# ECONOMIC GROWTH AND DEVELOPMENT OF SERBIA NEW MODEL

**Editors**
**Hasan Hanić**
**Stephane Ngomai**
**Goradana Vukelić**
**Dejan Erić**
**Ivana Domazet**

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Publishers
**Belgrade Banking Academy**
**Faculty for Banking, Insurance and Finance**
Zmaj Jovina 12, 11000 Belgrade, Republic of Serbia
Tel. +381 11 2621-730; fax: +381 11 2631-926
www.bba.edu.rs
office@bba.edu.rs

**Institute of Economic Sciences**
Zmaj Jovina 12, 11000 Belgrade, Republic of Serbia
Tel. +381 11 2622-357; fax: +381 11 2181-471
www.ien.bg.ac.rs
office@ien.bg.ac.rs

For publishers
Dean
**Gordana Vukelić**
Director
**Dejan Erić**

Reviewers
**Joao Soussa Andrade**
**Horst Brezinski**

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## CONTENTS

# CHAPTER 1. INFLUENCE OF GLOBAL CRISIS ON SERBIAN ECONOMY

**Hasan HANIĆ**, Belgrade Banking Academy, Serbia

## *Abstract*

*In this paper the main characteristics and parameters of functioning of the real and financial sector in Serbian economy in 2009 have been presented. First, elements have been given in brief that illustrate how wide and deep the financial and economic crisis is in the world, selected European countries, and the region Serbia belongs to. Then, key parameters follow, which show performances of functioning of the Serbian economy in the light of economic crisis both in the world and in Serbia. We have tried to integrate the most current data on economic trends in the world, in Europe and in Serbia based on relevant global and domestic statistical sources.*

## ECONOMIC CRISIS IN USA, IN THE WORLD AND IN SERBIA

The first significant signals of the world economic crises became evident in the United States in the period 2006-2007 when the real-estate price bubbles were deflated. The crisis culminated on September 15, 2008 by bankruptcy of Lehman Brothers, the gigantic investment bank. That day the stock exchange index at Doug Jones dropped by 503 points. That caused general illiquidity of financial and real sector of the USA economy.

The main causes of financial and economic crisis in the USA, which later spread to almost all countries in the world, were the following:

- Monetary policy of the Federal reserves (Central Bank) which created cheap money
- Appearance of new, synthetically structured financial products, which were hard to understand for a relatively huge number of investors.
- Insufficient regulations in securities trading, especially in trading financial derivatives.

Major consequences of the crisis quickly became visible in the following:

- Recession, that is fall in Gross Domestic Product

- Increase of unemployment (in the USA, 500 000 people lost their jobs monthly).
- Fall in the value of dollar.

The New York Stock Exchange, which reflects the pulse of the American economy, from September 2008 until the end of 2009 notified constant fall. Doug Jones index, which in pre-crisis years fluctuated around the average value of 14 500 points, reached the value of 8000 points during the crisis. In the last few months its value amounts to 10500 points.

Amid 2008 and during 2009 the world financial and economic crisis started, which by its depth and its consequences was the worst in the last 80 years, after the world economic crisis that took place in 1930s. Figure 1 clearly shows the beginnings of the crisis in the world, quarterly dynamics of plummeting of the world economy and the lowest point which was touched in mid 2008, after which a slight turn followed bringing about mild recovery of the world economy. The same figure in its shadowed part gives projections by the International Monetary Fund which refer to the expected trends in the gross domestic product in the world in this and the following year, according to which a conclusion can be drawn that certain stagnation of the world GDP could be expected in this and the following year.

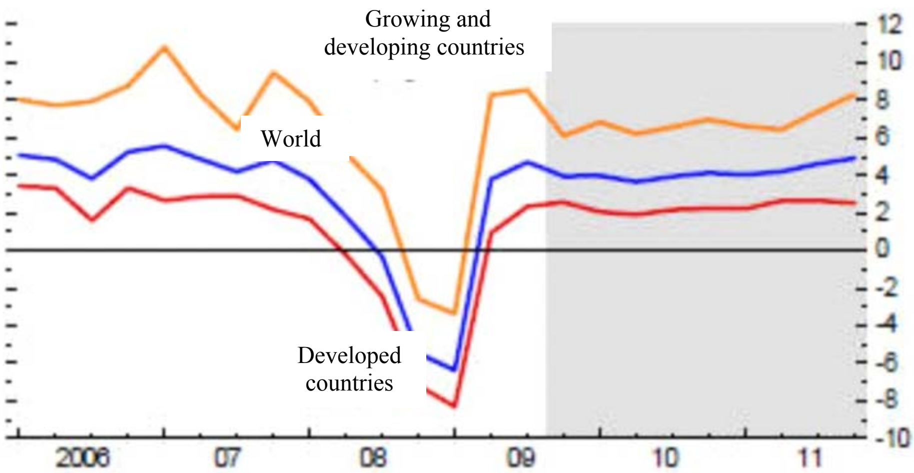
Gross domestic product represents the basic macroeconomic aggregate indicator of the general level of economic activity. Another crucial macroeconomic indicator is the pulsing of the economy. Due to that Figure 2 shows graphical image of the achieved (in 2006, 2007, 2008, 2009) and expected fluctuation of the industrial production (in 2010 and 2011).

Gross domestic product (GDP), the main macroeconomic indicator of the general economic activity, which indicates the value of the total annual production and services, fell by 0.8% in the whole world in 2009 in comparison with 2008. In the United States of America, the biggest economic power in the world, GDP dropped by 2.5% in 2009 in comparison with 2008. In Russia, which is an important economic and political partner to Serbia, GDP decreased even by 9.0%. In Japan, for example, it fell by 5.3%, etc.

It is worth mentioning that in China, the most populated country in the world, the GDP increased by even 8.7%, while in India, which is also hugely populated, GDP rose by 5.6% in 2009.

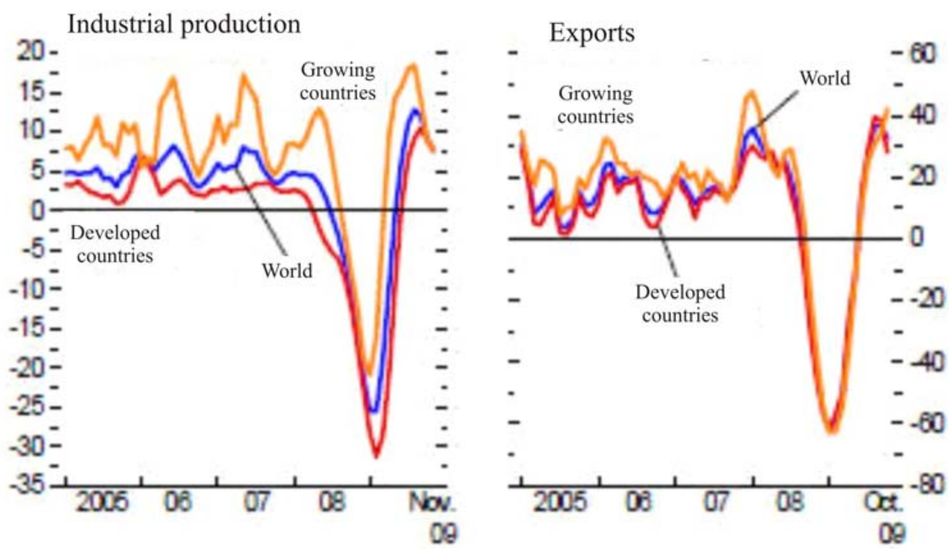
In the EU countries, gross domestic product dropped by approx. 4.0% in 2009. In Germany, the most powerful country of the EU and the whole Europe, which together with Italy and Russia is our most important foreign trade partner, gross domestic product fell by 4.8%.

**Figure 1. GDP Growth Rate in the world, 2006-2009 with projections for 2010 and 2011**




*Source: International Monetary Fund (IMF)*

**Figure 2. World industrial production trends, 2005-2009**




*Source: IMF*

We have to point out that the tables present data on the growth rates of gross domestic product in 2008 in comparison with 2007 so as to get more clear picture on the size and quality estimation of the quantitative elements of some of the categories. Data for the years 2010 and 2011 are actually projections by the International Monetary Fund.

**Table 1. GDP growth rate in the world by regions and selected countries, 2008-2011**

| | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|
| World output | 3.0 | -0.8 | 3-9 | 4-3 |
| USA | 0.4 | -2.5 | 2.7 | 2.4 |
| Euro zone | 0.6 | -3.9 | 1.0 | 1.6 |
| Germany | 1.2 | -4.8 | 1.5 | 1.9 |
| Italy | -1.0 | -4.8 | 1.0 | 1.3 |
| Japan | -1.2 | -5.3 | 1.7 | 2.2 |
| United Kingdom | 0.5 | -4.8 | 1.3 | 2.7 |
| Eastern Europe | 3.1 | -4.3 | 2.0 | 3.7 |

*Source: IMF*

**Table 2. GDP growth rate in the world: by regions and selected countries 2008-2011**

| | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|
| Russia | 5.6 | -9.0 | 3.6 | 3.4 |
| China | 9.6 | 8.7 | 10.0 | 9.7 |
| India | 7.3 | 5.6 | 7.7 | 7.8 |
| Brazil | 5.1 | -0.4 | 4.7 | 3.7 |
| Mexico | 1.3 | -6.8 | 4.0 | 4.7 |

*Source: IMF*

Along with the decrease of the gross domestic product (and in most cases as a cause of the decrease of the GDP) volume of foreign trade has decreased, too, among the countries in the world (see data in Table 2).

**Table 3. Growth rate of the world trade 2008-2010**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| World trade volume (products and services) | 2.8 | -12.3 | 5.8 |
| Source | | | |
| Developed countries | 0.5 | -12.2 | 5.5 |
| Growing and developing countries | 8.9 | -13.5 | 6.5 |
| Exports | | | |
| Developed countries | 1.8 | -12.1 | 5.9 |
| Growing and developing countries | 4.4 | -11.7 | 5.4 |

*Source: IMF*

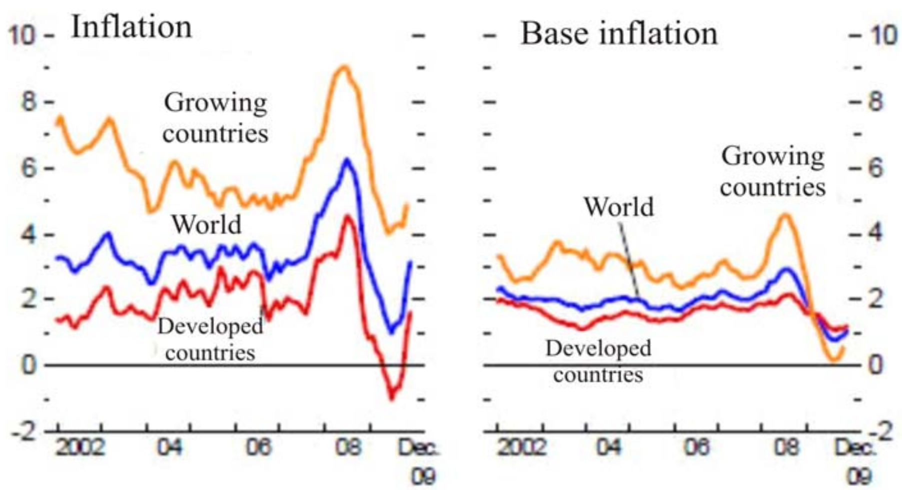
It could be expected that the decrease in GDP and industrial production brings about the increase in inflation. Shallow approach could have led to such (wrong) conclusion. However, in 2009 in comparison with the year 2008 there was a decrease in inflation, what is economically logical. (See Table 3)

**Table 4. Inflation in the world, 2008-2011**

| Consumer prices | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|
| Developed countries | 3.4 | 0.1 | 1.3 | 1.5 |
| Fast growing countries and countries in development | 9.2 | 5.2 | 6.2 | 4.6 |

*Source: IMF*

**Figure 3. Inflation in the world, 2002-2009**




*Source: IMF*

Impacts of the financial and economic crisis, which first started at the US financial market in a country which represents the leading economic power in the world – started to affect almost all countries of the world very fast (faster than ever – due to their economies being strongly interlaced and mutually connected). The exception is China which is a relatively closed country, as well as India and several other countries). Serbia was affected, too.

**Table 5. GDP growth rate in selected European countries, 2007-2011 (in %)**

Previous year = 100

| | | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| 1 | Croatia | 5.5 | 2.4 | -5.8 | 0.2 | 2.2 |
| 2 | FYR of Macedonia | 5.9 | 4.9 | -2.0 | 1.5 | 2.5 |
| 3 | Turkey | 4.7 | 0.9 | -5.8 | 2.8 | 3.6 |
| 4 | EU candidates | | | | | |
| 21 | EMU | 2.8 | 0.6 | -4.1 | 0.7 | 1.5 |
| 22 | Bulgaria | 6.2 | 6.0 | -5.0 | -1.1 | 3.1 |
| 23 | The Czech Republic | 6.1 | 2.5 | -4.8 | 0.8 | 2.3 |
| 24 | Denmark | 1.7 | -0.9 | -5.1 | 1.5 | 1.8 |
| 25 | Estonia | 7.2 | -3.6 | -14.1 | -0.1 | 4.2 |
| 26 | Lithonia | 10.0 | -4.6 | -18.0 | -4.0 | 2.0 |
| 27 | Latvia | 9.8 | 2.8 | -15.0 | -3.9 | 2.5 |
| 28 | Hungary | 1.0 | 0.6 | -6.3 | -0.5 | 3.1 |
| 29 | Poland | 6.8 | 5.0 | 1.7 | 1.8 | 3.2 |
| 30 | Romania | 6.3 | 7.3 | -7.1 | 0.5 | 2.6 |
| 31 | Sweden | 2.5 | -0.2 | -4.9 | 1.4 | 2.1 |
| 32 | United Kingdom | 2.6 | 0.5 | -5.0 | 0.9 | 1.9 |
| 33 | EU | 2.9 | 0.8 | -4.2 | 0.7 | 1.6 |

*Source: Eurostat*

In Serbia, gross domestic product in 2009 (in comparison with the previous year) fell by 3.0%. Such fall is, let us mention, smaller than in Slovenia in which GDP dropped by even 7.8% or in Croatia in which GDP decreased by 5.8%.

Industrial production (which represents the hart of any economy) in Serbia dropped by 12.1% in 2009. Civil engineering as the sector of economy which is most connected with other economic activities and, thus, with the biggest multiplier of economic growth, fell by over 20.0%. Agricultural production, which together with industrial and civil engineering production, make real sector of economy, increased by 2.5% and softened the fall of the total value of the gross domestic product in Serbia in 2009.

As a consequence of the general fall of economic activity and the decrease in demand at foreign markets, Serbian exports dropped by 26.0%.

Total number of employees in Serbia in January, 2010 which totalled 1,850 870 people, was by 6.7% smaller in comparison with January, 2009. According to the data gathered from the Survey on Workforce, the unemployment rate was 17.4% in October 2009, and was by 2.7 per cent points higher than in the same month in the previous year.

**Table 6. Performances of economy / economic growth in Serbia in 2009**

| | |
|---|---|
| **GDP** | **-3.0** |
| **Industry** | -12.6 |
| **Construction** | -19.9 |
| **Agricultural** | +2.5 |
| **Source** | -34.7 |
| **Export** | -26.0 |
| **Number of employment** | -5.1 |
| **Real salary** | -0.1 |
| **Inflation** | +6.0 |
| **Labour productivity** | -3.2 |

Average nominal net earnings in January 2010 in Serbia were 29,929 dinars and were by 1.1% smaller that in January 2009.

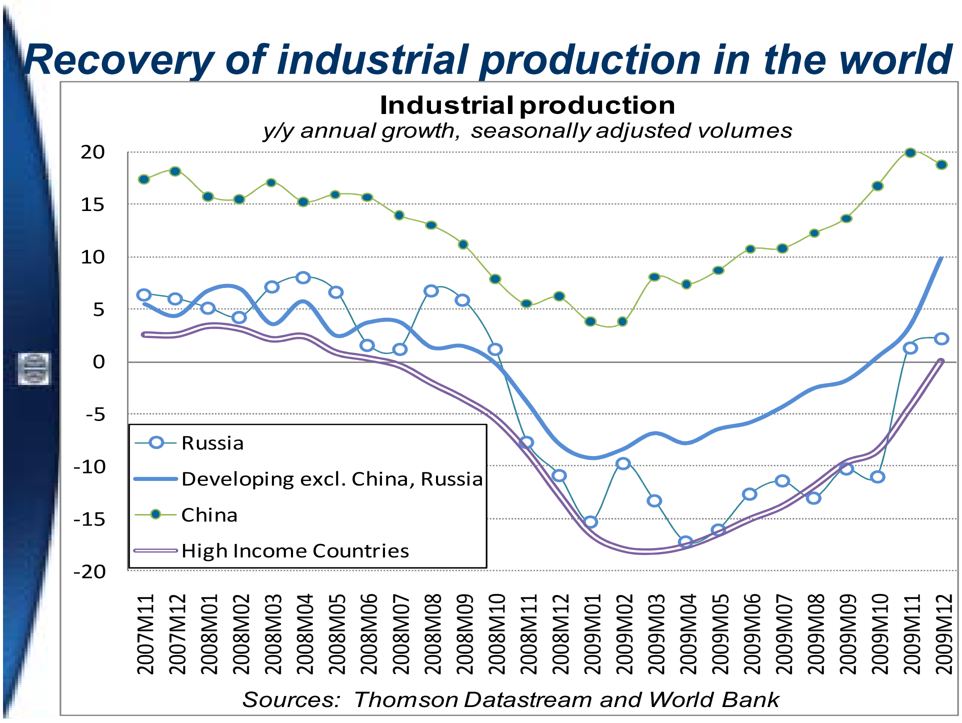
Average pension in January 2010 was 19,820 and was by 4.4% smaller than in the same month last year. Average pension currently totals only two thirds of the average net earnings of the employed.

The ratio between the total number of employees and the total number of pensioners (the so-called dependency ratio) in Serbia is very unfavourable and amounts to only 1.2 which practically means that one pensioner comes at one employed person.

## RECOVERY OF AMERICAN, THE WORLD AND SERBIAN ECONOMY

There are economic signals that American, world and Serbian economy are improving. The best proof of the recovery of the American economy is the increase of Doug Jones index. The value of this index has risen during the last 7-8 months and amounts to above 10 000 points, which is by 25-30% above its value in the period of crisis. Another important indicator of the recovery of the US economy is constant, although small, increase in retail trade during the last 7-8 months.

**Figure 4. Recovery of industrial production in the world**




The key economic signal regarding the recovery of the world economy is sent in the form of the data indicating industrial production in the world (See Figure 4)

## CONCLUSION

Current economic crisis has been the deepest crisis in the last 80 years, first after the big economic crisis in 1929-1033. This crisis is different in comparison with the one of the 1930s in terms of speed of its spreading and its duration. Due to the fact that economies of the countries in the world are connected to a high degree and interlaced among themselves, on the basis of international exchange and financial markets, the crisis which started in the USA quickly spread to other countries, first of all the European Union countries, and then to Serbian economy, as well.

Main restrictions to faster recovery of the Serbian economy are the following:

- Low level of competitiveness of the Serbian economy. In 2009 in comparison with the year 2008 the Serbian economy has weakened its competitiveness on foreign markets by eight points and in the group of 133 countries it is in the last third. According to the value of the competitive advantages quality index Serbia occupies the worrying 111 position in 133 countries on the list of the World Economic Forum, which create over 98% of gross domestic product in the whole world.

- With a very high unemployment rate and decreasing rate of employment, Serbia has latently high rate of inflation. In March 2010, the inflation rate in Serbia amounted to 1.2%. When the inflation rate in the first four months of 2010 is taken into consideration, the realized and the expected fall in the value of dinar in comparison with euro, modest growth of exports and stagnation in the scope of foreign direct investments, could lead to the inflation rate of 8-9% annually.
- Due to slow growth of general economic activities and significant illiquidity of economy, real fiscal revenues grow slower than the expenditures which generates relatively high budget deficit in comparison with gross domestic product. Planned budget deficit in relation with gross domestic product in 2010 amounts to 4%. However, due to slower growth of budget revenues (because of slow growth of general economic activities) in comparison with the increase of budget expenditures, the real budget deficit in 2010 would amount to 5% of gross domestic product, which together with a relatively high level of public and external debts represent huge development obstacle.
- Serbian public debt amounts to 32% of gross domestic product and has been increasing fast so that it represents a serious development restriction for economic growth. Having in mind relative level of public debt on the one hand and the profile of Serbia as a debtor, we believe that Serbia surpassed the critical level above which the public debt considerably hinders economic growth. External debt which amounts to 70% of gross domestic product in Serbia, also surpassed the ’upper level of tolerance’ and is a limiting factor in further growth and development of economy in the following period.

Strategy of economic growth in Serbia in the following period should be based on the following elements: (1) with provision of price stability, the results of the monetary policy by the National Bank of Serbia should be to keep the balance in the exchange rate of dinar which would contribute to the increase of competitiveness of the Serbian economy and, consequently, increase in exports and domestic production as well as sustainable economic development of Serbia. (2) Along with clearly defined development priorities in the field of industry and agriculture, better coordination of monetary, borrowing and fiscal policy, export-orientated production of tradable goods should be stimulated, thus ensuring bigger contribution of the real sector in the total economic growth which, by the way, was previously founded on disproportionately huge participation of service sector.(3) Adequate policy of taxation of revenues from interest rates and stimulating taxation policy should give incentives to savings and investments since they are the key determinants of the sustainable economic growth in Serbia in the following period.

## References

[1] *International Monetary Fund*
[2] *World Bank*
[3] *European Bank for Reconstruction and Development*
[4] *Eurostat*
[5] *Statistical Office of the Republic of Serbia*
[6] *Ministry of Finance of the Republic of Serbia*
[7] *National Bank of Serbia*
[8] *Thomson Datastream*

# CHAPTER 2. AMBIGUITIES OF THE NEW GROWTH MODEL – LEVERAGE AND THE CONSTRAINTS OF A CONCEPT MEANT TO BE A GROWTH STRATEGY –

**Ljubomir MADŽAR**, Institute for Strategic Studies and Development „Petar Karic“ of Alfa University in New Belgrade, Serbia

***Abstract***

*Due to the fact that over the last decade or so total absorption in Serbia exceeded the GDP by about one fourth, economic growth was clearly unsustainable. The mirror images of the excess of absorption over the GDP have been equally unsustainable large deficits in the trade balance and the balance of the current account. Another implied imbalance has been the substantial budget deficit. As the sources of the excess absorption and the said deficits predictably neared dramatic exhaustion, a painful adjustment – placing the economy into much narrower framework of the available domestic resources – became the order of the day. All major components of aggregate expenditure had to be considerably cut and the rate of growth had also to be reduced. The resulting protracted recession was at the very beginning – and still is – dubbed by the politicians as a start of a new growth episode for the economy of Serbia. The subject matter of this paper is the demystification of this political gimmickry. In particular, the „model“ lacks the basic elements of any – not to speak of a successful – growth, such as policy instruments and savings needed to finance the foreseen investments. Revealed are a number of oddities contained in this seductive imagery, one of which is the lack of finance to fuel the projected growth in face of wasted opportunities to accelerate growth in the course of the past decade. Abundant means were, namely, available during that period, but instead in investment they had been channelled into current consumption: when there were abundant means, growth had not been fostered; now that the means are lacking, the authorities speak about prospective, clearly unfeasible development. This is yet another instance of behaviour which is politically expedient but socially unfruitful.*

***Key words:*** *unsustainability of growth, current account deficit, the budget deficit, failed economic policies, means vs. ends in growth strategy, deficiencies of a policy blueprint.*

## INTRODUCTION: GENERAL AND SPECIFIC DIFFICULTIES WITH REGARD TO ECONOMIC REFORMS

A reform of any area of social life, especially one that should change the institutional arrangements in the economy is a difficult and hazardous job. The world is full of graveyards of started and not completed, as well as ambitiously launched, and sadly ended reforms. Successful reforms are rare, and the perception of their somewhat bigger presence is a consequence of the circumstance that there is more inspired talk about them unlike those which have commenced with great hope, and remained without trace and results. The number of unsuccessful reforms in the world is far higher than the number of the successful ones, and significantly higher than the one that has shaped the major impression in the media and the broadest social perception. In other words, it is bigger than the number of reforms that the public actually remembers, about which the public succeeded to keep any kind of knowledge. When being so emphasized and when they show systematic and striking regularity, the phenomena must have some serious causes. When we talk about reforms and such limited perspectives of their successful realization, there are many causes, and they can be finely divided into some general and universal ones, those that come to light in all reform projects and all meridians, and those which are completely specific, which represent the troubles which are characteristic to those particular economies. No one would be surprised by the claim that there is a high number of very specific troubles in Serbia, both for successful economic development and entire institutional adjustment. Those troubles will be demonstrated further in the text, when a complete analysis would be developed. In the introduction there will be an emphasis on the general obstacles in the reform implementation, barriers which do not pass over any country, especially not Serbia itself.

A general difficulty, universally represented in all efforts, instead of improving performances in the existing social regula there is a change and adjustment of the rules of the game, is the fact that reforms in most cases, in their far more prevailing part, are initiated in periods of crises and breakage, in troubled time when, for their successful realization there is the least bit of energy, system, resources and time. It should only be remembered that reforms in the ex-socialist countries did not in the right manner, especially not in the important, determining elements, start until there was a global collapse, until there was an epochal systematic breakage of the economies and entire societies. When we talk about the development of regulatory institutions of USA (for example, Rose and Hudgins (2005/1999/, p. 35-65), it could be observed that big steps in the creation of the regulatory institutions were almost without exception undertaken in the times of serious crises, in situations when the system was almost thrown out of track, and by doing so, demanded some external, outside the economy, initiated interventions. The periods of normal functioning of the economy, periods of out of crises and stable economic environment, not only were not times of effort to reconstruct and improve institutions, but were marked with *deregulation*, i.e. businesses of *removal wh*ich, in some difficult times, was constructed as an institutional defence from crisis strikes.. These circumstances lead to at least four conclusions which formalize the almost insurmountable obstacles for a truly successful economic reform, as well as an entire reform of the society. .

## GAP BETWEEN THE COGNITIVE DEFICIT AND FORCED SPEED OF REFORM IMPLEMENTATION AS A GENERAL OBSTACLE IN INSTITUTIONAL ADJUSTMENT: THE PRICE OF LATE INTERVENTION

*The first difficulty is the most thorough one and virtually fundamental* because it deals with *cognitive deficit* which must arise as an almost insurmountable obstacle for successful realization of any social activity. Since such sharp turns in institutional adjustments cannot be justified by changes in real economic circumstances, such change of direction of the adjustment clearly testifies about lack of knowledge and huge mistakes which are made in that socially important and politically responsible job. Namely, it cannot be, at the same time, appropriate, i.e. reasonable to built and degrade institutional mechanisms: it must be irrational to make at least one of these two mutually opposed movements, and it is most probable that both of them are burdened with huge failures. *Second,* if regulatory changes and other adjustments of the rules of the game are undertaken in the last moment, when the arisen difficulties do not allow any further delays, it would mean that there was no legal forecast, that the institution creators are taken by surprise and that there was no – the only effective measure – anticipated adjustment to possible disorders which could arise in some nearer or further future. *Third,* such following of events, such forced and rash adjustment of institutions and politics of difficulties which *have already appeared and even showed in high degree* means that the formation of regulatory mechanism with all widely ranged forms of institutional adjustment – in high degree an improvised activity and more or less unpredictable and deprived of the necessary coordination, are the sole economic processes which such institutional construction should regulate and stabilize. Marx, in a well known manner, talked about flow and anarchy of the market; with reasons which are no less convincing, nor less scientifically based, it could be talked about flow and anarchy of the institutional and regulatory interventionism in the economy. Concluding the elaboration of this first general obstacle in the reform implementation, it could be shortly postulated that the reforms start with critical, turbulent times when there are not enough possibilities for their analytically based design, nor financial and material resources for their realization. Initiating reforms in times when there is the least probability that they will be successfully implemented, is obvious and very big difficulty in the institutional development of any economy. Such elaborated *first difficulty* deals with a huge and permanent cognitive deficit and incapability of the authorized state organs and institutions to recognize and choose the optimal timing for their institutional cuts.

*The second* difficulty in reform implementation is a huge, in great deal imposed speed, by which they should be implemented with regard to the size of the disorders to which these brave reform moves should oppose. The concept of good institutions, even those which are not so, is especially complex and on intellectual level, a disturbingly huge challenge. The range and complexity of forecast, the identification of options and alternatives for removal of disorders, comparison and value of those variants and algorithmic mastering of the huge job of calculating the expected effects in alternative directions of activity – are so big that it would be difficult to perform them even in organized circumstances and with enough time for solving relevant problems with regard to their difficulty and range. It is easy to imagine the hazards and the extent of a possibility of a mistake when all that intimidating workload must be conducted in prohibitively short periods. Speed times skill is equal to a mistake, was said in the time of our youth by a Slovenian professor (at time junior assistant) P. Sicherl.

Fast deadline reductions and fatal temerity in the action, i.e. the *second in line* general obstacle for successful implementation of reforms, contribute on their side with two authentic structural factors. *The first* is connected to the way in which authorized state institutions battle challenges of devastating crisis disorders: when the deformity in real flow and following financial relations come to the level that the alternative to urgent, almost momentary activity of conciliation with the damage that surpasses all expectations, even the possible losses connected to the hazards of temerity of action, there is no time for fine tuning and the necessity for momentary reaction comes out from the ratio of the situation itself. If the events were anticipated and preparations for institutional adjustment started much sooner, there would be more time, knowledge and resources for thoughtful and professionally based realization of the necessary changes. As it is not the case, there is the painful alternative of panic jump with not enough studied interventions and conciliation with further deepening of the disorders without knowing how they would be spreading and what damage would arise from them. When the problems have reached threatening scales, the politician must prove that he cares for public well-being, that the *bonum publicum* is in his heart. Only by doing so, he can hope to gain votes on the next elections or a least prevent a drastic loss of political support which is almost inherent with troubled, crisis events.

*The second* structural reason of a too fast and thus weakly conceptualized and almost never thought out intrusion in the existing institutional system and given regulatory arrangements is the length, or to put it better, *the brevity*, of the horizon of decision-making of the political factors who have to give their imprimatur for each huge change. The political factors – parties, as well as their leaders – need fast, not to say immediate results. Only those results act as element of support and a factor of increase of a so-called political capital. The next elections will represent only the results achieved in the sitting mandate and in the further future it could be easily observed as someone else's merit, to someone who will win the following mandate and by doing so will take over the regulatory prerogatives. Institutional changes, especially ones which are well anticipated, give results in long-term, shorter decision-making horizon, which almost entirely defines the political activity, is a systematic demotivator of long-term motivation with regard to regulatory processes. Orientation towards direct impact and fast results come out of it, as well as the necessity of fast action even when it is evidently in clash with the imperative of rational decision-making. It is easy to foresee the outcome of all these improvised activities with the institutions with a probability of out of a myriad of conflicting, often mutually opposed changes, and other than some short-term, mainly political gains, there are changes where the expenses are higher than the benefits. That would conclude the argumentation connected to the *second structurally conditioner cause* of insufficient effectiveness and realization of reforms and their, figuratively speaking, high mortality rate.

## RELATIONS OF POWER AND DEFORMITY IN THE PERCEPTION OF ECONOMIC REALIA AS OBSTACLES OF REFORMS

*The third* reason for highly probable failure of moves in institutional adjustment are changes in the power relations. Actually, as it was established a long time ago by B. Horvat (1984/1982/, p. 60-5, especially p. 60-1), power is a *relation concept*, so its meaning implies that it is about growing advantage *with regard to some else.* Big economic disorders and social turbulence which are their immediate consequences – must provoke big changes in the structure of power. The implications which those movements can have with regard to the direction and shape of institutional adjustment are far from those which could be scientifically claimed as a road towards improvement of a wider social interest and trajectory of promoting public well-being. Decisions about modifying institutions and reshaping regulatory mechanisms follow the directions of power, and not recommendations from scientific domain and advise given by the profession. The road of actual moves and socially available changes does not follow the recipes from those who, by the logic of their orientation, can and should offer them (in their opinion), since they own positive and empirically proven scientific knowledge. That alone would stand as a reason to conclude that the changes in power reform the flow of institutional adjustment. That conclusion can be made without surprises, it can even be further concluded that these changes, in foreseeable future, clash with groups of different social needs, including ones of high priority. Even the insight that the interaction between particularly directed social powers with high probability will bring to process with opposing mark, including the, possibility not very remote, virtual degradation of what is (in the given time) constructed in the given circumstances, can be accepted without excitement. The relations of power only in certain cases can be fit in order to be suitable for the acceptance of economically based and public, general interest of inspired recommendations; but in situations of crisis turbulence, they are changing fast. The way in which unfavourable atmosphere of economically appropriate reform is further deteriorated is changed: ones who are guided by a particular interest in the decision-making process become stronger, which would imply that these are those who are interested and strong enough to block the more than necessary adjustments in the institutional system.

There is, finally, the *fourth,* general reason for high probability of inappropriate, and in not so far future reversible, regulatory adjustments. It is the general attitude of the professional, and wider public, about the general intellectual orientation which, in lack of more applicable notions, could be called the attitude of the epoch or the spirit of the time, something which out ancestors used to call *ingenium saeculi*. It is more than obvious, and hardly someone missed it, that the newest crisis in the intellectual circles, including the ones which are highly specialized professionally turned towards strictly understood economic expertise, brought a change in the relation towards the market, and by doing so, towards the state intervention. Scepticism towards the market has significantly grown, and the faith *in* the determination *for* state intervention has grown in a similar degree. It only shows inconsequence and sad hesitation of those who are under the influence of these crisis events. The crisis has obsessed and dazzled, even virtually disoriented, not only circles in the wider public, but even a more narrow circle of professional and highly expert stratum. Many change their attitude towards the market, even though in the current crisis there are no real *cognitive* reasons for that. Enchanted by the current disorders, people narrow down their intellectual focus and forget that the same market, despite its undisputable failures, was the foundation for growing of the material foundation of almost everything of significance in the modern civilization. For a balanced evaluation of the market the necessary thing is, which is often missing nowadays, *a wide angled approach*, a wide look which would, along with the current turbulence, entirely entail all that the market has given in the development of the civilization. The approach which, due to current and, *sub specie saeculi*, really ephemeric hesitation in the market flows – will not lose from sight the unequal *contributions and impacts* which the market economy gave during the economic history of the world, especially during the past three centuries, from the beginning of the Industrial revolution. The somewhat intellectual short-sightedness is kind of part of human nature: what happens at the time is taken as a heavy curtain which blocks the vision of incomparably bigger facts in a bit distant time perspective.

People change their attitudes under the pressure of the crisis even though it *in principle* did not bring any new, nor special information, which would require a revision of the point of view of the ones established in the last decade of the previous and the first eight years of the current century. This is not the first, nor the biggest crisis which has affected the world economy in its history. The ones who, at the turn of the century, believed in the power of the markets, should have the same opinion even today, because during all that time, there was the information about an even *bigger* crisis which shook the world from 1929 to 1933. But, people are not programmed to be consistent enough, and the general point of view about the range and limitations of the market has been changed and even affects the directions and shapes of institutional adjustment. The change in the intellectual climate will leave its mark on those adjustments, a mark which will be all but favourable and with the long-term needs of the society adequately harmozed.

The change of opinion, tendency to modify attitudes according to the *current* economic situation and the striking weakness in the intellectual perception of the complex world of intellectual realia, is a part of a significantly wider problem of lack of knowledge. This wider syndrome is an obstacle which in these taxonomy was taken as a first in line obstacle for successful reforms, but here we deal with a very specific factor which impedes reforms. The knowledge deficit as an expression of limited intellectual and spiritual capabilities for fighting the more complex problems which come in more and more powerful waves in the modern world. But, the change of the spirit of time, what used be calles *spiritus temporis*, is not a pure sign of lack of power to find rational solutions for the very complex problems. It is much more than that and appears as an aggressive initiative, as unhealthy agility to *impose* wrong solutions behind which there is the dogmatic belief that they are the right and only approach towards finding the way out of the current cataclysmic turbulences. We deal with wrong understanding which is obediently imposed as a finally discovered unconditional truth. It is a kind of pathological growth on the general fon of more than imperfect understanding of the economic and social facts. It could be said that it is a special and especially destructive form of the general lack of cognition.

This lack is always deeper and far reaching from what is typically accepted as a reasonable and welcome scepticism with regard to the intellectual capability to diagnose economic events and find a way to correct their deformations. It is deeper than the reasonable reserves with regard to the available insight showed by the unreliability of the data which help in making a judgement about the economic circumstances and tendencies of their movement. Lack of knowledge and unreliability of information are a source of big difficulties at the highest level of social organization, including different scientific centres which study the economic events in a systematic way and give recommendations for methods and shapes of modifying the economic politics. That is why it happens that institutional modifications and economic-political interventions follow events instead of anticipating them and – opposed to the obvious, logically founded tendency to target the generating of stability activities – they themselves become additional sources of disorders and cyclical blows. Better informed analysts will not be surprised that the flows of regulating interventions themselves and moves in the line of improvement of complex regulatory structure take a cyclical pattern and actually become a new kind of elemental aberrations which have torn off the social control (Djukanovic and Ivovic 2010, especially p. 260-1). M. Friedman spent half of his life to prove that, due to cognitive limitations, information defects and model and algorithm deficiency of the fake stabilization economic politics it turns into an additional source of economic disorders, as well as a powerful *generator* of economic cycles. Friedman kept the conviction of *counterproductive* effect of the „stabilizing " politics and, with even more convincing arguments, elaborated on it during his long academic career.

## NEW GROWTH MODEL – CONCEPTUAL AND TERMINOLOGICAL CONFUSION

The new growth model (NGM) launched as a huge and highly valued potential achievement, as well as a hint of valuable real improvements of economic performances and entire social situation. Political circles have put it in circulation and popularized it in the biggest possible measure to make it seem as attractive as possible and it became appealing to the wide layers of the public. Experts were not surprised by that loud commercial. Politicians are constant hunters for votes and in that perpetual race have mastered other skills, as well. Among other things, the skill of making virtue out of necessity. Although not even small steps have been made in this long running start towards the beginning of its actual realization, politician emphasize it as a result of some sort, as a tangible achievement. However, it should not confuse nor seduce analysts. An analyst, by the nature of his profession, is turned towards the improvement of a general interest, in whatever way it should be defined. Politicians, by the definition of their job, go by a particular interest – of the group they represent in a democratic society, their parties and movements, and of course, their own. Political factors are always leaning towards a profitable, i.e. electorally possible mystification of a model, while the task of a researcher is to demystify, and even present the model itself as it really is, as well as to demystify everything that is conducted around it, and what is aimed to be achieved by it.

The first step in the demystification of this «model» is a demystification of the conceptual and terminological lack of foundation in its name. None of the words in its name – namely *new, model* and *growth* – do not have a convincing conceptual justification. In a wider version of a paper on the NGM (Madzar 2010) it was shown that this newest creation of the political wits, there could be neither *model* nor *growth.* Here it will be shown that neither the word *new* has an unconditional justification. Saving space, it will be demonstrated in shortest possible manner.

Despite the fact that the word *model* has, as Krleza would put it, a wide *aura of meanings,* this creation of our political actors, namely NMG, cannot fit into any of the accepted and known interpretations of the word model. In the recently edited dictionary of Klajn and Sipka (2006, p. 782), there are six different interpretations of this word, and none of them corresponds to what the applicable political circles (seem) to understand by the word *model*, when we speak about the NGM. The same could be said about the *Big Dictionary of Foreign Words (Veliki rječnik stranih riječi)* by Kljajic (1966, p. 818-9), where there are five interpretations for the same word. Some variants of the meaning could be immediately discarded because they are totally out of the concept of the NMG (for example, a person who poses in front of an artist, or a mold by which some objects in certain workshops or plants will be made). The closest that could be found in the given meaning could be accepted as a reminiscence of what the NGM entails is the definition of a model as an abstract stylization of a certain object or process. In that interpretation a model is namely a collection of abstract schemes, simplified constructs and most often a mathematical relation which, in a myriad of richly shaded variants, gives a simplified picture of a certain object or process, in which, in order to present and understand some important interrelations and features, some real shades and details without importance for the interpretation of the essentially important components, are left out. What has been offered to the public as a new «model of growth» obviously is not a model, since there is no object nor process, nor there is a picture of concrete economic concepts. The NGM is a stylized representation of something which the authorities claim that could be, without getting into the chances that that collection could become more serious, not a picture of important ingredients which in reality would have a tangible match. It is possible, with regard to this fact, to make an additional step, and postulate that the NGM is not an organized picture of an imaginary entity, since there is a lack of a picture of the connection and interdependence between some of its elements, there is a lack of representation of anything which would make such stylization a model. In other words, that abstract creation is not a collection of consistently matched, analytically connected ingredients on the basis of which it would be possible, out of known numeric characteristics of a certain number of these components, to calculate the quantitative value of others.

The next link in this chain of denying the presence of elements which would possibly make the abstract construction a model is the observation that even the use of the word *growth* is not justified in this context. It cannot be seen, namely, how in this stylization of desirable development in the foreseeable future some growth, especially the one which in comparison to the previous one, would be faster or would show superiority in some other dimension, is likely to appear. In the mentioned stylization namely, the factors which could generate growth are missing. It cannot be seen how the necessary investments could be realized, how they could be financed and how, with regard to everything that was achieved in the last ten years, some other sources of growth, such as technical improvement or braver opening of the economy to the world,  could be possibly activated. From the only relevant perspective of the economic realia, from the constant point that represents the economic reality of this country, only the factors that could slow down the growth can be seen, it is evident that the factor of propulsivity will be missing, even with regard to the undoubtedly unsatisfactory growth in the past decade.

The current growth was not, namely, financed by the individual savings, but from the exogenous sources, among which mostly are likely to be drained in near future. Foreign direct investments (FDI) have largely drained, and inflow from privatization will, by its own logic, stop when everything that has remained is sold. They are significantly reduced even now, because potential buyers are offered less attractive objects. The further foreign debt is slowly draining and even stopping, because it meets its natural limit defined with the growing debt, seen through the GDP, and especially, measured in a known and proven manner: quotient through the export. The rest is allocation from «temporarily» employed abroad, for which it can be certain how they will behave, this factors could increase, but their accumulative potential is small since they are traditionally oriented towards, and tied to, consumption:  it is very likely that the increase of factors of income would induce adequate increase of consumption, with a small effect on national savings. To summarize, what has been launched as a certain model of growth, cannot be characterized as a phenomenon of *growth* because the possible changes of all relevant factors are such that by following them *a drop*, not *a growth* of development could be expected in nearer, and possible further future. It would be good if that *drop* influences just the *rates of growth* and does not spread to the *absolute levels* of relevant macroeconomic aggregates. The unpredictability is a consequences of the circumstances, thus it is not regulated in principle how economic politics will react to the current and upcoming turbulences, and equally important, what the effects of those factors could be expected even if there are any reactions and if they are adequately shaped and measured.

