund to be more effective than previously in limiting the damage from the global crisis, we are in the process of improving our crisis-prevention toolkit." (Lipski 22)

The new anti-crisis toolkit may provide a better set of instruments to counter liquidity shocks and "sudden stops" in capital flows, but still fall short of addressing the issues of proper global lender-of-last-rest and the gradual reduction in record high international reserves as the "self-insurance" mechanism of choice by China, Japan, and other surplus countries.

Conclusion: Are We Converging Towards a Stable, Orderly Global Economy?

A brief account of selected issues related to the fast evolving role of IFIs over the last two decades provides a basis to suggest the following tentative conclusions:

1. After almost forty years of searching for the new international financial system in the void created by the collapse of Bretton Woods system in August 1971, the G-20 process may finally take us on a long path to a more reasonable, stable and sustainable global economy, with balanced roles for nation states, the global private sector, and International Financial Institutions.
2. Huge success of coordinated action in fending off the threat of the crisis and the collapse of global economy, was only the first step on that path. Many more tedious steps will have to follow in order to build a balanced global financial and economic system.
3. The IMF, the World Bank and other international financial institutions have received a new lease on life, a mandate to help G-20 design the new international financial architecture, and a new role in implementing it.
4. In discharging this new role, IFIs should demonstrate professional excellence in diagnostic and monitoring work, and exercise ultimate restraint and humbleness in advancing their recommendations and advice. This will buy them respect from national governments, the private sector, and the people.

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ECONOMIC GROWTH, IMMIGRATION AND ETHNIC STRUCTURE CHANGE IN SOUTHEASTERN EUROPE: A LOOK AHEAD

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Abstract

Sub-replacement fertility has pervaded most countries of Southeastern Europe for a few decades, in several cases longer. As a result, after decades of steady growth, the working-age population in nearly all the countries of the region has peaked and is currently falling, or is about to follow this course shortly. While this unprecedented change in the pool of labour has been spreading from one Yugoslav successor state to another, economic growth has returned to all of them after the downturn of the 1990s. During the past decade, similar to many other transition economies, growth among the successors--insofar that this can be documented--has been mainly driven by labour productivity gains. In part due to this, except in Slovenia, low utilisation of human resources remains the norm across the former Yugoslav space, something not seen often in the neighbouring countries. As illustrative calculations show, the contraction in the pool of labour will become a constraint to economic growth, much earlier in Slovenia than among the rest of the successors, in particular Croatia and Serbia. The constraint could be relaxed by resorting to foreign labour, however, at the cost of ethnic structure change of the population arising from immigration. In view of this, it is suggested that balancing economic growth with immigration and ethnic structure change will become a major dilemma of the coming decades, much earlier in Slovenia than among the other successors.

Key words: *Southeastern Europe, sub-replacement fertility, working-age population decline, human-resources utilization, economic growth, immigration, ethnic structure change.*

This paper builds on the work of the author presented at the 2008 Miločer Economic Forum and subsequently published in *Ekonomika preduzeća*.[1] The object was an exploration of interrelationships between economic growth, immigration and change in the ethnic structure of the population in Europe's low fertility setting. It was suggested that the fertility depression that had existed on the continent for some time would continue to grow and that this trend would occasion a decline of the native working-age population and the native labour force. In time, the decline will become a constraint on economic growth, which will prove more severe in instances of faster contraction of native labour, and vice versa. Governments, it was further suggested, will seek to relax the constraint by making the recruitment of foreign labour easier. Immigration, a phenomenon well known to Western European countries for some time and new to others will contribute to the ongoing or cause fresh changes in the ethnic structure of national populations. It was noted that the public opinion in Europe is uniformly opposed to immigration due to the actual or just perceived growing presence of foreigners. In view of this, governments, it was implied, will be increasingly challenged to strike a balance between economic growth on the one hand and immigration and ethnic structure change on the other. Serbia, with its long history of low fertility, was expected to share in the pan-Europe dilemma between growth and ethnic structure change, but due to its current low human-resource utilisation, this is likely to happen only after a while.

These issues are being revisited here in the context of Southeastern Europe, the region better known for its heterogeneity and complexity than perhaps any other part of Europe of comparable size. As features like these invariably challenge analysis, to make our task more manageable, we will mainly focus on the Yugoslav successor states. Moreover, when that appears desirable due to data