The «model» finally is not even *new*. What has been announced as a collection of its determining ingredients – reindustrialization, especially renewal and acceleration of the growth of the sector of interchangeable goods, especially the reduction of deficit in the trade balance and balance of payment, the return of the currency rate on a level compatible with the power of the economy, especially with its export capacity, changes in the tax instruments and wider, in the fiscal system, the cutting of the public expenditure and strict control of its most important components – is not a spectacular novelty but, on the contrary, a return of the economy in completely standard frames, in the flow of a normal and regulated business which should not have been exited. It is certain that very big changes will have to take place since the economy and the society cannot live eternally above their possibilities, but those changes will be a matter of raw balance necessities, and not a result of thought-out and rationally conceptualized turns in the economic politics. Even if some of these changes could be marked as true novelty, they could not be tied to the economic politics nor to be entered in the books of the government balance of payment as a positive stance. There is only one, and a very limited and conditional point in which the «model» could be qualified as new. It is new with regard to the pathology of the growth which indelibly marked the past decade, and which the future generations will not be able to remember by any results, worth remembering.

What remains to be mentioned, since there is neither room nor need to elaborate, is that the inevitable and undoubted defeating mark of the present economic politics does not impose personalization of responsibility for such failures. Serbia is handicapped with raw limitation in the governing system. In that system many favourable things cannot be done even if there was political will. The ethnic heterogeneity and abundant ideological differentiation have, as a consequence, party fragmentation and wide coalition governments. The dominant feature of all, for us typical and almost destined governments, is not potential for constructive activity but numerous and different limitations of the manoeuvre space and thus making many of things which are routine in less exotic countries unavailable.

## APORIES WITH REGARD TO «THE NEW GROWTH MODEL»

An apory is a little exotic and not so often logical difficulty. It consists of big obstacles, to put it better impossibilities, which sometimes appear when there is an approach to a delicate operation of fitting a certain number of utterances or marks, which could relate to a world of actual facts or normative determinations, in a coherent whole; these conceptual differences cannot be put together without a clash with the laws of correct logical thinking. More precisely, an apory is „...an unsolvable problem which arises from the clash of two opposite logical conclusions“ (Klajn and Sipka 2006, p. 136). Or, it is „...a logical difficulty ..disputed issue ...doubt“ (Klaic 1966, p. 83). It is not good when regarding some issue or plan of action anything like apory arises. Apory, among other things, implies impossibility of an event or realization. It could be established without risk that nothing of what is logically opposed is realizable, and the thing is additionally complicated by the fact that logical consistency does not guarantee realization of a lot of things which are logically harmozed out of the space of available solutions.

*The first* apory is about the means for finance and by which the announced new model of growth would be realized. In the previous section, the concept that there are no sources out of which the necessary means would come out was elaborated, nor there is possibility that they could arise in the near future. Growth without accumulation is hard to imagine, even with the strongest urge for imagination. There were more means of that sort in the past. Just in the basis of privatization there were around 17 billion dollars through our public funds in the past ten years. Through different types of debts, both in the public as in the private sector, there was an inflow in our society – the concept *in the economy* is consciously avoided – potentially valuable, and unfortunately unused 24 billion dollars. In the first couple of years after the turn in 2000 there were donations which passed 3.5 billion dollars by estimations. Professor Kovacevic (Radosavljevic 2010, p.2) warns that since 2001 in Serbia on different foundations there was an inflow of at least 70 billion dollars; there are flows that are *external* for us (they come from outside) and *exogenous* (realized independently from the processes occuring in our economy). In the started period some of the most important inflows will simply drain, and some (for example, donations) have drained more than five years ago, long enough to be forgotten. Some inflows from external resources will remain, for which it can be expected, at least in smaller intensity, to keep flowing. But, they have always been directed towards consumption, they have appeared in wide social strata as means for insuring the existential minimum and it will not be possible to take them out from the current expenses, as they could not be so far.

Beside those means, the expected development of infrastructure and more serious investments in the production sectors is missing. It should not be stated again what has not been made from the necessary infrastructure objects and how many of the promises in this vital area have not been fulfilled. The apory is now obvious and consists of the following: when there were means, and according to our standards, *very high amounts*, there were no investments in the obvious priorities; now when the means are missing and their potential sources cannot be seen, there are announcements of some serious development initiatives. How can that, which was not completed during the time when there were serious means, be completed when there are no means? That is logic where everything is upside down. It is possible to understand that political competition chases parties and their leadership – and, which is worse, their exponents in the executive authorities

– on different kinds of mischief. Those aberrations, however, represent a *social activity* and demand their theoretically based and analytically challenged explanations. The biggest part of this text is dedicated to the *system* determinants and adequate distortions of the economic politics and other activities of public interest. In the text, in other words, there is an attempt to identify, in the specifics of the system, reasons for wrong measures that were undertaken, as well as actions in the economic politics and other areas. The intention to see power and pressure which lead to bad politics in the system, politics which in the greater part of the expert opinion is personalized and where there are concrete responsible *people,* with names and last names.

The system has, in this point of view, produced many things which have been anonymously evaluated as being in clash with principles of economic efficacy, unsustaible and destructive. Yet, with respect to the wrongly directed powers generated by the system, in the promotion of the politics which will be ostensibly led, a certain measure must be respected – the boundary where the insult to reason starts – should not be crossed. It can be reasonably stated that it could be established as political, not productive. Some things are hard to believe even for the widest mass of voters whose votes the politicians are most eager to get. Even if they believe in them, the big economic difficulties and unfulfilled promises will appear so soon that the (political, i.e. voting) public will not manage to forget what, even with load announcements, was promised. Such development of events will make some analysts to correct their vision: if they put the fatally bad results to the incorrect motivating structure as marked feature of the system, with the conviction that with regard to *that kind of motivation* they acted rationally, the promises combined with the prospect of *fast denial* give birth to serious doubts in the so far assumed rationality, thus in the intelligence of our most responsible officials.

*The second* apory is related to the subjects who stand behind the new model and advertise it as their new achievement and reference for which they expect to find public support and increase of the political capital and election victory. The new model is emphasized and described, with certain pride, or at least in a way that should leave such an impression. The behaviour which seems to be not so appropriate political exhibitionism is observed, which especially comes to be seen at the time when the IMF delegation visits, during the negotiations which could not be described neither as short, nor as easy. The instructions which are given by the IMF and their crucial influence on important determinations of the economic politics can easily be seen. The rhetorics of somewhat our new politics and valuable impacts which are going to come out of it with the role which is played by IMF in from of the expert and wide public cannot be connected. It cannot be connected with the radical redirection of that politics which brings it to Belgrade. The apory is, actually, in the fact that the idea of the *new politics as our creation* and our own choice cannot be reconciled with the striking and crucial influence of that politics by IMF. Having the method in mind, as well as the effectiveness, with which IMF fights the most destructive tendencies in the current politics, it is postulated that their role is constructive and welcome. After all, any opposing point of view would open an unsolvable problem of finding the reasons because of which it is invited in Serbia; it would follow that in the current government, as is the case with the previous governments, there would be someone immediately motivated to cause huge damage for the entire state. Many things could be contributed to a government, but the fact that its goal is to destroy the country – it could hardly be matched with rational and objective reasoning.

Therefore, the NMG is not a formalization of any new strategy, even less a strategy that anticipated and introduced consistency and a wider social rationality. It does not imply that what has been clear is to show up will not do so in the planned adjustment of consumption and total absorption, they will go back to their narrow frames of available resources. It is not possible not to see that ahead of Serbia there is an essentially changed and in many dimension not pleasant period of living in narrow frames which will inevitably go closer to the limits of individual resources, without the gallant increase by exterior means, as was the case since 2001. The necessity of such adjustment is specially well known to the expert public from the very beginning of that comfortable, but time limited immoderate spending. However, even in that return to narrow frames of individual possibilities there are certain – although not plenty, and not comfortable – options, alternatives and choices. If the political limitations and devastating competition of parties brought as a consequence imbalanced and thus inefficient current development, the possibility that on the downward movement would be deformations and inclination towards options which are far from the optimal should not be *a priori* excluded.

However, there is room for different reasoning and modified expectations here. Although the political combats, vertical division of authority and failure in the functioning of the system still remain a part of our social reality, one very important matter will significantly change. On the downward movement, which will turn out to be unexpectedly favourable if it is downward only with respect to the restriction of the consumption, we will not be alone. With organs, bodies and agencies which formulate and implement certain components of the economic politics there will be the IMF both virtually, i.e. physically, as well as by the previously given instructions, directions and limitations. That *via dolorosa* will be crossed along with the IMF and their professional *monitoring*. It will happen because we have already invited them, and will, as it would seem, continue to do so. When you start that steep downward path, it is not easy without support, and during the critical adjustments further down the IMF is practically the only one who is ready to enter into some kind of interaction with us. When trouble knocks on the door, the number of those willing to support you is sharply reduced, and the environment were you happen to be suddenly seems to be rarely populated. *Tempore felici multi numerantur amici, si fortuna perit, nullus amicus erit*.

The presence of the IMF on the road ahead, which we would most likely, if it would be possible, not start going, is a reason and occasion for something which could be called the third apory, some kind of an addition with relation to the two previously described in this section. Beside the fact that around the world it got a reputation of a sympathetic institution which cuts consumption and imposes bitter deprivation, the IMF is on the way to reduce the landing on hard and bare surface which is narrow, and for our consumer habits, insufficient for the individual resources. The bizarre curiosity consists of the fact that during this troublesome transitional period of going down to lower levels and personal demand and satisfying public needs, IMF will allow *higher* consumption and higher standard which *should be the case*. The IMF will make this going downward to the level of individual possibilities easier by (yet!) approving loans to us, even for the so called budget support, i.e. the *current consumption*. IMF gets a special weight because of the circumstance that so few alternative financiers (so far only one can be observed, with a modest amount), especially ones who would credit us in – at least when the interest rate is in question – so favourable conditions. When we say here *a higher current consumption during the transitional adjustment regime*, it does not mean – far from it! – higher than it used to be before the resource limitations got us. The consumption during the downward movement to a level which we, most probably, should not have moved from – higher not in the standard sense of absolute increase with regard to previous levels, but in relation to the frightening scope with which it could only be equal if we were moving downward without the support of the IMF. When we would return on the basis of our own possibilities as sharply as the available GDP dictates us, even if we (still) do not allocate anything for accumulation and investments, it could easily turn out that the deprivation would be such so that the serious question of social sustainability as well as political feasibility of that troubled and hazardous adjustment. With an IMF loan this would be a soft lowering, without it it would be a sharp drop, especially painful and a strike with crash on a hard surface.

The previously stated could imply that the IMF has changed not only the fur, but the character as well, *non solum pilum sed etiam mores*. There is an obvious element of truth in that, but it is far from the entire truth. It would seem that IMF wants to avoid political disturbances, and some more deeply rooted change of power would present a disturbance. We should remember the nervousness in the paired with us international circles when the «democratic block» lost the elections in May 2008. A lot of effort was put to gather a (too) wide government coalition on a completely new basis, just that «the other ones» do not come in power. A certain rerun of that event appeared at the end of April 2010 on the local elections in Arandjelovac: the one who got most votes seems not be able to reach power. On the prevention of that awful political turn in 2008 there was work with full steam ahead, and, as it seemed, with certain panic. And it was a success. The Fund itself changed the strategy with the aim of complete acknowledgement of the local specific features and understanding of the political limitations in which the «democratic» government works and with regard to which (it must) lead the economic politics. Maybe it is a cognition that a «softer approach» gives better results, and that it is more productive from the point of view of the objectives followed by the local government in interaction with the IMF. What is more important, it seems that there is an arrival to the cognition that the individual objectives – whatever they might be – could be better realized with a softer approach by the IMF, in a manner that contributes to the preservation of the existing government, if not its lasting survival. The complementarity of the objectives of the fund with the objectives of the democratic powers which have, despite the high risks, remained and kept on power, could be an important political and geopolitical fact whose implications have not been fully investigated, but could have a big impact on our current economic situation and the prospects of future development.

However, IMF is not going to stay on the described «softening» of our landing, which would otherwise be fast and risky, since it would mean a repetition of the scenario from the previous decade. That is the last thing the Fund needs, as it – which has probably become obvious to the wider public – would not be good for us, either. The IMF with its credit facilitates the adjustment and makes the drop of consumption less drastic than it could be, but it does not want to do it in a way which will *not* bring us back to the old track but to a significantly different one, resource compatible (in a sense that it corresponds to our well observed possibilities) and long-term sustainable. It is not completely clear how that can be done: to protect the society from a big and politically hazardous drop of consumption, and at the same time ensure a transition to a significantly different, resource compatible and long-term sustainable path of growth. The combination of these evidently opposing demands appears to be as insisting on making a shoe which will be narrow from outside and wide from the inside. It seems that the strategy is to be accepted, a combination of institutional adjustments («reforms») and turns in the use of resources in the economy itself. If that is true, than a decisively started and in good deal developed strategy with the Fund could grow into a kind of long-term symbiosis. Narrow and probably more permanent cooperation of our authorities with the IMF could be characterized by some as concubinage, so many in the professional, and even more in the wider public are not going to approve it. However, it does not need to be an alert since this kind of «sacrifice of the souverenity» practically does not cost a thing, and could bring something good. It is time that the public realizes that we had the most difficult time in the economy when we were left on our own and that it is difficult to find external factors which could distort to a degree, both the macroeconomic balance and development, as high as our own actors have. They did it in their known manner - pressured by devastating party competition and caged in the chains of a strong institutional system for whose crucial change there has not been, nor is, will nor power.

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As it is often the case, the NMG has opened numerous questions, and there are few that it is to solve. The hesitations move in wide range, from pure logical ones, to content directed (is it, or why is it not realizable, what has been offered as a vision of development), to the functional ones (who are the subjects of realization of the model and which instruments are available to them). The message of this text is that there is no rational foundation of many things which have been offered as hope for the future, but there is the political background, election rationality and somewhat cruel pragmatic functionality. The task of the profession is, to an extent, to prove what is evident, and that is that the offered options are far from the collection of available solutions and that, simply put, what is being promised will not be able to be fulfilled by any chance. Therefore, this text should be an addendum to the demystification of the current political strata.

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# CHAPTER 3. DIMENSIONS AND CAUSES OF SERBIAN ECONOMY COMPETITIVENESS BREAKDOWN

**Mlađen KOVAČEVIĆ**, Regular Member of the Economic Sciences Academy, Serbia

There are numerous definitions of competitiveness, but one can conclude that economy experts still disagree regarding the best of those. In the light of our topic, it is useful to underline that in its annual report for 1996, International Institute for Management Development has defined competitiveness as a „capability of national economy to create added value and increase national benefit", and has retained it till present. On the other hand, World Economic Forum has accepted two definitions of competitiveness. The first one was made by eminent economist Jeffrey Sachs and Andrew Warner (Harvard business school), and states that: "the competitiveness is the ability to accomplish dynamic economic growth in long period of time"; the other definition is made by M. Porter and says that: „the competitiveness is the ability of one country to accomplish high current productivity".

With the lack of conventional definition of competitiveness amongst most important institutions and individuals who are dealing with this complex matter, there is a high diversity when trying to identify competitiveness parameters as well as their importance. For example, associates of International Institute for Management Development assort a large number of economic and noneconomic parameters into ten following "pillars":

1. To create stable and predictable legal environment,
2. To create flexible and resilient economic structure,
3. To invest into traditional and technological infrastructure,
4. To promote private savings and local investments,
5. To develop aggressiveness on foreign markets (through export), as well as a country attractive for direct investments,
6. To force quality, efficiency and transparency in state administration,
7. To maintain optimal relationship between earnings, productivity and taxes levels,
8. To maintain social structure by removing the disparity of earnings and strengthening the middle class,
9. Maximize investments into education, in particular of the middle class, and long-term training and improvement of work force knowledge,

10. Harmonize the economy with surroundings and globalization towards providing permanent wealth and protecting the system of values that the citizens choose.

In 2002 the experts of the World Economic Forum have distinguished twenty most important parameters (or „locomotives") of long-term growth and development of the economy and its competitiveness:

1. Macroeconomic stability (low inflation, low budget deficit, stability of the national currency, etc.),
2. Favorable terms for flotation,
3. Successfulness of financial system (developed capital market, low interest rates, etc.),
4. High transparency towards foreign markets (low customs and non-customs protection, export without fiscal and comparable constrains, etc.),
5. Quality of managing public finances and competent personnel in public sector,
6. Accumulation of financial capital (high level of savings, high proportion of investments in domestic social product distribution, etc.),
7. Low taxes (on added value, profit) and taxing system that promotes competitiveness,
8. Stimulation of innovations through developed system of scientific institutes, improvement of economic cooperation with universities and institutes, encouraging scientific-research work by the government, achieving a high percentage of expenditures into research and development concerning the domestic social product, etc.),
9. As much as possible transfer of technologies from foreign countries (through import of equipment and know how, direct foreign investments, purchase of licenses, leasing and various in depth and more complex forms of cooperation of domestic companies with foreign partners),
10. Development and rapid improvement of so called New economy (involvement into the Internet, development of e-mail transactions, higher rate of computer utilization and their connection into World Wide Web),
11. High quality education system (absolutely and relatively large number of skilled staff and quality of their education, establishing strong professional education system, education through work, etc.),
12. Economic infrastructure (developed road network, harbors, telecommunications traffic, modern airports, airplanes, merchant ships, etc.),
13. Legal state and legal security (independent judicature, high-class legislation and its compliance, efficient jurisdiction, low costs of proceedings, etc.),
14. Low level of corruption (particularly in public acquisitions, taxation, granting loans, etc.),

15. Low level of administration and simplicity in respect to administrative procedures,
16. High level and dynamic development of the competition on domestic market (unbending entrance of new companies in the market, counteract against monopolies through forceful anti-monopoly legislation, etc.),
17. Achieving and maintaining high quality and enriching domestic products and services offerings in general, particularly professional services, spare parts, machines and information technologies offering, etc.),
18. Quality and motivation of employees (management, stimulant system of remuneration, equal status for female working class),
19. Flexibility of labor market (liberal system of employment and lockout, etc.),
20. Development, level of development and vitality of clusters.

Numerous thesis of prominent foreign economists have persuasively shown that successful economic development and growth of economy competitiveness in most developed countries, particularly in the USA, is less and less dependent from physical capital and labor, thus increasingly from technology and information in general. This is also known as so called human (people) capital. Human capital implicates: knowledge, skills and competences of people. Knowledge is a dynamic process achieved by formal education, but also by further improvement in the production, at universities, institutes and other institutions and has positive influence on the quality of people and environment. Nine years ago, one of the originators of the newest American economy system model and economic policy, Lee Iacocca has highlighted that the competitiveness of one country is not created on the field and in the factory, or in the laboratory – but in the schoolroom („Politika“, Dec. 13th 2001). Education and knowledge, in particular the one that yields scientific research and development work, become the dominant figure of competitiveness of growing number of countries, certainly foremost in most developed ones. In recent years, the ranking of countries has been made in respect to their competitiveness in knowledge, which is defined as “the ability not just to initiate new ideas, but also the ability to utilize their economic values”. While creating ranking lists (or „the indexes of the competitiveness in knowledge“) the comparative data regarding to: expenditures in personnel education and training, expenditures in science on a macro level, expenditures in research and development works in companies, level of infrastructure development for information technologies, number of employees in research and development sector within the companies, as well as the number of registered patents have been used (Financial Times, Apr. 22nd 2002). In addition, the rankings in respect to country’s potential for innovations are created. Undoubtedly, first places on these scoreboards are held by the USA. This is understandable since 45 of 50 leading so called science-technology parks in the world, are on the USA territory. Actually 21 leading science parks are settled in the USA, and best ranked European parks are in Stockholm (22) and London (50).

The existence and successful development of science parks increases the competitiveness between companies that are directly or indirectly connected to those parks in several ways. Intense of innovations, synergetic effects, spillovers*,* improvement in human capital, etc. that takes place in countries where the quality of these parks is high, contributes to increase in competitiveness of their economies, and especially in respect to small and medium business.

Human capital quality has decisive importance for the most rational choice for importing embodied technology and/or machines, their most effective utilization, spillovers based on that import and the increase ratio of export competitiveness accomplished through such import. Various empiric studies evidence strong correlation between investing into equipment and economic growth[1]. Furthermore, when speaking about developing countries and countries in the process of transition, that have undeveloped equipment industry, it is proven that high correlation between import of equipment and products and services competitiveness of those countries exists.

The increase of production and export competitiveness, based on equipment import, is accomplished through:

a) Reduction of individual production costs and decrease of prices based on that,
b) Improvement of quality and other non-price performances of products and services,
*c)* Broadening knowledge through *„spillovers“,*
d) Absorption, adaptation and improvement of imported equipment and technologies, that is accomplished thanks to domestic research and development work,
e) Stimulation of innovations made by domestic research engineers.

In the end of the last and the beginning of this century, in numerous studies and researches, particularly within the EU institutions, the strong correlation between competitiveness of industry and classic services on one side, and development level of so called business services on the other, has been proven[2]. Business services comprise of agglomerate of quite heterogenic activities, where the most

[1] Review of these evidences is provided in the study made by Ashoka Mody and Kamil Yilmaz, „Import Mashinery for Export Competitiveness“, *The World Bank Economic Review,* vol 16, 2002, no.1.

[2] The list of most important studies and results in respect to that correlation are provided in the Commission of the European Communities. *The Contribution of Business Services to Industrial Performance – A Common Policy Frame Work,* Brussels, 21. 09. 1998.

of them is based on high level of expertise. Valued consultancy services that include management, computing, marketing, engineering and technical services, law services, promotions and business propaganda, etc. excel amongst them.

High level of business services increases products and classic services competitiveness as follows:

a) Enable the decrease of their individual costs and prices,
b) Increase their quality (through strickt quality control, introduction of total quality control system, services engineering, design of services, certification, etc.
c) Assure higher diversification of products, in other words enrich range of products and classic services.

Professional services also enable higher degree of internationalization of products and classic services, as well as higher competitiveness on foreign markets through:

a) Research of foreign markets and customization of products and classic services to foreign customers specific needs,
b) Advertizing and promotions abroad,
c) Securing high-class technical and information service abroad, as well as consulting, management, services related to trade fairs and exhibitions abroad, choice of competent mediator, sales representative and feedstock purchaser abroad, etc.

Professional services also contribute to development of expertise and creation of innovations, since most of them are intensive in know-how.

With respect to the fact that Serbia is not ranked on the list of competitiveness of the International Institute for Management Development, in this study we are going to focus on World Economic Forum rankings. In 2007, Serbia was for the first time presented on their lists, ranking 91$^{st}$ (from 131 countries). On the list that was made in autumn 2008, it has advanced for six places, ending on position 85$^{th}$ (from 134 countries). At that time, Serbian magistrates, primarily the president of National advisory board for competitiveness, and vice-president of Serbian government, Mr B. Djelic, have entered in some kind of euphoria thus promising further dynamical progress on the list of countries in respect to economy competitiveness. Unfortunately that optimism was gratuitous and, as mentioned before, on the newest list (proclaimed last year in early September) Serbia ranked 93$^{rd}$. Considering transition countries, only Albania (ranked 96$^{th}$), Armenia, Bosnia and Herzegovina, Tajikistan and Georgia are ranked after Serbia.

So, during the times when Serbian officials, various expert and science institutions and academic, even quite prominent economists were emphasizing “strong” economic growth in 2007 a new ranking of countries, in respect to their economy competitiveness, where Serbia was listed for the first time was published. Concerning the fact that during that times political and vocational public was stressing that “Serbia is on the right way”, and that from beginning 2001, it achieved high GDP and export growth rate, the assessment of World economic forum that ranked Serbian economy competitiveness as 91 (from 131 countries that together create over 98% of GWP) was a great shock for many. The fact that the country was positioned, indeed, at the top of “the third league” in respect to competitiveness, was discordant to stories about “strong” and even “impressive” growth. The knowing that a large number of countries, that our public experiences as extremely undeveloped and that are believed to have anemic economy, were ranked in front of Serbia, was scandalous.

Comparative image was not changed during the next year when Serbia was ranked 85, that is to say, when it advanced for six places on the ranking list of countries in respect to their economy competitiveness. As mentioned before, on the newest list (published last year in early September) Serbia was ranked 93$^{rd}$, again in the “third league”. It is hard to believe that the following countries are ranked before Serbia: Malaysia (ranked 24$^{th}$, in other words 69 places in front of Serbia), China(29$^{th}$), Chile (30$^{th}$), Thailand (36$^{th}$), Bahrain (38$^{th}$), Tunis (40$^{th}$), Barbados (44$^{th}$), India (49$^{th}$), Jordan (50$^{th}$), Indonesia (54$^{th}$), Mauritius (57$^{th}$), Turkey (61$^{st}$), Montenegro (62$^{nd}$), Uruguay (65$^{th}$), Botswana (66$^{th}$), Columbia (69$^{th}$), Egypt (70$^{th}$ ) and Morocco (73$^{rd}$). Even Namibia, Vietnam, El Salvador, Peru, Sri Lanka, Guatemala, Gambia, Algeria, Macedonia, Trinidad and Tobago, Philippines, Honduras, Georgia, Jamaica and Senegal are also ranked afore. If we add that in respect to economy competitiveness Serbia considerably stays behind the most successful countries in transition, such as the Czech Republic (ranked 31$^{st}$, Estonia (35$^{th}$) and Slovenia (37$^{th}$). Only four countries that belong to that group are ranked after – Albania, Bosnia and Herzegovina, Tajikistan and Kyrgyzstan.

It is important to highlight that the majority of data used for creating this list relates to 2008, and till the beginning of the last quarter of that year when Serbia was not suffering the effects of the world economic crisis. To that effect, low position cannot be defended with the crisis (like some government officials, so called economic analysts and several academic economists are trying to do).

Statistically observing, from the data published by World economic forum within last three years, it can be deducted that the declining of Serbia on general ranking of the countries in respect to their economy competitiveness is primarily caused by growing retrogression in the field of so called fundamental, basic conditions. That is to say, when observing this parameter, in 2007 Serbia was ranked 78$^{th}$, in 2008 on 88$^{th}$, and in 2009 on 97$^{th}$ place. Furthermore, its’ growing leeway is obvious in all four subcategories: development of institutions, infrastructure, macroeconomic stability, health and elementary education. In respect to development and quality of institutions in 2007 Serbia was ranked on 99$^{th}$, in 2008 on 108$^{th}$ and in 2009 on 110$^{th}$ place – whereof emerges that only 23 countries were under ranked. Concerning macroeconomic stability, in 2007 Serbia was ranked on $92^{nd}$ in 2008 on $86^{th}$ and in 2009 on $107^{th}$ place. In respect to infrastructure development in 2007 Serbia was ranked on $92^{nd}$, in 2008 on $102^{nd}$ and in 2009 on $107^{th}$ place. In this field Serbia had the best grade in respect to health and elementary education, but also records significant drop: in 2007 Serbia was ranked on enviable $31^{st}$ place, in 2008 it declines to $46^{th}$ place and remains there in 2009, meaning it records a drop for 15 places in relation to 2007.

In the sphere of efficiency factors, Serbia has recorded a drop on ranking lists in following subsectors: high education and training – 6 places drop and $76^{th}$, labor market – 19 places drop and $85^{th}$, technology readiness – 17 places drop and $78^{th}$.

In the field of innovations and sophisticated factors Serbia also records a setback of its position: in 2007 it was ranked on $88^{th}$, in 2008 on $91^{st}$, and in 2009 on $94^{th}$ place. In business sophistication Serbia ranked 95th (year 2007), $100^{th}$ (2008), and $102^{nd}$ (2009). In the sphere of innovation, in 2009, Serbia records downturn for 10 places, ranking $80^{th}$.

During last few years World economic forum uses 110 concrete factors for competitiveness and in 43 categories Serbia took $100^{th}$ or worse place. It is tragically that its worse classification is related to brain drain. That is to say that only one of the ranked countries had higher intensity of drain of highly educated staff. It is not any better in respect to companies dominance rate on the market – only two countries are placed after Serbia, and concerning the effectiveness of antimonopoly policy – only three. Similar situation is with the comprehensiveness of state regulatory rules, since it is larger in four countries only. In addition, we must highlight that concerning absorption of technology in companies, Serbia is ranked $125^{th}$, national savings rate $122^{nd}$, apprenticeship $120^{th}$, cluster development $117^{th}$, which altogether unlikely mirrors not just to the competitiveness of the companies, but the economy in general. Adding that in respect to protection of minor shareholders Serbia is ranked on unenviable $128^{th}$ place, efficiency in resolving disputes $124^{th}$, development of local competition $120^{th}$, efficiency of companies managing boards also on $120^{th}$, relaying on professional management $118^{th}$, cooperation of employees, managers, and owners $113^{th}$, proprietary rights $111^{th}$, and concerning company's expenditures for research and development $110^{th}$.

Looking statistically, declining of Serbia on ranking list of countries in respect to their economy competitiveness has occurred due to most expressed collapse in the following competitiveness factors: a) transfer of technology based on direct foreign investments – 67 places drop, b) macroeconomic stability – 25 places drop, c) state budget deficit – 24 places drop, d) education system quality – 22 places drop, e) economy and research and development institutions cooperation quality –19 places drop, f) prodigality of state administration –17 places drop, g) harbor infrastructure quality–17 places drop, h) inflation increase – 16 places drop, i) corporate culture – 14 places drop, k) efficiency of legal institutions in resolving conflicts, air infrastructure quality and company's expenditures for scientific research work – 13 places drop each etc.

At the end, when speaking about concrete factors of economy competitiveness of Serbia, one should highlight its extremely inopportune rankings in respect to technology and apprenticeship field. For example, concerning availability of most modern technologies Serbia is ranked $114^{th}$, and considerably ahead it are: Chile ($32^{nd}$), Jordan ($35^{th}$), Malaysia ($36^{th}$), India ($39^{th}$), Tunisia ($40^{th}$), Senegal (42th), Namibia ($43^{rd}$), Philippines ($57^{th}$), Sri Lanka (58), Oman ($59^{th}$), Croatia ($61^{st}$), Trinidad and Tobago ($62^{nd}$), Morocco ($63^{rd}$), Dominican Republic ($68^{th}$), Botswana ($69^{th}$), Indonesia ($72^{nd}$), Ivory Coast ($78^{th}$), Montenegro ($75^{th}$), Gambia ($76^{th}$), El Salvador ($78^{th}$), Mauritania ($82^{nd}$), Kenya ($83^{rd}$), China ($87^{th}$), Cameroon ($88^{th}$), and even Pakistan, Mongolia, Zambia, Ghana, Macedonia ($103^{rd}$), Mozambique, Albania ($105^{th}$) and Bangladesh.

Even worse is Serbia's ranking in respect to absorption of modern technology in companies, since it is ranked $125^{th}$. The following countries are ranked afore: Malaysia ($37^{th}$), Tunisia ($38^{th}$), Sri Lanka ($46^{th}$), China ($47^{th}$), Egypt ($48^{th}$), Ivory Coast ($50^{th}$), Vietnam ($51^{st}$), Turkey ($52^{nd}$), Mauritius ($62^{nd}$), Namibia ($63^{rd}$), Dominican Republic ($68^{th}$), Jamaica ($69^{th}$), Gambia ($70^{th}$), Kenya ($71^{st}$), Botswana ($73^{rd}$), Nigeria ($74^{th}$), Morocco ($75^{th}$), Trinidad and Tobago ($78^{th}$), El Salvador ($79^{th}$), Syria ($81^{st}$), Cameroon ($82^{nd}$), but also Mauritania, Mozambique, Montenegro ($92^{nd}$), Cambodia, Mongolia, Pakistan, Albania ($100^{th}$), Zambia, Bangladesh, Ghana, Tanzania, Ethiopia, Uganda and Zimbabwe.

As mentioned before, concerning apprenticeship factor, Serbia ranks $120^{th}$, and the following countries are ranked afore: Malaysia (actually $16^{th}$), Tunisia ($31^{st}$), Indonesia ($33^{rd}$), India ($34^{th}$), Barbados ($37^{th}$), Philippines ($38^{th}$), Gambia ($41^{st}$), Vietnam ($46^{th}$), Ivory Coast ($47^{th}$), Kenya ($48^{th}$), China ($50^{th}$), Trinidad and Tobago ($55^{th}$), El Salvador ($56^{th}$), Namibia ($58^{th}$), Jamaica ($61^{st}$), Montenegro ($65^{th}$), Zimbabwe ($66^{th}$), Jordan ($67^{th}$), Sri Lanka ($68^{th}$), Guyana ($69^{th}$), Botswana ($74^{th}$), and also Cambodia, Tanzania, Ghana, Macedonia ($103^{rd}$), Mongolia and Pakistan.

Extremely low rankings of Serbia in respect to availability of most modern technologies in general, especially in companies – are the result of particularly low import of technologies, serious crisis that hit metallurgy and machine industry of Serbia, and extremely bad condition of science in general, namely almost completely paralyzed research and development work in the Serbian companies.

Serbian bad ranking regarding to apprenticeship is the outcome of unfortunate, rather unsuccessful privatization, apathy of employees, as well as unconcern of taskmasters, owners and employees for apprenticeship programs.

Substantial question is why the competitiveness of Serbian economy is so low, and why it has recorded eight places drop on the last rankings? The answers given by many – that the reason for this lays in the fact that Serbia has been ranked low in respect to upstate factors, or that it records a drop in respect to concrete factors – cannot be accepted, since they take into account only statistical, but rather essential explanation for the reason that why is Serbia ranked so low in numerous competitiveness parameters and why Serbia records a drop on concrete ranking lists in respect to series of competitiveness factors. Complete, substantial answer to these questions requires detail and serious research work that exceeds pretensions of this study. However, we will try to point out the most important reasons that have, in our opinion, led to this unpleasant phenomena.

The history of Serbian economy competitiveness breakdown is relatively long. On the basis of statistical methodology (so called constant market share analysis), in my doctoral thesis *Yugoslavian export competitiveness factors (Faktori konkurentnosti jugoslovenskog izvoza)* I have shown that it was decreasing. It is most probable that this phenomenon, concerning arising crisis of Yugoslavian society, disintegration processes in SFRY and growing economic crisis in 70-ties and 80-ties this breakdown has been increasingly intensified. During UN sanctions, disintegration of the country, disinvestments, hyperinflation and NATO air forces aggression against SR Yugoslavia, the competitiveness of Serbian economy has been dramatically declined. This was discussed in detail in my opening study *Foreign economic relations and the transition of Yugoslav economy* (*Ekonomski odnosi sa inostranstvom i tranzicije jugoslovenske privrede)* that was presented at the economic symposium in Herceg Novi in 1998. Following the NATO air strike, and intensified sanctions in 1999 and 2000, Serbian economy competitiveness has been declined even more, which was discussed in my opening report at the economic symposium held in September 2000[3] and in my book *International trading (Međunarodna trgovina)*[4]. In late 2000 and early 2001, this was the reason why, unlike other economists, I have anticipated that there was no reason for announced, promised and projected

[3] Published in symposium memoir *Economic an -financial relations with foreign markets and transition of Yugoslav economy (Ekonomsko-finansijski odnosi sa inostranstvom i tranzicija jugoslovenske privrede),* publication of Economic science society (Naučno društvo ekonomista), Belgrade and Herceg-Novi, 1998.

[4] M. Kovačević, Condition, perspectives and basic strategies of economic and financial relations with foreign markets (Stanje, perspektive i osnovi strategije ekonomsko-finansijskih odnosa sa inostranstvom), *Economic annals,* thematic issue, January 2001.

spectacular economy growth and development, and accordingly the growth of our economy competitiveness[5].

At the end of 2000 extremely high devaluation of Serbian dinar has been conducted. The formal standpoint that currency value will remain unchanged in 2001 has been taken. In May 2001, Federal ministry for international economic relations, headed by Prof. PhD. Miroljub Labus, has conducted haste and premature liberalization of import, so the unbalanced duty rate has decreased to 9.4%, and weighted to approximately 5%. Although the inflation rate in Serbia in year 2001 was over 40%, and only 3% in euro zone and USA, real value of exchange rate at the end of 2001 was 30% higher comparing to late 2000[6]. Together with haste and premature liberalization, this resulted in significant increase in price competitiveness, import and its growth as well. This growth, expressed in US dollars, has increased for 28%, therefore beginning to seriously undermine domestic production.

In May 2001 Serbia adopted a Low on privatization with all its weaknesses, which was the reason why its persistent appliance could not *a priori* provide good results in respect to increase of Serbian economy competitiveness.

When self-appointed “visionaries” of economic reforms presented a concept of those reforms and warranted that they will do all that is in their power to keep domestic currency value unchanged and that that concept will provide continuous stabilization (M. Dinkić), that in few years the whole world will be speaking about “Serbian economic wonder” (B. Đelić), and that external debt of SR Yugoslavia will come to circa 7 billion dollars in no time (M. Labus), I was explaining that that concept will bring more damage than benefits. My theory was slightly supported only by Prof. PhD Ljubomir Madžar[7].

All of our numerous arguments were arrogantly but inconvincibly rejected by ruling governor of National Bank of Yugoslavia[8]. Most likely, the International Monetary Fund has, through credit agreement regarding to so called extended financing of SR Yugoslavia, imposed the recopies of the Washington agreement

[5] M. Kovačević, *International trade(Međunarodna trgovina),*University of Economy publication, Belgrade, 2002.

[6] More detail can be found in symposium memoire held in late 2000, organized by Economic Science Society, Economic Science Academy and University of Economy in Belgrade, published in *Economic annals,* thematic issue, April 2001.

[7] M. Kovačević, “The effects of current exchange rate policy and liberalization of import” („Efekti postojeće politike valutnog kursa i liberalizacije uvoza“), *Economic annals,* thematic issue, January 2002.

[8] M. Dinkić, “Replication on M. Kovačević and Lj. Madžar expositions” (“Replike na izlaganja M. Kovačevića i Lj. Madžara”), *Economic annals,* thematic issue, January 2002.

in which the following commandments were dominant: fast and overall privatization, stabilization by all means, liberalization of foreign trade (primarily of import), liberalization of regulations that are dealing with direct foreign investments, independence of Central bank, whose prime aim was inflation suppression, etc. In addition, by forcing hast and excessive import liberalization, the leading "visionary" of economic reforms, M. Labus, has shown himself as a "bigger catholic than the pope". During that science experts symposium, ruling governor of National bank of SR Yugoslavia, has highlighted that growth of export will overgrow the import, and that increase of import will press domestic companies to decrease individual costs of production, therefore forcing them strive to make as bigger improvement as possible in the sphere of so called non-pricing competitiveness parameters. In his "vision", he further explained that this will have positive effect on increase of competitiveness of the companies in particular, as well as the economy in general. The result was that real currency value has been additionally increased for 16.8%, which led to further increase of import price competitiveness. Therefore, the commodity import, expressed in US dollars, has been increased for additional 32% in 2002, which caused supplemental extinguishing of domestic production.

During 2002 in many studies I have been discussing that the reforms model we were implementing had serious error in construction and that the consequences will reflect in so-called "Dutch disease" of Serbian economies, and therefore must be abandoned as soon as possible[9]. I have referred to similar appeals in various scientific papers during 2003, and the years that followed, but without any effect. The consequence of that concept was overvaluing currency exchange rate that reached the top in late September 2008, when it was practically for 110% higher than in the end of 2000. That had a positive influence on inflation and potential for purchasing foreign products and services at very low prices (expressed in dinars). On the other hand, overvalue of dinar produced a string of unpleasant economic and social consequences. Amongst them, I shall highlight the following:

- Extreme growth of commodity import, resulting in high external deficit growth.
- Complete dissolution of surplus in exchange of services that transited to deficit.
- Extinguishing of growing part of industrial production that was lower in 2008 than in 1998.
- Declining of price competitiveness, above all industrial and agricultural products, as well as construction services.

[9] M.Kovačević, "The necessity of abandoning hitherto concept of economic policy"("Nužnost napuštanja dosadašnjeg koncepta ekonomske politike"), *Economic annals,* thematic issue, December 2002.

- Significant growth of unemployment rate.
- Disincentive of savings and investments, and stimulation of spending (import products and services above all).
- Decrease in enterprise value.
- Inconsiderate and growing borrowing abroad, of enterprises in particular.
- Disincentive of export and direct foreign investments oriented on export.
- Stimulating of development of certain services that are based on import (trade) and foreign capital inflow (banking) or organizing tours of our citizens abroad in order to enjoy foreign touristic services.

Besides extremely overvalued currency, other important reason for low Serbian economy competitiveness and sinking on the ranking list of countries in respect to their economy competitiveness results from growing social crisis. Social crisis manifests through various segments of social life, where many of those contribute to its intensifying. The following are evident: a) country identity crisis, system of values crisis, b) moral crisis, c) human capital crisis, d) legal and jurisdiction crisis, e) reliance crisis, demographic crisis, f) family crisis, g) democracy crisis, h) Parliament and Government crisis, i) local autonomy crisis, j) countryside crisis, k) large number of small towns crisis, l) science crisis in general, and social sciences crisis in particular, m) educational crisis (from elementary to university), n) health system crisis, o) culture crisis, p) ecology crisis), r) written media crisis, s) Serbian orthodox church crisis, etc. All those elements of social crisis are reflecting in several Serbian economy competitiveness parameters, which are published by World economic forum[10].

Particularly anxious is growing human capital crisis that reflects in the following:

- The fact that there is a high mortality rate in Serbia (without KiM) the difference between newborns and defunct is 30.000 per year,
- Average age is growing, and Serbia pertains into group of 5-6 countries with highest average age.
- Immeasurable brain drain.
- High percentage of young people who have been waiting for employment for years is losing more and more of their knowhow, but is also losing confidence and self-respect, therefore giving themselves over to alcohol, drugs and criminal.
- Due to decrease in standard of living and growing unemployment, many people fall into depression, so the mental condition of great number of citizens in extremely unhealthy.

[10] www.weforum.org. (9th IX 2009)

- Due to decrease in higher education quality, science crisis and brain drain, professional quality of high educated personnel who choose to stay in Serbia is getting weaker.

All above stated reflects in very low level of production and export of highly sophisticated products and services, thus inopportune structure of export and therefore extremely low level of comparative advantages of the country. In respect to that parameter, regarding to World economic forum data, Serbia is ranked 111$^{th}$ (from 133 countries).

At the end, it is clear that economy and export competitiveness of Serbia cannot be significantly improved by taking certain partial measures or by adopting partial strategies.

Permanent solution for social and economic crisis and high level of Serbian economy competitiveness will be possible only if prominent elite, of different social and some scientific branches is actively involved into this process. This elite will have the task to create optimal vision of further social and economic development that would be, after wider public hearing, accepted in Serbian Parliament and later persistently conducted.

# CHAPTER 4. GLOBAL ECONOMIC PERSPECTIVE AND EUROPEAN DEBT CRISIS WITH EMPHASIS ON RUSSIA[11]

**Željko BOGETIĆ**, World Bank, Washington DC, U.S.A.

***Abstract***

*This paper summarises current global trends on the basis of the latest data on the world economy and wider analysis of the global economic movement; possible influence of a sovereign debt crisis in some developed European countries on the world economy, as well as a mid-term perspective of the world economy future recovery.*

## GLOBAL TRENDS - WORLD ECONOMY RECOVERY LED BY DEVELOPING COUNTRIES

***The world economy continues recovering from the Great Recession, with an accelerated recovery of developing countries in the course of the fist quarter of 2010.*** Large economies, in particular, countries with a mid level domestic product per capita, such as Brazil, China, India and South Africa have been quickly recovering. Growth of local and foreign demand has supported industrial production in developed countries, with an accelerated rise of 11.7% in the first quarter of 2010 in comparison with around 8% in the previous period (rolling 3m/3m, seasonally adjusted, annualized growth rates —hereinafter referred to as: q.s.a.) (Figure 1). The growth is less even in Russia, the tenth biggest economy in the world and growth engine in former Soviet Union countries. Industrial production has to a certain extent lost its momentum, following a dynamic growth of 6% in the last quarter of 2009.

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[11] Dr željko Bogetić, Chief economist and co-ordinator for Russia in the World Bank. This article is based on the recent World Bank Economic Report for Russia, number 22, a review of the latest global economic trends and Russia's economic policy (www.worldbank.org/ru).

**Figure 1. Industrial production—continued recovery**

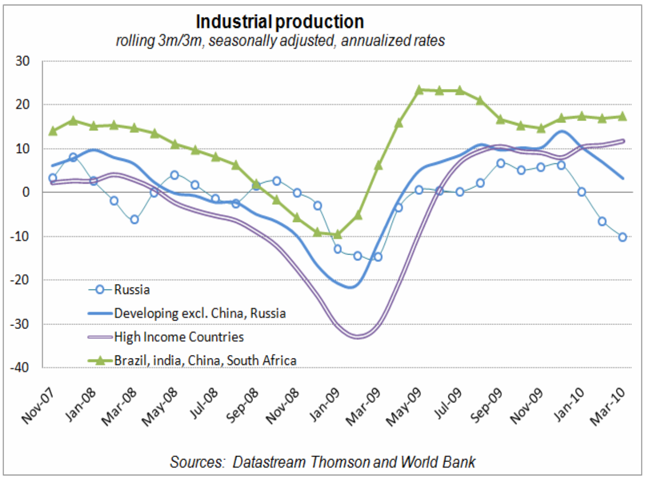
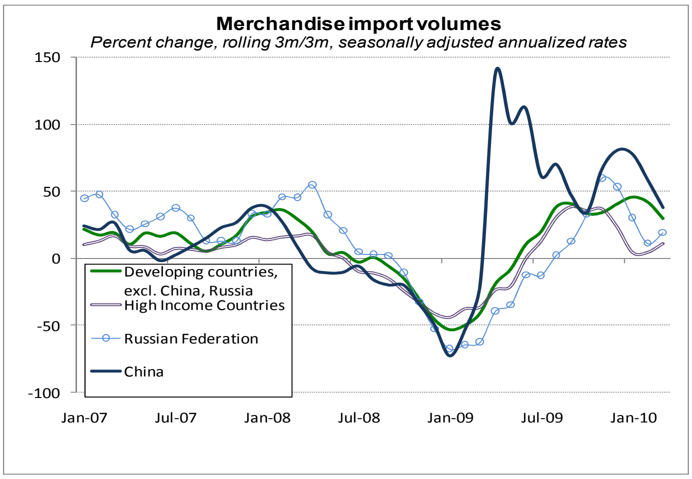



**Figure 2. Import volume—continued recovery in developing countries**




***Physical import volume in developing countries continues in line with their industrial production and economic activities recovery.*** Import in developing countries, except for China and Russia, has gone up by 30% (q.s.a), slightly less quickly than in the previous quarter (Figure 2). However, besides this, physical import volume is still around 4% below the highest level reached before the crisis. Chinese import demand is also very strong: 38% growth in the first quarter of 2010, twice slower than in the previous quarter at the time of import boom in China related to the Lunar New Year preparations.

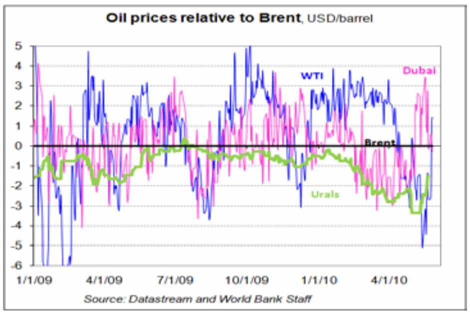
## CAPITAL FLOWS IN DEVELOPING COUNTRIES AND OIL PRICES — STABILISATION AT A MODERATE LEVEL

***Following a boom in the first quarter of 2010, capital flows in developing countries and oil prices —two important indicators of the global economic trends – have remained at a moderate level in April*** (Figures 3-4). In the period January-April, 2010, for example, capital flows in developing countries doubled in comparison with the same period a year before. Bond financing went up to $26 billion in the course of April, partly reflecting Russia's comeback to the international bond market ten years later. Namely, Russia has this year issued $5,5 billion euro-bonds with a 5-year and 10-year maturity, which has so far been the biggest euro-bonds issuance in the history of developing countries. Generally speaking, this issuance has proved that countries with a stable fiscal position and low or moderate level of sovereign debt and specified resources, may, even under difficult international conditions, ensure financial resources at relatively favourable conditions. On the other hand, a part of capital flows in developing countries related to bank loans has still be far below pre-crisis level. This is no surprise, having in mind existing issue with bad debts of many international banks and a high credit risk.

**Figures 3-4. Capital flows in developing countries and oil prices**

Capital flows to emerging markets

| *USD billion* | 2008 | | 2009 | | 2010 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Total | Q1 | Total | Q1 | Jan | Feb | Mar | Apr | May |
| Total | 103 | 390 | 48 | 353 | 104 | 41 | 17 | 47 | 45 | 15 |
| Bonds | 12 | 65 | 18 | 115 | 48 | 21 | 5 | 21 | 26 | 3 |
| Banks | 71 | 257 | 22 | 129 | 30 | 12 | 5 | 13 | 8 | 6 |
| Equity | 20 | 68 | 8 | 109 | 26 | 7 | 7 | 12 | 11 | 6 |
| Lat. America | 19 | 90 | 21 | 137 | 31 | 9 | 4 | 17 | 15 | 3 |
| Bonds | 5 | 20 | 10 | 62 | 19 | 8 | 2 | 10 | 9 | 0 |
| E. Europe | 36 | 157 | 6 | 72 | 26 | 13 | 2 | 10 | 14 | 2 |
| Bonds | 2 | 35 | 4 | 33 | 17 | 7 | 1 | 8 | 11 | 1 |
| Asia | 38 | 98 | 18 | 122 | 38 | 16 | 7 | 15 | 11 | 10 |
| Bonds | 3 | 7 | 5 | 16 | 9 | 7 | 2 | 0.3 | 3 | 2 |
| Others | 11 | 45 | 3 | 22 | 10 | 2 | 3 | 5 | 4 | 1 |




*Source:* World Bank

***Nonetheless, with escalation of the Greek debt crisis in May, capital flows in developing countries have significantly dropped.*** This particularly refers to issuance of bonds and stocks, reflecting an increased uncertainty in terms of depth and a wider influence of the sovereign debt crisis in Europe. Sovereign bonds issuance activity was very poor, with only one sovereign issuance by Malaysia at the amount of $1.25 billion, which was worse than in February, 2010 when the international market registered for the first time turbulences related to the Greek debt. This was also the lowest monthly volume range since December, 2008, and, historically speaking, lower than the average for the month of May ($8 billion) in the period between 2003-09. Even though, the Greek and European debt crisis, for the time being, cannot lead to such serious consequences, as this was the case with, for example, bankruptcy of Lehman Brothers in September, 2008, a regional risk has gone up in Europe; more serious consequences for inflicted countries, as well as for those strongly economically linked to them, cannot be excluded.

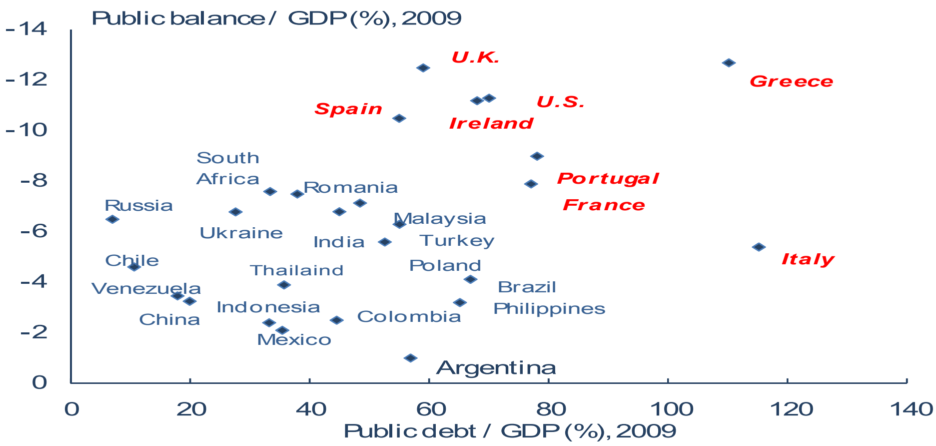
***Stabilisation of oil prices at a relatively moderate level, reflecting continuation of the global economic recovery.*** Following the drop caused by escalation of the global crisis, global oil demand increased by one percentage in the fourth quarter of 2009. International Energy Agency has forecast a total oil prices rise of 2% in the course of 2010. This increase has been envisaged for countries outside OECD. As a contrast to this, oil demand in OECD, which has been falling for four years now, will most likely be stable at the current level, with expected increase in North America and decrease in Europe. Oil demand in the USA went up by 2% in the course of three months by April, in line with recovery of the US economy and seasonal increase in petrol demand. Nonetheless, while global demand conditions are gradually improving, oil offer still exceeds the demand. Oil reserves in OECD countries went up in the first quarter, which is untypical; the US reserves significantly increased in the course of May.

## EUROPEAN DEBTS CRISIS INFLUENCE – LIMITED SO FAR, WITH AN INCREASED RISK

***Influence of the European debt crisis on general recovery of the world economy has been limited so far, however, global risks have increased.*** At this moment, *base scenario* for the world economy recovery implies *absence* of default or restructuring of the sovereign debt in countries significantly inflicted by the debt crisis (Greece, Ireland, Italy, Portugal and Spain) (World Bank, 2010). In other words, it is advocated that existing IMF and European Union support measures, as well as future developments, shall lead to a slow recovery in Europe without any bigger shocks that might be caused in the case of default scenario and trust crisis spread to other European countries. Interestingly enough, the most developed countries are much more indebted at this very moment than developing countries in Europe, which a reversed situation from the one dominating last decades (Figure 5).

***What does the European debt crisis mean for other countries in Europe in concrete terms?*** Generally speaking, it is expected that the European debt crisis will have limited influence on the economic recovery dynamics in countries such as Russia – with a far stronger budget deficit and public debt positions (less than 10% of the GDP) and many Western European countries with limited foreign trade and financial relations with Greece and other inflicted countries. Countries like Serbia, on the contrary, with significant foreign trade and financial relations with Greece and Italy, may face a rather strong negative influence on its economy, primarily through the balance of payments.

**Figure 5. Public deficit and debt in some developed and developing countries**



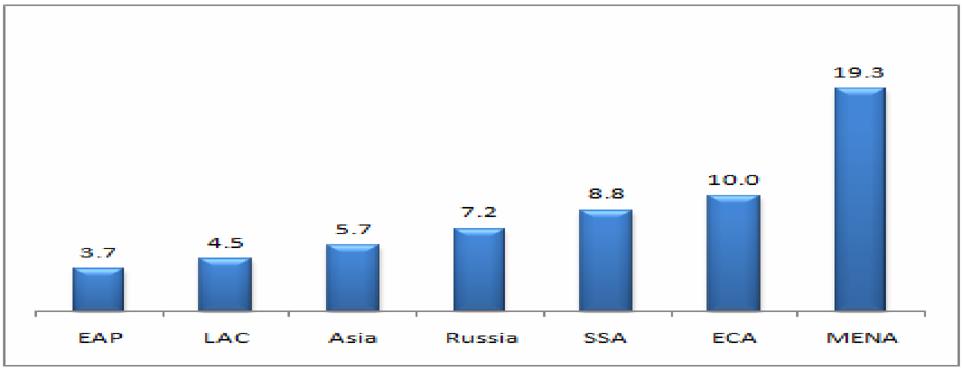

*Source:* World Bank, Global Economic Prospects 2010.

***Debts crisis in developed European countries is naturally a challenge and new risk, both for European and global recovery.*** Despite a relatively moderate resolution of fiscal issues in these countries in the coming years, the most likely scenario at this moment, and now less likely to take place, a chaotic economy adjustment scenario would brig about serious consequences for both developed and developing countries. According to the IMF's assessment, the total volume of fiscal consolidation, i.e. fall of fiscal deficit, ranging from 9.2% GDP (in Greece) to 4.8% GDP (in Italy) is essential to downsize public debt and gross domestic product ratio to, around, 60%, which is relatively acceptable. Such a huge fiscal consolidation will significantly weaken demand, thus level of economic activities in these countries, short and mid-term speaking. How will certain regions in the world be inflicted by such a situation in Europe?

***Our region, Europe, central Asia (including all east-European countries and former Soviet Union countries), will partly be inflicted by this crisis due to close commercial relations with highly indebted European countries*** (Figure 6). These West European links are even stronger with Middle East and North African countries. In countries, such as Albania and Azerbaijan, in particular, 20% or more of their export is to Greece, Italy, Portugal and Spain. It is therefore certain these countries would be affected by hindered economic activities in highly indebted European countries, it is just a question to what extent. This will largely depend on the fiscal consolidation volume in these developed European countries, as well as on to what extent inflicted developing countries are successful in redirecting their export flows to alternative markets.

***There are risks for other less developed European countries as well, strongly linked to highly indebted countries through the financial sector.*** Former Yugoslav Republic of Macedonia, Bulgaria, Serbia, Albania and Romania have been, for example, countries that have until recently significantly used capital flows from Greek financial organisations. In case banks from Greece and other highly indebted and developed countries, are forced to recapitalise or reduce the volume of their activity, capital flows to the abovementioned less developed countries may drastically drop, leading to a potentially strong negative influence on local demand, particularly in those countries that still 'desperately' need external financing.

**Figure 6. World regions with a high foreign trade links to highly indebted European countries: Share of Greece, Italy, Portugal and Spain in export, in percentages**




*Source:* World Bank; UN-COMTRADE.

## GLOBAL ECONOMIC PERSPECTIVE FOR THE PERIOD OF 2010/11

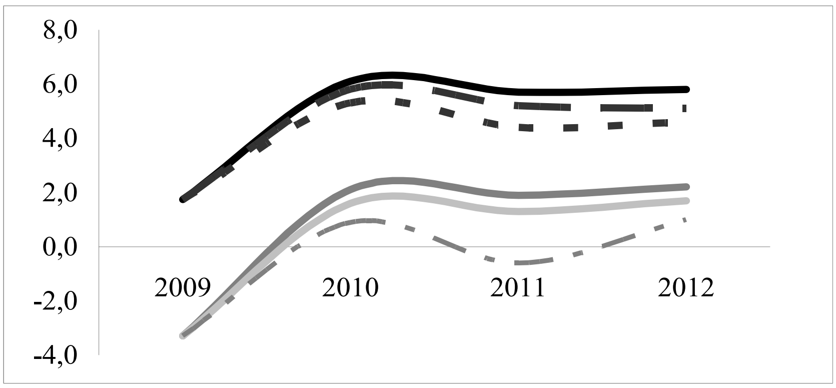
***It is expected that a real, global GDP will annually go up by around 3.3% in 2010 and 2011, and 3.6% in 2012. (Table 1).*** This ***baseline scenario*** of the World Bank implies the following: (1) a default or any greater restructuring of the sovereign debt in Europe will not take place, and (2) capital flows will continue to grow moderately, from the level of 3% GDP in 2009 to 3.5% in 2012. Growth in developing countries, as a group of countries is expected at the level of around 6% annually in the period of 2010-2012, reflecting a quick productivity increase and lessened effects of fiscal and monetary policy tense than in developed countries. This is twice quicker than expected growth in developed countries, envisaged to 2.3% in 2010, and 2.4% and 2.6% in 2011 and 2012. Good news is a forecast that three biggest world economies – the USA, China and Japan – are about to grow (China in particular) by significant rates in the course of next two and half years. World oil demand will go up by around 2% or 1.7 million barrels per day in the course of 2010, while the offer of oil from countries outside OPEC cartel will most likely increase by 0.7 million barrels per day. Oil prices will most likely stabilise at the level of around $78 per barrel in 2010, and then slightly fall to $74 per barrel, since OPEC is expected to continue increasing the offer in line with a greater demand in order to keep the price level within the preferable range of $70-80 per barrel.

**Table 1. Global economic perspective, 2010/12**

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| World | -2,1 | 3,3 | 3,3 | 3,6 |
| High income countries | -3,3 | 2,3 | 2,4 | 2,6 |
| Developing countries | 1,7 | 6,1 | 5,9 | 6,1 |
| China | 8,7 | 9,5 | 8,5 | 8,7 |
| Japan | -5,2 | 2,5 | 2,1 | 2,2 |
| USA | -2,4 | 3,3 | 2,9 | 3,0 |
| Euro Zone | -4,1 | 0,7 | 1,3 | 1,8 |
| Russia | -7,9 | 4,5 | 4,8 | 4,7 |

*Source:* Global Economic Prospects, June 2010, The World Bank. Data for 2009 are final historical data; data for 2010/12 – the World Bank's projections.

**Figure 7: Possible flows of a real world GDP, as well as GDP of developed countries (lower lines) and developing countries (upper lines), in percentages**



***However, taking into consideration, growth of global risks, unfavourable global scenarios are possible, which is why a health fiscal policy at national level should be a prerogative.*** Therefore, fro example, in a less likely, but possible alternative global scenario, gradual growth of sovereign risk premiums in Europe may lead to slower European, hence world economic recovery. In this case, the world growth is expected to be lower by around 0.3-0.4% scores annually in comparison with the baseline scenario in the Table 1 (Figure 7). Consequently, pressure on smaller countries in Europe, Western Balkans in particular, would increase, influencing negatively financial flows, liquidity and economic activity. Finally, 'the hardest scenario' ("lower baseline" in Figure 7) could be imagined, although the least likely at this very moments: chaotic default (debt repay incapacity) or a significant debt restructuring in Europe leading to trust crisis and "capital escape" from Europe to dollar. This scenario would naturally have much more serious negative consequences on the overall world growth, and small countries, in particular, that largely depend on commercial and financial relations with Western Europe. A new fall of economic activity in developed countries is quite possible under such extreme circumstances, i.e. a new recession zone for these countries economies in the course of next year, 2011. However, to underline again, this is the *least likely* scenario at this moment. In case of any scenario, countries with a stronger fiscal position and lower debt have much greater chances of remaining intact from such external hits and experience fewer negative consequences. Economic policy's central message in the course of Great Recession has been confirmed once again: low deficit and low public debt role is of critical importance for healthy fiscal policies, for a short-term capacity of an economy to resist economic shocks, as well as for its long-term economic growth.

## RUSSIA REVIEW – MODERATE RECOVERY WITH A LIMITED INFLUENCE OF THE EUROPEAN CRISIS

***Finally, having taken into consideration global, baseline scenario and oil price prognosis, as a key export product, Russian economy will most likely continue with its economic recovery by growth rates of around 4.5-4.8% in the course of this and following year (Table 2).*** This is good news for the Russian economy and neighbouring countries, particularly after last years' serious recession (World Bank, 2010). This growth will be led by domestic demand expansion, of household consumption above all, in line with gradually improved conditions in the labour market and loan-wise. Unemployment will remain relativity high, between 8 and 9%, and will start improving but only slowly, which will consequently bring about poverty drop in Russia, i.e. growth of the middle class in this country. 8-9% unemployment, which is lower than it was expected having in mind seriousness of the last year's recession, and renewed growth of real incomes, as well as a relatively low level of indebtedness of a Russian customer, are all factors determining a moderate growth of the demand. Bank's credit activities are now expected to be reinitiated, which will significantly improve their liquidity and reserves in comparison with the recession time. Investments-wise, reserves level changes effects will improve the situation. There will, however, be no new investments having in mind a high level of unused capacities and limited level of loans granted to the economy by the banking system. Net export will most likely not be a growth machine since import volume is expected to increase rapidly as the recovery process moves on.

**Table 2. Economic perspective of Russia, 2010/11**

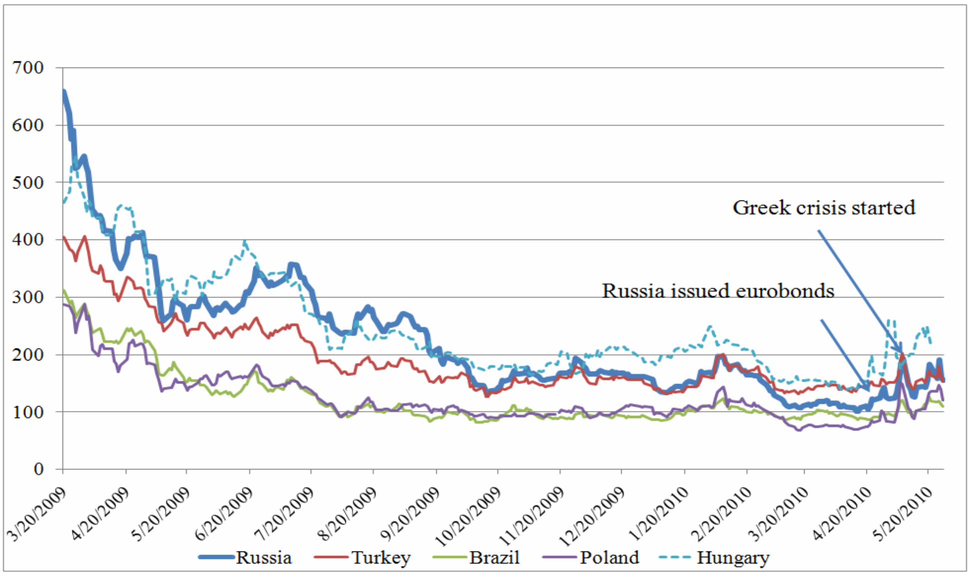
| | 2010 | 2011 |
|---|---|---|
| Real world GDP growth, % | *3,3* | *3,3* |
| Oil price, average, US$ per barrel | *78,1* | *74,6* |
| ***Russia*** | | |
| *Real GDP growth, %* | *4,5* | *4,8* |
| *Consolidated budget balances, % GDP* | *-4,6* | *-3,8* |
| *Current transactions, US$ billion* | *58* | *33* |
| *Capital transactions, US$ billion* | *31* | *60* |

*Source: Global Economic Prospects (World and oil prices), and Russian Economic Report, the World Bank.*

***Influence of the European debt crisis on Russia will most likely be limited.*** This is due to three reasons. Firstly, Russia is in a much better budgetary position and has a low level of public debt, below 10% GDP in comparison with many West European countries. Secondly, foreign trade, traditionally important channel for transferring external hits to local economy, will only be partly influential since Russia and Greece (as well as other three highly indebted European countries) have quite low key foreign trade relations. And thirdly, Russian and its financial sector is not largely exposed to links with these four developed European countries. Such a prognosis is supported by still relatively benign level of default-spreads to Russian state bonds, even after the Greek crisis, when it grew but still remained at a quite low level of around 240 basic scores (2.4%) (Figure 8).

***Nonetheless, a negative influence on Russia is still likely in case of worse European and global scenario.*** This would imply escalation of distrust in Europe and consequently "capital escape" from Europe to dollar, primarily through sovereign debts spreads escalation and capital flows drop. This premium rise could, in this case, have a particularly negative influence on Russian corporations with relatively high level of foreign debt.

**Figure 8. Default spreads – a sovereign debt of some big countries with a mid level income**




*Source:* Russian Economic Report No. 22, World Bank, Jun 2010.

## Reference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# CHAPTER 5. REFLECTIONS ON THE CREDIT CRISIS IN THE UNITED STATES

**John HENNESSY**, FINRA (Financial Industry Regulatory Authority), Washington DC, USA

About a year ago, I was conducting a seminar and posed the following question. "What is the purpose of the capital markets?" The answer given was of course "To make money". Given the poor example that has been set by the so-called developed capital markets, this answer was not surprising, but I believe it is very seriously the wrong answer. The purpose of the capital markets should be to *raise* money. The money raised can then be used by issuers of securities to actually create factories, products, services and jobs. It is this transformation of the capital markets in Europe and the U.S., from a system designed to raise capital into a system dominated by the profit motives of so-called banks, which is perhaps the most lasting and potentially dangerous development exposed by the recent global financial crisis.

I would like to begin my comments by detailing what I see as the four major contributors to the financial crisis; the overleveraging of households, corporations and governments; the general greed of investors who also disregarded risk; the failed regulatory environment which facilitated the asset bubble and was subsequently unable to control or effectively react to the popping of that bubble, and the transformation of the financial services industry from a conduit for capital into an overleveraged, self-serving end unto itself.

The Overleveraged Housing Market in the U.S.

In 1957, my father purchased our home in Alexandria, Virginia, a suburb of Washington, DC, for $25,000. That was quite a bit of money in those days. The average house in U.S. sold for less than $2,500 in 1957, and according to the U.S. Census Bureau, the average non-farm family annual income was only $5,000. In 1977, my father sold the house for $125,000 at a time when the average family income was $17,640. So in the preceding 20 years, wages had increased roughly 350%, but the value of my father's house had increased by 500%. Given that cumulative inflation during this period was roughly 225%; my father had made a "real" profit of 275%. That was better than the 225% he would have earned in the stock market (based on the S&P 500 returns from Nov. 1957 to Nov 1977).

There were many factors that led to my father's good fortune. As the old saying goes, the three most important words in real estate are "Location, location, location". His house was located close to Washington, DC during a period of tremendous expansion of the federal government. This increase in demand was also a result of the so called "baby boom". From 1946 – 1964, roughly 78 million Americans were born. Families were seeking bigger houses for their growing families. And starting in the 1960s, many of these "baby boomers" started to marry, have children and buy houses themselves. Many of these families also were leaving the pollution and crime of the big cities for the relative safety of the suburbs.

In 2007, my father's house was sold by the then current owners for $750,000. That represents a return of 600% over 30 years. If we look at the price change from 1957 to 2007, the house had increased in value by 3,000%! Let's compare that to some other numbers. Cumulative inflation as measured by the Consumer Price Index was 734% from 1957 – 2007. Mean household income for 2007 was $50,233, an increase of roughly 1,000% from 1957. It looks like buying and holding my father's house from 1957 to 2007 would have been a very good investment. It turns out that it was only mediocre when compared to the increase in the average home price between 1957 and 2007; 9,133%! That compares to a cumulative return from the S&P 500 of a mere 3660%.

It is clear from the preceding figures that home ownership, in addition to its many benefits, was also a very good investment during the second half of the 20$^{th}$ Century. The U.S. Government also helped to make it even better by making mortgage interest and property tax payments tax deductible, and by reducing and ultimately virtually eliminating capital gains taxes on the profit realized from the sale of one's home. In addition, low interest loans to military veterans and low income families also contributed to the furtherance of "the American Dream" of home ownership; a dream that 20$^{th}$ century politicians worked feverishly to perpetuate.

A close examination of the numbers does show at least one problem. If average household income rose by 1,000% from 1957 – 2007, how were households able to afford housing prices that increased by 9133% during the same period of time? The answer is simple; they borrowed. The average home price in December of 1977 was $57,600; roughly 3.25 times the average annual family income. In 2007, the average home price was over $300,000; roughly 6 times the average annual salary. Not only were homebuyers borrowing, they were borrowing more and more.

When my father bought his home in 1957, he was required by the bank to demonstrate that he had good credit, a solid job history, a salary that could support the monthly mortgage payments, and a substantial down payment. By

2007, mortgages were being offered to individuals with no job, no income, poor credit ratings and, most incredibly, no down payment. All this was fine as long as housing prices continued to increase at this tremendous rate. But like the returns of Bernie Madoff's hedge fund, some things are just too good to be true.

Not only did many U.S. homebuyers access the cheap credit of the 1990s and 2000s to over-leverage themselves, but business and government followed suit. Banks, corporations, hedge funds and commodities firms all used borrowed money to increase their returns. As a result, average S&P corporate bond ratings declined from A to BB.

Leveraged buyouts, a major strategy employed in the 1980s came back with a vengeance in the period leading up to the credit crisis. A leveraged buyout is where a group of investors uses borrowed money to purchase a controlling interest of a company's equity (stock). Targets are typically undervalued companies, with strong cash flow, little debt and potentially a high breakup value. The debt used to finance these transactions tends to be highly speculative, often involving so-called "junk bonds". In 2006 alone, private equity firms bought 654 U.S. companies for a total of $375 billion. In the aftermath of the credit crisis, the private equity market virtually ceased to exist, and much of the $302 billion raised in 2006 by private equity firms was never used.

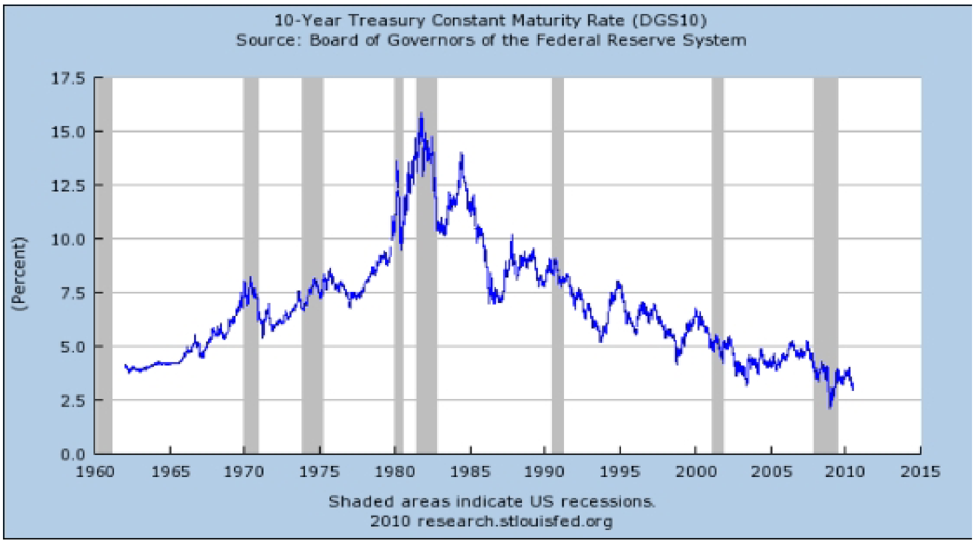
Governments also gorged on the cheap debt markets of the 1990s and 2000s. As I write in July of 2010, Japan now has government debt in excess of 200% of annual GDP. Italy's debt/GDP is over 120% with Germany, Portugal and the UK at 80%. The U.S. Treasury's debt stands at over 13.1 trillion, or 61% of GDP. The combined indebtedness of Great Britain (including, banks, businesses, individuals and government) is equal to almost 400% of annual GDP!

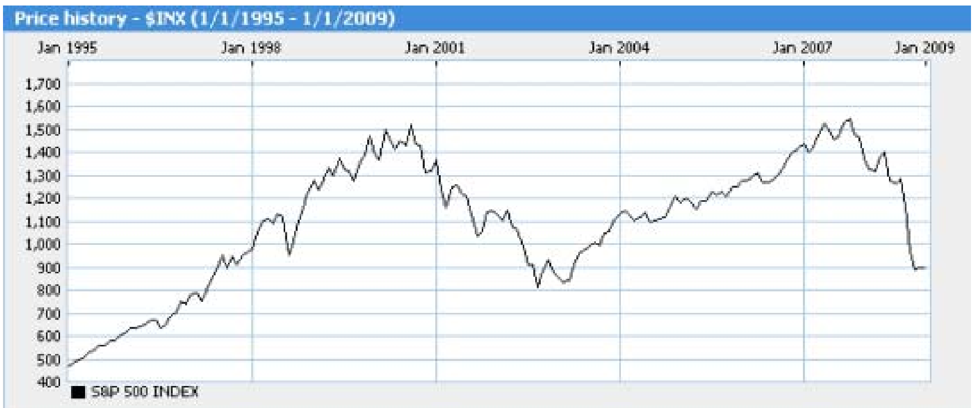
It is a tribute to the size and strength of the U.S. economy that the meltdown in house prices that has taken place since 2007 (roughly a 25% drop in average sales price between March 2007 and January 2009) and the subsequent loss of over $5 *trillion* of home equity across the U.S. has not resulted in a more serious economic meltdown in the U.S. The same cannot be said for Greece, Spain, Ireland and Portugal, where similar real estate bubbles and general overleveraging has led to even more serious economic concerns.

## INVESTOR GREED - THE SEARCH FOR YIELD

One might ask why investors were so willing to take on such high levels of risk in the 2000s. It is my belief that investor expectations were distorted during the 1980 – 2000 period and that these irrational expectations created demand for higher returns, regardless of risk.

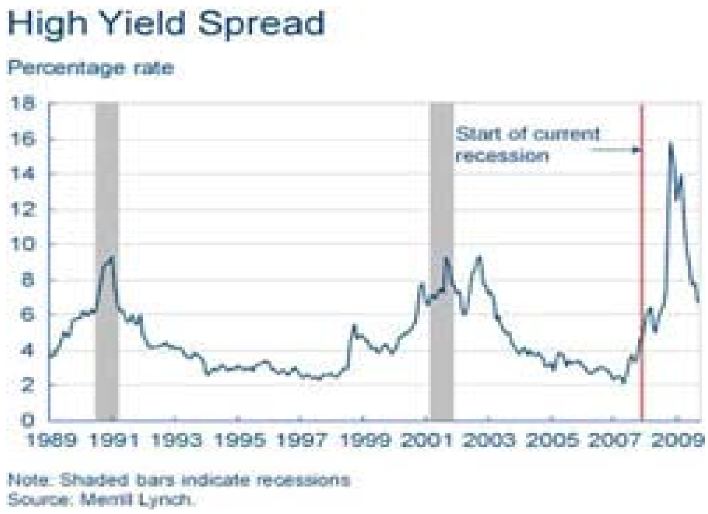
In 1980, an investor could by a 10 Year U.S. Treasury note and earn a risk free interest rate of over 15%. It is true that inflation averaged over 13% in 1980, but inflation steadily declined and was averaging only 3.3% by 1983 (thanks in large part to former Federal Reserve Chairman Paul Volker). From 1980 to 1990, the S&P 500 stock index increased by over 300%. From 1990 to 2000, the S&P 500 increased by over 420%! Investors began to feel that it was a God given right that they earn over 15% per year, even though the historic return on the S&P 500 (going back to 1926) is around 10%. In 2000, however, the markets began to change.



As a result of the bursting of the dot com bubble and the terrorist attacks of 9/11/2001, the increase in the S&P 500 from 2000 to 2007 was a paltry 7.8%. That is not an average annual increase, that is cumulative! At the same time, 10 year U.S. Treasuries were mostly yielding less than 5%, with a low of 3.33% in June of 2003. Very few investors realized that these treasury rates were "normal". From January of 1953 through June of 1966, 10 year U.S. Treasuries rates were never over 5%. But from 1980 to 1985 they were almost always over 10%, and that is what investors remembered.

In the 2000s, the talk was all about "alternative assets". Since traditional stocks and bonds were not generating the "required" rate of return, investors sought other asset classes to invest in. Real Estate, commodities, hedge funds, exotic derivatives, emerging markets and collectibles began to draw investor capital. This phenomenon was not new. So called "junk bonds", that is to say non-investment grade, high-risk debt, were central to the leveraged buyout strategies of the 1980s. In the 1990s, demand from investors was such that the spread, or difference in interest rates, between junk bonds and the most highly rated AAA corporate bonds fell to a little more than 2%. When the dot com bubble burst, that same spread rose to over 9%. After the effects of the dot coms and 9/11 began to fade, however, demand for risky debt began to increase again, with spreads dropping back to 2% by 2007. The following chart shows what happened after that.




In addition to junk bonds, investors sought out higher yields from another new product, asset backed securities. The earliest forms of mortgage-backed securities began in the 1970s and were issued by a government agency (GNMA or Ginnie Mae), or government sponsored agencies (FNMA, FHLMC or Fannie Mae and

Freddie Mac). These governmental and quasi-governmental agencies were developed to insure adequate funds were available to qualified individuals who wished to purchase a home. Initially, these borrowers (similar to my father in 1957) had to meet income, credit and down payment minimums to qualify for a bank loan. The agencies would then purchase these mortgages from the banks, enabling banks to make even more loans. To raise the money, the agencies would issue debt that was backed by the mortgage. There was some risk of default, but everyone assumed that the U.S. government would step in to insure the bonds in the worst case scenario. The result was a “safe” investment that paid slightly higher interest than a corresponding U.S. Government bond. The system worked well for almost 40 years.

Beginning in the 1980s, investment banks began to package and resell pools of debt including home mortgages. As time went on, the various slices of mortgage pools (called tranches) sold by investment banks became more and more complicated. In addition, the mortgages were not all being issued by the agencies. Banks were also issuing mortgages that did not conform to the agencies higher standards. The result was a security with higher risk, but a higher rate of return. As pressure grew, the government allowed the agencies to relax their own standards as well. Then a race to the bottom ensued, led by mortgage originators who were paid to write mortgages, but took on none of the risk. Mortgage banks were of course willing to underwrite these loans, because there was an insatiable appetite from investment banks. Investment banks were happy to purchase the mortgages, package them into complex securities and sell them at a substantial profit to the end investors who had an insatiable appetite for high-yield debt.

In the end, many homeowners were unable to keep up with their mortgage payments and began to default. The added inventory of defaulted homes that banks had to unload, combined with a realization that many properties were overvalued, created a snowball of defaults and housing price declines. Investment banks such as Bear Stearns and Lehman Brothers, which had become giant asset backed security factories, held vast quantities of bad mortgage inventories and other debt. The rest, as they say, is history.

## A FAILED EXPERIMENT IN LAISSEZ FAIRE REGULATION

By now you may be asking, “But what about the famous regulatory system in the U.S. that became the model (thanks to consultants who were former employees of the SEC) for securities regulation around the globe?” That system, when introduced in 1930s, was indeed a model for the world. The stock market crash of 1929 and subsequent depression taught many hard lessons and the securities regulation of 1933 and 1934 set a new standard for safety, disclosure and much needed oversight by the newly created SEC. Beginning in the 1980s, the lessons of the crash of "29 had been mostly forgotten and the era of Ronald Reagan and Margaret Thatcher was one dominated by deregulation. Government wasn't the solution, it was the problem. Like some Ayn Rand novel, society strove to free the spirit of capitalism. But in 2007, Atlas indeed shrugged.

The biggest change came about in 1999 with the passage of The ***Gramm-Leach-Bliley*** Act, also known as the Financial Services Modernization Act. In 1933, the Glass Steagall Act separated investment banks from commercial banks and insurance companies. No more would customers' bank deposits be used to fuel stock market speculation. That all changed in 1999. Now commercial banks, investment banks and insurance companies could combine to create mammoth financial institutions. As it turned out, these institutions were indeed "too big to fail" without causing catastrophic injury to the world's financial system.

Another key regulatory decision was made in 2000 with the passage of the Commodity Futures Modernization Act. Since credit default swaps, a form of insurance against the default by a bonds issuer, were exclusively traded between "sophisticated" institutional investors, the laissez faire philosophy of the times saw no reason in regulating them. The CDS market has enjoyed significant growth since 2000; the market at that time was estimated to be $631 billion. Today the market is estimated to be $58 trillion and it still remains virtually unregulated. Credit default swaps were the prime cause of the failure of AIG, then the world's largest insurance company, which ultimately was bailed out by the U.S. Government at an initial commitment of $152 billion.

In addition to the rewriting of regulation that had served the largest capital markets in the world for over 66 years, and exempting a credit default swap market that covers more than 4 times the total indebtedness of the United States, securities regulation and enforcement was relaxed in a myriad of ways. The Federal Reserve, led by Ayn Rand disciple Alan Greenspan, was traditionally light on regulation and loose on monetary policy as well. The bursting of the credit bubble led to this curious exchange during Congressional hearings, between Representative Henry Waxman and Mr. Greenspan:

Waxman: "In other words, you found that your view of the world, your ideology, was not right, it was not working,"

Greenspan: "Absolutely, precisely, you know, that's precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it was working exceptionally well."

In addition to weakening financial regulation, enforcement of the existing rules was piecemeal and weak at best. The failure of the SEC and other regulators to uncover the massive fraud perpetrated by Bernie Madoff is a prime example. Of course it is difficult for an organization like the SEC to function if it is starved of cash and held hostage by political interests. It seemed whenever a Commissioner began to address problems in the system (e.g. Commissioner Donaldson), they were replaced by a more pliable Commissioner.

Perhaps the most ironic aspect of U.S. regulatory policy in the period from 1990 – 2008 was the desire to ape financial regulation in the UK. Arguments were made that the U.S. with its rigid rules was losing business to Europe, and the UK in particular, where a more business friendly, light-touch, principles based regulation was in force. Today, "light-touch" is considered a dirty word among UK regulators. The end result in both the U.S. and UK was that financial service companies were basically left alone and were expected to act prudently.

## THE TAIL WAGS THE DOG – THE NEW WALL STREET

A good example in the U.S. of how the capital markets seem to have been turned upside down is the business model adopted by Goldman Sachs. Prior to the 1990s, Goldman Sachs was renowned for its expertise in bringing new issues to market; in other words, raising capital. It also excelled in the buying and selling of securities in the secondary market for its clients, as well as for itself.