1 See, Macura (2008).

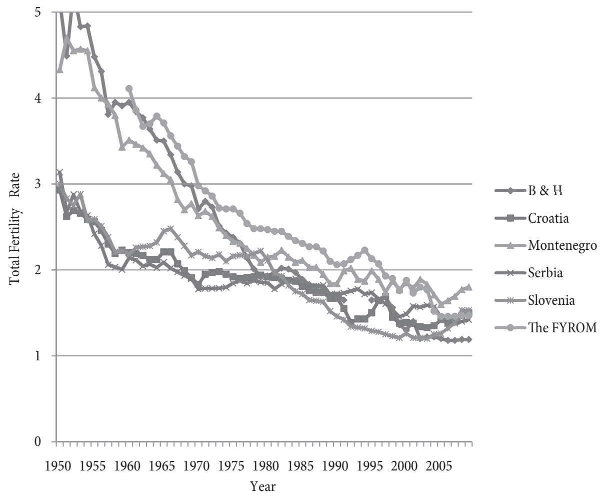
limitations or other reasons, we will confine ourselves further, concentrating on Croatia, Serbia and Slovenia. Taken together, these three countries account for a sizeable share of the economy and population of the former federation's space, rendering the narrowing down acceptable. We will look at the successor countries in a wider regional context by contrasting the six, or the three, as the case may be, to the seven immediate neighbours--Albania, Austria, Bulgaria, Greece, Hungary, Italy and Romania, another diverse group of nations. It is this expanded geographical coverage that justifies the reference to Southeastern Europe in the title and elsewhere in the paper. When it appears advantageous, the discussion ventures beyond the borders of the region.

The paper consists of six sections. The first two sections consider persistent low fertility and the decline of the native working-age population it continues to occasion. Sections three and four respectively look into recent patterns of growth of the gross domestic product, employment and average labour productivity and the nearly universal under-utilisation of human resources among the successors. Using simple illustrations, the fifth section explores implications that the decline in the working-age population would have for employment and, indirectly GDP change. It also considers how employment decline along with its growth consequences can be averted by resorting to immigration. The last section brings to the fore a future dilemma between economic growth on the one hand and immigration and ethnic structure change of the population on the other. Much of the paper rests on data drawn from international databases, the information on which is provided in the annex to the paper.

Persistent Low Fertility

The former Yugoslavia along with its neighbours has fully shared in the Europe-wide trend toward very low fertility over the past one-half century. Early on, in large parts of the former federation, the total fertility rate, TFR, reached or approached 2.1 children per woman.[2] In Croatia and in the parts of Serbia comprising central Serbia and Vojvodina, TFR reached replacement level about 1960 and never recovered thereafter.[3] As of the second half of the 1960s, Croatia's and Serbia's fertility was securely below 2.1 (Figure 1). Slovenia lagged somewhat behind, however, when it's TFR underwent the last episode of decline starting around 1980, the fall proved the fastest across the former Yugoslav space. Elsewhere in the former Yugoslavia, fertility descended steeply from remarkable postwar highs, crossing replacement first in Bosnia and Herzegovina in the late 1970s, then in Montenegro and eventually in The former Yugoslav Republic of Macedonia (FYROM) in the mid-1990s.

Figure 1. Successors: Total Fertility Rate; 1950-2008



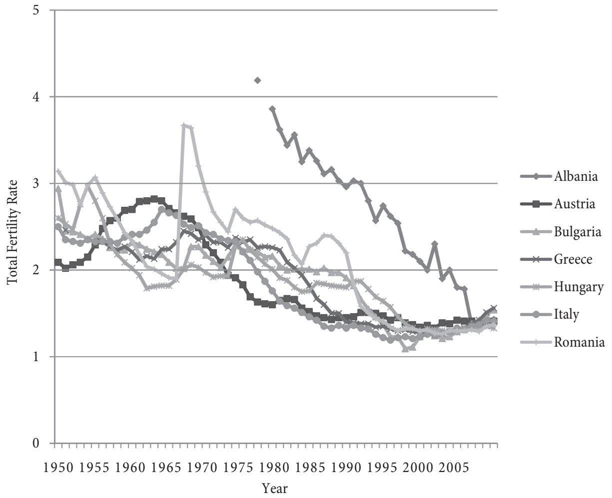
The declines in the neighbouring countries differed in two important respects from those of the former Yugoslav republics, i.e. the Yugoslav successors. Like the rest of Western Europe, Austria, Greece and Italy experienced the postwar baby boom and saw their TFRs falling only as of the mid-1960s at varying pace, permanently settling at sub-replacement levels starting in the late 1980s (Figure 2). Similar to the more developed parts of the former Yugoslavia, Bulgaria, Hungary and Romania experienced early postwar declines toward replacement. In each of these cases the State responded by pro-natalist policies, seeking to reverse the trends and keep TFR above replacement. The draconian policies of Romania appear to have been most effective and the relatively mild, family-frien-

2 This number of children per woman is sufficient for replacement of generations in a closed low-mortality population and is, therefore, frequently referred to as replacement fertility, replacement level or simply, replacement.