If we think of raising capital as the primary function of an investment bank, it becomes difficult to define Goldman Sachs as an investment bank. For the third quarter of 2009, Goldman Sachs recorded Net Revenue of $12.37 billion, and $3.19 billion of Net Income. This is an incredible feat given the staggering capital market losses of 2008. But did these results mean that the U.S. Capital Markets were rebounding? A brief look at the revenue breakdown leaves some questions.

The third quarter of 2009, selected revenues from various Goldman Sachs business lines (with comparisons to the third quarter of 2008 were as follows:

- Investment banking: $899 million in revenue, down 31%
- Financial advisory: $325 million in revenue, down 14%, mostly due to a decline in merger activity
- Underwriting: $574 million in revenue, down 15%
- Asset management: $1.45 billion in revenue, down 29%
- Securities services: $472 million in revenue, down 48%

The largest part of the performance came from; Trading - $5.99 billion in net revenue – mostly from trading credit products, Equities - $2.78 billion in net revenue - mostly from equity derivatives, and net revenue of $1.28 billion from Principal Investments securities that the firm owns either short or long term. In other words, roughly 81% of third quarter net revenues were from trading securities. Given that Goldman Sachs is now considered a bank by the Federal Reserve, it calls into question why they should have access to the Fed Discount

Window (where money can be had for between 0 and 0.25% interest), when it seems they are doing little to alleviate the credit needs of traditional bank customers. There is also the question of what value the formerly called "Investment Banks" add to capital formation in general if their business models increasingly look more like hedge funds than banks, investment or otherwise. It is also interesting to note that former Treasury Secretaries Robert Rubin and Hank Paulson were both former Chief Executives of Goldman Sachs.

## THE CAPITAL MARKETS OF SERBIA

It is dangerous to apply the lessons learned from the U.S. experience and apply them to the very different capital markets in Serbia. Many may be tempted to argue that strong central control of these markets should continue. This would, in my opinion, be a great mistake. The U.S. example is one in which the markets became overly deregulated and, in the classic economic sense, overly liberal. The Serbian situation would seem to be the opposite.

The Serbian capital markets do however seem to share a similar distortion in their purpose. Like many developing economies, Serbia has used the capital markets for capital *distribution*, rather that capital *raising*. The privatization of government owned enterprises was, in theory, an opportunity for the average Serbian to acquire ownership in these companies. This would have served the dual purpose of fostering democracy, and providing the base for a reborn capital market. The problem was that the value of this "free money" was not properly understood by the average citizen, and as in Russia, a relatively small group of individuals were able to buy up the shares cheaply and consolidate ownership. The next step was typically to de-list the securities from the BELEX in order to avoid the bothersome regulatory filings and open disclosure required by such listings.

Another key obstacle in the ability of Serbia to develop true capital markets designed to raise capital for business ventures is the virtual absence of a corporate bond market. There are two reasons for this absence; the first is the lack of long-term sovereign paper that could serve as a benchmark for pricing corporate debt, while the second may well be the reluctance of commercial banks to lose the monopoly they currently enjoy.

Although I expressed my concern with the current state of the capital markets in the U.S., I must admit that ability to issue corporate bonds and the thriving bond market in the States have done a great deal to help companies deal with the lack of credit being offered by commercial banks as a result of the credit crisis. According to an October 12 story on Bloomberg, Oct. 12; "Borrowers have sold more than $1 trillion in U.S. corporate bonds in 2009, the fastest pace on record, taking advantage of lower rates and government support to bolster cash holdings after last year's credit freeze…s(S)ales compare with $873.2 billion in all of 2008, and $1.17 trillion for 2007, the biggest year for bond sales".

Debt in and of itself is not a bad thing. It depends on what the money is used for. If it is used to buy cheap, disposable consumer goods from China, a nation of consumers is bound to run into trouble. If it is used to upgrade infrastructure, invest in education and training, and enable entrepreneurs to develop new and better products and services, debt is central to the growth and development of any economy.

Where equity markets are important sources for raising capital, they require that firms trade control of the organization for capital. In the start-up and growth phases, this may be required, but a developed company can much more efficiently raise capital through borrowing. Although commercial banks have traditionally offered this form of capital, corporations large and small have found that they can often raise capital more cheaply by going directly to the market itself. Without a corporate bond market, Serbian companies do not have this option and must rely solely on banks or other private lenders to raise capital for expansion.

Another key roadblock in the development of the Serbian capital markets is the lack of effective supervision and guidance. Serbia is fortunate to have a Securities Commission that has many competent and experienced members, and a staff which is knowledgeable and dedicated. This has become apparent to me over the last three years during which I have visited Belgrade on five occasions, and have had the opportunity of meeting with commissioners and staff. It seems, however, that the progressive development of the capital markets Serbia may be hindered by a lack of proper authority and independence which is typically granted to securities commissions in many other countries around the world. Excessive government interference in the capital markets was, I believe, a contributing factor in the subsequent financial crisis. The current efforts to draft a new set of rules for the Serbian capital markets must be supported, and will hopefully result in a more efficient, transparent and growing market, and a more effective and independent regulator.

I would like to thank all the many people who I have had the pleasure to meet in Serbia and Montenegro. I will always cherish my very fond memories of the friends I have made, the places I have seen, and of course, the wonderful food I have eaten. This region is one of critical importance to the continued success of a peaceful, progressive and democratic Europe. The world needs a strong and thriving Serbia, and the Serbian people deserve nothing less.

# CHAPTER 6. "NEW" MODEL OF GROWTH

**Danijel CVJETIĆANIN**, Singidunum University, Serbia

## INSTEAD OF INTRODUCTION

Have you ever wondered what the gross domestic product per capita (in today's prices) was in Serbia 1810? Do not look for statistics, because I'm not sure that the statistical office in Constantinople (if it existed) collected economic data in rebellious Serbia. We can assume (imagine, without relying on empirical research) that our great grandmothers and great grandfathers were twenty times poorer than us, that is that they were deprived of 95% of goods and services in which we now enjoy. However, I am afraid I exaggerated! They also ate every day, and wore clothes and had a roof over their heads? In this case, their annual GDP per capita (which now amounts to about 6000 dollars) was about $ 300. If since then, GDP growth had been constant at the rate of 2%, today we would have had more than 15 500 dollars per capita, and if it had grown at a rate of 5% (domestic experts and forecasters adore this number), it would have amounted to over $ 5 million ! This invented example shows how important but difficult (read: impossible) it is to maintain positive growth rate in the long term, and it simultaneously indicates that the temporary recession and depression in the economic development are necessary and regular.

Deep crisis in which has stricken Serbian economy in the last few decades require serious rethinking on the selection of models and policies of development and growth. A number of offered and implemented concepts, as well as professional public reaction to them, indicate the presence of a number of misconceptions in the concept of development, and even in the very idea of national (social) welfare and wealth. The depth of these mistakes requires everyone to wonder whether he/she have understood the category of growth and level of general wealth and prosperity, which are now so easily mentioned in the daily economic analysis, forecasts, and polemics.

## IS HEAVEN AN IDEAL PLACE?

No one would dare to doubt the truth that Heaven, in the awareness and perception of each individual, the place of maximum welfare and absolute fulfillment of all desires and needs. Still, economists would, sticking to the principles of their science and profession, even make objections in Eden, of which we can specify at least a few: a small number of people (one man and one woman), modest supply of goods (they were naked and barefoot), low level of education and science (especially before they tasted the forbidden fruit from the tree of knowledge) and almost no possibility of growth and development. Their work skills (qualifications) are flat zero and would start to develop only after being expelled from the Garden of Eden. And what to say about the achieved level of culture and art? However, each of us is sorry that the first people made a mistake and missed a chance to live forever in paradise without suffering, work, sin, deception, conflict, crime and uncertainty.

Indeed, what we might think of a society that seeks the lost ideal of Eden, but to act contrary to all contemporary economic reasoning? It is obvious that the economic profession (and science), even during the last three - four hundred years (it's only a moment compared with the period that divides us from Eden time), has not had a single answer to the fundamental questions of development: what is the economic wealth of a community (people) and how it is created and increased? Maybe the whole process in which one misconception is replaced by the other could be called evolution of knowledge. Or it is a process of approaching the scientific truth. However, there would certainly be a considerable number of those who are convinced that we consistently and systematically get away from the truth. This indicates certain caution in the evaluation of each theory and model of development, and the necessity to point to a set of assumptions on which the model relies and the objectives which should be met.

## WEALTH AND GROWTH

We would like to remind that the Mercantilists (15 – 18 cent.) were convinced that only supplies of gold and other precious metals can be considered the nation's wealth, and their growth was considered to be most reliable indicator of economic development. Naturally, they considered that that wealth was created in trade, i.e. in export and trade with other countries, mostly in the east, which, at the time, just "Swam" in the luxury, which particularly impressed Europeans. Maybe this idea we owe the rapid development of transport (maritime) and a number of discoveries at a time when technology of transport was exposed to high risks. You would notice that in such a concept of wealth and growth of particular importance is the state, whose role in preparation of naval expeditions (interventionism), and in regulating the conditions of imports and exports (protectionism) – was very significant.

As much as this concept of wealth (and its development and growth) seems unusual today we would notice that in intuition, it retains its important place. Ask yourself whether someone who is endowed with creative abilities, knowledge of technology of some business, good education, problem-solving skills, organization , etc., richer than those who have a million dollars in bullion? If you answer is no, you can easily be accused that you are enslaved by ideas of "bullionism", and that you are very far from the modern concept of „knowledge society ".

Physiocratic school of economics (4) criticized Mercantilism, considering that the wealth of nations is created in the production (in agricultural production), and its final form was shaped by the classical theory of economics (6) and development given by Smith and Ricardo (1), having recognized in industrial and agricultural production and division of labour the basic sources of national wealth. We should not however ignore the fact that the exchange and the market maintained the central place in the classical model. Free initiative and competition in the market of goods, services and factors of production, ensure functioning of "invisible hand" that leads entrepreneurs, investors and wage-workers to the best decisions for themselves, but also for society as a whole. In the competitive struggle, everyone recognizes and uses their comparative advantages, i.e. works (produces) what he/she knows best (what is most cost-effective) and in which does not necessarily have to be better than others. The same rule can be applied to international exchange.

Neoclassical models by Solow (5), Lucas (2) and others, whose modifications are still dominating the course of thinking about economic development, also insist without major exceptions, on the market and free competition as the main regulators of development and growth. In the neoclassical model, material and human capital is a basic factor of growth and development, but it also includes technological progress in a specific way. The concept of creative destruction, which was introduced by Schumpeter (7), stressed the role of technical (technological) progress, and entrepreneurship in development. Moving at the market capital from less profitable to more profitable use, reducing one sort of products to be replaced by another, entrepreneurs develop new products, processes and more rational models of management, generating, thus, growth and development. It is a process of "creative destruction", which capitalism uses.

## THE ROLE OF STATE IN LIBERAL MODEL

What is the role of the state in the liberal concept of development? The misconception is widespread, especially in our country that if the government does not intervene and "direct" economic development and growth, it plays an insignificant role in the economy. However, after more serious analysis, the role of the state is huge and decisive. Free private initiative is not possible in the environment of weak legal system. And the strength of the legal order and the maintenance of spatial order is governed by the state. And that is its most important task, far more important than any "guidance" of investments and “defining strategy” of economic development. When weak state is unable to provide the main institutes of market economy (contract, property and spatial order), "Invisible hand" by A. Smith is unable to allocate resources in a rational (optimal) way. And then all main generators of economic development are switched off.

Indeed, imagine a state in which property relations are unclear and where no one knows what belongs to whom, while the majority of contracts can be interpreted in one way or another. Would you like to invest your savings and run a business, if you know that it is always possible that some bully would deny you the right of property (and its "right" would be arbitrated and defended by some powerful officials of the ruling party, with whom he „befriended "). Or if the state can take away your company, considering, for who knows what logic, that you have gotten it in an indecent (though legal) way, and then give your company to someone else (e.g. to a foreign state corporation, to which the government has decent obligations)? Would you invest in such economy? The answer is yes only if you have already provided support by some of the powerful parties, clubs, or circle around the centre of political power. Then doors of the banks would be open for you, as well as government and other institutions and your business will flourish, especially if your "friends“ provide a kind of monopoly, or near monopoly, position. But do not for a moment forget that the fate of your business is related to the organized party members you have access to, not for competitive fight in the open market. When it comes to "regrouping " of forces of political power, it might be better to withdraw from work, unless you belong to the most favourable group - foreign investors , whose interests must be protected by any government that wants to keep the Serbian economy in the "road map "of Euro- Atlantic integrations.

## ECONOMIC MIRACLES

In all modern theories of economic development, including Keynesian and Neo-Keynesian, it is hard to find at least one that would deny the role of free markets in the allocation of production and consumption of goods, services and production factors. In the Keynesian model (as in Roosevelt’s New Deal) the state fixes the defect of excessive savings occasionally generated by free competition, by boosting aggregate demand and investment in infrastructure, but it does not affect the entrepreneurs and investors, and their decisions, nor to extrude their products and services out of the market.

Advocates of the interventionist (command) models often refer to examples of the so-called economic miracles in the near and distant past. Cases of command economy - the Soviet Union in the first two or three five-year plans after the revolution, as the first development period of China (immediately after the Second World War), are cited as examples of success - economic miracles - and with no false modesty fast economic development of Yugoslavia in the period 1947 - 1970 can be added to the group of these economic miracles (3). It is true that the economies at a very low level of development can, in a short period of time, be organized as a single company, with decision-making power in one place. The elements of such economies operate without intermediary services at the market, and directives on what, how many, how and for whom to produce (and at what price - if it is important at all) participants receive from the planned management, as well as all other strategic decisions (about investments, employment, research, etc.). You may notice that in the developed market economies, large corporations (with a huge number of companies and plants) are successfully working on such principles, which supporters of command models point out as a strong argument against the free market.

In practice, however, it quickly became evident that centrally planned economies, after reaching a certain level of development, face unsurpassable, mostly motivational, obstacles to its growth. It happened, without exception, in all socialist countries, which, after ten years, began to lag behind in economic performance. Economic miracles of socialist countries did not last long, although many of them, in this period solved the problem of severe famine and demographic transition (transformation of the rural population to urban or rural population in the industrial).

The development of West Germany after the war has to be added to the list of economic miracles, which was based on the market grounds, but with strong U.S. subsidies and the entire Western world.

## TIGERS

A special group of "economic miracles", i.e. miraculously rapid GDP growth (3-4%) in sufficiently long period (1960 - 1990) is represented by East Asian countries (Taiwan-China, Indonesia, Hong Kong, Singapore, Korea, Japan). Analysts are particularly impressed by the fact that the long-term sustainable growth was achieved in terms of a relatively small increase of social inequality, measured by Ginny - coefficient of income distribution (8). In the last fifteen years, in East Asia, over-populated Chine joined the tigers, while India awoke, too.

Reasons for the rapid growth of these economies, analysts have found in the increase of domestic savings in these countries, reduction of the rate of population growth, but also in improving the education system and better regulation of administration.

The truth is that state intervention and state industrial policy in these countries were strong in the period, but (especially for us) it is important to note that the incentive measures to defined priorities (as well as numerous state subsidies) were implemented in the environment of stronger legal system and more strict respect of private property rights and contracts. There was government intervention, but with free market competition and already strong legal system.

Not entering the debate whether state intervention and clearly defined development strategy were responsible for the rapid growth, supported by the followers of the review of the neoclassical school, or the growth was achieved thanks to the strengthening of the legal system and, on that basis, the swing of competition, which is claimed by the followers of the neoclassical school, we have to notice that even the state industrial policy cannot prove successful in terms of a weak legal system, loose institutions and continuous and unprincipled arbitrage of political factors in economic matters (including property and contract). It has been proven in numerous examples of countries, particularly in Latin America, and Serbia, with its development on that track (from the 1980), joins the list of countries with unsuccessful growth models.

## TWO FACES OF THE WASHINGTON CONSENSUS

After the fall of the Berlin Wall, the former socialist economies of Central, Eastern and Southeastern Europe have adopted the Washington Consensus (WC - agreement by the IMF, World Bank and the U.S. government), which was previously applied as a basis for economic policy, and concept of development in many, especially Latin American countries (9). Recommendations given by the WC, which can be interpreted as guidelines for economic policy, are summarized in ten points as follows:

1. Strengthening fiscal discipline,
2. Redirect public spending (moving subsidies from political priorities, to education, health and infrastructure)
3. Tax reform (with the expansion of the base along with tax rate decrease)
4. Market determination of interest rates (real positive and moderate)
5. Freely established (competitive) exchange rate,
6. Liberalization of foreign exchange,
7. Matching the treatment of foreign and domestic direct investment,
8. Privatization of state enterprises,

9. Deregulation (the release of regulations that restrict free competition, apart from those necessary for safety, environment and population, and monitoring and control of financial institutions),
10. The legal protection of property rights

WC was promoted as a liberal (even ultraliberal) program of development policy, so their critics were often presented as opponents of liberal ideas in the economy. But the declarations and principles are one thing and practice is something else.

Although promoters of the WC, IMF missions, responsible for supervising the implementation of stabilization programs in countries supported by this institution, easily (and with pleasure) accepted the idea of transition countries giving up economic policy of liberal principles (e.g. giving up protection of property rights, price liberalization, establishment of a competitive exchange rate, strengthening the legal system, free competition, etc...), when these measures were not in accordance with the interests of Western capital.

Contrary to another recommendation, the mission did not mind the measures of the state (or political) intervention in the economy, even when they received forms of despotic business models, but the IMF insisted on those measures which stimulate fast borrowing by the country, easy penetration of the Euro-Atlantic capital and taking over natural and economic resources at low prices. IMF also insists on the removal of protectionist measures in the foreign exchange (although these measures in developed countries were abolished only in the advanced stages of development), but does not suggest that the exchange rate should be freely formed (competitive) at a level that would reduce the huge deficit in trade with foreign countries, and that would be provided by the laws of free market.

So the program of liberalization and democratization of economic relations, which relied on apparently good recommendations, turned into an anti liberal process of a new type of economic colonization. Measures of anti market command economy are implemented by the government, with the support of foreign consultants in the environment of poor legal system and administrative negligence, caused by, among other things, an avalanche of bulky and contradictory laws. Party officials and powerful circles arbitrate in economic issues at all levels, and in such circumstances, with the inevitable deindustrialization of society, there are no serious obstacles to flourishing of corruption and crime, and the population (with the help of the media) is pushing the low-down boxes of urban primitivism and violence.

## SERBIAN EXPERIENCE AFTER THE YEAR 2000 – BSC MODEL

Serbian experience with the model of growth after the year 2000 is very interesting. It is certain that a similar development "philosophy" can be found in theory, but not in the examples of economic "miracles" or "tigers". The growth in this period relied exclusively on borrowing, sale and consumption of resources (BSC model). Population, economy and the state borrowed abroad, as much as it was possible, and foreign exchange inflows are mostly used for import and consumption. Trade flourished, as well as banking and other services sectors, but the industry (and exports) declined, and agriculture generally stagnated.

Foreign exchange inflows were realized from “privatization" (although sometimes the foreign buyers were also mixed, and state-owned companies). And these inflows have been used for consumption. The government has promised voters increasing consumption and increasing loans from abroad, as long as the considerable sums of money could be obtained at international credit market and that spiral accelerated until the outbreak of the global economic crisis. Luckily or unluckily (only future can show), the fall of the credit potential of large banks in the west (2008 - 09) stopped this whirlpool.

The peculiarity of this model is contained in the question: is it possible to increase GDP without any activity? One hypothetical example - actually a caricature - shows that it is possible. Assume that the domestic bank with foreign capital (and a large parent bank in the West in which National Bank of Serbia holds foreign exchange reserves) announces to the NBS governor that they would enter 1000 monetary units in Serbia. Assume that obligatory reserve requirements are 40%, and that credit multiplier is 5 / 3 (approximately 1666). In this way, the credit potential of domestic bank increased just by 1000. Imagine now a foreign consultant (from experienced Bank – parent bank) explaining our monetary authorities that these 1000 would cause inflation. Horror! Therefore, this inflow should be sterilized in some way. How? Consultant proposes to emit bonds (interest rate – breeze, 15% per year), but our governor already knows that, and issues bonds in nominal value of 1,000. You will notice that in the "process"(and maybe only a conversation) 150 monetary units have been produced without problems. It is not clear how they would be paid, but let tax payers think about that. Or some public company could be solved so as to solve the liquidity problem. The Governor will have clear conscience to tell public that “stability price” has been paid. (It amounted to over 200 million EUE in some of the past years).

We showed that in the current "growth model" it was possible to "produce" even without activity, i.e. without any employment of labour and capital. The structure of GDP, in which constantly increased the share of financial and other services, confirms this finding

Nothing is more natural and logical at this point but to reveal that it is not the ‘model of development’ but consistent (and persistent) implementation of the method of destruction of national economy, which is brought to collapse by borrowing, selling off resources and encouraging excessive spending and cannot come out of it.

## NEW MODEL OF GROWTH AND DEVELOPMENT

And when it became clear to all that the destruction of the economy took root beyond any measure, the government has announced a change in the "model of development." Immediately, advisors started to appear from all sides, as well as experts and consultants, with proposals of the model of economic growth based on "new" grounds. Numerous conferences, round tables, workshops and conference discusses this topic. Business clubs, political parties, ad - hoc group of experts and scientists, governors of the NBS and other interested citizens, compete in suggestions, sometimes publishing them in an encrypted form, or keeping the announced programs in the greatest secrecy. This time, of course, to make programs of sustainable growth, because the previous model proved to be unsustainable.

A large number of analysts did not miss the opportunity to praise the government for having recognized the unsustainability of the old "development model, which relied on borrowing, selling of resources and consumption. Sudden sobering of government and its consultants, foreign and domestic, has sparked a wave of admiration. The moment in which the government, after they discovered their grave error, had to bang on the forehead and exclaim "We are stuck! was declared to be the turning point in the strategy of the economic development of Serbia.

Summary of most programs which were offered, points to some common features: they all rely on the strengthening of state intervention and state direction of investment. As if no one noticed that our economic development, especially in recent years, mostly suffered from excessive interference by the parties (and state) in the economy. However, many think that some, not yet employed, interventions would give fantastic results.

Of course, this would bring new obligations to taxpayers. And since very few believe that water can be squeezed out of the dry bone, the developers of the offered programs have (I guess) already prepared reports in their drawers with excellent excuses why their great ideas could not be applied in practice. Only a few billions of Euros were lacking otherwise Serbia would be a Heaven for just a few years. So would speak creators of the above mentioned programs, but in vain.

Although it borrowed a lot and sold most of its resources, Serbia, for its economic performance, remained quite weak. And now it is not easy to find a path of recovery, with no serious trouble, effort and sacrifice by vast majority of population. For years, at least it was spent 20 percent more than it was produced, and imported more than double than what was exported. Of course, there are several hundred very rich families, but even if, by some miracle, their wealth were distributed to millions of poor, the latter could hardly experience any improvement.

Our economic disaster is composed primarily of defect development policy (economy of destruction), which has generated unemployment and poverty, and then the dramatic social differences among the majority who are poor and a small number of wealthy citizens. Similarly it can be concluded for relations between regions. This means that the damage (lost product) is thousands of times greater due to badly formed environment and bad economic policy, than the amount which the rich took from the poor in an unjust distribution.

Many would notice that it is now impossible to reduce already low spending, or reduce the cost of health care, education, culture, science or social aid. On the other hand, the Euro-Atlantic elite is not ready to give up their pray - generous amounts from the taxpayers. Big businessmen, too, are not ready to spend any of their capital earned by hard efforts.

When nothing can be changed, harsh laws of economic reality operate so that, in the near future all comes to "a new level of equilibrium”, with extreme social turbulences, misery, even greater poverty and perhaps civil war with a huge number of missing people, refugees and victims. When there is no alternative, it is realized what is possible, ruthlessly and without time to comply. Then it becomes crystal clear to all how expenditures could be (at time) reduced, and how, and with fewer tears, imports could be brought into balance with exports. I wonder if we have learned something from similar experiences in the past.

Above all, I wonder whether the idea of the rule of law and free economy, which make up the lion's share of any serious economics course, would occupy a place in the minds of the creators of economic policy, but also in public opinion. Or there are so many generations of interventionists – to make us happy, with further decline in economic performance, which usually follows this philosophy of development?

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# CHAPTER 7. SERBIA ECONOMIC GROWTH QUALITY – CRITICAL ANALYSIS

**Biljana JOVANOVIĆ GAVRILOVIĆ**, Faculty of Economics, Belgrade, Serbia

***Abstract***

*Socialist countries have entered transition process aiming at reforming their economic (and social) system and create prerequisites for renewal of economic growth and change its quality. Economic growth quality concept is a very complex one and cannot be quantitatively presented in one figure only. It can however be operationalized through appropriate components – economic, social and ecological. Growth quality analysis in Serbia after 2000 indicates presence of certain weaknesses, which have been triggered by the economic crisis 'outbreak'. A new model of economic growth in our country should be self-sustainable, based on healthy economic foundations and contribute to increased wellbeing of the population.*

***Key words:*** *economic growth quality, transition, crisis, economic growth new model, growth quality indicators*

## INTRODUCTION

Two hundred years following the Great French Revolution, *annus mirabilis* 1989, announced huge changes in economic and political scene of East European countries, following the socialist development path. Determination orientated towards political pluralism and market economy, as general transition objectives, was fully supported by scientists and experts in both East and West. Development of market system, appropriately supported by the state, should create prerequisites for renewed economic growth in failed East-European economies, as well as for change of its quality.

Former socialist countries have, at the time of socialist development, demonstrated capacity to reach very high economic growth rates. Quick production expansion was a primary *raison d'etre* of their economic mechanism. However, this economic growth was not sustainable in long-terms. Following the initial success in increased production, growth rates of all planned economies slowed down, to eventually drop to zero or negative prefix. The economic growth in these countries was exhausted at the income level as well (and expenditures) *per capita,* which was far behind Western standards.

Socialist economic growth may be characterised as a pseudo-growth. Firstly, there are some indications that official data on production increase pace exceeded the real economic growth. Secondly, economic growth quality was not satisfactory, which led us believe production increase data reflected more losses growth (under condition that all costs required for such an expanded production were taken into consideration and realistically reviewed) than enhancements in social wellbeing.

Transition was expected to re-establish economic growth process, but on qualitatively different basis. Increased production characteristics were, as it proved to be the case, equally important as the economic expansion dynamics. Growth rate legitimacy was definitely questioned. A quality, selective growth was subordinated to a quantitative, undifferentiated growth. Despite the fact that transition has placed an emphasis on institutional changes, the success, at the end of the day, does not depend on 'institutional beauty', but on results achieved in a real sphere, capacity of post-socialist system, above all, to generate high and sustainable economic growth rates.

## ECONOMIC GROWTH QUALITY CONCEPT

Economic growth quality is a complex concept comprising economic, social and ecologic aspects of increased production. Different approaches to economic growth (development) have been established in the last half a century, ranging from an economic growth model dealing with production expansion, but not necessarily with enhancement of quality of living, to human resources development concept bringing a man down to a pure production factor, a tool for, but not an objective of economic growth; followed by an approach focusing on people's wellbeing and perceiving human beings as growth beneficiaries, but not as participants in the process itself, up to basic needs and poverty reduction concepts intended for the most marginal social groups and assess economic growth through it's a prism of effects it has on economic position of these social categories. Economic growth quality concept is a comprehensive idea and incorporates different partial approaches to growth itself, such as ones we have already mentioned above. Resources are essential, from the economic growth quality viewpoint, i.e. the way the growth is achieved, as well as its objectives, i.e. results reflected in a form of human wellbeing.

M. Camdessus argues that a good-quality economic growth is, in the first place, a sustainable growth, i.e. a constant growth, resistant to external shocks. Such an economic growth urges for internal and external financial stability. In addition to this, a good-quality growth is dynamic, creates prerequisites for the future expansion of production through increased investments in human capital, above all. Care for socially destitute categories (the poor, weak and vulnerable) is also an important characteristic of a good-quality growth; plus a responsible behaviour in the natural environment as a joint heritage of all mankind.[12]

A report recently published by the World Bank, related the growth quality to economic growth type reducing extreme poverty, narrowing structural inequalities, protecting natural environment and, as such, maintains the growth process itself.[13]

Since sustainability of economic growth is one of key quality indicators, it is quite natural that good-quality and sustainable economic growth concepts are very close, practically identical. Sustainable growth meets needs of today's generations in a way that does not question ability of future generations to fulfil their own needs.[14] Even though sustainable growth was initially considered to be a growth sustainable from an ecologic viewpoint, a modern interpretation refers to a growth that is economically and socially sustainable as well, and not only ecologically.

Current world economic crisis has turned the focus to economic growth – not only its dynamics (quantitative side of growth), but, what is particularly important, its quality. A sustainable growth model has been affirmed on both global and national level, based on simultaneous observation of economic, social and ecologic criteria. The question is, however, how to provide such a growth and whether dynamic increase of production on healthy and stable foundations is realistic and feasible?

The Commission on Growth and Development, gathering all eminent experts in the area, has examined causes, consequences and dynamics of growth in 13 countries around the world that, in the period after 1950, managed to achieve an average annual growth rate of 7% or more in an interval longer than 25 years. [15] These cases have confirmed that quick and sustainable growth is possible, but not easily achieved, since we would have more successful examples if it were. Each observes economy has its own idiosyncrasies, which does not exclude possible generalisations and best practices for other countries of the world.

[12] A. Camdessus (1990) "Aiming for High Quality Growth", *Finance & Development,* September, p. 10-11.

[13] R. Lopez – V. Thomas – Y. Wang (2008), *The Quality of Growth: Fiscal Policies for Better Results*, The World Bank, Washington, D.C., p. 11-12.

[14] World Commission on Environment and Development (1987), *Our Common Future*, Oxford University Press, Oxford, p. 43.

[15] Commission on Growth and Development (2008), *The Growth Report – Strategies for Sustained Growth and Inclusive Development,* The International Bank for Reconstruction and Development / The World Bank, Washington D.C.;

Authors of the *Growth Report,* resulting from the abovementioned research, emphasise that sustainable and high growth could be explained and even repeated, they believe, and it's not an 'economic miracle'. There is, however, no readymade formula for policy makers to take and apply. Every country has its specific characteristics and historical experience that have to be reflected in its growth strategy. The Report, nonetheless, offers a framework that may help some countries define their own road to sustainable production growth.

The most important shared features characteristic for economies with constant and high growth rates are the following: 1. *involvement in the world economy,* enabling developing countries to import know-how, expand market and form a strong export sector; 2. *macroeconomic stability,* implying a relatively low inflation and fiscal responsibility of the country; 3. *orientation towards the future,* resulting in high savings rates and investments; 4. *market resources allocation,* including manpower mobility; 5. *leadership and management* i.e. devoted, credible and capable government, since a quick and sustainable growth is not spontaneous. According to this research, involvement in the world economy is of special importance among five mentioned characteristics. [16] Global economy is therefore an important resource of sustainable growth, which is important to underline at the time of crisis, when the process of globalisation itself is brought into question.

## ECONOMIC GROWTH QUALITY IN SERBIA BETWEEN TRANSITION AND CRISIS

Serbia started with transition process at the end of '80s. However, conditions for intensification of market reforms and achievement of dynamic and good-quality economic growth was not possible before 2000 in this region, when sanctions 'external wall' were abolished and relation with international politic, economic and financial organisations was normalised.

Transition process in Serbia after 2000, followed the model 'reform and grow', and not 'first reform and then grow'. Our country's economy in the period of 2001-2008 is characterised by a dynamic increase of Gross Domestic Product – GDP, at an average annual rate of 5.4%.[17] Growth rate configuration during the reviewed period shows that production movements are quite unbalanced. Two extreme indicator values (minimal – 2.5% and maximal – 8.4%) were spotted in two consecutive years (2003 and 2004)

[16] Ibid, pp. 21-28.
[17] Calculated on the basis of the RZS data.

**Table 1. Main indicators of macroeconomic trends in Serbia (2001-2009)**

| | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|---|---|---|---|
| GDP, bill. EUR | 12,8 | 16,0 | 17,3 | 19,0 | 20,3 | 23,3 | 28,8 | 33,4 | 31,5[1] |
| GDP, *per capita*, EUR | 1.709 | 2.138 | 2.313 | 2549 | 2.729 | 3.144 | 3.900 | 4.547 | 4.304[1] |
| GDP, real growth, % | 5,6 | 3,9 | 2,4 | 8,3 | 5,6 | 5,2 | 6,9 | 5,5 | -3,0[2] |
| Retail prices, end of period, % | 40,7 | 14,8 | 7,8 | 13,7 | 17,7 | 6,6 | 10,1 | 6,8 | 6,6 |
| Exchange of goods deficit, bill. EUR | -2,8 | -3,8 | -4,1 | -5,8 | -4,8 | -5,4 | -7,1 | -8,1 | -5,2 |
| Current account deficit (without donations), % GDP | -7,6 | -11,5 | -9,7 | -14,0 | -10,2 | -14,3 | -16,6 | -18,7 | - 6,2 |
| FDI, net, mil. EUR | 184 | 500 | 1.194 | 774 | 1.250 | 3.323 | 1.821 | 1.824 | 1373 |
| Foreign debt, bill.EUR | 12,6 | 10,8 | 10,9 | 10,4 | 13,1 | 14,9 | 17,8 | 21,8 | 22,8 |

*Source: RZR, RZS, MFIN*

[1]Assessment MFIN. [2]Assessment RZS.

As a result of economic growth achieved in Serbia in the period between 2000 and 2008, level of GDP *per capita* significantly increased and reached almost 4,550 Euro (see *Table 1*). The World Bank data on Gross National Income – GNI *per capita* could be used for making international comparisons of economic development levels. They reveal that GNI per inhabitant in Serbia in 2008 was 5,710 dollars, which placed us in a group of countries with higher mid-level income, together with Montenegro (6,440), Bosnia and Herzegovina (4,510) and Macedonia (4,140). Croatia joined industrialised countries with a high income level (13,570), while Slovenia was within the group for a long time (24,010 dollars).[18] 2008 data are also available on GNI per capita in international dollars. As we expected, this figure is higher in our country (11,150 dollars), as well as in other former Yugoslavia countries. [19]

The most difficult financial and economic crisis caused by production collapse at the very beginning of market reforms unfortunately coincided with the 20th anniversary of fall of socialism for countries in transition and the 5th anniversary of joining the EU for many of them. Global crisis did not start in the East, but in the Western world. This is an external crisis for East European countries, but they are partly responsible for its consequences. East European markets largely relied on foreign loans and established bank loans' system, the volume of which significantly exceeded resources accumulated in the countries themselves, what resulted in their increased vulnerability.

Crises ranges were such that they exceeded capacities of individual governments. However, most countries, including Serbia, have undertaken certain economic policy measures. It is estimated that in 2009, GDP in our country dropped by 3%, which is less than the production fall in the EU (-4.2%) and most neighbouring countries. [20] According to the International Monetary Fund prognosis, published in April, 2010 edition of *World Economic Outlook,* GDP is expected to grow in Central and East Europe this year by 2.8%, and in 2011 and 2015, by 3.4% and 4% respectively. Data for Serbia are 2%, 3% and 5%.[21] European Union is also on the road of economic recovery, which will be relatively slow, witnessed by expected GDP growth rates of 1% in 2010 and 1.7% in 2011.[22] Until 2015, economic growth in the EU will exceed 2% and thus come closer to an average from the pre-crisis period.[23]

According to assessments of the European Bank for Reconstruction and Development (EBRD), level of GDP in countries in transition in 2008 exceeded on average by 40% the corresponding level of 1989, when the market reform process started in this part of the world. In SSE region, this percentage is lower - 14%. Serbia, however, reached only 72% of its GDP from 1989 (similar to BaH -

[18] World Bank (2009), *World Development Report 2010 – Development and Climate* Change, The World Bank, Washington, D.C., pp. 384-389.

[19] Ibid.

[20] See: European Commission (2010), "European Economic Forecast – Spring 2010", *European Economy,* May, N$^0$ 2.

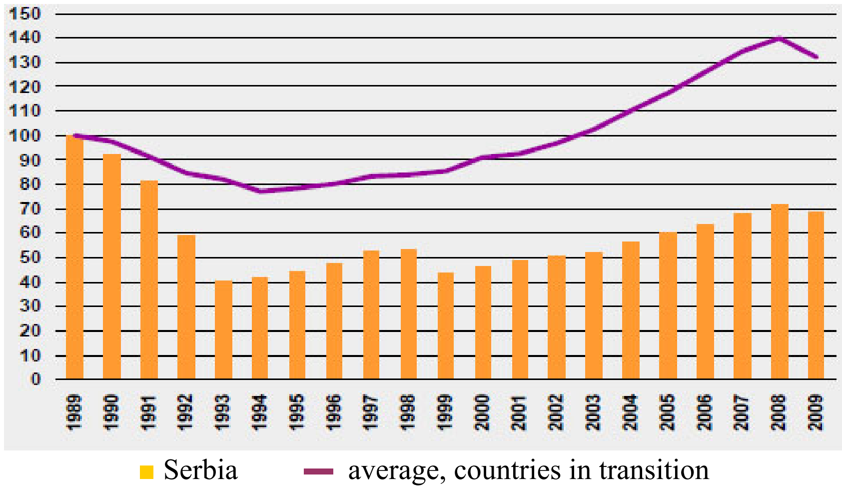
[21] IMF (April 2010), *World Economic Outlook – Rebalancing Growth*, Washington, DC, p. 177.

[22] European Commission (2010), "European Economic Forecast – Spring 2010", *European Economy,* May, N$^0$ 2., p. 182.

[23] IMF (April 2010), *World Economic Outlook – Rebalancing Growth*, Washington, DC, p. 173.

84% and Montenegro - 92%). Having been influenced by economic crisis, our country distanced even more from the initial position of the end of the '80s (see *Graph 1*).[24]

**Graph 1. Real GDP (1989 = 100)**




*Source: www.ebrd.com*

Serbia economic growth structure aspect deserves to be mentioned as well. In the period of 2001-2008, services sector in Serbia dynamically grew, which was followed by increase of its share in the Gross Added Value (GAV) from 57% to 66.2%. Telecommunications, retail and wholesale trade, as well as financial services sector achieved the highest share growth. At the same time, industries share fell from 25.8% to 21%, while the sector of agriculture also reduced its share in GAV from 16.3% to 12%. A relative importance of services in GAV creation continued growing in 2009, when this sector reached a share of 68.6%. Industry at the same time significantly dropped to 18.9%, whereas share of agriculture slightly increased up to the level of 12.6%. A noticeable fall of interchangeable goods was present throughout the observed period – by 10.7 percentage scores. [25]

In comparison with the EU-27, Serbia's economic structure was characterised by much higher (seven times) share of agriculture in GAV in 2009, while the share

[24] EBRD (2009), *Transition Report – Transition in crisis?*, p. 21.

[25] Republic Development Institute (RZR) (2010), *Report on Development of Serbia, 2009*, Belgrade, p. 36.

of industry is below the average in the observed group of countries, as well as services' share.[26] However, services' share in Serbia is above the level typical for neighbouring countries, such as Bulgaria, Romania, Poland, the Czech Republic, Croatia, Slovenia and Hungary.

Above average growth of service sin our country might be linked to realisation of a high-profile export and the accompanying financial support, having in mind that export was quite modest for years, which had a negative influence on foreign trade deficit. On the other hand, industry was seriously lagging behind since industrial capacities were not restructured and revitalised through the privatisation process.

Current balance of payment deficit creates main macroeconomic instability in our country. It is, mainly, a result of a high foreign trade deficit we have already mentioned. Serbia's economy low export leads to a risk of foreign indebtedness. The value of foreign debt is over two times the value of annual goods and services export. With an exception of 2001 and 2009, foreign debt, within this interval, was constantly around the figure of 60% GDP, although, in absolute sense, it significantly increased (by more than 10 billion Euro than in the beginning of the observed period).[27]

Investments are, doubtlessly, one of key factors of the economic prosperity in countries in transition. Data show that gross fixed investments rate in Serbia has gone up from 10.4% in 2001 to 23.2% in 2008.[28] Average annual investment growth rate in the observed period was 7%. Besides a dynamic growth of investments after 2000, they are still relatively modest having in mind development related needs of our country. Investment activities become weaker in 2009 under the influence of the economic crisis – it was assessed that gross fixed investments share in the GDP was only 18.4%.[29] Investment efficiency has noticeably reduced in recent years; hence their effectiveness has to be improved together with increase in numbers.

Foreign direct investments (FDI) deserve to be paid a special attention under conditions of low domestic savings and in relation to investments financing needs. Serbia has not attracted many FDI in comparison with other countries in the SSE region. In the period of 2001-2009, the total FDI were 12.3 billion Euro.[30] Under the influence of the world economic crisis, FDI dropped in all countries. Other

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[26] Ibid.

[27] Ministry of Finances of the Republic of Serbia, (May, 2010), *Public finances bulletin - April, 2010*, Belgrade, p. 20.

[28] Ibid. p. 14.

[29] Republic Development Institute (RZR) (2010), *Report on Development of Serbia, 2009*, Belgrade, p. 116.

[30] Ibid, p. 117.

reasons included: reduced possibilities for foreign capital to enter through privatisation, as well as weaknesses of our economy's structure.

Inflation has been a great challenge for Serbia since the very beginning of transition. Relative price stability in our country was characteristic for the period of 2001-2008. Inflation, measured on the retail prices basis, was reduced from 40.7% in 2001 to 6.8% in 2008 (See *Table 1*). This is a significant result, particularly if we take into consideration it was achieved at the time of price disparities correction. It is obvious that the inflation in our country in the last couple of years might be presented in a form of cyclic fluctuations; hence, a one-digit price rise was missing, as key indicator of macroeconomic stability. Serbia faced the economic crisis at the relativity high inflation level in the last quarter of 2008 exceeding 10%, but fell in 2009 to 6.6%.[31] This result is largely a result of a low aggregate demand, frozen salaries and pensions in the public sector, as well as of reduced food prices.

With reference to the labour market, data show that, as a result of transition processes, the total employment rate in Serbia in the period of 2001-2008 decreased by average annual rate of 0.6%. Employment rate fall was caused by redundancies in enterprises, trade unions, institutions and other organisations, while the number of private entrepreneurs and their employees grew by average annual rate of 7.9%.[32]

Employment rate in Serbia is still low and far from the objective set in the *National Employment Strategy* (67% in 2010). Employment rate growth in 2008, as well as employment rate fall in the same year are mainly a result of methodology changes in the Manpower Survey Questionnaire.[33] With regard to 2009 data, they reflect influence of the economic crisis, which has soon spilt over the market labour brining about reduced employment and increased unemployment in both absolute and relative sense. Unemployment is the biggest economic, social and development issues Serbia has been facing with 700 thousand actively unemployed persons, as well as unfavourable unemployment structure with a high share of long-term unemployed and young people.

A high average annual net income growth of 13.7% (from 102 in 2001 to 400 Euro in 2008) was typical for the observed period, which was largely a result of public sector incomes.[34] Increase in salaries significantly exceeded GDP and work

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[31] Ibid, p. 5.

[32] Republic Development Institute, *Employment in Serbia in 2008 – structure, dynamics and key indicators, February,* 2009.

[33] See: FREN (2008), "Employment and earnings", *Quarterly monitor*, *No.* 15, pp. 17-18.

[34] Republic Development Institute, (2009), *Employment in Serbia in 2008 – structure, dynamics and key indicators,* Belgrade.

productivity growth. In 2009, with a fall of economic activity, net incomes growth slowed down, so that their average level was 338 Euro.[35]

**Table 2. Labour market indicators in Serbia (2001-2009)**

| | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|---|---|---|---|
| Number of employees, average, in ,000 | 2.102 | 2.067 | 2.040 | 2.051 | 2.069 | 2.026 | 2.002 | 1.999 | 1.889 |
| Actively unemployed persons, end of period, in ,000 | - | - | - | - | 896 | 916 | 785 | 728 | 730 |
| Unemployment rate, %, (Manpower survey) | 50,3 | 48,6 | 47,6 | 53,4 | 51,0 | 49,8 | 51,5 | 53,3 | 50,4 |
| Unemployment rate, %, (Manpower survey) | 13,4 | 14,5 | 16,0 | 19,5 | 21,8 | 21,6 | 18,8 | 14,4 | 16,9 |
| Average net income, real growth, % | 16,5 | 29,9 | 13,6 | 10,1 | 6,4 | 11,4 | 19,5 | 3,9 | 0,2 |

*Source: Ministry of Finances (May, 2009),Public finances bulletin –April, 2010, Belgrade, pp. 14, Ministry of Finances (2010), RZS (2010), Manpower Survey, 2009, Belgrade.*

Poverty related situation in Serbia was slightly improved after 2000, but that was still one of key issues our country was facing. In October, 2003, the Government of the Republic of Serbia adopted *Poverty Reduction Strategy,* which envisaged the poverty in our country should be almost halved. This Strategy promotes development orientated towards poverty reduction through a dynamic economic growth, higher employment rate and income levels, prevention of new poverty creation in the course of privatisation process and economic reconstruction, as well as through enhancement of social security network for the most destitute residents.

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[35] Republic Development Institute, (2010), *Report on development of Serbia, 2009*, Belgrade, p. 5.

According to the Standard of Living Survey, poverty in Serbia was halved in the period of 2002-2007, so that the main objective, set by the Government in the *Poverty Reduction Strategy* was achieved. In 2002, 14% or around a million people was poor (with consumption below 5,234 RSD per month per consumer's unit), and in 2007 6.6% or around 490,000 (with consumption below 8,883 RSD). Extreme poverty, defined by the consumption level below the food level (2,764 RSD per month per consumer's unit in 2002, i.e. 4,138 RSD in 2007) was almost nonexistent in this period.[36]

Household Consumption Survey data show that poverty related situation deteriorated in 2008, the trend that continued in 2009 as well when the world economic crisis effects were much more felt in our country. 9.2% of Serbian population lived below the poverty line.[37]

Two indicators could be used for a synthetic review of economic and social results Serbia has achieved in the recent period: Human Development Index – HDI and Global Competitiveness Index - GCI.

With reference to HDI, it is composite indicator resting on three pillars, i.e. reflecting average achievement of country in the following domains: health, education and standard of living (measured by GDP per inhabitant in international dollars - PPP). HDI value is in interval between 0 and 1, should be as high as possible. United National Development Programme (UNDP) in its regular annual *Report on Human Development Worldwide,* did not publish value of this indicator for our country. However, the Republic Development Institute calculated HDIs of Serbia for the period of 2001 until 2005. Results indicate that HDI increased in this interval from 0.768 in 2001 to 0.810 in 2005.[38] Judging by the value of this indicator, Serbia joined the category of countries with a high human development level in 2004, when HDI exceeded the level of 0.800.

In December, 2008, UNDP published data on HDI value for 2006 and three last years, based on slightly changed and improved statistic data (new purchase power parity assessments were taken into consideration, when establishing GDP per inhabitant). Serbia found its place for the first time among 179 countries in the world, as the 65th in the list, with HDI of 0.821 in 2006.[39] Last available data refer to 2007 and according to them Serbia is holding the 67th place among 182

[36] Republic Statistics Institute (RZS) (2008), *Study on Standard of Living, Serbia, 2002-2007*, Belgrade, p. 10.
[37] Republic Development Institute (2010), *Report on Development of Serbia 2009*, Belgrade, p.136.
[38] Republic Development Institute (2007), *Human Development Analysis, Serbia,* Belgrade, p.6.
[39] UNDP (2008), *Human Development Indices – A statistical update 2008*, New York, p. 26.

countries, with HDI of 0.826. Among former Yugoslav republics, better positions were held by Slovenia (29), Croatia (45) and Montenegro (65), whereas Macedonia (72) and Bosnia and Herzegovina (76) were lagging behind.[40] It is important to emphasize that in international comparisons, our country holds a better position by HDI than by GDP *per capita* (difference between GDP *per capita* and HDI in Serbia in 2007 is 8 places), which means that Serbia was quite successful when it comes to translating incomes into populations wellbeing.[41]

The World Economic Forum data for 2009 show that Serbia's economy competitiveness is quite low. Among 133 countries in the world, our country is holding the 93rd place by GCI.[42] This indicator rests on twelve pillars: institutions, infrastructure, macroeconomic stability, health and primary education, advanced education (secondary and high) and training, goods market efficiency, sophistication of financial markets, technology equipment, market volume, business sophistication and innovations. Serbia is the worst positioned when it comes to goods market efficiency (112th place), macroeconomic stability (111th place), institutions (110th place) and infrastructure (107th place), and the best in the area of health and primary education (46th place). In comparison with former Yugoslav republics, our country is only better positioned than BaH (109th place), and worse than Slovenia (37th place), Montenegro (62nd place), Croatia (72nd place) and Macedonia (84th place).[43]

Competitiveness of the country, according to the World Economic Forum's concept incorporates a number of factors, policies and institutions determining its productivity level. Productivity growth, i.e. better usage of available factors and resources, has an influence on investment return rate, which again determines economy's growth aggregate rate. Consequently, one should expect that a more competitive economy would grow more quickly mid and long-term. Finally, competitiveness is also manifested through ability to fulfil a dynamic and sustainable economic growth and development in the course of time.

Ecologic aspect of Serbia's development could be judged on the basis of numerous indicators witnessing quality of air, water resources, soil, waste management, preservation of biologic diversity, etc.[44] Not going into a detailed analysis, we may say that Serbia inherited a poor environment quality (particularly in some locations) from the previous period, as well as inadequate

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[40] UNDP (2009), *Human Development Report 2009 - Overcoming barriers: Human mobility and development,* New York, pp. 171-172.

[41] Ibid. p. 172.

[42] World Economic Forum (2009), *The Global Competitiveness Report 2009-2010.*

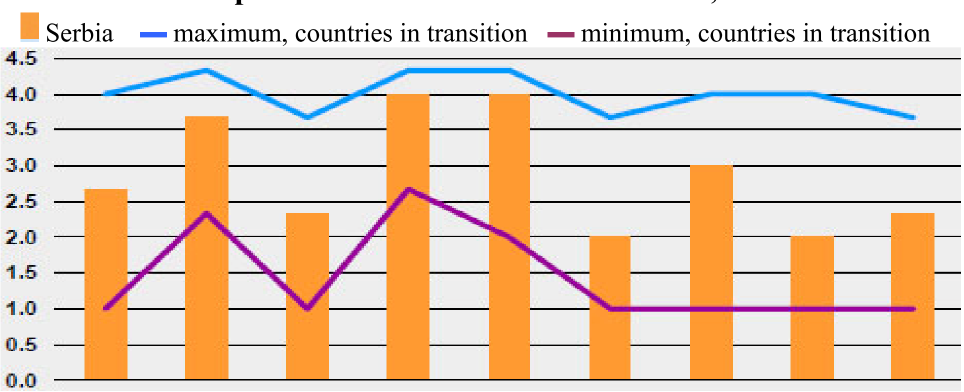
[43] Ibid. p. 13.

[44] See: Agency for Environmental Protection (2009), *Report on Environment in the Republic of Serbia for 2008*, Ministry of Environment and Spatial Planning, Belgrade.

environmental protection policy framework. Even though certain positive progress has been made in the recent years, including passing a large number of laws and other legal regulations for their enforcement, the fact is that total allocations for this purpose (including international assistance) were only 0.68% in 2008. Having in mind that assessed minimal and maximal damages from environmental degradation in Serbia were 4.4%, i.e. 13.1% GDP respectively, these investments are far from being sufficient. According to the *National Environmental Protection Programme,* ecologic related allocations should reach 1.2% GDP in 2011, i.e. 2.4% in 2016.[45]

European Bank for Reconstruction and Development (EBRD) has been assessing the progress, for many years now, the countries in transition make in the market reforms process, relying on nine transitional indicators. Progress in different areas is measured in relation to industrialised market economics standards.

**Graph 2. EBRD transitional indicators, 2009**




Column 1 – Large enterprises privatization
Column 2 – Small enterprises privatization
Column 3 – Restructuring enterprises
Column 4 – Price liberalisation
Column 5 – Foreign curr. and trade liberal.
Column 6 – Competitors Policy
Column 7 – Reform of banking sector
Column 8 – Reform of non -banking sector
Column 9 – Infrastructure Reforms

*Source: www.ebrd.com*

Graph 2 clearly shows results Serbia has achieved in different domains in terms of the reform process. It is essential that, at time of crisis and orientation to resolving current issues, a reform pace should be kept, since a full market transformation of economy (policy of competition, in particular, as well as restructuring and modernisation of enterprises) is important if we want to achieve a good-quality, long-term sustainable growth and development.

[45] Ibid. p. 146.

## INSTEAD OF CONCLUSION: WHAT KIND OF ECONOMIC GROWTH DO WE NEED?

Having summed up developing results Serbia achieved after 2000, we may conclude that economic growth process was initiated in our country, but the quality of the increased production was not a satisfactory one. There are problems in all three spheres: economic, social and ecologic. The world economic crisis revealed weaknesses of our development path, which would have, eventually, sooner or later, emerged.

Transition in Serbia started a bit later, which enabled us to learn from other countries' experiences. The truth is, however, that commenced reform process without any plan, clearly established sequence of events and change dynamics; without a new development philosophy and strategy that would serve as a base for passing a solid macroeconomic and developing policy. A lack of clear and generally accepted strategic 'landmarks' in achieving developing process is closely linked to a neo-liberal approach, which was typical for other transitional countries in the beginning of '90s. Serbia became interested in defining developing strategies long after it made a step into economy and society transformation process, which brought many irrationalities and overlapping to the surface, what could have been avoided. *The Republic of Serbia Economic Development National Strategy, 2006-2012* was adopted in the sixth transition year, which was preceded (instead of following) a number of sector related strategies. In May, 2008, *National Strategy of Sustainable Growth* was passed, which should have been a foundation of a dynamic and good-quality economic growth and development in our country. Let me reminds you that Slovenia, as an EU member, formulated only one national development document – a development strategy, which, at the same time, was a sustainable growth strategy of this country as well.

The crisis has largely brought into question formerly established strategic determinations of Serbia for the forthcoming period, but not the need itself to define key directions for the future country's development. Scientific and expert circles in Serbia have been long discussing 'a new economic growth model'. One has the impression that there was an economic growth model after 2000 that functioned well until the crisis, but changed circumstances exhausted its capabilities, hence different solutions should be sought. The fact is, however, that our growth and development in the previous period was largely unplanned, without any 'paper strategies', which were passed late to make a real basis and guidelines for defining development strategies. All serious analyses, even before the crisis, underlined that our economic growth was not a good-quality one, self-sustainable for the coming years, but, on the contrary, directly jeopardised prospects for economic progress in the future. This is a topical grow only that cannot be valued positively.

Serbia achieved a relatively dynamic economic growth after 2000, but on low grounds, which diminishes its results. Numerous problems have been hiding below achieved growth rates surface, which the crisis has only revealed - ranging from inadequate production structure with exaggerated share of services and neglected sectors producing material goods, to foreign trade unbalance due to a reduced offer of export goods and increased demand for import goods, quite modest employment rate, rather uneven distribution of growth benefits and insufficient care for the environment. A low competitiveness of our country (among the lowest in Europe) is a clear signal of its (in)ability to generate a dynamic economic growth on healthy and permanent bases.

Serbia has to focus on enhancing economic growth quality in the forthcoming period. Special attention should be paid to both economic growth base line (more efficient usage of production factor, changes in structure of the economy in line with the permanent growth demands), as well as to its contribution to increased people's wellbeing (distribution of growth benefits among different social groups and regions, economic growth effects on the environment). It is well-known that economic growth quality achieved in the production domain might be later degraded in distribution and consumption sphere.

Economic growth itself is a long-term phenomenon. One should have in mind time related interdependence of achieved growth rates when reviewing short intervals. Production expansion at one period of time might have either positive or negative influence on production growth pace in the coming period depending on qualitative characteristics of economic growth. Low-quality growth is hindering future production expansion; good-quality growth is, however, self-supportive.

Therefore, there is a close interdependence between a pace and quality of economic growth and this should be kept in mind. Growth pace might significantly speed up to the detriment of its quality – we have already had such examples in our recent past. However, sooner or later, when a low-quality growth causes hindrance of the economic dynamics, it becomes obvious that this temporary acceleration was actually achieved at the expense of future production expansion and a long-term growth rate. Nonetheless, you may start dealing with these growth quality issues, once the issues occur. Economy recovery measures in this case are much more expensive and not that effective, since you have missed a right moment for qualitative changes.

Future model of economic growth in Serbia should be established on the principles of good-quality, sustainable growth, fully respecting economic, social and ecologic criteria. Having in mind that capital flow intensity towards countries in transition will reduce in comparison with the pre-crisis period, we need to focus on domestic savings, investments and real sector development, which was neglected in the past. This may provide, in mid-terms, growth of export, employment and standard of living. Increase of investments is closely related to enhancement of business environment, since not all possibilities have been exhausted in this area. Creation of new economic structure with a competitive product and service programme is an important prerequisite for achievement of a good quality growth together with more investments and their improved efficiency, and linking domestic products with foreign ones on partnership bases. In addition to this, qualifications should be improve din ling with demands aiming at decreasing unemployment and increasing work productivity. Education system performances should be improved at the same time and facilitate young people join the labour market. Introduction of modern and above all information technologies, more investments in scientific and research work plays an important role in a new growth model. Serbia's economy should decisively focus on the economy with a small emission of carbon-dioxide, increased usage of renewable sources of energy, more modern traffic sector, and higher energy effectiveness. It also important that growth and employment benefits are equally distributed so that poor people and people from socially marginalised groups live decent lives and take an active part in the society.

Good-quality, sustainable growth principles should be incorporated in Serbia's economic growth strategy and policy. We need an integrated set of policies (economic, social and ecologic) that will act jointly in improving human wellbeing.

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# CHAPTER 8. BUSINESS INCUBATOR FACTOR OF ECONOMIC GROWTH IN SERBIA

**Olja ARSENIJEVIĆ, Milan VEMIĆ, Milan STAMATOVIĆ**
Faculty of Management, Novi Sad, Serbia

***Abstract***

*The establishment and work of business incubators in Serbia should become one of the priorities of economic development in Serbia, which should enable strenghtening of economic capacities and improving international cooperation. It is known that everything is based on the economy, infrastructure building, culture, education and health, and because of that, it is necessary to find the adequate solutions for its rapid recovery, and one of them could precisely be through inciting the development of entrepreneurial culture, which should be aided by establishing business incubators with the support of local communities, state, economic entities and NGOs. Therefore, the aim of this paper, apart from historical reference to the establishment of business incubators in the world, closer environment and in our country, review of different defining of business incubation and conditions for establishing business incubators, is the review of criteria for measuring success and sustainability of business incubators, as well as to highlight the role of local self-government in the process of economic development of the country and region.*

***Key words*****:** *business incubator, self-sustainability, business success*

## OPENING REMARKS

Throughout the world, economic development is very dependant on small business. In all parts of the world, the most new workplaces appears and opens in a new, small companies that are in „growth“, and they are specialized for th production of different goods and services. These small companies are of a vital importance for the healthy economy of each country. In one of the most developed countries of the world, the USA, precisely small and medium companies make up almost a half of overall business, and they make almost a half of total domestic production. The analyses of European economy give similar results, too. In the period 1988-1993, small and medium companies in Europe were „responsible“ for the growth of 2.6 million of new workplaces. In the same period, big companies abolished a million of workplaces. Data for the whole European Union show that small and medium companies with ten employees make up approximately 33% of all the business and make more than a quarter of total turnover.

These new, small and medium companies are the reality of the global economy – in which individual's flexibility and creativity play a much greater role than it used to be before. In Great Britain, only, there was about half a million of new companies established in 2000, out of which a third has survived longer than five years, thereby providing the employement and income to its community.

However, precisely the first years of work represent the most difficult period for newly-established companies. In that period, they are faced with difficulties which most frequently refer to the lack of capital, lack of staff in the field of management, problems related to development managing, developing new skills in the fields such as marketing, accounting, regulations and laws.

The most common reasons for the failure of companies are exactly in the fact that they have to ovecome all the obstacles by themselves, with no direct support to entrepreneurs, which would helped them to preserve their enthusiasm and sustain as higher level of motivation when facing the difficulties.

Time of privatization and restructuring of economy, which is also the case of our country, makes a large number of people lose their jobs. One of the ways to solve economic and social problems, which emerge because of that, is the development of small entrepreneurial organizations, companies, i.e. starting a private business. It is a very complex process that presupposes the existance of more conditions: idea for a new business, a certain material funds for start-up, as well as working conditions, and it also implies a certain risk. Precisely because of the risk, as well as for the inability to provide enough funds for starting a business, but also because of the insufficiently developed entrepreneurial culture, establishing of entrepreneurial organization in our country has not began to live as it should be.

It is known that everything rests on the economy, infrastructure building, culture, education and health, so it is necessary to find the adequate solutions for its rapid recovery, and one of them could be precisely through the encouragement of entrepreneurial culture development, which should be aided by founding business incubators with the support of local communities, state, economic subjects and NGOs.

Business incubator is one of the possible instruments for reviving the economy on a local level. Therefore, it is important that precisely the local authorities understand the significance of the need for establishing business incubators, and also to work on raising the awareness and contribute to creating the conditions for the functioning of incubator.

This field gives the chance to local agencies, institutions and authorities to show that they are willing to undertake specific activities and support the entrepreneurs. The experiences show that this type of aid can bring a real benefit to local economy.

## THE IMPORTANCE OF BUSINESS INCUBATORS ESTABLISHMENT

Business incubators have appeared in the developed countries as independent profit or non-profit organizations, with the aim of encouraging the development on a local level.

The significance of entrepreneurship is also realized in the countries in transition, so that in these countries, there are more and more initiatives concerning the entrepreneurship in the recent years. The experiences of developed countries are mostly used, and most of the countries in transition, which have used those experiences, admit that private entrepreneurship is of a huge importance for the economic growth and that it represents a significant element of reform process.

The significance of establishing business incubators in Serbia primarily ensues from the need to rapidly invest in development of entrepreneurship in all the aspects (legislative, financal, institutional, educational...), and therefore, to create the possibilities for supporting each entrepreneur with a good idea, especially in the phase when he starts his own business and when he needs help the most.

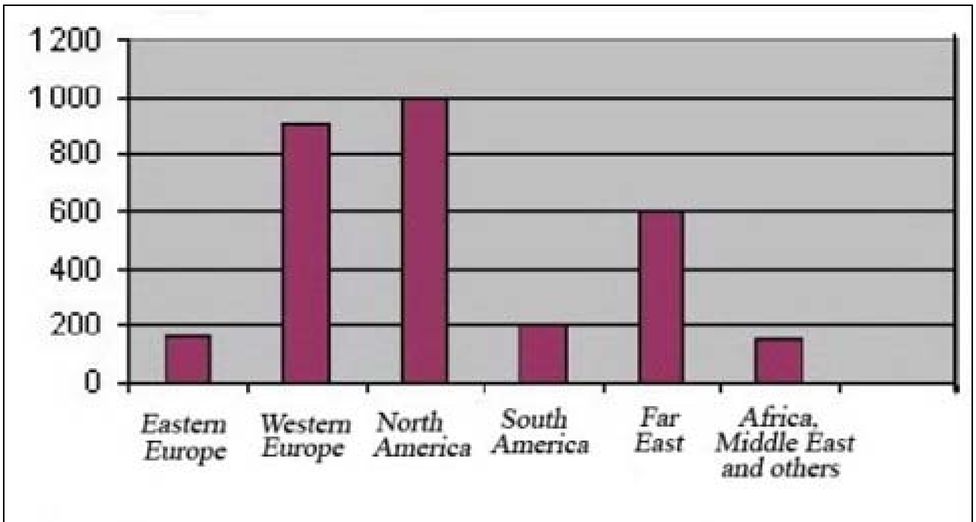
In the process of restructuring our economy, there appears a surplus of business space, surplus of equipment and skilled labour, which represent the opportunity, with good organization on a regional level, to organize the centres for development of entrepreneurship, especially business incubators and to accelerate the local development in that way. What is especially significant is that in our country, there are a large number of research institutes and faculties, which represent the true repositories of knowledge at the moment, and thus, they represent the key development carriers. This fact opens a possibility for the development of entrepreneurship based on the transfer of knowledge and technologies from this sector to creation and development of economy based on knowledge and new skills.

What could also be said from the experience of other countries is that in order for the projects of business incubators to be developed successfuly, it is necessary to develop the efficient regional agencies and business support centres, and to project the incubators as centres for linking the research-developmental process and small and medium companies, establish them on the basis of public and private sector partnership, choose a good management team, develop a business plan of the incubator itself, and devote enough time to the process of planning and establishing the incubator with a special emphasis on the sustainability of business incubators in the long term.

## THE EMERGENCE OF INCUBATORS

A more significant emergence of incubators was recorded in the 60's in the USA, at the time of great crisis it Pittsburgh steel mills, when the reduction of business volume and large costs of machines, buildings and equipment removal caused high unemployment. The solution was found in a programe, which predicted the use of the existing space, equipment and installations for starting new business based on entrepreneurial ideas of the workers.

**Graph 1. Business incubators in the world**




This way of solving the problem of a large number of employees who have lost their jobs was rapidly spread to other parts of USA as a programe within which it was started from the idea that the existing space, tools, certain machines and installations should be used for starting new businesses based on the entrepreneurial ideas of the fired workers. In order to moderate the ignorance and inexperience of workers in managing, accounting, knowledge of the market in the initial phase of new, small companies – these functions are integrated through common services or occasional engagement of consultants, who performed all these jobs for all these companies in the hall – incubator.

Today, there is over a thousand business incubators in the USA, but not all of them have emerged as a result of firing the employees, but also as the instruments of development.

**Table 1. Business incubators in the countries of EU**

| State | Number | State | Number |
|---|---|---|---|
| Austria | 63 | Italy | 45 |
| Belgium | 13 | Luxembourg | 2 |
| Denmark | 7 | Netherlands | 6 |
| France | 192 | Portugal | 23 |
| Finland | 26 | Sweden | 39 |
| Germany | 300 | Spain | 38 |
| Greece | 7 | Great Britain | 144 |
| Ireland | 6 | **TOTAL** | **911** |

In Europe, the incubators firstly appeared in Great Britain and Germany during the 80's of the 20$^{th}$ century after the great economic decline (1982, 1983) and high unemployment. Till 1996, 25 incubators were registred, and their number is still growing and today there are more hundreds of them in Great Britain only.

**Table 2. Business incubators in the countries which have joined the EU later on**

| State | Czech Republic | Estonia | Hungary | Poland | Slovakia | Slovenia |
|---|---|---|---|---|---|---|
| Business incubator | 16 | 2 | 17 | 53 | | 9 |
| Scientific-techn. park | 4 | 1 | 4 | 3 | 6 | 3 |
| Business innovation centre | 4 | 3 | 4 | 3 | 6 | 3 |
| Other types of bus. incubators | | | 6 | | | 1 |
| **TOTAL** | **24** | **6** | **34** | **56** | **11** | **13** |

Financial funds for the initiation of incubator's work were mostly provided by local authorities as well as EU. Almost a half of incubators in Great Britain include the universities and even secondary schools in their work, and that through giving the real estates (most frequently the buildings), or the support of staff, i.e. the assistants or graduated specialists.

At the time of shipping industry crisis during the 80's in Italy appeared the Business Innovation Centre „BIC", which is considered one of the best types of incubators. Common interest in overcoming the hardships of crisis, i.e. employing the workers and specialists who lost their jobs has linked the government (state, regional and city), science (university, research centres and institutes) and capital. This Business Innovation Centre was governed by the formula popularly called „5 and":

1. instruzioni – teaching
2. invezione - invention
3. imprenditorialita - entrepreneurship
4. innovazione - innovation
5. internazionalizzazione - internationalization.

Today, there are several such incubators in Italy and this recipe was used in establishing the incubators in Poland, Russia, Hungary and Slovenia.

In the countries in transition, business incubators are regarded as particularly suitable instrument for development of entrepreneurship because they can help in reducing the obstacles by know-how merging and reducing the fixed costs of the company. In the countries that are in transition, there are about 250 incubators, the most of which are in Poland – 56 business incubators.

The concept of business incubators in the countries in which it began to live is mostly supported by the funds of European Union whose Directorate for Employment and Social Policy has provided the guidelines by which the establishing of business incubators as the measures for inciting the active labour market is encouraged as well as the exclusion of particular social groups whose economic rights are threathened. Member countries of EU and the candidates for accession to the EU have adopted a model of incubator in different areas.

We have adopted this model, also. The project Fund for Business Incubators Establishment, as one of the 14 priority development projects, was predicted by the Programe of economic development in Vojvodina.

Till the beginning of 2010, there were 4 other business incubators established in Vojvodina.

In Subotica and Zrenjanin, „incubation processes"i.e. the process of starting a business is in progress in approximately 25 companies with 80 employees, while the incubators in Senta and Novi Sad are in the formation phase.

**Network of business incubators in Serbia**


Regional strategy for strengthening the capacities of business incubators in Vojvodina is planned to be built in 2010 and to establish partner relationship with business incubator and technological park TEC2B in Linc.

In addition, the objectives are also to strengthen the capacities of the existing business incubator management and develop the functional model for improving the efficiency of its functioning, as well as strengthening the network of partnerships with business incubators in the region.

**Table 3. Review of business incubators in Serbia**

| | |
|---|---|
| Functional incubators | Business incubator Subotica,<br>Business incubator Zrenjanin,<br>Business-technological incubator of Technical Faculties Beograd (Palilula)<br>Business innovation centre Kragujevac<br>Business incubator centre Prokuplje<br>Business incubator Ltd. Kruševac<br>Incubator centre Niš<br>Business incubator centre Knjaževac<br>Business incubator centre Bor<br>Business incubator centre "Rtanj" Boljevac<br>Business incubator centre Užice |
| Registred incubators<br>(in the phase of choosing companies - tenants) | Business incubator centre Vranje<br>Non-profit incubator centreNeprofitni razvojni centar incubator Korrak d.o.o. Rakovica, Beograd<br>Business incubator centre Medveđa<br>Incubator centre for entrepreneurship development Rača<br>Business incubator centre Senta |
| Towns in which exists the initiative for establishing the incubators | Novi Sad<br>Pančevo<br>Valjevo<br>Kraljevo |

## AN EXAMPLE OF A BUSINESS INCUBATOR „ZRENJANIN“- CASE STUDY

Business incubator „Zrenjanin“ is the first incubator established in Vojvodina. Development plan of business incubator „Zrenjanin“ is made within the framework of the Program for establishing business incubators. This program refers to two priority items: using the internal potentials APV and improving the framework for the economic development of the region.

The aim of establishing the incubator in Zrenjanin is to arise the entrepreneurial spirit, to provide the realization of technological innovations through establishing new companies and to provide the socio-economic growth by openning new workplaces and promoting the differencies in private sector and region.

Socio-economic situation in Zrenjanin is similar to that in entire Vojvodina. High rate of unemployment and high percentage of the young with university degrees and small chances of employment are present in amny towns of Vojvodina, too. Also, the weak link between universities and economy restrains the economic and social development of the region, and the result is low commercialization rate of research institutes.

The decision of putting mostly the companies for software development in business incubator „Zrenjanin“ has been made for more reasons. Some of them are:

- Information and communication technologies (ICT) are the generic technologies, which are necessary to all the sectors of economy and society in the 21st century. They provide the job for a relatively small number of educated and trained persons, but, on the other hand, the products and services they offer are invaluable for all human activities. Therefore, ICT is also called the infrastructure technology and it is the main precondition for functioning of all the other sectors in economy and society;
- Software development is more efficient and less demanding within the framework of ICT sector. There are numerous countries whose experience could serve as a model for the process of economy reconstruction. They have turned the software development into a primary activity, which has proved itself to be an excellent solution for the countries with problematic economy (India – employing the external assistants, Ireland – software development in the field of e-commerce, Israel – development of anti-virus programs);
- The processes of transition and restructuring the economy and society in Serbia, under strong international political and economic pressure and in relatively unfavorable economic and social conditions in the country, require more efficient and cheap technological solutions. Software development is, quite obviously, imposed as the best solution in this case.

In addition, reports of the Serbia Investment and Export Promotion Agency have set aside ICT as a key sector for attracting foreign investments and increasing export (SIEPA report, 2005):

- There are about 3,000 of the top IT engineers who are currently working on the projects for foreign partners, mainly in the fields of software production and development of software services. Total annual income is estimated at about 100 million of USD, only in this sub-sector;
- Annual rate of IT sector growth is 18.3%, and the expected compounded annual growth rate (CAGR) 16.8%. Serbian IT market value was estimated to 340 million of USD in 2003;

- With major multinational companies that do business in Serbia such as Ericsson i Siemens, a certain number of smaller European companies have established themselves in the country with the aim of expanding their market domain as well as to develop their products for this region;
- The price of employing the graduated, qualified people is significantly lower than in the Western Europe. Net amount of salary for qualified workers with experience is between 350 EUR and 850 EUR per month. Total cost of the salary of one programer/expert for IT systems is between 700 and 1.400 EUR per month. Numerous companies claim that this sector has completely different approach to work, commitment and results in comparison to traditional branches of economy. Total costs of this sector in Serbia are much lower than in most of the countries of Western and Eastern Europe;
- Serbia has done a lot to bring the business in IT sector closer to the EU standards, in legal sense. In order to enhance a more rapid growth of information society, the following laws were made:
  - Law on Electronic signatures,
  - Law on Patents,
  - Law on Trademark,
  - Law on Copyright and Related Rights,
  - Law on Legal Protection of Design,
  - Law on Protection of Topographies and Integrated Circuits,
  - Law on Personal Data Protection,
  - Law on Consumer Protection,
  - Law on Free Access to Information,
  - The amended Criminal Code.
- Serbia offers new and old investors with numerous incentives with the aim of improving the competitiveness of the country as good location for investments. Among the business incentives for software development in Serbia, there are:
  - The lowest corporate income tax - 10%,
  - 10 years of exemption from paying taxes for investments exceeding 600 million dinars (about 7.4 million EUR) and employing more than a 100 of new workers,
  - Tax credt of up to 10% of investment amount for investing in fixed assets,
  - Tax reliefs that are leveled according to gross earnings as well as the exemption from contribution payment at the expense of the employer for each new worker employed in the period of 2 years,
  - Accelerated decline of ecological and computer equipment value, as well as the equipment in teaching,

- Import of equipment and other assets as well as the construction material, which represents the investment of a foreign resident are exempted from customs duties paying,
- The import of raw materials, semi-processed and component parts necessary for the realization of a long-term agreement with foreign manufacturer is exempted from paying the customs duties and other import taxes,
- Liberalization of property laws has facilitated for the foreigners to own real estates,
- Labour costs are significantly lower than in Western Europe – total labour costs for graduated and qualified staff make about 30% of costs in comparison to Western countries,
- Excellent basic knowledge refined at the high-quality universities, where the professors with significant international experience and good world reputation teach,
- Good communication network in the country and out of it,
- Fluent English language and educational profile, which is significantly higher than in any other country of Eastern Europe (Inquiry of Gallup Poll Agency in 2003 has shown that the level of English language fluency in this category of the young is much higher in our country than in any other country of Eastern Europe. There is 42% of literate people who speak English),
- The companies know the new markets in the Balkans and Eastern Europe very well,
- The companies have the staff that know the language and have the skill of localization for central and East-European market and for the Russian market.

ICT sector has significantly grown over the last 10 years in Serbia. This modern economy branch, especially the segment which refers to software services because it has provided the development of business and entrepreneural activities in general. It resulted from economic reforms and with a great commitment to the education, which is fostered for more than five decades. With intellectual and technological potential, which reaches the level of developed countries, Serbia currently has competitive attributes that satisfy the needs of IT companies all over the world.

Commitment to higher education in the field of ICT in Serbia last for more than five decades. Each year, about 1,000 students of Electrical Engineering and Computer Science graduate, which represents a 7% of the total number of graduate students.

In the report of OECD (Organization for Economic Cooperation and Development) under the name „Investment agreement for South-Eastern Europe" the importance of ICT sector development is emphasized: *„ICT sector in Serbia is growing, unlike many other sectors in the country, mostly for the domestic market expanding, while the Government is preparing to to implement the e-governance program at national and regional level, and while the economy and public sector search for the ways of modernizing the basic administrative and legal functions. Encouraging signals are sent by foreign companies that want to appear on domestic and foreign markets by their presence in Serbia, than small private companies that tend to make a profit from export in their market field, and finally, the universities and research institutes that start the initiative for developing the innovation centres within the campus that would specifically deal with international cooperation" (OECD, 2003)***.**

## ORGANIZATIONAL AND LEGAL STRUCTURE OF INCUBATOR IN ZRENJANIN

In relation to establishing business incubator in Zrenjanin, in the Protocol on business and technical cooperation signed by the VIP fund and Municipality of Zrenjanin stands that the both partners are owners of the incubator:

- Municipality of Zrenjanin with 65%
- VIP fund with 35%

According to the Protocol, the Municipality of Zrenjanin has provided 500m² of space for business for the business incubator „Zrenjanin". It is the common interest of both partners to support the structures that will provide the further work and even after the project is finished. Partners are, also, obligated to provide the support to the management and employees in incubator and to provide the adequate assistance that will ensure the effectiveness of the business. Both VIP fund and Municipality of Zrenjanin are obligated to monitor the activities of the management and employees in incubator.

Partners are committed to provide the appropriate human resources (local population) and the associates for creating a work group. Work group will be responsible for the realization of infrastructure, monitoring the openning and the work of incubator. Employing the local staff for managerial workplaces should contribute the feeling of local „ownership" of this project.

Project activities that refer to the work with positively valuated newly-established companies that are not the members of incubator, will include providing the training and professional development, promotion of the business and other forms of assistance. Permanent contact and assistance providing should have a positive impact on the local entrepreneurs who did not become the tenants of incubator immediately, but they will now wait for a new opportunity to become that.

Both partners are interested in supporting the activities that refer to the project's end itself in order to foster the local economic growth. More precisely, the long-term interests this support brings include:

- Struggle against unemployment;
- Expansion of business infrastructure;
- Commercialization of university research;
- Helping socially neglected groups such as youth and the unemployed.

Linking the proposed incubator and local community should provide the local community with „ownership" over achieved results through:

- Income from the taxes payed by incubator tenants;
- Creation of new workplaces;
- Creation of incomes;
- Impose software products as the brand of Zrenjanin;
- Incubator should have the role of „local economic centre", which will trigger the economic development of Zrenjanin and Banat.

In addition, VIP fund as a regional mediator for investment promotion aims at supporting the foreign investors and to facilitate their business in Vojvodina. One of its activities is helping the foreign investors to find the appropriate locations for their companies. VIP fund as co-owner of the incubator offers a pat of incubator office space as a potential business space to the foreign investors interested in it. It is expected that openning of a new business space within incubators will bring numerous benefits to Zrenjanin and entire Banat. For the local community, the most important of those benefits are the higher tax income and openning of new workplaces.

Presentations of incubator activities on trade fairs, seminars and conferences in Serbia will be the way of promoting the incubator, its tenants and their products, and at the same time, Zrenjanin and Banat will be promoted.

The main activities during the establishment of business incubator „Zrenjanin" are:

1. Establishment of the incubator (incubator management and other staff, work space, equipment and objects);
2. Competition for the best ideas/proposals for the new companies in the field of software development, which should be developed during the following three to four years;
3. Placing the companies-tenants in incubator
4. Monitoring and evaluation of the progress in incubator

Direct beneficiaries of business incubator are the existing start-up companies, emerging companies, the unemployed and students.

Target group for the IT business incubators are the experts for software development-programmers. In Zrenjanin, there are more than a hundred of unemployed programmers, as well as a significant number of IT graduates from the Faculty of Engineering „Mihajlo Pupin“ in Zrenjanin – about a hundred of them graduates per year.

Direct beneficiaries also are the potential buyers of software products, which will be made by the companies that belong to the incubator. Choosing good marketing ideas for incubation, the number of direct beneficiaries could significantly exceed the iniatial expectations and forecasts.

Announcing the competition for collection and selection of the best ideas for software products development, the experts for software development from Zrenjanin are identified.

Method of critical evaluation is applied in the further selection by defining the additional criteria for evaluation of expertise and experience of the candidates, evaluation of financial sustainability and marketing value of proposed ideas, dynamics and range of the future work, direct and indirect influence on the local economy and society.

Having in mind the structure of economic activities in the country during the 90's, it is logical that a greater number of unemployed programmers actually works in the so-called „grey“ economy. Incubator provides them with the opportunity and possibility to legalize their business and thus facilitate the transition process.

Knowledge and experience of unemployed programmers from Zrenjanin will, in that way, be used and channeled in a good way – it will be of the personal benefit for the programmers and for the local economy and society as well.

Internet projects that are developed within the scope of Business Incubator Zrenjanin

- Net in Serbia, Serbia on the net - www.netsrbija.net
- Travel club - www.klubputnika.com

Among the direct beneficiaries of IT business incubator, there are:

a) Local authorities in the town and region – through support and promoting the solution for economic recovery, the authorities will create the conditions for efficient managing and raise the level of citizens' confidence in this and other activities of local authority;
b) Population of Zrenjanin and Banat – promoting the information technologies is an important and necessary step in creating the economy and society based on knowledge.

IT is the most useful, especially in business, when it is used skillfully and efficiently, so that the incubator will be focused on enabling the newly-established companies to intensively and efficiently apply the most modern managment and IT skills, to facilitate the organizational transformations and productiveness increasing for them, and to help them improve the business. The proposed activities should:

- Stimulate the economic activity in Zrenjanin and Banat, create new workplaces and enable for the IT to foster the integration of local companies in the global economy based on new knowledges;
- Develop the skills of managers and the employees in the newly-established companies related to promoting and providing the collection of funds for IT of small companies and e-business development;
- Foster entrepreneurship and stimulate the innovation growth in business with managers and the employees;
- Cause the stronger competition for rents by successful examples and therefore, stimulate the investments and development and growth of local small companies;
- Promote the equality and variety in development of companies by actively engaging the socially neglected groups such as women, youth an the unemployed in the incubation process;
- Provide the business support to small companies and new entrepreneurs, which belong to the group with insufficient number of representatives in the business world;
- Promote the spreading of business contacts network and spreading of knowledge that refers to efficient application of IT skills and other services linked to achieving competitiveness, as well as general socio-economic development;
- Training should improve management skills since it refers to business planning, efficient management, etc.;
- Legal aid should inform and explain the issues regarding the protection of intellectual property rights to the managers and employees;
- Transfer of technological knowledge and skills, as one of the main incubator’s tasks, should improve the capacities of technologocal knowledge and skills of the tenants.

Several studies have shown that business incubators significantly strenghten the chances of small and mediumcompanies to overcome the initial and critical phases of development. Those studies, also demonstrate that business incubators increase the possibilities of the companies to succeed on the market up to 80%, in comparison with20% if the companies are out of the incubator.

## DEFINITION OF BUSINESS INCUBATION

The name „incubator“ refers to the beginning of life, the time when a greater attention is necessary and care is obligatory. That is precisely what happens in the incubators: there are new, small companies that are being established within them.

Incubators primarily provide the survival for the entrepreneur, and afterwards the smooth development as well. When a company “becomes” an incubator, it becomes strong and with a particular conception of development, and its management is established and experienced, it can go the free market and start an independent life. Generally speaking, business incubation is related to the practice of providing premises and common services at low cost and in common space, in order to foster the development of the new companies.

At the workshop in Helsinki in 1998, business incubators were defined as: „A place in which the newly-created companies are concentrated in a limited space. Their goal is to improve the chance of growth and surviving rate of these firms in a way of providing for them a modular building with some common material and technical means and premises (telephone, fax, computer equipment etc.), as well as managerial support and other support services. The main emphasis is on a local development and creating workplaces.“ (European Commission Enterprise Directorate-General, 2002, p. 4-5) Furthermore, UKBI and German ADT define business incubation as a „dynamic process of the development of the company. Incubators raise the younf companies, help them to survive and grow during the initial period in which those companies are the most vulnerable. Incubators secure practical management support, access to the finances, and exposure to the key businesses or services of technical support. In addition, they provide the entrepreneurial companies with common premises, equipment access, flexible renting of the premises and the space that can be expanded – all under one roof. “ (cited in European Commission Enterprise Directorate-General, 2002, p. 5) Furthermore, „business incubator is a business unit that is specialized in providing space, services, advices and support in order to assist the new and growing businesses to become firmly established and profitable“. (SIEID, 2005, p. 1)

From the above-mentioned definitions, we can distinguish three elements without which it is impossible to understand the concept of business incubator:

1. Business space, business infrastructure, i.e. “hardware”
2. Services that are offered, i.e. “software”
3. Set goal to support the new companies, their survival and employement.

In contrast to the „European“, in the definition of business incubator, according to the United States National Business Association (USNBIA), the emphasis is not on the space, but the services that are provided for the tenants: „Entrepreneurial incubator represents one of the tools for economic growth devised in such a way that it can speed up the growth and successfulness of the company through a series of resources and services that foster the business growth. The main goal of incubator was production of successful companies, which will be financially self-sustainable and independent once they come out of the incubator“.