3 Throughout the paper, central Serbia and Vojvodina taken together will be referred to as Serbia. The reason is that the lack of reliable data for Kosovo and Metohija since the late 1990s precludes having this province treated as part of Serbia.

dly policies of Hungary least successful. However, after the old regimes collapsed, these three countries, like the rest of the former Soviet Block saw a rapid fertility fall to very low levels. Albania's fertility decline was entirely different, having little to do with the mainstream European experience. For this reasons, Albania will often receive a tangential treatment.

Figure 2. Neighbours: Total Fertility Rate; 1950-2008



This curt review of the fertility change in the region along with the underlying data suggests the following. First, sub-replacement fertility is not a recent phenomenon. Notably, it has been endemic to the northern and eastern parts of the former Yugoslavia, as well as to the neighbouring Bulgaria, Hungary and Romania considerably longer than elsewhere in the region. Second, the pathways from the moderate to high postwar fertility levels differed, but they all converged on low levels below 1.5 children per woman during the past decade, in some instances somewhat earlier. The lowest levels attained appear to be on average somewhat higher among the successors than the neighbours. Third, in the case of Croatia and particularly Slovenia, there are signs that fertility recovery is under way. Among the other successors, no indications of this nature could be detected yet. The Croatian and Slovenian experience is similar to that of Greece and Italy, but not, for example, of Austria, where fertility continues to stagnate. The recovery in some instances but not in others replicates what is being observed elsewhere in Europe, as the shift in childbearing toward ever higher ages appears to be ending.

Decline of the Working-age Population

The persistence of sub-replacement fertility over an extended period leads to a slowdown of growth and eventually to a decline of a population that is not subject to substantial gains due to migration. During the slowdown and decline the numbers of the young, of the working-age people and of the old all reach a peak, however, at dates spread out over a longer stretch of time. Then, they undergo decline. The succession of shifts from growth to decline in the numbers of the broad age groups is accompanied by a change in the age structure of the population, away from a youthful, to an older one. Although driven and dominated by sub-replacement fertility, this process is also influenced by mortality and, in the case of any open population, by migration.

The process in question is long drawn out, occurring over decades rather than years. It is for this reason that the changes in the making due to the persistence of sub-replacement fertility are as a rule not appreciated before they began, or are about to start to fully manifest themselves. Thus, it was only some thirty years after fertility in a number of EU countries dropped under replacement that the European Commission documented the imminence of the shift from growth to decline across the EU in the working-age population, labour force and employment (Carone, 2005). In what follows, we shall look into how the numbers of people of the working age grew, peaked and now decline among the successors and the neighbours.

We shall consider the numbers of people of the working age over a hundred-year period that started in 1950. Through 2010, our numbers represent the observed size of the working-age population, the size shaped over time by fertility, mortality and migration. Beyond 2010, the numbers represent the projected size of this group, where the projections are based on the assumption of a gradual recovery of fertility, such as recently seen in Croatia and Slovenia and further reductions in mortality. Importantly, they are also based on a zero-migration assumption, i.e. an assumption that populations neither gain nor lose numbers due to migration. Our interest in the zero-migration projected numbers derives from the fact that it is these numbers that are capable of depicting how national populations succeed or fail to generate sufficient own human resources.

In this section, we are interested in the *change* in the numbers of people of the working age over time and across countries rather than in their absolute values. Therefore, in the case of all the countries that we consider, we normalise the numbers pertaining to 1950-2050 before looking at them. For each country, the normalisation involves the division of the numbers by the largest of them and the multiplication of the results by 100. Figure 3 shows the normalised size of the working-age population of the successors over time. As our numbers pertain to the years ending in 0 and 5 rather than to individual years, the dates when maxima are attained are approximate.

With this caveat in mind, we observe that Slovenia reached the peak approximately this year, that FYROM will follow suit shortly and that the other four countries have already reached the maximum. The overall picture is complex and we cannot, in the allotted space do full justice to it. We, therefore, pay more attention to Croatia, Serbia and Slovenia. Of the three, Serbia was the first to attain the peak--in 1985, soon after which it saw its working-age population declining. Under the zero-migration assumption, the fall is projected to accelerate. Croatia, after it attained the peak in 1995, has also seen a decline, not much different from that of Serbia, which is also projected to gather pace. Slovenia's decline has been postponed till present, in part due to substantial gains caused by migration, but under the zero-migration conditions it would be one of the steepest. It may amount to close to 9 per cent of the peak value per decade, on average.

A glance at the changes across the one-hundred-year period suggests that the century in question is truly unique. The gains in the size of the working-age population that the republics of the former Yugoslavia witnessed until late in the 20th century will be watched by the successor dissipating. If we take the zero-migration projections as a guide to the future, we see that Croatia, Serbia and Slovenia are all likely to lose nearly one-third of the maximum size of this population group by the middle of the century. The losses of FYROM and Montenegro may be about one-fifth or less. In sum, to a varying extent, the changes in the pool of labour that once supported economic growth will, as time goes by, increasingly turn into its constraint.