According to the classification of the Official Journal of European Communities (C 186/52), business incubator is a place in which newly-established companies are located in a limited space. Its goal was to increase the odds for survival rate growth of these companies by providing them with:

- Spatial capacities
- Common technical capacities
- Support in managing
- "Back-up" services.

## THE MAIN TASKS OF BUSINESS INCUBATORS

The main task of business incubators is helping the new companies to succeed in starting their own business and thus create the opportunities for employing and openning new workplaces.

In addition, business incubator helps all the users to overcome the initial problems, delays and regulatory obstacles towards rapid establishment of the company by facilitating the running process for them and through access to the network for support within a community.

Business incubators provide for the entrepreneurs the following:

- Cheap business space for the beginning of work
- Use of the common infrastructure
- Continious specialization and training
- Marketing services, market research, book-keeping and such.

Social task of incubator is to encourage the development of entrepreneurial culture and increase the participation of entrepreneurs in the economy of the region or state, including the youth, women and other specific groups.

Specific tasks of business incubators depend on the focus of business incubator and they can include:

- Technological innovations – through the cooperation with universities and research centres, with the aim of initiating the innovative products and services,
- Regional development – through decentralization of economic activities from urban areas

- Industrial subcontracting – linking with industrial zones and the opportunity for *spin-off*
- Providing international support – through helping the foreign companies to enter the domestic market in a short period of time and initiate the cooperation with local partners
- Encouraging women or other groups to include themselves to enterpreneurship.

## PREREQUISITES FOR THE ESTABLISHMENT OF BUSINESS INCUBATOR

Before the initiation of the business incubator project, it is necessary to determine what the stakeholders and local community expect from it, i.e. what are the main reasons for the development of incubators. Considering the expectations and reasons for incubator initiation, it is necessary to define the role of incubator in the local entrepreneurship development programs i.e. the programs of social, economic and technological development.

In order for the initiators of entrepreneurial incubators establishment to receive an adequate local support, it is important to emphasize the role of incubators in those programs.

The reasons for which the project of incubator establishment should receive the local support are:

- Creating new workplaces
- Providing support to entrepreneurs-beginners
- Positive influence on the local economic growth
- Linking the science and entrepreneurship
- Networking entrepreneurs

In addition, it is necessary to conduct a research and identify production and service sectors in the region, basic main fields of their action in order to define the potential business partners for the incubator. With the insight into existing infrastructure in the area, road network, for example, it is possible to acquire significant savings when building the incubator. Similarly, the proximity and connectivity of incubator with educational and research institutions will represent a significant support to incubator development, whose activity is linked to advanced technologies.

Determining the key people, companies, state institutions and organs for encouragement of entrepreneurship, which will be included in the project, sets the future direction of incubator development. The relationship between institutions and political interests and their mutual relations, which should not be in conflict, is very important as one of the basic prerequisites of positive attitude when creating the incubator.

One of the most important prerequisites is the way of financing the project of starting a business incubator. Depending on the support of local community, politicians, powerful private companies and the planned own incomes from providing services for the tenants of incubators, it is necessary to define the long-term sources of finance in the feasibility study. They should be in accordance with the decision of incubator's initiator on his profit or non-profit form, because it will influence the basic goals of incubator's work.

However, the existance of these prerequisities is not sufficient for initiating the business incubator project, since without those to whom it is meant for and their interest for including in the project, the incubator can not succeed.

Although a large number of people in general say that they want to deal with entrepreneurship, many of them lack the determination and skill to turn their ambitions into real undertakings, reality. That is precisely where the incubator should be recognized as an additional encouragement and support to those who need it to include in the world of entrepreneurship.

Regardless whether it is about small production or service programs or projects that are linked to advanced technologies, all the future entrepreneurs have a common need for education, spatial and financial support, advices, administrative services etc.

## SUCCESS AND SUSTAINABILITY OF BUSINESS INCUBATOR

The most professionals agree that there is no optimal „design" of the business incubator that would guarantee its success. According to observations of Mark Ripen (Ripen, M. 2002), success of incubator can be viewed in two basic ways:

1. Possibilities of incubator's self-sustainability through continious providing services for the tenants
2. Through the success of tenants' business after they are out of the incubator.

Self-sustainability of incubator is conditioned with good managerial skills of the management, long-term financial goals, stable and constant support of local and regional community and the founder, including the financial, legal, managerial, technical and every other support.

The success of tenants' business after they are out of the incubator will depend on the types of services provided by the incubator, and not on the form of incubator. In this case, the emphasis is on the entry criteria that the tenants must fulfill when entering the incubator, then development of their business plans, education, market research and similar services meant for the tenants of business incubators. Business undertakings that survive the incubation period and become independent successful companies are the best witnesses of the quality of services that are provided by the incubator.

According to the United States National Business Association, the key of the success of business incubator, regardless of his mission and focus of action, depends on the following factors:

- Feasibilty and sustainability studies and business plan of incubator in which the market for which the incubator is established is clearly defined
- Orientation towards providing the servises with investing in people and knowledge
- Quality management
- Clearly defined missions and visions of the incubators and readiness of their constant evaluation and improvement
- Good links with social community and institutions that encourage the development of entrepreneurship
- Compliance of the incubator development strategy with economic strategy of the community
- Monitoring of the work of other successful incubators in the environment and world
- Continious education and improvement of the management and improvement of the management members skills
- Lidership features of incubator’s director.

David Lewis, in the critical review of incubator’s work «Does Technolgy Incubation Work – A Critical Review», states the following advantages of support to development of incubator: rapid emerging of new work places by developing entrepreneural spirit and establishing new companies, development of innovatorship and retaining highly educated labor in the region. He states that for achieving these advatages, it is necessary to pay the attention on two key issues when establishing the incubator:

- Financing
- Work organization.

In fact, the financial support oscillates during the work of incubator and management must devote most of their time to finding new sources of financing. As a result, there can be a lowering of the criteria for company’s entry in the incubator, or extending the planned time for spending in incubator as long as the rent is payed. This author suggests finding the new source of financing by entering the ownership structure of the tenants and if it is about new technologies, they can provide a significantly higher financial effect for a long period of time.

According to the program that has emerged on the basis of European Charter for Small Enterprises, the sustainability of business incubator is actually an indicator of incubator's successfulness in the creation of small and medium companies that can independently do business on the market, and a measure of its own stability. According to this program, sustainabilty of the business incubator can be measured from the level of:

1. Tenant's sustainability – through commercialization and the growth of incubator
2. Incubator's sustainability – through feasibility and stability

Both levels depend on the ability of the incubator management, infrastructure, establishment and the policy of managing the incubator.

Tenants' sustainability is, to a great extent, conditioned by the following factors:

- Professional engagement of the entrepreneurs
- Concept of the incubator
- Trainings and individual development of the tenants
- Planning and gradual reduction of financial support to companies
- System of measuring and setting the targets for tenants
- Development of the tenants
- Specific platform for abandoning the incubator
- Assistance in the promotion, marketing and networking.

According to this program, for the sustainability of incubator the following factors are important:

- Obtaining income from the rent, training, canteen etc.
- Introduction in the new profitable products and services
- Finding additional sources of financing
- Performing the activities in accordance with the laws and founding documents
- Conduct in accordance with the standards and procedures of the incubator
- Successful implementation of business plan and the action plan of strategic development of the incubator.

The ways for measuring the quality and results of incubator's work, i.e. tenant's work are important precisely because of the success and sustainability of the incubator. Management requires the understanding of the requirement of modern economy and the culture of managing a company. It is of a particular importance that the quality and the results of incubator's work are monitored and measured and available to interested parties. Monitoring, measuring and presenting the work results and quality from the part of the manager is also a proof of the success of his work.

The indicators of incubator's work quality also include:

- **Location,** i.e. the records on monthly and annual rent amounts, profile of the owner as wellas the employees of the company. It is necessary to keep the record on the use of the object, for example meeting rooms, equipment, including its use in the evening hours or at night.
- **Quality and result of financial operations,** i.e. it is important to monitor which are the successful tenants and due to what. Supposing that the incubator deals on commercial basis, it is necessary to carefully monitor the financial situation.
- **Quality of business in incubator,** refers to the basic verifications of business „health“ of the company, which should be performed in certain time intervals, in order to obtain the information on which companies have developed real plans and achieved success, which have the potentials for expanding and keep creating new workplaces.
- **Quality of provided services,** i.e. receiving the feedback from the tenants of incubators on the quality and efficiency of provided services from the part of the management.

In one study conducted in Czech Republic, the potential tenants of a business incubator were interviewed. Inquiry has involved 22 potential tenants, from which 12 were the companies and 10 individual entrepreneurs. They were asked to answer the questions that are related to the needs of their business or services in relation to the possible use of incubator's services. In other words, what their expectations from the business incubator are. The respondents answered by rating the offered services on the scale from 1 to 5. Rating (5) was given for the service of the highest priority, rating (4) for the service of a very high priority, rating (3) for medium priority service, rating (2) for the service of a low priority and rating (1) for the service of the lowest service priority.

The results of this research demonstrate that the answers on the expectations of potential tenants in relation to the services in business incubators can be classified into five groups.

- **Standard services** (they refer to the building). These services imply the incubator's possessing of basic work conditions: electricity, water, heating, telephone, fax, computers, Internet access, photocopiers, air conditioners, as well as the services of cleaning and guarding. In addition, it is also stated that the incubator must have a room for rest – canteen.
- **Additional services** (also refer to the building) but they imply the existance of reception, meeting room and room for presentation and providing advisory services, trainings and education.
- **Business services** such as the possibility of business plan development, marketing and promotional services, legal-advisory services as well as the existance of an appropriate library.

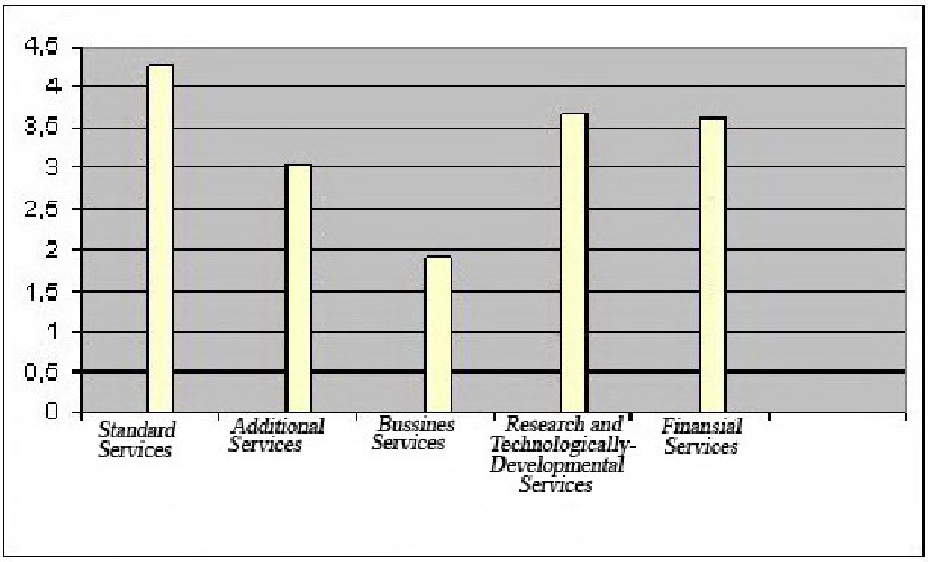
- **Research and technologically-developmental services,** i.e further researches and technological growth.
- **Financial services,** i.e. the possibilty of an easier approach to various financial forms of support, such as loans, favourable credits, association of capital and the like.

The largest number of respondents has attributed the highest average rating-4.26 to standard services, i.e. these services are considered the highest priority in business incubator. Very high rating-3.66, as a second service desirable in business incubator, the respondents have given to the research and technologically-developmental services. After that, there are financial services to which the respondents have given the average rating 3.63. On the penultimate place, with the rating 3.06, there are additional services and on the last place, there are the business services with the average arting 1.89.

Looking at these results, it is noticed that the highest priority given to the services that refer to „accomodation" needs of potential tenants. This information is expected, considering that it is about potential tenants and with generally accepted attitude on the essence of the business incubator which is that his basic role is renting business space under very favourable conditions. Naturally, the adequate business space is important, but it does not secure the success of the incubator by itself. Furthermore, a very high level of expectation also refers to the other services related to the research and technologically-developmental services, which demonstrates that the potential tenants of the incubators are very interested in improving technological processes of their businesses and thay thay would gladly use the results of researches that are referred to that. The information obtained in this research, which refers to the expectations of potential tenants when it comes to business services, for example, the assistance in creation of business plan or project elaboration, is suprising.

This kind of research result can be explained by the fact that entrepreneurs believe that their business plans are business secrets, and they are not willing to discuss them openly, or that they actually do not have a completely developed business plan, but only a fragments or a rough picture of what they would like to apply for the position of a tenant in incubator with. This information from the research is very significant in the sense that refers to the significance of business plan development. Namely, business plan serves for the tenant to „check" the justification of his business idea, and not only to acquire the status of a tenant. This information can also be linked to the system of financial support to entrepreneurs and small and medium entrepreneurs, since in the countries in transition, there are still insufficiently developed support instruments (credit lines, loans) and the entrepreneurs who do not link their business plans for the same type of support and for that reason, they are considered business secrets.

**Graph 2. Types of services and average rating**




"Efficiency of business incubators should be rated on the basis of a number of successful companies that reach the maturity and continue to operate out of the developmental areas". (Grozdanić, E. 2008.)

Moving on, even with accordance with European Commission Enterprise Directorate-General, Centre for Strategy and Evaluation Service, the main indicators of the best practices of BI efficiency are „Wealth creation – average turnover of the tenant companies and the average growth rate, added value of business activities and employement – number [and the type] workplaces per tenant company and annual growth rates, proportion of employees from the local areas, quality of the jobs" (2002, p. 28). The first indicator is more significant in the countries that are not faced with a high umemployment rate, and in the countries such as Serbia, the employment would be the main field of interest, though the other indicators certainly should not be ommited when assessing the efficiency.

In the member countries of EU, „the average of 41 company has successfully went out of each incubator" (European Commission Enterprise Directorate-General, Centre for Strategy and Evaluation Service, 2002 p. 83). This represents an important indicator of EU business incubators efficiency, which can be classified as those on a very high level.

If we look at our neighbours in Croatia, we can observe that the incubation rate is 77 %.

## MEASURING THE SUCCESS OF BUSINESS INCUBATOR

There is a significant difference in the success and the way in which the incubator works that depend on the type of incubator, services that the incubators provide to their tenants, criteria and the ways of financing and other factors. The professionals agree that there is no optimal “recipe” that would guarantee the success of business incubator. One of the main reasons is in the fact that the definition of incubator’s success is not uniquely placed actually.

Success of the incubator, according to Rippen[1], is possible to observe in two basic ways: **self-sustaining capabilities of incubator** with continuous providing the services for the tenants, and **success of tenant’s business after they are out of** the incubator.

Self-sustainability of the incubator is conditioned by good management team of incubator, long-term financial goals, stable support of social community including the financial, managerial, legal, educational and other types of support.

Success of incubator tenants business after they are out of the incubator primarily depends on the services that the incubator provides for the tenants, and not on the form of incubator organization. The emphasis is on the entry criteria that must be satisfied by the future tenants of incubator, development of their business plans, education, assistance with development of products and their testing, market research and similar services intended for the tenants of incubator.

Business undertakings that survive the period of “incubation” and become independent successful companies testify on the quality of service and support provided by the incubator. (Atkins, D. 2009.)

The key of incubator’s success, regardless of his mission and action goal, according to Dinah Adkins (http://nbia.org) from the National Business Incubation Association, depends on:

- Feasibilty study and business plan of incubators in which there is a clearly defined goal for the emergence of incubator
- Orientation towards service providing with investing in people and knowledge
- Quality and well-payed management of the incubator
- Flexibilty and realization of good relationships and communication between the management of incubator and the tenants
- Clearly defined missions and visions of the incubator
- Good connections between incubators and social community, institutions that encourage entrepreneurship
- Monitoring the work of other successful incubators’ work in the environment and the world
- Continious education and improvement of incubator management.

In the critical review of incubator's work, David Lewis (Lewis, D. 2001.) states the following advantages of supporting the work of incubators: rapid formation of the new workplaces, development of entrepreneurial spirit, whose result is the creation of new companies, private investments and development of innovatorship, as well as retaining highly educated labour in the home country. This author, also, states that in order to realize those advantages, it is necessary to pay the attention to two key issues in the functioning of incubator: **financing** and **work organization.**

Namely, having in mind that financial means and donations oscillate during the work of incubator, the incubator manager has to engage himself in providing sufficient means for smooth work of the incubator. Therefore, it can happen that the criteria for entering the incubator are reduced or that the time allowed for spending in the incubator for those tenants who pay the complete rent is extended. Lewis states that because of that it is neccessary to find new ways of financing, and one of them is entering the ownership structure of incubator's tenants. In most cases, it is about new technologies that can provide a significantly greater financial effect for a long period.

## THE ROLE OF LOCAL AUTHORITY

Many authors have recognized the significance of local authorities in the process of local economic development. Čapková S. claims that „local authorities in the countries of Central and Eastern Europe have an important role in economic growth because the centralized authorities have, during the transition, transferred the signifiant property and other assets onto the local authorities. As the result of property restitution, many local authorities have become the owners of a significant part of property, where the municipalities have received the significant parts of urban land“ (Čapková S., 2005, p. 9)

Local authorities should have the key role in understanding the needs of entrepreneurs and other key participants, which would result in the creation of the best environment for the growth and development of companies.

While the identification of an „adequate“ role of local authorities is performed, we need to have in mind that there are two types of services that will control the development of SME:

1. Those provided by the authorities
2. Private services.

“The role of the state [would be]: establishing the attractive economic environment, correction of market failures and providing public services. The role of the state is not providing private services“ (Szirmai P, 2006, slide no. 13)

This brings us to the explanation of the two main concepts that are applied, and that are related to business incubation:

1. Market replacement and
2. Market development.

The approach based on market replacement includes high dependence on donor funds. “This approach enables the absorption of certain transaction costs, but they still remain significantly high“ (Bajmocy Z., p. 8).

Market development access „is focused on the development and sustainability of service market in the sense of market failures, so that thay can really reduce the transaction costs for a long period. (Bajmocy Z., p.8).

The second option includes the private capital in business incubators.

The government should create the environment that would enable the formation of this type of incubators, which would become self-sustainable and independent from the donors. This would be done through the creation of conditions such as the adoption of legal frameworks for public-private partnership projects, making the premises available, initiating the process of incubation.

Logical opinion would be that the only applicable model in Serbia would be the first one, due to the undeveloped service market, high transition costs of the second option, which we cannot afford. However, „many countries in development, with worse basic conditions, successfully implement the incubation programs that successfully deal with market failures“ (Bajmocy Z., p. 9).

The role of local authorities is not in sponsoring the market replacement, but in the creation of conditions for market facilitation.

Business incubators are considered expensive instruments of economic development. However, this statement can be taken into consideration only if the concept of market replacement is applied.

Answer to the question of how the local authorities obtain the adequate characteristics that will help them to become one of the major partners in the mentioned process, is in the transformation of bureaucracy into a modern model of organizing the structure of local authorities that will be able to recognize the „adequate“ support.

Increasingly, the modern local authorities assume the role of the facilitator and real partner of business sector, and therefore, by applying various measurments, the local authorities should enable an easier development and business, with the aim of providing support to the investments from which the whole community will have the benefits. (Grozdanić, E.)

Considering the above explained role of the local authorities in the process of economic development, all the activities, including those in the establishment of business incubators, should be done in partnerships with all the other key participants who work on the creation of a better business environment, economic growth and employment.

This necessity is emphasized, because the „local authorities are increasingly becoming aware of the fact that they do not have sufficient resources, skills or organizational foundations to meet the needs of economic growth in their areas" (Čapková S., 2005., p. 201).

However, partnerships will be created only if the relevant parties recognize their interests in participation in such an initiative, i.e. that the „founder" of business incubator recognizes his interest. This interest of the „founder" of business incubator is in the contribution to approaching the recognized mission and vision. This means that the „founder" of business incubator can only be an organization that has a long-term strategy for reaching self-sustainability and market orientation in providing business services and that „partner", i.e. local authorities recognize their interest in the creation of a favorable business environment.

## ADVATAGES AND DISADVANTAGES OF BUSINESS INCUBATORS

The most important question related to the work of business incubators in the world is can thay justify the funds invested in their establishment and work?

A simple and unique answer to that question is very difficult to provide. One of the approaches is to expose the advantages and disadvantages of incubators and try to evaluate if there is a justification for their work in that way. Most professionals who deal with the problems of encouraging entrepreneurship, state the positive effects that arise from investments in institutional support to the development of entrepreneurship. In the same way, the growth trend of business incubators number in many countries and their popularity have influenced everyone to think of incubators as very successful instruments for encouraging the development. Numerous authors have dealt with the advantages and disadvantages of business incubators.

Antal Szabo (Szabo, A. 2002.) emphasizes the following advantages of business incubators:

- Incubators can become long-term developmental factors for the society as a whole, especially through the assistance in economy of region diversification and increase of the number of employees,
- Incubators assist in the creation of the positive opinion on the entrepreneurial initiative, innovations, risk acceptance,

- Incubators, in most cases increase the level of entrepreneurs-beginners success probability,
- Great significance of incubators is also in the fact that the old and abandoned objects get a new role in the creation of conditions for entrepreneurship development.

Gwyer Schuyer (Szabo, A. 2002.) sees the advantages of business incubators work in the following way:

- Incubators create a positive entrepreneurial and innovative image of the society in which they act,
- Incubators promote the linking of small and medium companies, and raise their competitive advantage in that way,
- Incubators enable the openning of new workplaces and therefore, higher payments of contribution and taxes from which the work of incubators, i.e. budget is financed.

On the other hand, the entrepreneurs, who are not the tenants of an incubator, criticize the role of incubator as discriminatory, because only some and not all can use its support. Besides, the most incubators cannot be financed from their own incomes, and thus the funds from the budget of local or regional community, i.e. state funds are used, in whose recharging the largest share goes to the entrepreneurs who are not the tenants of an incubator.

In the context of the critical reflection on the work of incubator, the author David Lewis (Lewis, D. 2001.) states a several researches that were conducted in the USA among 500 companies, out of which a half were in some incubator, and which has shown that the tenants of incubator have a better success (better turnover and employment) but only when they are in the incubator, and afterwards there is no signicant difference in the business success.

However, many authors emphasize that there exist positive effects of incubators that are difficult to measure, such as, for example, raising the awareness of the importance of entrepreneurship and entrepreneurial culture of the society, importance of education and constant acceptance of new knowledge, i.e. creating the new possibilities for the local population.

Precisely these effects are considered very important for our conditions, since the long-term backwardness of our country concerning entrepreneurship trends in the world needs to be repaired, development of economy, which is in a difficult situation, needs to be accelerated, and new possibilities need to be presented to local communities.

Having in mind that new incubators are established every day all around the world, and that their establishment, to a significant extent, depends on the support of the society, state, politics, university, it is important to encourage such a support in our country as well, because it contributes for the public to realize that such initiative is positive and that it has to be further developed.

If there is no such support, giving up on the idea or closing the incubator can occur. For that reason, it can be said that a successful business of the incubator depends on its own ability to survive on the market, i.e. to have a sufficient number of clients included in the projects provided by the incubator.

In addition, it is necessary to publicly influence the change of the most common opinion of that the main role of business incubator is only renting the business space under more favourable conditions. Although that function is very important, merely renting the space cannot guarantee the sustainability of the incubator. Far more significant is the role of the capable management and the team that runs the incubator, which will result in the quality services that the incubator should provide for the tenants.

## CONCLUDING REMARKS

Expansion of the business incubators development in the world has brought valuable experiences on their establishment and work. Experiences of developed Western economies have already been used by the countries in transition and most of them acknowledge that private entrepreneurship is of a great significance for the economic development and that it represents a significant element in reform process. Among the institutions for development support, there certainly are business incubators, industrial parks and technological parks, which have shown themselves, on the examples of other countries, as efficient instruments for the support to entrepreneurs in starting business, for encouraging young companies and providing support for surviving during the initial period, when they are the most vulnerable. Business incubators are among the most significant instruments that can help the establishment of the new, sustainable companies on the local level. That is especially important because many companies and entrepreneurs, in the very beginning of their work, face the problem of lacking the initial capital, insufficient experience in managing a company and ignorance of the market, both in the terms of demand for the products offered and in terms of new, unknown markets.

The result of this is a very small number of newly-established companies, and indirectly, a smaller number of new workplaces on the local level. Incubators represent one of the solutions to this problem in terms of supporting the newly-established companies in all the aspects of their business. However, the establishment of business incubators must be observed in an overall context of economic growth and they have to be a part of a general strategy for economic recovery.

The significance and necessity for the establishment of business incubators in Serbia primarily results from the need to invest more rapidly in entrepreneurship development in all the aspects (legal, financial, institutional, educational…), and therefore, to create the possibilities for supporting each entrepreneur with a good idea, especially in the phase when he starts his own business and when he needs help the most.

Surplus of business space, equipment and qualified labour that exists in our country due to the process of restructuring the economy, is the opportunity to, with good organization and on a local and regional level, establish the centres for entrepreneurship development, which include the business indicators as well, and to accelerate the local development in that way. In that process, the university and scientific institutes have to be included in such projects, because they provide the possibility for entrepreneurship development to be based on new knowledge and technologies, which is also the fastest way to create a healthy economy based on knowledge.

What can be concluded by analyzing the previous experiences in establishing the incubator, as well as the experiences from the region, is that the future business incubators should be projected as centres for linking the research processes and small and medium companies, establish them on the basis of the partnership between public and private sector, choose a good management team, develop a business plan of the incubator itself and plan it as a sustainable project for the long period.

We have the task to make up the time and to, using already developed models of good practice (recognizing all the potential options), adapt them to the current conditions and thus set good foundations, evading greater mistakes.

We have already emphasized that a healthy company that is able to survive on the market is actually the main benefit of the local community from business incubator. Such companies positively and progressively influence the environment, primarily with the quality of their products and services. The role of business incubators in promoting the entrepreneurial spirit and entrepreneurial culture, which encourages the acceptance of responsibility for their own future, is significant. The work, self-employment is promoted as opposed to the previous periods and the habit to expect a complete social care and initiative for providing workplaces.

In countries that are in transition, such as our country, business incubators can give a strong impuls for creating new, sustainable workplaces. That is especially significant in the conditions when privatization and restructuring of the economy leave a great number of people without their jobs. Including in the modern, global trends of business incubation represents one of the ways of opening new possibilities for development, of both the region such as Vojvodina and the entire country.

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# CHAPTER 9. UNSUSTAINABLILITY OF THE CONSUMER AND NECESSITY OF THE INVESTMENT MODEL OF ECONOMIC GROWTH OF SERBIA

**Marinko BOŠNJAK**, Ministry of Finance Republic of Serbia

***Abstract***

*The new growth model requires a significant drop of aggregate private consumption share in available GDP, and increase of share of the domestic accumulation to encourage economic growth and job creation. In the same order it is necessary to direct additional accumulation from privatization, foreign capital (investments and loans), and factor income inflow to economic development instead of in current consumption. The new growth model as a big change in the development strategy and economic policy includes appropriate institutional adjustments and decrease of political and cognitive limitations on macroeconomic political stability and economic growth.*

***Key words:*** *old and new growth model, national accumulation as constraint, institutional and political limitations, decrease of consumption and increase of investment in distribution of GDP.*

## INTRODUCTION

Republic of Serbia, within ex Yugoslavia, in a social self-ruling system which functioned in the period from 1952 to 2000, applied an inadequate model of growth and a development strategy based on it, out of which an inadequate and inefficient economic structure dominated by energy, food and raw material production arose. The key consequences of such development strategy and economic politics were low-grade economic growth along with high rates of growth and big structural disproportions (1952-1980), economic stagnation (1980-1990) and economic recession (1991-2000).

The key indicator of the economic processes on the territory of Serbia in the second half of the 20$^{th}$ century is the efficacy of investments as growth of domestic product (concept of material production) to 100 dinars gross economic investments in basic means. The efficacy of investments (prices in 1972) in

Yugoslavia and Serbia in the period from 1952 to 1960 was 38.8 and 43.6, in the period from 1961 to 1970 was 26.8 and 26.0, in the period from 1971 to 1980 was 21.1 and 22.5, and in the period from 1981 to 1990 was -3.5 and -2.7. [46)] According to information from the Republic Institute for Statistics, the efficacy of Investments in Yugoslavia and Serbia during the nineties of the previous century crossed a deeper negative zone.

The concept, as well as the development strategy of Yugoslavia directed towards energy, raw material and food, has not changed much during the five decades of socialist planned-market economy. The built market structure was adequate for the determined development strategy and survived thanks to the closed market, price control and redistribution of income. Such economic structure, which requested high investments and high debts, relied on structure of use of social product, where investments in fixed (basic) funds contributed with 40%. The production capacities were built and used thanks to affordable loans and money expansion, with sustainable price stability. The built capacities could not return the invested means, thus making the accumulated foreign debt of Yugoslavia by the end of 1981 a total of 21.1 billion dollars. The foreign exchange reserves were drained, the credit rating was lost, and the service of debt was made impossible, i.e. there was a crisis of foreign liquidity of the country, financial transactions were blocked in 1982 and there were more arrangements with the IMF starting from 1983. In a situation like that the growth of the financial mass M1 was around 30 %, which made the inflation faster, with lack of financial adjustment. During the 80's, the social product was in stagnation, the participation of fiscal investments was reduced by half, and the technology was not renewed, while during the 90's, there was a huge drop of macroeconomic indicators and devastation of the economy.

After the stagnation of the economy and the crisis of foreign liquidity of the country during the 80's, there was the collapse of Yugoslavia and formation of FRY (Serbia and Montenegro) at the beginning of the 90's and economic recession during the 90's. The economy functioned in conditions of reduced market, sharp trade and financial embargo by the International community and bombing by NATO. During the decade, the financial and the real sector collapsed, and the country functioned by emission financing and social function of companies, whereas the foreign debt was inactive. The Republic Institute of Statistics calculated the gross domestic product (GDP) for 2000 as 11.9 billion euro, i.e. 1600 euro per inhabitant, which clearly represents the economic

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regression of Serbia. There were no investments and just half of the amortization was invested in the economy. The production capacities were quickly becoming obsolete and were not used due to lack of working capital. The industry was devastated with low share of production equipment in the total industrial production (around 5 %). Such state of the economy brought high surplus of employees who were not laid off, drop of salaries, pensions and living standard for the majority of the population, including the middle class. The foreign exchange savings of the citizens were devastated. The quality of education and health care was drastically reduced. More than several hundred thousands young people left the country, out of which 100000 educated people. The number of the Poor significantly increased.

Republic of Serbia, in the transition period from 2001 to 2008, made a faster average growth of the economy than the average growth of the world economy, yet slower than the total growth of the developing countries and the growth of some countries in the region. The growth of GDP in this period, calculated by the regular prices in 2002 was 5.4 % in average a year, whereas the growth of the countries of central and eastern Europe was 4.7 % in average. Slovakia marked a growth of GDP of 6.2 % in average, whereas Bulgaria marked an average of 5.6 %. The realized growth of investments in the period from 2001 to 2008 could not make up for the lack of investments during the 80's and 90's. Thereby, the structure of investments was not changed and the part of interchangeable goods, as well as part of export in forming GDP was not increased.

## UNSUSTAINABILITY OF THE CONSUMER MODEL OF ECONOMIC GROWTH

The undertaken economic reforms and politics in the transitional period from 2001 to 2009 did not solve the long term structural problems in the economy related to the participation of the sector of not interchangeable goods in GDP, high currency risk as a consequence of eurosation of the financial assets and their transfer to credit risk, high level of deficit of current account in GDP and high rate of foreign debt in GDP. These imbalances are a consequence of a model of growth based on domestic demand, where the income from privatization and credits was mainly aimed at consumption. Such model of growth is unsustainable and leads to balance of payment and debt crisis. It enabled overflow of capital in consumption, which brought pro-cyclic fiscal politics. The domestic demand grew faster (7.3 % a year) from the growth of GDP and satisfaction by surplus of import against export, i.e. deficit of goods and services. In the frames of total consumption, the state consumption grew 6.9 % a year, which is slower than the growth of household consumption (8 % ) and faster than the growth of GDP (5.4 %) a year.

The part of total consumption in GDP in the period from 2001 to 2008 was between 95-10 % of GDP, which brought a growing deficit in exchange of goods and services and a growing deficit of current transactions covered by foreign direct reserves and growth of debt. The reduction of the part of the deficit of goods and services in GDP, i.e. reduction of the negative net export in the use of GDP required a reduction of the part of domestic consumption for around 80 % of GDP, and it was not fulfilled.

The dominance of consumption and lack of domestic accumulation brought the situation that the dynamics and structure of economic growth in the first eight years of transition did not create new comparative advantage of Serbia in international exchange. The growth was not fast enough, especially the growth of gross value added GVA which was an average of 4.8 % in the period from 2001 to 2008. The more than average rates of growth of GDP in the sectors of transport, storage and connections (15.9% a year), trade sector (14.6 % a year) and financial mediation sector (9.3 % a year). These three sectors were the main components of economic growth. The sectors which produce interchangeable goods showed below-average growth, specifically agriculture 1.6 % a year, civil construction 4 % a year. With the slower growth in the sector of interchangeable goods, there was a reduction in the supply of goods for export and increase in the demand for import of goods, even with faster growth of domestic consumption than the growth of GDP, which increased the deficit of the current account. The investments did not provide an expansion of export of interchangeable goods which was necessary for servicing the foreign debt.

In the creation of GDP, according to the data from the Republic Institute for Statistics for 2006, 59.6% came out of the services sector, 29.1 % from the industry and construction, 11.3 % from agriculture and fishing. Serbia, at the end of 2008, had a 50.7% level of industrial production from 1990, which shows that the services sector was a generator of growth of the Serbian economy. In the creation of GDP EU 27, according to the data from 2006, 26.5 % came out from industry and construction. Many countries from Central and Eastern Europe have a more developed industry than Serbia. The participation of industry and construction in GDP in 2006 was 38.3 % in the Czech Republic, 35 % in Slovakia, 34.5 % in Romania, 34.1 % in Slovenia, 31.7 % in Poland, 31.5 % in Bulgaria, 30.7 % in Hungary.

The formed economic structure of Serbia is not favourable from the balance of payment point of view, as well. The underdevelopment of the sector of interchangeable goods led to a faster growth of import than export, growth of foreign trade deficit and deficit of current account and low coverage of import by export below 50 %. The foreign trade and current deficit in 2008 was 22.8 % and 17.8 % GDP, whereas in 2009 it was 16.5 % and 6.2 % GDP, due to the reduction of export of goods of 19.7 % and import of goods for 28 %, as a consequence of the global economic crisis.

Serbia, with the formed economic structure, could not provide net employment in the transitional period. The economic reforms did not bring higher employment rate. The employment dropped in the production sector, especially in the manufacturing industry, and grew in the services sector. The new owners of the privatized companies did not create employment opportunities, especially in the export-oriented sectors.

## NECESSITY FOR AN INVESTMENT MODEL OF ECONOMIC GROWTH

Serbia, after nine years of transition, needs a new investment model of economic growth which will be largely financed by the domestic savings, whereas the current model of growth is based on inflow of foreign capital in the form of loans and direct investments and inflow of single income from privatization.

The new investment model of growth means a change in the current economic structure, which, along with construction and modernization of the economic infrastructure, is an imperative, from the point of view of economic growth and employment, equality in the balance of payment and sustainable external stability. During the first nine years of the transition, an economic structure is formed where the services sector dominantly contributes to the growth of GDP, while the contribution from the production sector is small. The key carriers of the economic growth currently are the sector for transport, storage and connection, trade sector and financial mediation sector. The participation of these three sectors in GDP was increased from 18 % in 2002 to 30 % in 2008. The change of the formed economic structure requires a significant increase of domestic savings, investments, production and export from sector of interchangeable goods which are created in industry and agriculture. The creation of a new agricultural structure according to the concept of development based on knowledge and new technologies, with a higher participation of the sector of interchangeable goods in the formation of GDP required higher investments.

The economy of Serbia after the crisis will not be able to found the growth on inflow of foreign capital and higher consumption from production, and the inflation will not be able to be stopped by the overvalued dinar. The sustainable economic growth demands economic reforms and politics aimed at reduction of consumption and prevention of overvaluing the dinar through the growth of the value of dinar in real expression, not economically based. With that aim, it would be desirable that in time of crisis, the depreciation rate would be a little higher than the inflation rate, the country debt would not cross 80 % GDP due to the reduced inflow of foreign capital, the domestic consumption would grow slower than the domestic production, and thus the deficit of the external sector would be brought to sustainable level which can be financed from the reduced capital inflow. It would be necessary in short and medium term to reduce the consumption of the public sector and go from fiscal deficit to surplus, which would require a reform of the public sector. It would be necessary for the private sector to slow down the growth of consumption by slower rate of loans and profit of this sector. The real depreciation would reduce the domestic consumption and import, and increase domestic production and export, with reduction of foreign deficit.

## NEW MODEL OF GROWTH AND ECONOMIC POLITICS

The investment model of the economic growth of Serbia demands changes in the economic politics and end of the institutional and structural reforms which improve the business and investment climate in the country in order to encourage domestic and foreign investors to invest in production in the export oriented sectors of the economy, with sequential rationalisation of all expenses on all state levels because of the reduction of public consumption as a key limit to the economic prosperity of Serbia.

In the transition period the macroeconomic stability and growth were based on significant net inflow of foreign direct investments (12.4 billion euro) and foreign loans (12.7 billion euro), as well as fast growth of domestic demand (over 7 % a year). The establishment and sustainability of macroeconomic stability and growth of the economy mean a responsible monetary and fiscal politics which both the National Bank of Serbia, as well as the Serbian Government should lead independently from political (election) cycles. So far, at the time of elections, there was an extensive monetary and fiscal politics, which brought increase of consumption, employment and production in short-term, but led to increase of inflation, stagnation of production and increase of public debt mid-term.

The implemented reforms of the real sector, including privatization, bankruptcy and liquidation of state companies did not provide a development of export oriented sectors and increase of employment. Another factor that led to that was the business incompetence of the owners of the privatized companies and their inability to create new jobs and new employment opportunities, as well as insufficient number of quality new-founded companies and firms as generators of production, export and employment. On the other hand, the slow bringing of laws and bylaw acts and their weak application, the insufficient capacity of executive and legal authorities and the powerlessness of the economic politics to provide incentives to export sectors and productive employment, not stimulating business environment and political instability, discourages business people and investors to do economic and investment activities.

The new growth model means changes in the monetary and fiscal politics. The National Bank of Serbia, over the currency politics and interest rates politics contributed to higher inflow of foreign investments in the country and debts of households, companies and the country abroad. The expansive fiscal politics also contributed to the instability of the currency rate. The new growth model requires a new currency politics, as well as interest and new fiscal politics, which encourage increase of savings and reduction of consumption, as well as investments in production export oriented sectors.

The new model of growth demands a correction of the monetary politics and politics of the currency rate in the focus of which there is the currency stability and consequently, price stability. The most important measures of the monetary politics applicable for the new model of growth would be moderate realistic depreciation of the dinar which contributes to export increase and reduction of foreign trade deficit, and which would not put pressure on inflation and currency rates, targeting the price stability and currency rate, taking into the account the liquidity and financing the economy; monetary measures which contribute to the creation of stimulating the environment for financing the export sector of the economy and infrastructure. The current sustainability of the stability of the currency rate brought to real and even nominal appreciation of the dinar in certain periods. The currency politics should strengthen the export sector which could reduce and eventually eliminate the payment imbalance. It would also be necessary to prevent excessive depreciation of the currency rate which would increase the inflation pressure and credit risk of the debtor who pays debts with currency clause, including the payment of the foreign debt of the country.

In the focus of the new fiscal politics, applicable to the new growth model, it would be necessary to reduce the public expenditure and bring its participation in GDP between 35 % and 40 %. The most important measures of the fiscal politics which contribute to the realization of those aims are: fiscal incentives for foreign and domestic investors who invest in the export sector of the economy and infrastructure and by doing so contribute to the economic growth of the country, employment, technological and regional development and environment protection; reduction of the overloading of work expenses with taxes and incentives, restructuring income taxes and property from the point of view of justice and incentives, suppression of grey economy and corruption. At the same time, it would be necessary to improve the conditions for attracting investments from all sources in the economic growth of the country, especially in the export parts of the economy and infrastructure. Such politics lead to the formation of new economic structure whose basis would provide stability and economic growth and increase of the employment increase, as well as the living standard.

The new model of growth also implies active structural politics aimed at sustainable growth of Serbia based on the growth of domestic savings, increase of productivity and improvement of competitiveness. The other reforms would provide strengthening the private sector through privatization of the rest of the companies with social and state capital, strengthening the competition, efficient bankruptcy activities, support of small and middle companies, support of technological and other innovations, as well as through the reduction of the public sector and increase of its efficacy (state administration, public services and state companies).

Prior to that, Serbia must get over the consequences of the economic crisis and provide recovery of the economy, as well as to match the expenditure to the production capacities. Moreover, Serbia must strengthen the banking sector to increase the domestic savings and to encourage the economy to increase the productivity and competitiveness. At the same time, Serbia must reduce the public expenditure through a sharp fiscal adjustment in short-term and mid-term and to balance the public income and public expenses by 2015. With that aim, it would be necessary to harmonize the social protection system with the needs and possibilities of the mid-developed market economy and to implement the necessary reforms of the pension and tax system. Thereby, the priorities are protection of expenses of the poor classes and continuation of investments in construction and sustainability of the national infrastructure.

## THE NEW MODEL OF GROWTH AND DEVELOPMENT STRATEGY

Serbia needs a new development strategy adjusted to the new growth model, compatible to the new development strategy of EU: Europe 2010, which was preceded by the Lisbon strategy of 2010. The new EU development strategy gives directions for economic growth of EU in the next decade. It is called European strategy for intelligent, sustainable and comprehensive development in the next 10-year period and would be the starting point for different politics and programmes realized by EU.

The principles of the development strategy Europe 2020 are: 1) development based on knowledge and innovations 2) efficient use of resources and “green economy” favourable for the environment and 3. development which provides higher employment rate and social and regional cohesion.

The main numeric directions of the economic development of EU till 2020 are: increase of the employment rate from 20 to 64 years from 69 % to 75 % in 2020; increase of the participation of the expenses for research and development in GDP with 1.9% to 3 % in 2020; reduction of the emission of gases for at least 20 % in relation to the level in 1990; that at least 20 % of the energy would come out of renewable sources and that at least 20 % of the energy would be saved by the increase of energetic efficiency; reduction from 15 % to 10 % of people who drop-out of school early and increase of the participation of young people who have tertiary education from 31 % to 40 %,, that there would be less than 20 million people below the poverty boundary in comparison to the current 80 million people.