The neighbours will not be much better off than the successors (Figure 4). What awaits Austria, Greece and Italy may be similar to the future outlined for Slovenia. Having attained the maximum earlier, Hungary and Romania have already seen slippages at a moderate pace, which are likely to accelerate shortly. Albania, due to a late fertility transition to low levels may attain the highest point toward the middle of the present century. Entirely different is the experience of Bulgaria, which, like Serbia, peaked very early on--in 1985--and which may approach one half of its maximum level by the middle of the century. This experience of Bulgaria, a country that has lost a considerable portion of its population through emigra-

Figure 3. Successors: Working-age Population; Maximum = 100; 1950-2050

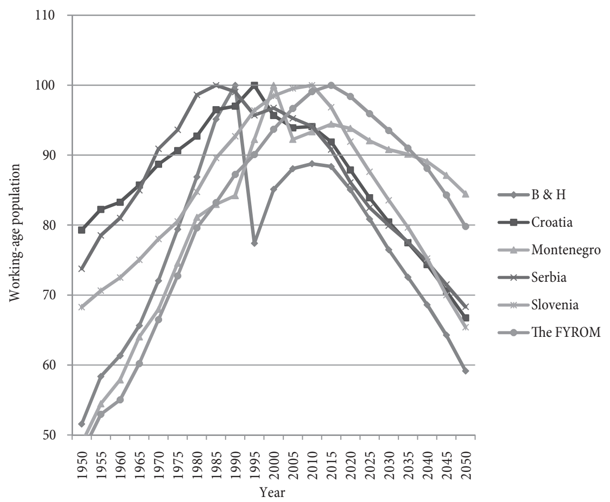
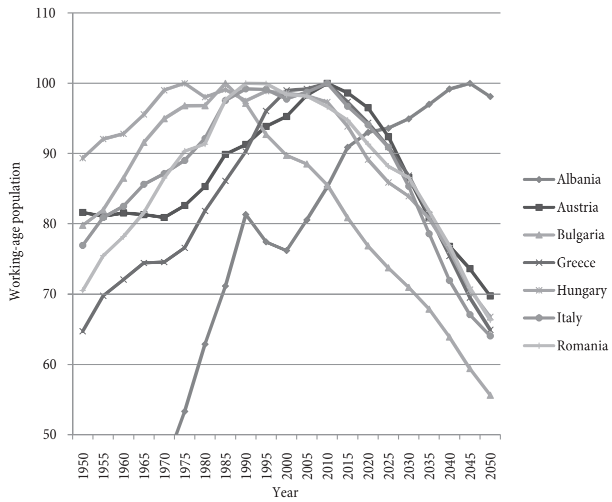


Figure 4. Neighbours: Working-age Population; Maximum = 100; 1950-2050



tion since the change of government in the late 1980s provides a potent illustration of how emigration eats into the pool of labour of a country losing its people.

GDP, Employment and Productivity Growth

After Yugoslavia's dissolution, economic growth has first returned to Slovenia, then to the other successors, but only hesitantly to one. During the pre-recession years of the past decade, 2000-08, the GDP growth of the six countries varied between a reasonably rapid in Serbia to a disappointingly slow in FYROM (Table 1). Bosnia and Herzegovina and Montenegro grew at a pace just somewhat slower than Serbia, while the pace of Croatia and Slovenia lagged more. Save for FYROM, this growth performance was similar to that of a number of other transition economies during the period considered here. For example, Serbia was on a par with Bulgaria, while Croatia and Slovenia were not much different from the Czech Republic and Poland. FYROM did not lag much behind Hungary. None of the six, however, matched the performance of Romania and particularly Russia.

Table 1. Successors: Average Annual Rates of Growth of GDP, Employment and Labour Productivity; 2000-08 (in per cent)

Country	GDP	Employment	Productivity
Bosnia and Herzegovina	4.8		
Croatia	4.4	0.6	3.7
Montenegro	5.0		
Serbia*	5.4		
Slovenia	4.3	1.3	3.0
The FYROM	2.7	1.3	1.4

*Note: * The GDP, employment and productivity growth rates for Serbia for 2004-08 are respectively 5.8, -0.9 and 6.8.*

Judging from the data that are limited to four of the six, productivity increases were by far the key driver of growth in three of the four.[4] The contribution of productivity expansion to the GDP increase was remarkably high in Croatia and somewhat smaller in Slovenia. In Serbia, the productivity increase during 2004-08 was so rapid that the GDP growth, in fact, occurred in the face of employment decline. This preponderance of productivity growth in the GDP growth appears to be a commonplace of the transition economies. Therefore, it is not surprising that the variations in productivity growth across Croatia, Serbia and Slovenia appear to be a mirror image of what can be observed elsewhere. In particular, Romania's experience is similar to that of Serbia, but more drastic. Importantly, some other transition countries, however, at different times, have seen their employment shrinking or stagnating hand in hand with the economy expanding.[5]

Grosso modo, the employment growth in the four successor countries, and in a number of other transition economies has been on a par with the employment expansion in a number of market economies, including the three neighbours (Table 2). The productivity increases in the total of 12 market economies examined, however, have been much smaller and, consequently, their economies have grown at a considerably slower pace than the transition countries. Unlike the latter, including the four successors, most of these market economies, exemplified by Austria, have stricken a fair balance between productivity increases and employment expansion. Yet, there were two particularly notable exceptions, i.e. Italy and Spain, where in the face of productivity losses, the economies have been growing entirely due to employment growth.