The realization of the set aims of development of EU by 2020 would be based on EU development programmes, including: the programme “Innovative Union” with the aim to encourage the application of innovation; the programme “Youth in Movement” with the aim to improve the education and employment of young people; the programme “Digital Agenda for Europe” with the aim to spread the use of fast internet and use the potential of a single digital EU market, the programme “Resource efficient Europe” with the aim to reduce the resource dependability of economic growth and encourage the application of renewable energy sources; the programme “Industrial Politics in the Globalization Era” with the aim to improve the business environment and to support the industrial development in the global market match; Agenda for new skills and businesses with the aim to modernize the job market, including the mobility of the employment power and to promote life-long learning, the programme “European Platform against Poverty” with the aim to increase the quality of life as an effect of economic growth and to prevent social and territory problems in EU.

The development aims of EU by 2020 determine the key directions of development: research and development, knowledge based economy, economically acceptable technology, energy efficacy, spread of benefit of the economic growth. The realization of the development goals asks for commitment and responsibility of each member state for the fulfilment of all the aims of development in the second decade and better informing of the economy and inhabitants about the aims, instruments and effects of the new development strategies of Europe in 2020. The key limitation for the realization of the set development aims is the necessity for rehabilitation of the consequences of the global financial and economic crisis from 2007 to 2010.

Serbia, as the EU members, prepares a new development strategy for the period from 2010 to 2020, compatible to the new Development strategy: Europe 2020. In the focus of the Serbian strategy in the second decade of the 21 century it would be necessary to put the export. Republic of Serbia has a relatively low level of export of goods and services measured by the participation of the goods export in GDP, despite the fast development of export in the period between 2001 and 2008, with average annual rate of 21 %. The main reasons for that are low competitiveness of the domestic economy, non-diversification of the export, low prices of the export products on the world market, unfavourable structure of export of goods with dominating participation of products with low level of processing within which raw material and semi-products dominate. The lagging behind of the sector of interchangeable goods in the past nine years of transition unfavourably affected the level of export, as well as the fast development of import based on the higher domestic demand due to fiscal and credit expansion. The Serbian economy, in the past transitional period, based the development on the services sector, not developing the interchangeable goods sector, especially the industry sector. Consequently, the income from services was higher than the income from export of goods.

The Serbian economy as a relatively small and not sufficiently developed economy with model development resources mist be export oriented with developed sector of interchangeable goods (agriculture and industry). The higher level of export is necessary because of several reasons: (1) the domestic, relatively small market cannot provide an economy of a scale as key condition for strengthening the competitive position of domestic companies on the world market and (2) it would be necessary to provide import growth because of the lack of basic production input on the domestic market and lack of domestic goods and services for satisfying the consumer demand.

Within the development strategy of Serbia, export orientation and increase of the participation of export from current 20 % GDP to over 50 % GDP would be significant. In the development context it is represented as a necessary condition for the increase of domestic production, employment and total service of the foreign debt. The high foreign imbalance is a consequence of the structural changes and significant inflow of capital. The establishment and preservation of foreign macroeconomic balance means that Serbia should strengthen the economy and increase export in mid-term. With regard to the competitiveness and level of export, Serbia lags behind the advanced transition countries and countries from the region. Beside the low competitiveness, the Serbian export is characterized by unfavourable sector structure dominated by products with lower phase of processing, which requires the export potential of the economy to be increased, first of all in the processing industry, as well as to increase the finalization of products in export.

Having in mind that the Serbian export is not on a level which could provide sustainability in the movement in the foreign sector beside the higher levels of growth, it would be necessary to increase the production and geographic diversification of the export programme and establish an efficient system of export support, including the special incentives for inflow of export oriented foreign direct investments.

## NEW MODEL OF GROWTH AND REGULATORY MECHANISMS

The sustainable development of Serbia means establishing regulatory mechanism in the democratic society and market economy which limit the power of the state. The privatization with the economic-systematic adjustments reduced the power of the state in Serbia, and strengthened the private ownership and entrepreneurship. The role and responsibility of the state are reduced to creating a favourable environment for the economy, which means establishment and development of a legal system, protection of ownership and other rights, protection of contracts, financial discipline, functioning of an independent and professional judiciary system, as well as incorporating the country in wider economic-political integrations.

The state works within formal, as well as informal limits set by Institutions, customs, values, tradition, culture. [47] Formal limits are under state control and could be replaced, whereas the state has not control over informal limits, they change slowly through the evolution flow. It would imply that the institutional development is partly under the influence of the state, and in that part, some long-term regulatory institutions could be developed. Thereby, the political system of a heterogeneous society imposes limits which disable the creation of new institutional arrangements for the regulation of economic flow or modification of the existing ones, i.e. they slow down the institutional development. The national, ethnic, religious, cultural and economic heterogeneity of the Serbian society causes tardiness of reforms and slow institutional adjustment. Taking into account that political and institutional adjustments are more difficult to be directed and fulfilled and thus limit the leading of current economic politics with numerous measures and actions. The functional lack of performance of political mechanisms and processes generate difficult consequences of political decisions for which the system is responsible, and not the actors who participate in it (state of economic subjects). They are limited by real (resources and technologies) potentials, i.e. technology and scarce resources, as well as the governing institutional limitations, including the motivation conditioned by them which sets adequate activity. Countries with developed institutions have higher growth and increase of standard even when resources are scarce, which represents the importance of institutions which generate real incentives for their allocation and use. Institutions can compensate the lack of resources, technological solutions and production knowledge, by stimulating the creation and economic use of new knowledge in a production-technological system, as well as economic freedom for development of entrepreneurship.

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[2] Look at two newer books by professor Ljubomir Madzar: Economic Politics in from of the Challenges of Limited Regulations and Lack of Dimension in the Evaluation of Microeconomic Performances, Ministry of Finance, Belgrade, 2008 and 2009

Institutional changes remove even bigger system defects (for example, privatization) because of the increase of resources allocation or improvement of formulation and realization of economic politics. They demand a longer period of implementation to be better prepared and successful, especially in decentralized political processes and processes of institutional adjustment, which demand enough knowledge and social consensus. Huge institutional changes are done by rule when the system does not function satisfactorily and when they are difficult to be conducted, so the causes of crisis are removed with delay, and not small macroeconomic losses come out of it. Institutional stability and consequently stability of the economic politics is a precondition of successful functioning of the economy. The economy suffers damage if there are often unprepared institutional changes due to adjustment of the current economic situations. The institutional instability reduces the coordination and increases the expenses to the actors of market processes because of the often adjustments to the current situation.

A big change of the political system and institutional order of Serbia happened in October 2000. Nine years after it, there is no established adequate political mechanism with regard to the perception (expectations) of the public. The governing elite at the time was not efficient enough in the significantly changed and suddenly established environment. There are different remaining limitations, including political and wider social limitations, since the political relations are not consolidated, because the society was exposed to frequent and deep political changes and the domestic order is not consolidated. The frequent changes of the governing elite are an inefficient performance of functions in the newly established political and social system.

The society in Serbia is in many aspects heterogeneous and difficult to be managed. The economic politics in the presence of political, institutional and resource-technological limitations could not be effective. The governing limitations must be taken into account in the evaluation of the economic politics. The unfavourable institutional and social circumstances reduced the macroeconomic performances. The undeveloped regulatory system applicable to the democratic society and market economy is a huge limitation to the economic and developed politics and technologically unpropulsive and structurally unadjusted economy as a controlling object. In a macroeconomic environment of that kind, the state is unsuccessfully meddling in the economic processes and does little about construction and development of the legal system, by strengthening the judiciary system and protection of contracts and human rights. It spends money of tax payers on socially irrational activities without the capability to contribute to the removal of limitations of the economic politics and economic subjects. The creation of the institutional conditions should be in the focus of the activities of the country, so that individuals and actors of the economic processes in conditions of competition with individual work and entrepreneurship could solve business and life problems, without irrational expectations that the state would solve them for them.

The particular interests of the actors of the political processes limit the functioning of the state in general interest, and the regulatory mechanisms are inefficient with regard to the macroeconomic stability and development of the economy which is currently technologically stagnant and structurally imbalances. In an instable political milleau and institutional order of the macroeconomic performances are under the social needs and resource availability. The dysfunctional institutional arrangements which are maintained in a particularistic political system disable efficient direction, regulation and governing with the Serbian economy. The limitations in regulatory system reduce the impact of the economic politics which is registered by state statistics. The state would have to initiate and contribute to the removal of governing limitations in order to achieve economic efficacy as a whole, in accordance to the identified development possibilities of the country.

# CHAPTER 10. TOWARD A NEW GROWTH MODEL OF THE MONTENEGRIN ECONOMY

**Milenko POPOVIĆ**, Montenegro Business School, Mediterranean University, Montenegro

***Abstract***

*In the new world of the Washington consensus, small countries have been advised, encouraged, and, not rarely, pushed into the growth model in which direct foreign investments (DFIs) are regarded as a sole or at least the main engine of growth. All South East European countries are small and all of them have accepted this view on growth and development. Being the smallest among them, Montenegro can serve as the best possible example for the research of characteristics and consequences of this kind of the growth model. This research revealed that the Montenegrin growth had indeed been driven solely by the movement of DFI. The period from 2001 to the end of 2008 was the period of permanent increase in GDP induced solely by DFI. Not only the growth rate, but the whole macroeconomic position of Montenegro was determined by this variable. In fact, the Montenegrin economy is so addicted to DFI that, without it, it is not possible to keep even the basic macroeconomic stability in our economy. In contrast to the development of the foreign economic structure, our own economy has stagnated if not declined. A part of the economic structure has been destructed and fragmented as a result of an inappropriate model of privatization and corruption based on it. On the other hand, the small, imperfect, and shallow market was not able to generate further growth of domestic economy. Firstly, our market is not able to generate new business ideas and in this way increase absorption capacity on the side of investment. Secondly, our market is not able to coordinate some very important complementary industries, like agriculture and food industry, electricity and aluminium production, construction industry and skill formation for construction industry, and so on. Finally, we have a peculiar relationship between the labour market demand and the demand for educational services, which can produce a lot of other economic problems. We definitely need a new growth model, the one which is able to attract greenfield and hi-tech foreign investment, on the one hand, and the one that is able to generate development of our own export-oriented and import substitution-oriented economy, where reasonable, on the other hand. Needles to say, development of own economy is the main part of this new growth model. Even more importantly, it assumes an* *active industrial policy of the state. Firstly, this policy should be oriented to building the architecture of knowledge which is able to increase generation of business ideas. This architecture is made of universities, R&D in larger companies, incubators, clusters, business centers, and similar. Secondly, the financial system should be completed in order to help realization of business ideas developed in that way. Thirdly, coordination of complementary activities, where not done properly by the market, should also be supported by the government.*

***Key words:*** *growth model, foreign direct investment, market failure, active industrial policy*

## SOURCES OF GROWTH OF THE MONTENEGRIN ECONOMY

1. One recent tentative research (Popovic, 2009) on the sources of growth of the Montenegrin economy has revealed that total factor productivity (TFP) had a negligible influence on the growth rate of the economy in the period 2000-2008. As the results in Table 1 show, the relative contribution of total factor productivity, which can be taken as a measure of broadly understood knowledge, is only around 6%. The results contrast sharply with prevailing experience which shows that the relative influence of TFP on GDP growth in countries with similar level of development should be between 30% and 40% (Madison, 1987, 1995; Bosworth and Collins, 2003).

**Table 1. Sources of growth of the Montenegrin economy, 2000-2008**

| | **Sources of growth** | **Coefficient *a* and *b*** | **Rate of growth** | **Absolute contribution** | **Relative contribution in %** |
|---|---|---|---|---|---|
| A | Employment | 0.67 | 2.10 | 1.41 | 27.39 |
| B | Capital formation | 0.33 | 10.33 | 3.41 | 66.34 |
| C | T F P - residual | | 0.32 | 0.32 | 6.27 |
| | Total / GDP | 1.00 | | 5.14 | 100.00 |

*Source:* Popovic, M. (2009)

An earlier research on the Montenegrin economy (Popovic, 1990) for the period 1965-1985 revealed almost the same anatomy of growth. As Table 2 shows, contribution of a broader knowledge measured by TFP was even smaller – only 4.1% of the overall growth. The rate of growth of GDP was also almost the same – 5.2%.

**Table 3. Sources of growth of the Montenegrin economy, 1965-1985**

| | Elements | 1965-1975 | % | 1975-1985 | % | 1965-1985 | % |
|---|---|---|---|---|---|---|---|
| 1 | GDP | 5.23 | 100.00 | 4.97 | 100.00 | 5.10 | 100.00 |
| | Capital formation | 2.38 | 45.5 | 2.00 | 40.2 | 2.19 | 42.9 |
| 3 | Employment | 2.28 | 43.6 | 3.13 | 63.1 | 2.70 | 53.0 |
| 4 | T F P | 0.57 | 10.9 | -0.16 | -3.3 | 0.21 | 4.1 |

*Source:* Popovic, M. (1990)

2. When we decompose the influence of employment into the parts that measure the influence of "raw" labour and the influence of educational efforts made to sustain the existing level of education of the growing labour force, the overall influence of broader knowledge becomes a bit larger. However, when we subtract from the measure of TFP improvement of the educational structure of labour force, we get a smaller contribution of residual, which can now be regarded as a measure of the influence of applied knowledge on the rate of growth.

**Table 3. Influence of education and applied knowledge on the Montenegrin economy, 2000 do 2008**

| | Elements | Absol | % | % | % |
|---|---|---|---|---|---|
| A | Improvement of educational structure | 0.18 | 3.59 | 11.59 | 19.38 |
| B | Efforts to sustain the existing level of education | 0.62 | 12.25 | 39.56 | 66.16 |
| C | „Raw“ labour contribution | 0.79 | 15.47 | 48.85 | |
| D | B+C | 1.41 | 27.72 | | |
| E | A+B+C | 1.59 | 31.41 | 10.00 | |
| F | Capital formation contribution | 3.41 | 66.34 | | |
| G | Applied knowledge contribution | 0.14 | 2.68 | | 14.46 |
| H | A+B+G | 0.95 | 18.52 | | 100.00 |
| | GDP (E+F+G) | 5.14 | 100.00 | | |

*Source:* Popovic, M. (2009).

As we can see from Table 3, the total contribution of education, the sum of row A and row B, is significant and it accounts for 15.84% of the growth rate of the economy. This contribution is mainly made of efforts made to keep the existing level of education of the growing labour force – 12.25%. The influence of improvement of the educational structure of labour force is less important –

3.59%. It is quite understandable, given that the educational structure changes very slowly, mainly through the improvement of educational structure of new generations of younger and more educated workers. A relatively large total contribution of education in Montenegro is quite understandable given that, due to small employment opportunities, young people tend to be very eager to invest in education.

The finding that the contribution of applied knowledge is negligible is much more significant. By applied knowledge we understand the knowledge that is embodied in new physical capital and the new organizational structure of companies. This part of the growth rate is only 0.14% and it accounts for only 2.68% of the growth rate of the economy.

Similar conclusions apply to the anatomy of the growth rate for the period 1965-1985. As we can see from the following table, the only difference is in the contribution of education, which is in this period a bit lower due to the fact that the wage premium for the higher education group was much lower.

**Table 4. Influence of education and applied knowledge on the Montenegrin economy, 1965-1985**

| | **Elements** | **1965-1975** | **%** | **1975-1985** | **%** | **1965-1985** | **%** |
|---|---|---|---|---|---|---|---|
| A | GDP | 5.23 | 100 | 4.97 | 100 | 5.10 | 100 |
| B | Capital formation | 2.38 | 45.51 | 2.00 | 40.24 | 2.19 | 42.94 |
| C | „Raw“ labour | 1.72 | 32.89 | 2.35 | 47.28 | 2.03 | 39.80 |
| D | Educational structure improvement | 0.44 | 8.41 | -0.60 | -12.07 | -0.08 | -1,57 |
| E | Efforts to sustain the existing level of education | 0.56 | 10.71 | 0.78 | 15.69 | 0.67 | 13.14 |
| F | Applied knowledge | 0.13 | 2.49 | 0.44 | 8.85 | 0.29 | 5.69 |

*Source:* Popovic, M. (1990)

The main conclusion regarding the sources of growth analysis is that the contribution of both TFP and applied knowledge is very small and almost negligible. This conclusion applies to both periods of the analysis. This is a puzzling finding indeed, especially bearing in mind that in other countries with similar level of development these elements have much bigger contribution and influence on the economic growth.

3. Apart from obvious institutional differences between two periods, there are some common characteristics that, in fact, explain a low level of TFP and weak contribution of knowledge to the economic growth. Firstly, in both periods,

accumulation of physical capital originated from external sources. In the first period, it was the Yugoslav Fund for Development of Undeveloped Areas, which used to contribute with 40% in the Montenegrin total final expenditure (individual, public, and investment). In the second period, it was direct foreign investment (DFI), which used to be larger than gross investment in physical capital. The second common characteristic is that all investment was directed toward those sectors that rely heavily on natural resources. Those sectors are characterized by a low level of value added and a low level of technological progress. It, in fact, explains a low level of TFP. In the first period, investment was directed toward development of tourism, energy production (capacity in production of electricity), metal complex (primary aluminium and steel production), forestry and wood-processing, construction industry, and similar. In that way, the basis for development of industries with higher value added and higher technological progress was established. Instead of developing an active industrial policy to support this direction of development, our government opted for "non-interventionist" approach and started to believe that market knows everything and can solve everything. As a result of this market fundamentalist approach, we witnessed strong development of tourism and real estate and construction industry related to development of tourism. Needless to say, this development was the result of large inflow of DFI that we had in the last decade. Other sectors of economy were fragmented, destructed or at least neglected. It is how and why, even in the last decade, we had a low level of TFP and weak influence of knowledge on the economic growth.

## DIRECT FOREIGN INVESTMENT AS A SOLE ENGINE OF GROWTH

1. Direct foreign investment is the main, if not the sole, engine of growth of the Montenegrin economy. It can easily be seen from Table 5 that interdependence between GDP rate of growth and DFI is most obvious if we compare dynamics of gross and net DFI (rows 2 and 3 of Table 5) and dynamics of GDP (row 5 of the Table). Correlation is so obvious for the whole period 2000-2008 that we do not need a more powerful tool to prove it. An exception is the last year of crisis in which we recorded a maximal amount of gross DFI and a negative GDP rate of growth (-5.3%). This time, large DFIs are a result of partial selling of the Montenegrin electricity system and of large investment of foreign banks in their affiliations in Montenegro. It was a part of the crisis management policy of the Government and banks rather than the result of autonomous inflow of DFI in the country as it was the case in the previous years.

**Table 5. Dynamics of gross and net DFI and financial account**

| | In million euro | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|
| 1 | Financial account | 12.01 | 68.47 | 304.45 | 572.63 | 1,061.41 | 1,330.21 | 537.86 |
| | Index in % (previous year) | | 567 | 447 | 188 | 185 | 125 | 40 |
| 2 | Net DFI | 38.73 | 50.57 | 380.92 | 466.70 | 557.71 | 551.71 | 910.91 |
| | Index in % | | 131 | 747 | 123 | 194 | 99 | 165 |
| 3 | Gross DFI | 43.80 | 52.65 | 392.72 | 644.33 | 1,007.68 | 832.10 | 1,068.40 |
| | Index in % | | 120 | 746 | 164 | 156 | 83 | 128 |
| 4 | Gros investment in physical capital | 201 | 286 | 326 | 470 | 684 | 820 | |
| | Index in % | | 142 | 114 | 144 | 145 | 120 | |
| | [(3)/(4)]x100% | 22 | 18 | 120 | 137 | 147 | 102 | |
| 5 | GDP Index | 102.5 | 104.4 | 104.2 | 108.6 | 110.7 | 106.9 | 94.7 |

*Source:* The Central Bank of Montenegro

The fact that in the whole period, except for the first two years, gross DFIs are larger than the investment in physical capital is even more convincing support for this hypothesis. As we already noted in the previous section, a great part of those investments were investments in real estate related to development of tourism. The other part of gross DFI is mainly related to the selling of our companies to foreign entities (Telecommunication system, Electricity system, Jugopetrol, KAP, Zeljezara Niksic, and so on).

2. Not only the growth rate of GDP, but the movements of all other macroeconomic aggregates have been strongly determined by the movement of DFI. This is not surprising, bearing in mind not only the size of the economy, but also the fact that Montenegro accepted the German Mark first and then Euro as its currency by the end of the last century.

First of all, constant, more than a decade long, trade account and current account deficit was possible only because of a large surplus of net DFI and financial account. It can easily be seen from Table 6 that, due to inability of domestic production to follow the increase in total spending (row 5 of Table 6), caused by the increase of DFI, import of goods increased dramatically. So did the trade deficit and current account deficit.

In the last year of crisis, the trade account and current account deficit dropped dramatically as a result of decrease of financial account, discussed earlier, caused by the economic crisis.

**Table 6. Relationship between curent account deficit and GDP**

| | In million of euro | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|
| 1 | GDP | 1,510.10 | 1,669.80 | 1,815.00 | 2,149.00 | 2,680.50 | 3,085.60 | 3,003.00 |
| 2 | Current account deficit | 102.09 | 119.64 | 154.04 | 531.21 | 1,007.64 | 1,564.29 | 896.27 |
| 3 | Goods deficit | 359.37 | 416.44 | 513.65 | 849.32 | 1,524.18 | 2,082.34 | 1,371.50 |
| | 3.1. Export of goods | 270.57 | 452.15 | 460.65 | 648.33 | 627.72 | 467.38 | 296.28 |
| | 3.2. Import of goods | 629.94 | 868.58 | 974.30 | 1,497.65 | 2,151.89 | 2,549.72 | 1,667.78 |
| | (3/1)x100% | 23.8 | 24.9 | 28.3 | 39.5 | 56.9 | 67.5 | 45.7 |
| | (3.1./1)x100% | 17.9 | 27.1 | 25.4 | 30.2 | 23.4 | 15.1 | 9.8 |
| | (3.2./1)x100% | 41.7 | 52.0 | 53.7 | 69.7 | 80.3 | 82.6 | 55.5 |
| 5 | (1+2) | 1,612.19 | 1,789.40 | 1,969.00 | 2.680.2 | 3,688.1 | 4,649.9 | 3,899.3 |
| | (5/1)x100% | 107 | 107 | 108 | 125 | 138 | 151 | 130 |

*Source:* The Central Bank of Montenegro

3. The budget position was also strongly determined by movement of DFI (see Table 7). As we already saw, the increase of DFI was followed by the increase of import which, on the other hand, increased taxes generated from it. These taxes dominate in the structure of public revenue. For example, in the period of expansion, value added taxes (VAT), generated from imported goods, accounted for 85% of all VAT. Later when, as a result of the crisis, import of goods declined, a share of VAT from imported goods also dropped to 60% in the total VAT revenue. As a result, shares of VAT in the total public revenue dropped from 50% in 2006 to around 34% in 2009. The consequence is the movement from positive position of budget in the years of expansion to deficit position in the year of crisis 2009.

**Table 7. Movement of budget suficit / deficit**

| Description in million / Period | 2006. | 2007. | 2008. | 2009. | plan 2010. |
|---|---|---|---|---|---|
| Deficit/Suficit of public sector | 63.21 | 178.25 | -12.11 | -106.45 | -140.62 |
| % share in GDP | 2.94 | 6.65 | -0.39 | -3.54 | -4.51 |
| Deficit/Suficit of budget with state funds | 71.50 | 176.14 | 15.12 | -69.1 | -133.19 |
| % share in GDP | 3.33 | 6.57 | 0.49 | -2.30 | -4.27 |

*Source:* CB CG (2010)

The same cyclical movement can be noticed when we consider the public debt of Montenegro. It first dropped from 38.5% of GDP in 2005 to 27.5% of GDP in 2007 and then sharply increased to 38% at the end of 2009.

4. The financial sector is also predetermined by DFI. The movement in the banking sector can be seen from Table 8. The increase of DFI induced an enormous increase of assets, deposits and credits from 2003 up to September of 2008. The total asset increased 10 times. In the same period deposits increased 11 times, while credits increased 14 times. Credits expansion was especially dramatic from the end of 2006 to September of 2008, when the total amount of gross credits increased by 2 billion euro. Credit expansion was far larger than what investment capacity of the economy would allow. As a consequence, a lot of credits were, most probably, bad credits.

The economic crisis caused a withdrawal of deposits, which dropped from 2,326 million in September 2008 to 1,991 million at the end of 2008, and then decreased a bit more at the end of 2009. This decline in deposits was compensated by an increase of loans on the side of liabilities and by an increase in capital in the last year. This increase of bank capital by foreign banks that are owners of domestic banks, as another important part of DFI, was part of the banks' crisis management. On the whole, credits declined from 2,852 million in September 2008 to 2,398 million at the end of 2009.

**Table 8. Aggregate statement of the banking sector**

| | **In million euro** | **2003** | **2004** | **2005** | **2006** | **2007** | **Sep08** | **2008** | **2009** |
|---|---|---|---|---|---|---|---|---|---|
| *1* | *ASSET* | *350* | *444* | *696* | *1,431* | *2,975* | *3,510* | *3,310* | *3,025* |
| | Money and deposits | 96 | 108 | 267 | 512 | 664 | 593 | 473 | *529* |
| | Credits, gross | 201 | 281 | 376 | 847 | 2,246 | 2,852 | 2,797 | *2,398* |
| | Reservations for credits losses | -7 | -11 | -14 | -19 | -52 | -81 | -111 | *-150* |
| | Credits, net | 194 | 270 | 362 | 828 | 2,193 | 2,771 | 2,686 | *2,247* |
| | Securities | 16 | 23 | 17 | 26 | 18 | 18 | 19 | *69* |
| | Other assets | 46 | 45 | 51 | 66 | 101 | 136 | 140 | *186* |
| | Reservations for losses on other assets | -3 | -3 | -2 | -1 | -1 | -8 | -8 | *-6* |
| *2* | *LIABILITIES* | *350* | *444* | *696* | *1,431* | *2,975* | *3,510* | *3,310* | *3,025* |
| | Deposits | 211 | 273 | 488 | 1,076 | 2,091 | 2,326 | 1,991 | *1,825* |
| | Loans | 27 | 60 | 80 | 172 | 536 | 778 | 908 | *735* |
| | Other liabilities | 23 | 21 | 21 | 35 | 111 | 123 | 131 | *132* |
| | Capital | 89 | 91 | 106 | 149 | 237 | 283 | 279 | *332* |

Source: *The Central Bank of Montenegro*

Cyclical movements at the stock market were much more volatile. It is quite natural, bearing in mind that the Montenegrin stock market is weak and shallow.

The number and value of transactions in different years can be seen from Table 9. Figures speak for themselves and do not need special comment.

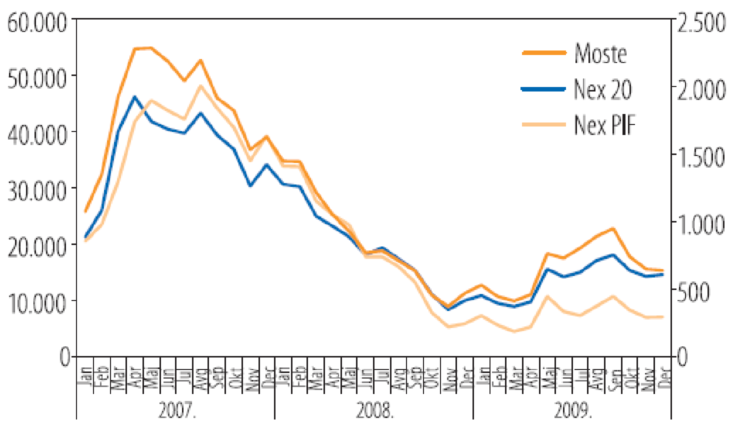
**Tabela 9. Turnover at the ontenegrin stock markets**

| Year | Turnover in mil. eur | No. of transactions |
|---|---|---|
| 2001 | 10.8 | 909 |
| 2002 | 14.3 | 4,293 |
| 2003 | 43.5 | 21,323 |
| 2004 | 42.8 | 57,920 |
| 2005 | 198.4 | 111,053 |
| 2006 | 377.0 | 114,073 |
| 2007 | 727.0 | 224,637 |
| 2008 | 160.3 | 83,348 |
| 2009 | 405.8 | 58,778 |

*Source:* CB CG (2010)

The movement of the stock price was even more volatile. Graph 1 speaks for itself. The stock market reached peak in the middle of 2007. It is exactly the year when DFI in real estate was the most dramatic. After that, the stock market dramatically declined up to the end of 2008, and then mildly increased in 2009 due to the selling of the electricity system of Montenegro.

**Graph 1. Indexes of the Montenegrin stock markets**




5. The main problems with the growth model in which DFI presents the main engine of growth are as follows:

- The first problem is related to a negligible amount of greenfield direct foreign investment, which is one of the most important sources of knowledge transfer from the most developed economies. Greenfield investment increases the level of technologic knowledge, not only via direct transfer of knowledge, but also via the effect of spillovers, which may be even more important than direct transfer of knowledge. This is a partial explanation of a low level of total factor productivity.
- The second problem is that almost all DFIs arrive as a result of the selling of domestic resources. In the beginning, they mainly arrived from the selling of domestic companies. Later, especially in 2006 and 2007 they dominantly arrived from the selling of real estate. The growth based on the selling of domestic resources is problematic because it is, obviously, not sustainable in the long run. It is also followed by faster growth of GDP and slower growth of gross national product (GNP). We have no measure of GNP for Montenegro, but it is obvious that this model of development implies slower growth of GNP. In other words, the value of all incomes earned in Montenegro used to grow much faster than the value of all incomes earned by the Montenegrin citizens.
- Thirdly, this kind of a growth model makes the economy very unstable and volatile. The Montenegrin economy is volatile by its nature. As a small economy, which has a great share of tradeables, it is very sensitive to shocks coming from the international trade. However, relying mainly on DFI makes the economy even more volatile. There are two additional sources of its volatility induced by DFI. Firstly, DFI initiated development of mono-cultural economy by being directed mainly toward tourism and related real estate development. Secondly, being a residual variable by itself, DFIs are more volatile than trade. Therefore, an economy based on DFI is even more volatile. In fact, we can say that the Montenegrin economy is addicted to DFI. Without DFI it is not able to keep even the basic macroeconomic stability.

## DETERIORATION OF DOMESTIC SECTORS OF ECONOMY

All those problems that arise from DFI wouldn't arrive if we developed our own sectors of economy. The basis for development of much more diversified and much more productive domestic economy was established in the previous period of development. As we noted, in the period 1965-1990, the basis for further development of tourism, agro complex, metal complex, energy production, forestry and wood-processing, construction industry, and similar was established. In that way, the basis for development of industries with higher value added and higher technological progress was established. Our trade and current account deficit would be in a much better position, the economy would be much more diversified and, in that way, less vulnerable to external shocks, much higher level of employment would be generated, and so on. If it is so, the crucial question is: what were the problems that obstructed such development of domestic sectors of economy. In what follows, we will discuss some of the main reasons for retardation, if not destruction, of domestic economy.

1. One of the most important impediments for the development of domestic economy was, contrary to all expectations, an inappropriate model of privatization and corruption developed on it. The initial model of privatization established by the last Prime Minister of SFRY Ante Markovic can now be evaluated as a very good for our situation in several respects. Most importantly, it was based on the idea to make the existing, implicit and nontransparent property rights immanent to self-managed firms, explicit and transparent. The main vehicle for this transformation was the so-called “internal” shares sold under symbolic prices to employees. As such, it was widely accepted by all social segments. It was especially welcomed by the management structure and employees in companies. Secondly, it almost instantly improved the motivational structure of companies. Finally, corruption was less likely to develop within this framework due to the lack of principal-agent dichotomy which is a prerequisite for corruption. The problem with privatization started in mid-nineties when decisions on privatization were shifted from the level of companies to the level of the government. In this framework, the principal-agent dichotomy opened widely and, as a consequence, corruption started to flourish. A huge amount of production surplus was diverted from productive usage (investment) to private pockets. Big companies and systems were fragmented and destructed. New owners were not able, and very often even not interested, to reestablish and modernize their companies. Instead, they used their resources for quite different purposes, like the usage of land for real estate development, for example.

2. Other reasons for underdevelopment of domestic sectors of economy are related to the fact that the small and incomplete Montenegrin market was not able to generate development from its own disposable resources. The most important problem that we have in this respect is a low level of generating business ideas. There are several reasons for this.[48]

The first reason is related to the fact that in Montenegro we now do not have large companies and systems that are a natural place for development of new business ideas.[49] In the process of privatization some of our large companies that used to

[48] This is acording to Hausmann, Rodrik, and Velasco (2004) one of the most important characteristic of majority of other small, underdeveloped and developing countries.

[49] For different arguments explaining this phenomenon, see Schumpeter (1942), Galbraith (1978) and Williamson (1985).

be able to do this job, were fragmented and weakened. Their research institutes were closed. Others were sold to foreign companies, not interested in developing business ideas in Montenegro. They are now part of their own business matrices and not part of the Montenegrin economy. They are almost like foreign structures built in Montenegro for their own purposes. KAP, Zeljezara Niksic, Agrokombinat 13 Jul, Elektroprivreda Crna Gora, SIK Crna Gora, and similar are only some most obvious examples of large systems that once used to be able to develop new business ideas. We now do not have any single company with its own research institute or a research and development center.

Secondly, development of new business ideas is followed by spillovers, as a special kind of externalities. Our development of new business ideas is mainly related to diffusion of advanced technologies from abroad and to their modification for domestic purposes and domestic business environment. So, our business ideas are not protectable by property rights (patents and similar), because they do not have elements of technological novelty. Nevertheless, their introduction can produce huge social benefits. The problem here is that, due to spillovers, they are usually not profitable to their investors. We have a situation where private rates of return on investment in development of business ideas are much lower than social rates of return, and, as a consequence, propensity to invest in their development is very low.

Finally, the new Montenegrin business elite, that earned their first millions during the period of war, by smuggling tobacco and drug and doing similar businesses, was not either able or interested to develop business ideas. Their entrepreneurial efforts are now mainly oriented toward rent seeking and similar kind of businesses. Not only is their capital not involved in production and realization of new business ideas, but they contribute very much to development of business environment which is highly inappropriate for business development.

As a consequence, absorption capacity on the side of investment is very limited and cannot swallow free financial resources in an appropriate manner. In that respect, paradigmatic is the situation that we had in the peak of growth, from 2005 to the last quarter of 2008, when a huge amount of money in hands of our citizens from the coastal area, earned by selling real estate, ended again in real estate, this time in Podgorica, and on the stock market. All this produced an enormous increase in the real estate and stock market prices. This price increase made an illusion that real estate and securities are good investment, people continued investing in the same way. Both markets, as we know, dropped dramatically at the end of the drama.[50] All this would not have happened if we had had enough business ideas to direct disposable saving in.

[50] For more detailed analysis of those episodes of the Montenegrin economic growth, see Popovic (2008, 2009a).

3. The second problem with our market is its inability to coordinate some complementary activities. The most obvious example is related to its inability to coordinate agriculture and food processing industries. Capacities of food industries are much smaller than the demand of the Montenegrin market and therefore we import a lot of food industry goods. On the other hand, those capacities are larger than what the Montenegrin farmers can offer, and consequently we import agricultural products as well. All in all, Montenegro's import of agricultural products and food industry products is above 230 million euro.

The main problem is obviously underdeveloped farming and deterioration of villages. Village life and farming are not attractive for young people. Existing farmers are those that still have not managed to find an appropriate place in the cities. Not only is the market unable to solve this problem, but we can say that market "arbitrage" caused the problem. In order to develop agriculture, we need to make the farming activity attractive to young people. In that respect, it is necessary to target all elements of equation that determine the present value of farmers' lifelong expected net benefits. Monetary cost and benefits are only part of this equation. Even much more important parts of this equation are those that refer to nonmonetary costs and benefits (access to schools, communal services, cultural life, marriage, other particular reciprocity relations, and so on). It is the main reason why programs aimed solely at improving farmers' monetary benefits have not been successful. Apart from that, those monetary programs (subventions and similar) have not been strong enough, systematic, long-term, and reliable to attract people for this activity and for village life as a destiny.

What we need is an active industrial policy in this industry, a policy that will target all elements of farmers' welfare equation. This policy should be very comprehensive and innovative. In fact, this policy should be directed toward reinventing the Montenegrin village, especially in the northern part of Montenegro. Bearing all that in mind, it is obvious that revitalization of our farming and villages will take at least a couple of decades. Only with this policy we can develop our agriculture, make it competitive and reduce the import of agricultural products. Similarly, only with this policy we can give space for further development of food industry and the reduction of the import of its products.

4. Our market is also unable to coordinate production of electricity, primary aluminium and production of downstream aluminium industries. Cheap energy is a prerequisite for profitable production of primary aluminium. The existence of primary aluminium in Montenegro is on the other hand a prerequisite for development of downstream aluminium industries, which are much more profitable and technologically advanced than the production of primary aluminium. However, privatization of KAP and the electricity system and

introduction of the market price for electricity will make production of primary aluminium unsustainable. Without it, we will not be able to complete the chain of this metal complex, which is, as a whole, very profitable.

The only way to coordinate those industries is to keep the electricity system as well as production of primary aluminium under the state control, as state-owned companies. In that case, it would be possible to provide cheap energy to KAP, a producer of primary aluminium, to have certain losses in production of electricity, but to more than compensate these losses by high value added earned through production of products based on primary aluminium. The other way to solve this problem - development of downstream industries within KAP- is not likely to emerge. Firstly, the owner of KAP is not here to develop the Montenegrin economy, but his own system. Secondly, this kind of development requires time and investment for which the existing owner of KAP is most likely not interested.

5. A similar problem of coordination can be seen between educational outputs provided by the secondary educational system, on the one hand, and demand for labour of this level of education, on the other hand. Montenegro has a high level of unemployment at the level of secondary education (17%) and at the same time Montenegro “imports” a huge number of workers with secondary education. In the last several years about 30,000 to 40,000 workers from neighbouring countries worked in Montenegro in the construction industry, and about 15,000 to 30,000 in tourism.

The main explanation for this phenomenon offered so far is that our secondary education system offers an inappropriate structure of output. This is, however, only one side of the story. Another part of the story refers to the demand for different professions at the secondary level of education. To support this viewpoint, we can mention that in the last decade the State Employment Agency has offered different vocational training programs aimed at increasing a number of workers able to work in construction industry and tourism. However, the interest for those programs has been very weak.

So, we have to explain a negligible interest for those professions, especially bearing in mind that in the period before transition, the interest for respected professions was large indeed. The main differences between two periods that explain this phenomenon lie in the industrial organization of those industries. Construction industry companies, for example, used to be large companies, able to signal long-run profitability of respected professions and reduce the risk related to volatility of their earnings. In new circumstances – private construction industry – our shallow and incomplete market was not able to develop appropriate industrial organization that might signal profitability and iron earning volatility of respected professions. New construction industry companies are characterized by a small number of full-time employees and a large number of part time and seasonal workers. A lack of appropriate industrial organization able to signal obvious long-run profitability and reduce earnings volatility in construction industry is, therefore, responsible for a weak demand for those professions. The situation is similar with professions for tourism industry. So, what we need is an active industrial policy that might help development of appropriate industrial organization of those industries.

6. We have similar problems with higher education as well. There is a huge demand on the side of students for professions related to the social and humanitarian science, especially economics and law, and a small demand for technical sciences. This is not a new thing. The education system of the Montenegrin University has had overproduction of social science graduates since the beginning of the seventies. The new thing is that now we do not have the broader Yugoslavian, mainly Serbian, labour market to swallow those surpluses. Within several years the market will signal that this kind of investment in education has been very unprofitable. We do not need, however, to wait several years in order to check if the market is going to send those signals. It is already an obvious thing, and the government should have an active role in the enrolment policy of the state-owned university. What we have here is quite the opposite. The state-owned university is, with its enrolment policy, the main generator of an emerging bubble on the market for economists, lawyers, and similar professions.

## A NEW GROWTH MODEL: PILLARS OF AN ACTIVE INDUSTRIAL POLICY OF THE STATE

In order to develop our domestic sectors of economy and to attract greenfield foreign investment in high-tech industries we need an active industrial policy of the state, a policy that will be able to complete the incomplete market and to substitute the market where it is inefficient. What follows are the pillars of that industrial policy.

1. Firstly and most importantly is to build *the architecture of knowledge*. In other words, with all reserves regarding the quality of our knowledge, we can say that we have more than enough knowledge for development of our economy, but that we do not have any organization of this knowledge. Building of this organization is the most important part of a new growth model, firstly, because it targets the problem of generating business ideas, which is the most severe developing limitation of the market, and, secondly, because it has a strong relaxing influence on all other limitations of the market discussed earlier.

Reorganization of *the State University* is the first and the most important part of this rebuilding of the knowledge architecture. At the moment, our State University functions as a teaching university. As we all know, even this function is not being performed in an appropriate way, and the first task, therefore, should be directed toward reorganizing its teaching function. Secondly, and more importantly, the State University should finally start developing its research function which is at the moment of negligible magnitude. This research function should be directed toward projects that are relevant for solving development problems of the Montenegrin economy and society in general. Of course, the main sources of financing, at least in the beginning, should be from the budget. At the moment, we in Montenegro, spend only 0.04% of our GDP for research and development. The EU target is 3%. In order to fulfill this research function, the University should have its own research centers for certain strategic research areas. In that way, two organization schemes would exist, a teaching and a research scheme, as well as two sources of financing, budget resources for education and resources for research.

The second part of the new architecture of knowledge is a set of *regional incubators* or business centers (seven to eight). Their main task will be to develop new business ideas in the area that they cover. Given financial and other limitations of our small companies, those centers should be financed from public resources. Needles to say, they should be connected among themselves and they should share the data base regarding new business ideas. This data base of business ideas should also be publicly available to all interested parties. Incubators should, of course, be connected to the University research centers. This collaboration can take all different forms that the real life can induce.

The third part of the knowledge architecture is a set of *industry clusters* organized in different areas of the economy. They should be organized around different industries, and their main task should be to improve marketing capacities of existing small companies. Apart from that, they should also be engaged in development of new business ideas for existing companies that are members of clusters. Given a small financial capacity of our small companies, the clusters should be, at least for a certain period of time, financed from public sources. The same as incubators, they should be connected to the University research centers. Also, they should be a part of broader regional clusters.

Finally, certain big or at least propulsive and dynamic companies should be given a public mandate, and public resources, to develop business ideas and business in general in the area of their expertise. Giving this mandate to some food producers in the north of the Montenegro can be of great importance for development not only of food industry, but for development of farming as well. KAP, as a state-owned company, on the other hand could have been given a mandate not only for development of business ideas relevant to KAP, but for development of the whole aluminium downstream industries as well.