Table 2. Neighbours: Average Annual Rates of Growth of GDP, Employment and Labour Productivity; 2000-08 (in per cent)

Country	GDP	Employment	Productivity
Albania	6.1		
Austria	2.1	1.0	1.1
Bulgaria*	5.5	2.0	3.4
Greece	3.9	1.4	2.5
Hungary	3.3	0.1	3.2
Italy	0.8	1.2	-0.4
Romania	6.3	-1.7	8.1

*Note: * The rates for Bulgaria pertain to 2000-06.*

These similarities and differences between the transition and market economies lead us to speculate next on future likely changes in GDP, employment and productivity growth in the transition countries, specifically the six successors. First, the evidence examined here appe-

4 Note that in Table 1, due to data limitations, the employment and productivity growth rates for Serbia are not available for the entire period under observation, but only for 2004-08.

5 The case in point is Poland. From 1998 to 2007, the Polish economy grew at 4.7 per cent annually. At the same time employment first fell, then rose to a level that in 2007 did not quite matched the 1998 level.

ars to suggest that after the economies of the six recover from the present recession, employment over the medium-term and beyond will not be expanding at rates higher than one per cent per annum. Faster employment growth, such as recently observed in Bulgaria, should not be ruled out, however, it will be an exception. Second, productivity gains are likely to remain the key driver of GDP growth, especially in the case of the countries that saw a late resumption of growth after the economic decline of the 1990s. However, as the evidence from the market economies suggests, the primacy of productivity growth will dissipate over time. Third, as a result, economic growth will show a tendency to slow down. It is not worth speculating how quickly or slowly this could happen, as this is impossible to determine.

Underutilization of Human Resources

Except for Slovenia, the successors have been making poor use of their human resources. Employment rates, as measured by the EU Labour Force Survey (LFS) show that just over half of the people of the working age (15-64) are employed in Croatia and Serbia (Table 3). In Bosnia and Herzegovina, FYROM and Montenegro, the share employed is slightly above 40 per cent. In Slovenia, it is 7 out of 10. This is what the most recent data show, which in two instances are unavailable after 2006 or 2007. The Slovenia's high employment rate has been achieved after a nearly interrupted rise during the past decade. Croatia also saw a steady, but shower rise, while the experience of the remaining four has been mixed.

Is the picture that the employment rates of the five successors paint indeed as grim as it appears? Could it be that everywhere but in Slovenia only about one-half or less people work? In all probability the answer is negative. The EU LFS captures the extent to which people are in employment, as the Survey defines it.[6] However, it does not account for undocumented recurrent or odd work, such as that performed by a street vendor or a refuse collector. That work, however, is the only lucrative activity that many can engage in in situations where regular employment is limited but the living nevertheless must be earned. In other words, employment rates do not tell the full story about the extent of work. Yet, they shed light on the availability of work that is nearly decent, if not fully so.[7] Despite these caveats, the impression is that everywhere but in Slovenia the most abundant factor of production is being extensively wasted.

Comparisons with the neighbours provide further credence to this impression. They also highlight the extent of Slovenia's achievement over the past decade (Table 4). By 2008, its employment rate was just a few percentage points shy of Austria's rate, which was by far the highest among the neighbours and respectably high when compared to the rates of many other European market economies. Thus, it was not only higher than the rates of Greece and Italy, but also those of France and Spain; significantly, it was very close to the rate of Germany, the country that saw its rate rising rapidly during the second half of the past decade. On the other hand, the other successors have fared worse than all the neighbours except Albania. Moreover, they lagged

6 According to EU LFS, employment comprises: (a) employees (employed persons who receive salary or fees for their work), (b) the self-employed (employers who manage a business entity and employ one or more employees, and persons who work for their own account and do not have employees), and (c) unpaid family workers (household members working in the family business).

7 The LFS data for Serbia for 2010 call into question the 'decency' of employment for all employed. According to these data, one out of five employed finds himself in informal employment, which the Statistical office of Serbia defines as employment in 'non-registered companies' and in 'registered companies, but without any official working contract and without social and pension insurance' and employment of unpaid family workers.

Table 3. Successors: Employment Rate; 2000-08 (in per cent)

	Year								
Country	2000	2001	2002	2003	2004	2005	2006	2007	2008
Bosnia and Herzegovina							35.0	36.8	40.7
Croatia		48.7	49.9	50.0	51.4	50.9	51.4	52.8	53.4
Montenegro					44.1	42.4	42.2		
Serbia					55.3	52.3	51.0	51.3	
Slovenia	62.9	63.4	64.1	62.5	65.7	65.9	66.5	68.0	69.2
The FYROM	39.8	42.6	39.9	38.7	37.0	38.2	39.8	41.0	42.0

behind the three other transition economies--the Czech Republic, Poland and Russia--that we looked in.

Implications of the Working-age Population Decline: Illustrations

During the past decade, Switzerland displayed the highest employment rate in Europe. During 2000-08, the Swiss rate ranged between 77 and 79 per hundred and exceeded by a considerable margin the rates of a number of other European countries. From this, it is possible to conclude with a large measure of confidence that 8 out 10 is the upper limit to employment rates and that this limit may not be for everyone to approach, let alone reach.

Slovenia is some 10 percentage points below this limit, the other successors nearly 30 points or more. Consequently, all the successors, Slovenia much less that the others, may be able to enjoy future increases in employment in the face of the declining working-age population. If the successors can achieve sufficiently rapid increases in employment rates, this decline will not act as a constraint on employment growth, at least not for a while. However, in time, after the limit is reached or employment rates, although short of the limit, stop rising, the decline may begin to call into question further employment expansion. Whether it will slow down the expansion, bring it to a halt or cause employment to shrink will depend on whether foreigners will be allowed to complement native labour and any foreign workers already in the country. Much will depend on whether immigration of workers and their dependents along with concomitant change in the ethnic structure of the population will be seen as a price worth paying to secure sustainable GDP growth.

Simple illustrations can convey what is at stake. As Slovenia's situation is more graphic than that of the other successors, we will focus on it, but also consider the case of Croatia and Serbia. Let us assume that in view of possible future labour shortages, Slovenia opts to reduce its rate of growth of employment during the 2010s to one-half per cent per annum and to keep it at that level through 2050.[8] Also, let us employ the zero-migration assumption, i.e. postulate that Slovenia will stop importing labour from 2010 on, but will solely rely on labour that people currently residing in the country and their future descendants can provide over time. Furthermore, assume that the country is capable of raising over time its employment rate to the 80-per-cent limit and doing so rapidly enough so that the assumed employment growth is not hindered before this level is reached.

Simple calculations show that the exclusive reliance on the current resident population and their descendants will soon render employment growth impossible, even before the one-half-per-cent growth rate is reached. According to the calculations, employment grows according to the assumed rates until 2018, the date when the employment rate reaches the 80-per-cent limit. From that date on, constrained by the declining working-age population and the fixed employment rate, employment declines, too (Figures 5 and 6).[9] During much of the time through 2050 employment contracts at rates that are initially of the order of -1 per cent, then lower. As long as recent gains in labour productivity could be maintained, the employment contraction will not necessarily reduce the

8 Specifically, let us assume that until the beginning of the 2010s Slovenia's employment growth rate stays at the level observed during 2005-08, that it then declines linearly to 0.5 per cent at the beginning of the 2020s, and that subsequently it remains at that level through 2050.

9 The meaning of the symbols used in these two figures and the next one is as follows. WAP stands for the working-age population and Emp denotes employment. ER and EGR respectively denote employment rate and employment growth rate. Share stands for the share of the working-age population due to migration.

Table 4. Neighbours: Employment Rate; 2000-08 (in per cent)

	Year								
Country	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Albania		57.7	54.2					56.5	51.9
Austria	68.2	67.5	66.7	67.5	65.5	67.8	69.5	70.8	71.5
Bulgaria	51.0	51.0	51.4	52.7	54.6	55.2	57.6	60.5	62.7
Greece	54.1	53.8	54.8	56.0	56.8	57.4	58.4	58.9	59.4
Hungary	54.4	55.1	55.2	56.1	55.6	55.9	56.3	56.3	55.8
Italy	54.2	55.4	56.5	56.9	57.0	57.3	58.1	58.4	58.4
Romania	63.5	64.2	60.1	58.7	58.5	57.7	58.9	59.0	59.2

GDP growth below the pace typical of many market economies of the past decade. However, as the gains become progressively exhausted, which is something we expect to happen, economic growth is likely to slow down considerably, possibly turning negative.

Figure 5. Slovenia: Working-age Population and Employment; Zero Migration; 2005-2050

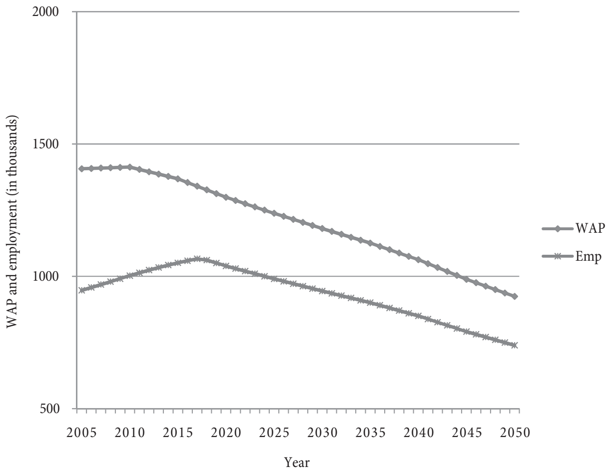
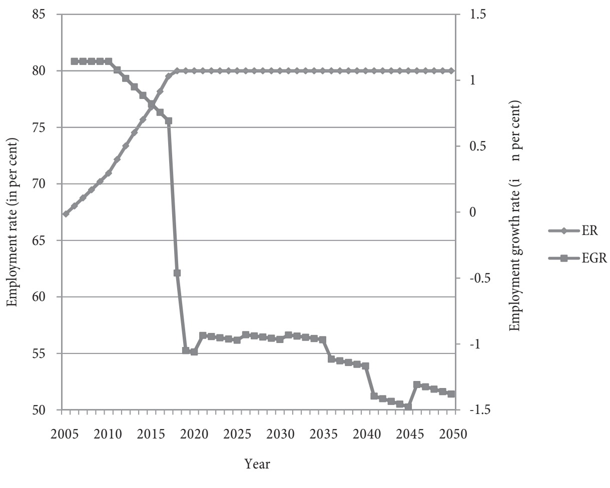
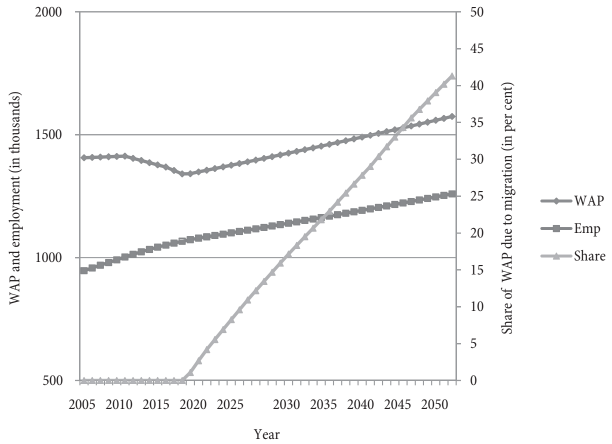


Figure 6. Slovenia: Employment Rate and Employment Growth Rate; Zero Migration; 2005-2050



In view of its implications, doesn't the zero-migration assumption appear excessively strong? What if this assumption were relaxed, while maintaining the other two assumptions? Under these circumstances employment growth until 2017 does not occasion immigration (Figure 7). After the 80-per-cent employment rate is reached the following year, immigration takes place. The working-age population resumes growth, while employment expands at the assumed one-half-per-cent rate. The difference between the free-migration working-age population and the zero-migration working-age population increases. This difference, expressed as a percentage share of the size of the free-migration working-age population steadily grows, surpassing the 40-per-cent mark by 2050. This amounts to a major shift in the foreign-native mix of the people of working age within just over three decades. One could reasonably argue that this shift would not cause as dramatic a change in the foreign-native composition of the entire population, but it would come on top of the ethnic diversification that has already taken place due to past immigration.

Figure 7. Slovenia: Working-age Population, Employment and Share of WAP due to Migration; Free Migration; 2005-2050



The calculations performed for Croatia and Serbia employ the same assumptions as those for Slovenia. The only differences are due to the fact that the initial employment growth rates are different and, consequently, that during the 2010s, employment in the case of Croatia and Serbia expands at a pace different from that of Slovenia. From the beginning of the 2020s on, it grows at the one-half per cent annually. With this in mind, we compare Croatia and Serbia with Slovenia. The comparisons show that when the zero-migration assumption is employed, the assumed pace of employment growth turns into a decline in 2036 in Croatia and in 2048 in Serbia. The rates of decline fall to about -1 per cent, remaining largely unchanged thereafter. When the zero-migration assumption is relaxed, employment continues to expand at the assumed pace, while the percentage difference between the free-migration and the zero-migration working-age population reaches by 2050 19 per cent in Croatia and 4 in Serbia. Clearly, the initial, low employment rates in these two instances cause the postponement of the moment when the contracting zero-migration working-age population begins to act as a constraint on employment expansion and thus economic growth.

Economic Growth versus Immigration and Ethnic Structure Change

Intentionally, our illustrations are rudimentary and speculative. Their purpose is not to foretell the future, but rather to bring the issues they address to the fore. Hence, we allow ourselves to assume that Slovenia will cease gaining population numbers due to migration as of the next year, a highly unlikely prospect. For the same reason we make a very favourable assumption that the 80-per-cent employment rate is the limit and that employment, if unimpeded, would expand at a modest one-half per cent annually. In view of this, the comments that follow should not be seen as purporting to chart the future, but rather suggest what future developments appear possible, even probable. Like the illustrations, the comments pertain to the three successors.

Short of a spectacular rebound in fertility and, after a lag, in the working-age population, long-term sustained GDP growth will only be possibly if, in response to native labour shortages, as these begin to emerge, immigration and the attendant ethic structure change are allowed to take place unabated. Put differently, considerable restrictions on immigration, in the case of Slovenia much earlier than in the case of the other two countries will frustrate attempts at growth. Although the episodes of growth in the face of employment decline or stagnation have been seen in several transition economies over the past decade or earlier, it is unlikely that over longer stretches of time, especially two to three decades into the future, GDP could expand at, say, 2-3 per cent annually at the time when employment continues to contract.

Immigration is a charged issue in nearly every contemporary society that in recent decades experienced inflows of substantial numbers of foreigners. Opinions on immigration range over a broad spectrum. At one extreme are the positions held by neoliberal economists, who maintain that unrestricted international migration is a welcome phenomenon, as it is nothing else but a reflection of mobility of a factor of production. At the other extreme are the views espoused by far-right political parties that promote xenophobia and preach intolerance of foreigners, whom them routinely portray as people taking jobs from the natives, perpetuating crime or causing all sorts of social ills. One can fairly safely disregard fringe positions, but could not do the same with mainstream views based on reasoned judgement or scientific insight. Among them we single out the following three. First, according to one of these views, immigration can be tolerated, even welcomed by the host society "provided that the numbers of entrants and their pace of assimilation do not seriously challenge existing perceptions of national identity"[10] Second, continued immigration over the long-run under conditions of low fertility necessarily leads to a replacement of a native population by foreigners (Coleman, 2006), a development that could hardly be met by approval in much of Europe. Third, the public opinion in many European countries appears negatively disposed toward immigration even at levels that are unlikely to cause a relatively rapid native population replacement.

Our illustrations, especially the one made for Slovenia suggest that even under favourable assumptions, including the one regarding the modestly rapid employment growth, the numbers of entrants appear large and the contribution they make to the changing foreign-native mix of the working-age population major. In view of this, it is difficult to imagine that economic growth occurring over the long-term at a pace similar to that recently observed across market economies will not call into question the safeguarding of national identity, the preservation of the preponderance of the natives in the national population and a placid public opinion. Indeed, it appears highly likely that the issue as to how to reconcile growth with immigration and ethnic structure change will inevitably find its place on the policy agenda of governments of the successors, the neighbours and others. Also, it seems nearly certain that the issue of balancing economic growth with the unprecedented demographic changes will become a major dilemma of the coming decades. How soon that will

10 From the unsigned introduction to the article, "Alexander Hamilton on the Naturalization of Foreigners", *Population and Development Review*, Volume 36, Number 1, 2010.

happen is likely to vary a great deal across the countries, with Slovenia leading the six.

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Annex

Information on data sources

This annex provides information on the sources of data used in the paper. For most part the sources are on-line international databases maintained by international and national organisations. The types of data drawn from the databases are listed along with the information on the databases and their URLs. In one particular instance, notably in the case of Serbia (i.e. central Serbia and Vojvodina), some data came from national sources, which are also identified.

The data on fertility were extracted from the Base de données des pays développes maintained by the Institut national d'études démographiques (France). http://www.ined.fr/fr/pop_chiffres/pays_developpes/base_pays_developpes/

The estimates of the size of the working-age population for the period 1950-2010 and the projections of the size of this population group through 2050 for all the countries but Serbia were taken from United Nations (2009). Selected results of the 2008 Revision of the UN population estimates and projections are available from a United Nations Population Division's web site. http://esa.un.org/unpp/

The data on the Gross Domestic Product at prices of 2005 and Purchasing Power Parities, PPPs, came from the statistical database of the United Nations Economic Commission for Europe, known as the UNECE Statistical Database. http://w3.unece.org/pxweb/Dialog/

The data on employment, in most instances based on the EU Labour Force Survey were taken from the International Labour Office database on labour statistics, LABORSTA Internet!. http://laborsta.ilo.org/default.html

The employment rates were derived from relevant population and labour market data available at the UNECE Statistical Database.

As United Nations population estimates and projections for Serbia pertain to the country comprising Kosovo and Metohija, the data on the working age population for Serbia without this province were taken from former-Yugoslav statistical publications and recent statistical publications of Serbia. The zero-migration projections of the working-age population are from Penev (2007).

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