We have already mentioned that Montenegro spends only 0.04% of its GDP for research and development. It is in accordance with our previous finding that TFP and applied knowledge have negligible influence on our economic growth. The EU standard of 3% of GDP, that is about 100 million of euro, is far from our reach. The reason for this is not so much in the lack of public resources, but predominantly in the fact that we do not have the absorption capacity on the side of research and development activity for such an enormous sum of money. Our real measure at this moment is around 1% of GDP, which is around 30 million of euro. These resources are also above the mentioned absorption capacity. We now need this amount of money to enlarge our absorption capacity by building this architecture of knowledge. Later, when we improve our absorption capacity, we can afford an increase of R&D spending even to 3% of GDP. In the first couple of decades, the sources of money for this development would be mainly from public resources. It is only in the future that we can expect an increase of the companies' share in R&D.

2. It is not enough to have business ideas. Their implementation requires support of an appropriate financial system. Banks are usually not interested in small and new business ideas. Other kinds of financial institutions are necessary for this purpose.

In Montenegro we already have the Development Fund whose purpose is exactly to support new and small business. However, this fund still does not have a strategic role in our system. Firstly, in order to get this role it should be financially much stronger. Secondly, in order to be much more supportive it should give loans under much more favourable conditions. The interest rate should be much smaller than now, although it is already below the market level.

We should also take a look at possibilities to develop other financial institutions for this purpose (venture funds and similar).

3. *Agriculture and Food industry coordination* should also be supported by the state. Note that, the above mentioned development and implementation of new business ideas can, by themselves, be of great importance in relaxing this market constraint. A lot of this development is supposed to take place in the north of the state. This is supposed to revitalize the cities in the north and to improve their "supply". This, in turn, will make the living in neighbouring villages more attractive. Companies developed in this area are also supposed to increase demand for farmers' products and to support their development in other ways (business ideas development, financial and technical support, and similar).

Apart from that, the state should make a lot of other efforts in order to coordinate development of farming and food industries and to initiate development of villages. Before that, we need a serious long-term strategy for development of agriculture and villages. This study should provide two sets of measures that are supposed to be taken. The first one is a set of measures that target a monetary part of farmers' welfare equation. The second one is a set of measures that target nonmonetary part of farmers' welfare equation. Once those sets of measures are defined, they should be carefully and seriously performed.

4. The state should also take a role in coordinating production of *electricity, primary aluminium, and aluminium downstream industries*. In order to do this job, the state should keep production of energy and primary aluminium within state-owned companies and coordinate their activity as we already explained. The electricity system is still predominantly owned by the state and should stay that way. KAP, a producer of aluminium, is already privatized, but since the "strategic" investor has not fulfilled any serious promises from the privatization contract, especially those related to investment, there is a good reason and justification to return it under the state control.

This is the only way in which we can solve the problem of coordination of these two complementary activities. A low price of electricity and losses incurred in that way would be more than compensated by high value added earned from development of aluminium downstream industries. In order to make this possible it is, as we noted, necessary to develop a research institute within KAP. The institute will develop a new line of businesses within the company itself, but will also have a public mandate to develop business ideas that would be implemented outside the company. This will bring us to the completion of the aluminium complex in the way that is economically and socially productive and justifiable.

5. It is also of strategic importance to coordinate the development of *construction industry* and the whole complex of industries related to it. First of all, it is reasonable to expect a huge quantity of construction works in Montenegro in the next 3 to 4 decades. They are related to all kinds of construction works: infrastructure development (Bar-Belgrade highway, electricity systems, water supply systems, and similar), tourism facilities (at the coastal area and later in the northern part of Montenegro), and residential apartments in all cities. It is simply unacceptable to leave this enormous amount of work to foreign companies and foreign workers. On the other hand, this is a good chance to develop our own construction industry complex able to go abroad, once this huge domestic development is stabilized. Furthermore, construction works have been through the economic history regarded as a good place to direct public resources aimed at having anti-cyclical effects during the economic crises. The reason is that this course of action has a strong multiplicative effect on the whole economy. We do not have this complex of industries completed and we cannot expect planned infrastructure works to produce any multiplicative and anti-cyclical effect soon. We are too late with this for the ongoing crisis.

We already know that the shallow and small Montenegrin market is not able to manage coordination of the construction industry complex in an appropriate way. Even larger economies are not able to manage this job in the area of infrastructure development. This is the reason why many countries have state-owned companies in infrastructure development. This is exactly how Montenegro should develop this part of construction complex. Furthermore, for other areas of this business, (building of tourism facilities, residential apartments, and similar) the state should help the existing construction industry companies to find and build market mechanisms able to signal long-run profitability of construction industry professions. This is the only way to increase demand for these professions and to increase their supply on the labour market. Only in that way can we develop a completed construction industry complex.

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# CHAPTER 11. QUALITY OF ECONOMIC GROWTH OF SMALL AND OPEN ECONOMY

**Besim ĆULAHOVIĆ**, Faculty of Economics, University of Sarajevo, Bosnia and Herzegovina

## INTRODUCTION

In seeking answers to the many unknown things that are related to growth and development of a country we will encounter a number of questions to which we must find a convincing answer, but also we will face numerous dilemmas that must be considered from many aspects. Some of these are typical questions as: Where do the present development of humanity and its social and main geographic agglomeration go? Is the world running to its end yet in this millennium? Have the old development paradigms gone to history and whether new paradigms are emerging that will dominate in this millennium? Does the reliance on extrapolation of trends from the past means repeating of the past? It seems better to look for some new engines of growth and development which would generate better and happier future for the mankind.

The current human civilization lives ranging from great wealth to extreme poverty. On one side of the world there is a large number of hungry or malnutritioned people, one billion people have no access to clear drinking water, 1 / 3 of people live in homes without basic sanitary facilities, and because of illness caused by contaminated water over 10,000 children die every day. On the other side of the world, in rich countries, the main health problems are the result of excessive abundance.

Huge differences in welfare between countries and regions in the world are a mystery, which should be uncovered in the analysis of the development of some small and open country. Why are some countries so rich, and others extremely poor? Should it really be so? Can factors that influence the creation of wealth and poverty be identified and modified in order to avoid making of enormous difference between the rich and the poor? Or, why in most countries of the world the post-war "virus" of growth has not had any effect, and why they had become ever poorer? Indeed, which sources of growth and development and which factors produce such divergent experiences?

Analysis of previous international experience may confirm how wrong the persisting premise is that small and open countries should follow the models of development of large countries and their development strategies need to adapt to the dictates of the development of large players. And the current wave of globalization proves the same, for the deeper globalization is, the more important local component of growth becomes. It is not difficult to prove that small countries have a greater chance of developing than medium and large countries. But the smaller the country, the more open it must be, more competitive, innovative, free, honest, brave and attractive.

In fact, the most important tools of economic growth are stable democracy, elitism, willingness to challenge, daring, small, efficient, educated and honest government, more freedom to conduct business, creation of competitive niche and competitive areas, and the corresponding parallel development of social sphere and the sphere of welfare .

Economic history of the world can easily verify the above thesis about the greater developmental capacity of small states. Until the mid-1500s, Italy - land of free cities-states was aggregately the richest country in the world. Germany its current leadership position in Europe owes to the free Hanseatic cities. Holland, then a small country, overtook Italy in 1564 and remained the leading position until 1836. Belgium, also a small country, was the first continental country that was industrialized. Switzerland was the second next industrialized country, which a small mountainous country, without conventional natural resources, just before World War II achieved the highest living standards in Europe and in the last quarter of the 20th century in the whole world [1].

And the post-war examples of small countries (Luxembourg, Iceland, Singapore, Hong Kong, Taiwan) can only strengthen our argument. From these and similar examples it is evident that the most fundamental factor in economic life of a country or region is its specific location and cluster nature of the most important economic activities.

Given the arguments and statements set in the paper, factors that must be taken into account when designing a long-term strategy for the development of small economies would be discussed in details, which are primarily related to the substance and production of welfare as well as the main factors of economic and social growth and development. Then the need for creating and implementing a new development paradigm is elaborated, and the main issues are analyzed which must not be ignored in creation of a new development philosophy. Finally, relevant conclusions and recommendations are given.

## FACTORS OF WELFARE AND ECONOMIC GROWTH

### Processes and dimensions of new theories of economic growth and development

Analysis of the existing growth theories indicates that all the recent theories of economic growth are increasingly moving away from traditional analytical tools and areas and limits of economic growth in order to cover all the important social goals such as reducing poverty, improving quality of life, increase opportunities for better education and health, etc.

New growth theory does not exclude environmental issues, particularly those which will be the turning point for many of humanity's most important issues such as population growth, food security, lack of water, climate change, preservation of cultural values and diversity, etc. They do not exclude any contemporary forces that reshape developmental stage of humanity, such as technological innovation, globalization and localization, the dissemination of knowledge, aging of population, the financial interdependence of the world and the growing need for greater political and human rights.

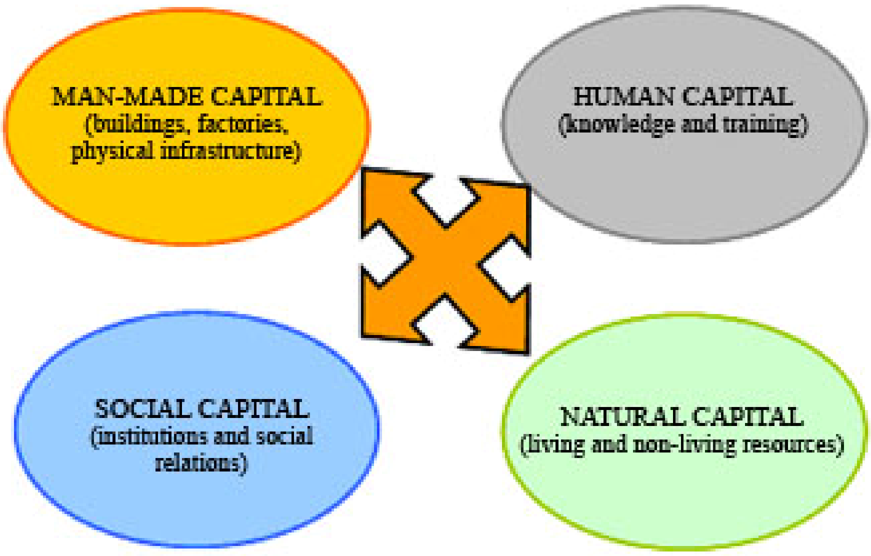
every process of economic growth has its own qualitative and quantitative dimensions. Their relationships determine the quality of growth and the growth of prosperity. Therefore the quality of growth is based on three key principles: (i) - balanced development of all development factors, i.e., all types of capital, (ii) - concern about the distributional aspects of welfare during the entire period of growth and (iii) - building an institutional framework for managing growth processes.

But before we define the concept of developmental factors (resources), we should take a more detailed look into and define the concept of needs, which are major determinants of sustainable growth and development.

The concept of "needs" is much broader than consumption per capita, which is now often used as a measure of human welfare. The desire for a clean and healthy environment, and priorities relating to equality and social development, are also part of the concept of needs. The needs and desires of people vary with respect to time, the type of social group and type of culture

Meeting the social needs depends on the availability of different types of growth factors that will further be referred to as capital. One of the conditions for achieving sustainability in meeting the needs is that the total sum of different kinds of capital (human, natural, built, social) that makes up the production base of mankind (see Figure 1), does not decrease in real time [3].

**Figure 1. Production base of mankind**




Well-being is not so simple as the concept as it may appear at first sight. In the heart of it there is economic prosperity, but also welfare consists of civil liberties, relative freedom from crime, cleaner environment and state of mental and physical health of individuals.

Amartya Sen distinguishes "social skills" of people, i.e., the ability of individuals to choose and achieve those life goals that best suit them (work, leisure, political, and cultural activities), which cast doubt on the classical philosophy of development that the growth of economic output is the only development aim of mankind [4]. The realization of social abilities of people is a very important category for broader measurement of their human and social development. Human welfare is much larger than the simple sum of the welfare of every man, because it includes both individual and social priorities of achieving equality, the possibility of achieving civil liberties, a fair distribution of resources and the possibility of permanent learning

## Economic well-being and sustainability

Economic well-being as a result of economic output is very important component of welfare. However, the concept of GDP as standard measure of economic output has significant limitations. GDP shows the current consumption and investment goods and services that are calculated in the national accounts, but not the value non-market activities, results of social preferences from the basis of gender equality and the activities conducted in the field of conservation of natural resources in order to facilitate the realization of some future prosperity for some future people. Also, the concept of GDP involves the value of the goods and services that essentially do not produce wealth (‘regrettables"), such as income arising from environmental pollution, corruption and crime as well as costs that do not directly create prosperity, but are necessary for its achievement (e.g. national security) [5].

To understand the essence of well-being one needs to know values that vary between individuals and social groups. Also, numerous technical difficulties should be understood in methods and ways of measuring of different dimensions of welfare, since many subjective aspects of well-being (level of social satisfaction and the level of personal well-being) are difficult to accurately identify and measure. In addition, in the process of defining social needs of different groups of civil society and their evaluation it is necessary to make certain estimates and assumptions. For example, some levels of income inequality are desirable because they provide incentives for better work, meet the priorities of individuals under a certain lifestyle, place of residence, profession and work-life balance.

The capacity to meet social needs and achieve well-being is affected by many factors that are associated with four types of capital that make up the production base of humanity, as well as their complex interactions. These four different types of capital can be defined as follows:

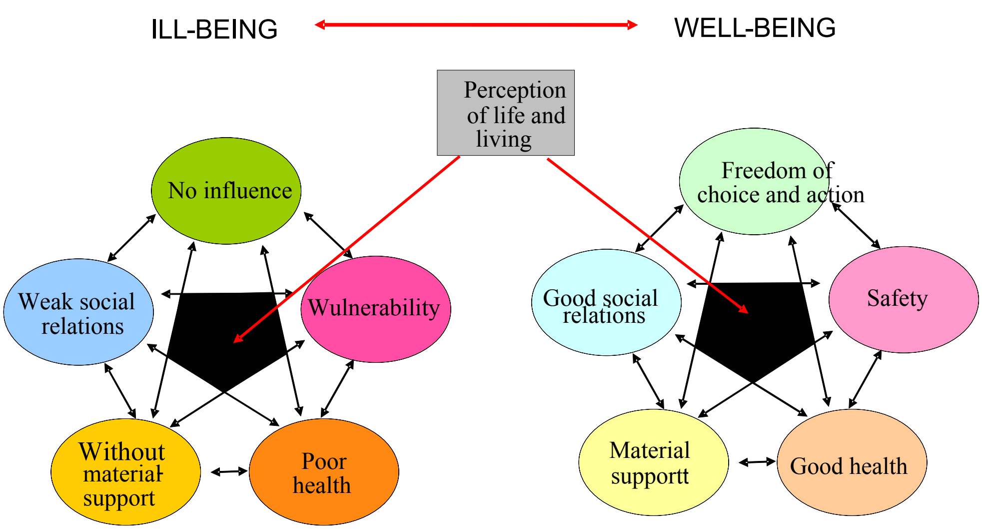
- Physical (manufactured, made, man-made) capital: produced assets in production, such as, for example, machinery, equipment and buildings, but also non-production infrastructure, intangible assets and financial assets that provide management of current and future flows of outputs;
- Natural capital: renewable and non-renewable natural resource which enter production processes and meet the needs of consumption and environmental assets that provide enjoyment and productive use and which are essential for systems that support life;
- Human capital: education, training, competencies and attributes possessed by humans, which facilitates the creation of personal, social and economic well-being [6];
- Social capital: networks of assigned norms, values and understanding that facilitate cooperation in and between different social groups [7].

Economists who deal with problems of creating welfare agree that welfare includes basic material needs for a good life, liberty, health, personal safety and good social relations, which, together, provide conditions for achieving physical, social, psychological and spiritual pleasure of people. Some of the leading theoreticians of the welfare distinguish between the means for achieving prosperity and its constituent elements. According to them the welfare is experience, i.e. human value [8].

Determinants of the means of achieving wellbeing are most commonly used as inputs for goods and services that ecosystems provide (food, fiber, fuel, clean water, building materials, crop, livestock, forest products and minerals). Lack of determinants of welfare and its constituent elements causes poverty. Welfare and poverty are the two extremes of the continuum. In its annual report on the development for 2000/01, the World Bank defines poverty as "pronounced deprivation of welfare" [9].

Expression and perception of welfare and poverty depends on the situation or context of local, social and personal factors such as geography, ecology, age, race and culture. Although the concepts of welfare and poverty are complex, some of their elements are so widespread that they became even universal. This universality is especially evident in the "voice of the poor", through which poor people from many countries are trying to illuminate, analyze and express their ideas about bad and good life [10].

**Figure 2. Main dimensions of well-being and ill-being**




Main dimensions and interconnected components of welfare and poverty (see Figure 2) are as follows [11]:

- material resources needed for life (safe and adequate maintenance, income and assets, enough food for life, shelter, furniture, clothing and access to resources);

- Health (strength, feeling good and healthy physical environment);
- Good social relations (social cohesion, mutual respect, good gender and familial relations, the safety of children and the ability to provide assistance to other people;
- security (secure access to natural and other resources, security of persons and property and life in a predictable and controlled environment that is safe from natural and human disasters;
- Freedom and possibility to choose (control over the events and the ability for recognition of your own work and personal values).

These five dimensions of welfare and poverty are either positively or negatively mutually reinforced. Changes in one dimension often cause changes in other dimensions. Hatched areas in the figure represent the experience of life and living (livelihood), including stress, pain, and concern about bad life, serenity and spiritual experience in good life.

In this multidimensional formulation of welfare and poverty mutual positive or negative interactions are all networked. For example, on the one hand, poor people are vulnerable to diseases, which make them even poorer, and poor social relationships make people more vulnerable to shocks which deepen material poverty, all of which leads to further poverty. On the other hand owning material goods reinforces the physical strength, allowing better life, good social relations provide security for the stresses and shocks, and this increases the security of material prosperity, all of which strengthens freedom of choice and freedom of action. Therefore, economic growth and economic development can be observed as a gradual and sustainable improvement of welfare.

## Implications of the sustainability concept on development paradigms

There are no other elements that might cast doubt on the need for creating new philosophy of growth in small and open economy. Specifically, the differences in the achieved level of development are in fact differences in the strategies of use of capital which they had at their disposal, as well as differences in the quality of their general and sectoral policies

Systemic view on the creation of welfare shows that at the input side of welfare there is natural and physical capital and human and social capabilities of human (knowledge, training and health of individuals) and social capital, which are in constant interaction with political, institutional and legal system of the country. On the one hand, there are direct relations of human and social capital with the natural and physical one, on the other hand, there is strong complementarity between human capital, social capital and the political, institutional and legal organization of the country. Good and quality institutions, highly educated and trained workforce connected to networks that facilitate social cooperation encourage more investment in physical capital and strengthen the restoration of devastated natural environment. To achieve prosperity and good economic performance, health of people is a very important input, because the prosperity and good economic performance are related to the age of the people, their lifestyles, social status, education, social connections and interpersonal support.

However, distortion of the general and sectoral policies, corruption, poor management, market imperfections and external factors (negative component of social capital) caused uneven and non balanced accumulation of physical, natural and human capital (resources), which reduces the rate of economic growth and reduces the potential for achieving sustainable prosperity. In such circumstances the level of total factors of productivity is reduced, sub-investments are made in the all types of capital (reducing the profitability of investment, failure in physical allocation of investments, favouring areas such as defence and basic infrastructure, the regressive allocation of public spending, underestimation of taxes, rents, royalties and weak regulations to maintain the quality of natural resources), overinvesting in physical or human and natural capital, etc.

Unfortunately, only a small number of countries are able to connect all types of capital in a logical framework within which the climate can be created necessary for sustainable growth. In some other countries, which by robust reforms (liberalization of trade, capital markets, labour and other markets), attracted massive private domestic and foreign direct investments, investments have been a vital instrument for increasing yield, especially physical capital

However, in the absence of complementary investments in human and social capital, this way of expansion of physical capital, as a rule, led to declining yields and consequently to reduction of the growth dynamics. Also, measures to attract FDI are in the global capital market, intensified competition among countries and exhausted domestic private entrepreneurial sector, which in the long run, proved counterproductive.

Many economists argue that differences in economic performance between societies can be better explained by differences in institutions and policies that these institutions undertook, more than by cultural factors. But culture also affects the ability of societies to build these institutions and to manage them. Culture affects economic behaviour by creation of social network. Different influence of cultural values on the network of social relations is, in fact, the basis for the concept of social capital. Social capital consists of norms and values shared by people and groups that promote cooperation and trust between people. Social capital, like physical and human capital, is the source of well-being [12].

## NEW DEVELOPMENT PARADIGM

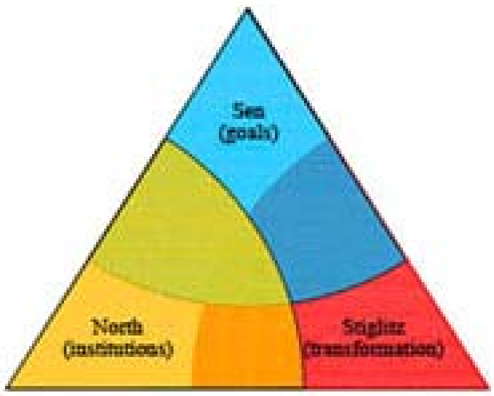
### Needs for new development paradigm

As never before, the future of mankind has not been marked by issues which only one country can solve or one group of countries. Climate change, bird flu, financial instability, terrorism, the waves of migrants and refugees, lack of water, high poverty are typical questions whose resolution requires close cooperation between all nations of the world. Each of these issues affects a huge number of people in different parts of the world; it directly or indirectly affects all countries and requires a new way of settlement, as it became clear that only market forces cannot solve the above problems.

Global issues and global public goods are present in all areas of our lives. They affect our economy, our environment, our ability and our decision-making processes of cooperation with other people. All these issues are, though at first glance it does not seem so, very connected to each other. For example, energy consumption launches climate change, which then affects the catch of fish in the oceans due to changes in temperature and ocean regimes, as well as other food resources due to changes in precipitation regimes [13].

Understanding economic growth is quite a complex issue, and predicting the future is even more difficult, perhaps impossible question. It is therefore necessary to develop and open up some important questions of the new paradigm of development

**Figure 3. New development paradigm**




Economic development thought has dramatically changed. The classic economic paradigm of development, based on static factors of production, has been replaced by a new dynamic paradigm. Driven by another wave of globalization, openness, competitiveness and economic freedom have become very important disciplines, both for theoreticians and for economic policy makers. The most characteristic events that accelerate dynamics of replacement of the old development paradigm by a new one are market liberalization, technological advancement, ideological and cultural changes, the growth of alliances of modern capitalism, and their network relations, learning from experiences and trajectory of the past, the appearance and growth of new players on the world economic scene, especially China and India, as well as the growing importance of institutional structures as important determinants of economic success.

It seems that the three Noble Prize Laureates had the biggest influence in creation of a theoretical basis for designing the new development paradigm: Amartya Sen, Joseph Stiglitz and Douglas North (see Figure 3) [14]. Though they started from different perspectives, they were all dissatisfied with the context of the old development paradigm, particularly the part that reflects the principles of the Washington consensus. They all watched the development of a comprehensive and multi aspect concept that encompasses the diversity of human needs and goals. They were all concerned about the structural dynamics of social transformation and they all stressed the importance of institutions for development (see Table 1) [14]. Interweaving of their ideas has shaped the scene for the emergence of a new development paradigm, and the interaction of access to full development.

**Table 1. The three Noble Prize Laureates' approach to main issues of development**

| Sen | Stiglitz | North |
|---|---|---|
| Freedom of choice | Structural transformation of society | Growing importance of institutions |
| Multi-aspect approach in contents and management of development | Holistic and dynamic approach | Dynamic approach towards changes |
| Wider concept of goals (through GNP per capita) | Emphasis on ownership and participation | Structures of favours and supporting mechanisms |
| Development as enlargement of choices and opportunities of stakeholders | Mental capacity and building up consensus | Values, perceptions of reality and value systems |
| Different aspects of freedom | Partnership | Emphasis on human (physical) environment |
| Public goods/social values | Social capital | Focuses on reducing uncertainty |
| Culture/human rights | Accumulated learning and experience | Expanding transaction costs to institutions |
| Institution operations | Responsibility of freedoms | "Top-down" and "bottom-up" institutions |

Amartya Sen most attention focuses on ways to improve the real freedom of people. According to him, this can best be achieved either by removing the main sources of "unfreedom" (poverty, tyranny, low economic opportunities, the neglect of public goods and intolerance of repressive government), or by increasing freedom of choice, opportunity and personal skills [15]. Sen considered essential freedom as a means to achieve and facilitate the development at some end.

In implementing the five types of freedoms (political freedom, economic freedom, social freedom, guarantees of transparency and the protection of security), special attention must be paid to improving the institutions, which, according to Sen, is an essential prerequisite for people to better evaluate and control their lives, improve their functional resources and responsibilities and provide a desirable balance between the priorities of the various constituents in the process of creating wealth and resource allocation. In fact Sen recognizes the great difficulty in measuring or assessing the results of development for which she urges, but suggests that the appropriate indices of measuring human well-being should include the necessary freedom and ability.

For Joseph Stiglitz, the primary goal is the development process of economic and structural transformation of the resources, abilities and preferences of companies, such as awareness, values and entrepreneurship of their individual and organizational participants. For him, the old development paradigm was focused very narrowly. It was unable to respond to the challenges of the global economy. In their approach it is usually controversial, and ignores issues of ownership, sovereignty and participation, underestimates the role of stakeholders in reducing or countering market failure in providing collective goods or goods that generate externalities or spillovers. It does not pay enough attention to the institutional infrastructure and its quality which is a critical determinant of the direction, structure and speed of transformation processes. It does not recognize the inseparability of the development goals of efficiency and connectivity, distribution and cultural identity) [16], [17].

Stiglitz believes that the new development paradigm must be more holistic, consensual, more socially active, open and participatory than its predecessor. It should be better to recognize and evaluate the role of partnerships, networking and social capital as a very important factor contributing to these objectives. It should establish a learning process and enable the willingness and ability of individuals and organizations to adapt to economic and social regeneration. It has to take into consideration the role of civil society and special interest groups. It must be dynamic in its perspective. Also, it should include a review of current objectives and functioning of the leading supranational organization) [18].

Douglass North focuses the most attention on the role of the structure of privileges and strengthening systems that affect the trajectories and structure of economic development. Such institutions, which he accurately identifies in some of his works, [19], [20], [21] in the neoclassical literature were either completely ignored or underestimated. North, like Sen and Stiglitz, believes in the modern global economy and re-evaluation of individuals and organizations about the purpose and content of development. Its determinants are forcing scientists, business community, civil society and governments to review their institutions and institutional infrastructure which support economic activity.

According to North, with the development of society its economy becomes more complex and specialized, with growing transaction costs of economic activities, while production costs fell. Globalization and its two main drivers (technological improvement and market liberalization) cause mixed effects on the transaction costs. For example, the expansion of electronic commerce dramatically reduces the costs of cross-border communication, but at the same time, increased complexity and specialization in modern dynamic and changing economy requires a more flexible structure of privilege and strengthening mechanisms.

## Effects that should not be ignored in developing of the model of growth

When creating a new strategy of development and growth, there are five important facts that development planners should not ignore. This primarily refers to a) - further development of rapid acceleration (acceleration of acceleration), b) – faster creation of the middle class as the holder of the development of innovation, creativity and sustainable jobs, c) - a stronger development of the NGO sector, d) - features of the so-called community, i.e. microeconomics as complementary counterpart of the stream economy, and e) - a stronger focus on global, regional and local environmental problems.

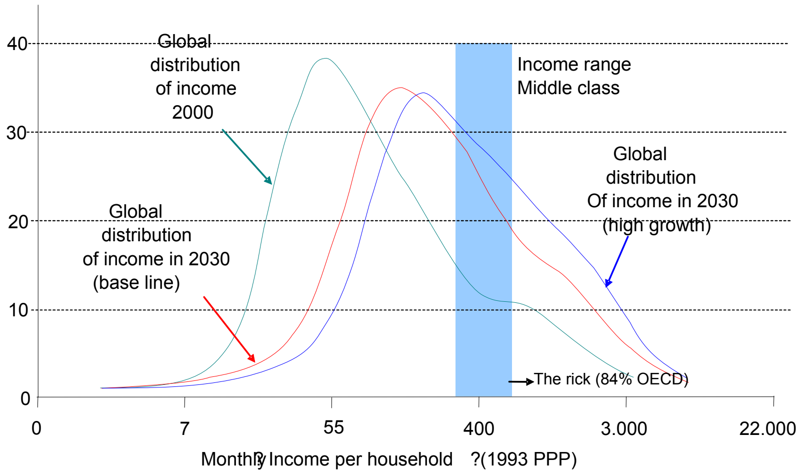
The changes in the last 25 years seem slow if you compare them with changes that will happen in the next 25 years. After all, who believed 25 years ago that hundreds of millions of people would be able to search through billions of computer pages in less than one second, and at no cost, or that instead of a nuclear war between the USSR and the U.S. the crew of the U.S. space ship would travel to the International Space Station in a Russian rocket, or that the detection of the genetic code would lead to the invention of completely new forms of life. Or, who would believe today that in the next 25 years we would all have the ability to reach the capacity of genius, that everything that can be linked would be linked and that the global mind will emerge from the Internet and become "compressed" (conscious) technology, which characterizes post informatics era. Table 2 speculates historical changes and provides an alternative future [22].

**Table 2. Simplification of history and alternative future**

| Periods or eras | Products | Major force | Wealth | Place | War for | Time |
|---|---|---|---|---|---|---|
| Agricultural extraction | Food/ resources | Religion | soil | soil/ resources | Location | Cyclic |
| Industrial | Machines | National state | Capital | Factory | Resources | Linear |
| Information | Info/servi-ces | Corpora-tion | Approach | Office | Perception | Flexible |
| Conscious-Technology | Connec-tions | Individu-als | Essence | Moving | Identity | Invented |

Globally, the middle class in 1993 included 8% of global population and achieved 12% of global revenues. Although in the period from 1993 to 2000 the share of the global middle class in the total population remained unchanged, the share of their income in total income has increased from 12% to 14%.

**Figure 4. Expansion of middle class**

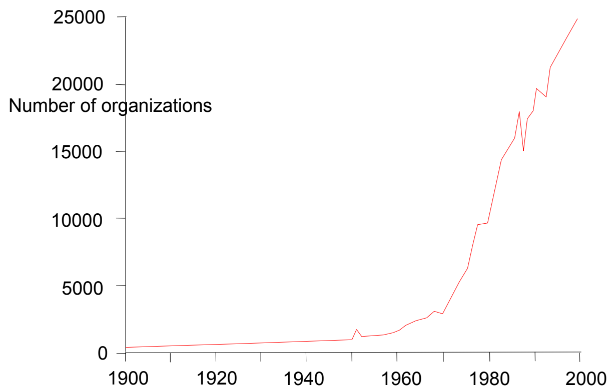



It is assumed that in 2030 the number of people who will be in the category of middle-class would exceed one billion, which would create the world's fastest-growing segment of the population. Today, approximately 56% of individuals from middle-class live in developing countries, while in 2030, that share will be increased to as much as 92%. Since the average middle-class families in developing countries have 4.3 household members, this means that a household's annual income ranges from 16,800 PPP USD to 72,000 PPP USD.

Figure 4 [23] illustrates the forecast of growth of the middle class under different growth scenarios. For a large number of people living in developing countries will convergence of income compared with OECD countries will be faster than the averages suggests. For example, in 2030 16.1% of the world's population would belong to the "global middle class, much more than in the year 2000 (7.6%). This means that in 2030 in developing countries, one billion people will be able to buy a car, engage in the international tourism, seek world-class products and require international standards in higher education. This is a huge increase from the present 400 million people. But if the convergence of income is calculated by faster growth scenario, the share of the global middle class may be increased up to 19.4%

Today's middle class in the developed world is most responsible for its progress, technological leadership, development of democracy and the narrowing of corruption. Without a strong middle class there is no transition from one development stage to another, nor transition into a knowledge society, i.e. an innovative society. Moving of a huge number of people into the middle class will produce a large group of people who will seek high standard of living, excellent schools and hospitals, healthy environment and protection of property rights and democracy. Pressures for the creation of policies that favour global and regional integration would be increased, as well as policy which would support faster development of innovative private sector.

**Figure 5. Growth of global civil organisations**




Global and local civil society organizations (Figure 5) [24] began to emerge in 1970s. Coincidence with the spectacular rise in their number is more or less parallel with the strengthening of the interdependence of global and local economies. Trends of their increase are confusing in their exponential form. This happens at both the world and at the level of individual countries, and there is no doubt that these trends would splash Montenegro, too.

**Table 3. Contrasts between the mainstream and "communal" economies**

| **Mainstream economy** | | **Communal economy** |
|---|---|---|
| Non-spatial/global | – | Related to place |
| Specialized | – | Diversified |
| Singular | – | Multiple |
| Large scope | – | Small scope |
| Competitive | – | Cooperative |
| Central | – | Decentralized |
| Acultural | – | Culturally characteristic |
| Socially non-built | – | Socially built |
| Non local property | – | Local property |
| Agglomerative | – | Dispersed |
| Integrated | – | Autonomous |
| Exports orientated | – | Local market orientated |
| Advantage to short-term returns | – | Value of long-term investments |
| Growth-orientated | – | Vitality-orientated |
| Taken value brought out | – | Local recycling of value |
| Private property | – | Community property |
| Management-lead | – | Community-lead |
| Private board-controlled | – | Community controlled |
| Private taking of property and distribution of surpluses | – | Communal taking of property and distribution of surpluses |
| Environmentally unsustainable | – | Environmentally sustainable |
| Fragmented | – | Whole |
| Amoral | – | Ethical |
| Caused by crises | – | Harmonised |
| Participates in spatial division of labour | – | Locally self-supported |

Civil society organizations have many forms, as well as different ways of their interconnectivity. One of the most difficult issues is the one related to social responsibility, of global, regional companies and large businesses, because it is an open question to what extent they need to make and implement strategies of corporate social responsibility. Is Friedman postulate still valid today that the only thing in business is maximization of profit and returns to shareholders? Although today many business leaders share this view, they are under great public pressure, which forces them to formulate views on corporate responsibility. Corporate social responsibility can be spread through the entire spectrum of relations between firms, states, civil societies and markets.

The future map of the global economy is quite unclear. It should be borne in mind that past trends and past values cannot simply extrapolate. More than anything, we need to think about the type of community in which we will, as well as our children wish to live. The key issue for the future is no longer what the world can be, but what it needs to be [25].

In thinking about alternative scenarios for the future there is a tendency to polarize positions. Neoliberal hyperglobalists see resolution in even stronger market opening, the undisturbed flow of goods, services and capital. In other words, many, many more of the same. Antiglobalists claim completely the opposite: since the strategy of hyperglobalists can create a world of even greater inequality (as well as the world of bigger environmental damage), and that strategy of antiglobalists contains risk of return to the medieval economy, the choice lies between these two diametric opposites.

There are many types of economy that can offer different options in relation to the big global economy. They are especially important for small countries, and innovative countries. Many of them are, in fact, what is tentatively called "community economies". Table 3 summarizes the main differences between these economies relative to mainstream economies [25].

Today's diversity of economies offers significant opportunities for creating satisfied and fair community. But these communities are usually small in size and highly localized in space. These facts open up an important question of how these economies can be bind into a larger picture that will be able to attract more attention.

And finally, it has become clear that the benefits of economic growth can easily be reduced by "side" environmental effects. To prevent these side effects many national and international institutions would be needed to control and manage global and national public goods

The complexity of environmental problems can be best observed in three typical examples of side effects: global warming as a long-term phenomenon, overfishing as a medium-term phenomenon and the spread of infectious diseases as the current phenomenon. All three of these examples are very risky for each part of the human population, regardless of where they are. In fact, slowing down of climate changes, keeping infectious diseases at the site of origin and conservation of marine world are three prominent global public goods, which clearly demonstrate the need for the establishment and strengthening of local and international cooperation and national and international policies.

These three examples of the typical side effects of economic growth bring many risks to the progressive expansion of the global economy, and on small and underdeveloped economies. If some of the current catastrophic scenarios of global warming come true, they can, through their effects on agriculture, water and ecosystems, undermine development opportunities in many countries.

Many people believe that today's modern society, like ancient societies, has embarked on a path that leads it toward self-destruction. Modern environmentalists, for example, believe that the environment has a fixed capacity to sustain the population, and that, when the capacity exceeds, it would lead to catastrophic consequences for humanity. According to them, human civilization must refer to a transition path that leads from the "adaptation to nature," towards "management of nature."

Management of nature includes a large area of human activities affecting the life processes of a country and its resource base. Food production, biomass and clean water are areas that are very important for the survival of people and areas where current models of economic activities threaten the sustainability of natural resource systems.

Do economic growth, which requires natural resources to produce materials and energy, and environmental waste disposal take place at a high price of environment pollution? Is environment-friendly development possible despite the fact that economic growth has to hit the environment to some extent? If you must make some compromise between development and environment, how to determine the right balance and who should do that? The above questions underline the importance of relationships between people, growth, resources and environment, which must be resolved in a satisfactory manner.

## CONCLUSIONS

Given the many unknowns and uncertainties that are related to the quality and sustainability of small and open economy, it seems that by creating a new concept of development and new development documents some of the following facts should be taken into consideration:

- Reliance on extrapolation of trends from the past means the repetition of the past. It is far better to seek new engines of development and growth that will generate better future.
- Small and open economies should not follow the models of development of large states. The smaller the country, the more open, competitive and innovative it must be, In fact, the most important tools of economic growth are stable democracy, elitism, willingness to challenge, small, efficient, educated and honest state government, freedom to conduct

business, creation of competitive niche and competitive areas, and the parallel development of social sphere and the sphere of welfare.

- All recent theories of economic growth are increasingly moving away from conventional analytical tools, areas and boundaries in order to cover all the important social goals such as reducing poverty, improving quality of life, increase opportunities for better education and health, and they do not ignore environmental issues nor contemporary forces that reshape the development scene such as technological innovation, globalization and localization, the spread of knowledge, population aging, financial interdependence and the growing need for greater political and human rights of people.
- Any process of economic growth has its own qualitative and quantitative dimensions. Their relationships determine the quality of growth and the growth of prosperity. Therefore the quality of growth is based on balanced development of all development factors, i.e., all types of capital, worries about distributional aspects of welfare during the entire period of growth and building an institutional framework for managing the processes of growth.
- Main dimensions and interconnected components of welfare and poverty are the material goods necessary for life, health, good social relations, security and freedom and choice. These five dimensions of welfare and poverty reinforce each other, either positively or negatively.
- System view of the creation of welfare shows that the input side of the well-being contains natural and physical capital and human and social capabilities of human and social capital, which are in constant interaction with political, institutional and legal system of the country. Distortion of general and sectoral policies, corruption, poor management, market imperfections and externalities reduce the rate of economic growth and reduce the potential for achieving prosperity.
- The classic economic paradigm of development, based on static factors of production, is replaced by a new dynamic paradigm. Openness, competitiveness and economic freedom have become very important disciplines. The events that accelerate dynamic replacement of the old development paradigm are new market liberalization, technological advancement, ideological and cultural changes, the growth of alliances of modern capitalism, and their network relations, learning from experiences and trajectory of the past, the appearance and growth of new players on the world economic scene, and growing importance of institutional structures
- When creating a new strategy for development and growth of small and open economy, there are five important facts that development planners should not ignore. This primarily refers to the further acceleration of

already rapid development, fast creation of the middle class as the provider of development of innovation, creativity and sustainable jobs, stronger development of the NGO sector, the characteristics of the so-called community economy, i.e. microeconomics as complementary counterpart of the stream economy and a stronger focus on global, regional and local environmental problems.

- The future map of the global economy is quite unclear. So we need to think about the type of community in which we will, as well as our children, want to live. The key issue for the future is no longer what our world might be, but what our world should be. There are many types of economy that can offer different options in relation to the big global economy. They are especially important for small countries, and innovative countries, which in many segments can become global "niche" leaders.
- It has become clear that the benefits of economic growth can easily be reduced by "side" environmental effects. To prevent these side effects many actions and policies for the control and management of global, national and local public goods would be needed. Production of energy, food, biomass and clean water are the areas that are very important for the survival of people but also the areas where current models of economic activities threaten the sustainability of natural resource systems. Relationships between people, economic growth, resources and environment in the new development concept must be resolved in a satisfactory manner.

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# CHAPTER 12. TOWARDS A NEW FRAME OF FISCAL AND MONETARY POLITICS

**Nikola FABRIS**, Faculty of Economy Belgrade, Serbia and
Central Bank of Montenegro

***Abstract***

*From time to time, in the history, there have been certain seismic changes which mark the transition from one era to another one, which denote the end of the old one and the appearance of a new orthodoxy. The global economic crisis was certainly one of those situations. The current crisis brought a review of the governing orthodoxies in the domain of fiscal and monetary politics and the creation of a new macroeconomic frame.*

*The paper investigates and suggests possible directions of changes when dealing with fiscal and monetary politics. In the domain of the fiscal politics there is a review of the fiscal agencies, introduction of fiscal rules and law about fiscal responsibility. In the domain of the monetary politics there are three key concepts that are reviewed which relate to the financial stability, transparency and responsibility of the creator of the monetary politics.*

***Key words****: fiscal politics, monetary politics, fiscal rule, law of fiscal responsibility, financial stability*

## INTRODUCTORY REMARKS

There has been a present growing tendency of application of rules in the monetary and fiscal politics in the last couple of years. Although the rules have a much bigger application in the domain of the monetary politics, since the 1990's they gain higher importance in the domain of the fiscal politics, as well. What is common to those rules is that no matter if they apply in the domain of the monetary politics or the domain of the fiscal politics. their basic objective is to increase credibility.

The rules on one hand reduce the room for "misuse" of macroeconomic politics, and on the other hand they "tie" the hands in the domain of leading countercyclic politics. Thus, it is difficult to have a single attitude about the question if the rules are good or bad in the domain of macroeconomic politics. In the Keynesian theory rules are counterproductive and the creators of macroeconomic politics should have discretionary rights, while in the schools on monetary-classic traditions, rules are favourable in order to prevent misuse of the macroeconomic politics.

As B. Steil emphasized, the key issue of the majority of countries is excessive accumulation of debt. Therefore, the question which is asked is if the monetary and fiscal politics encouraged excessive debt. [51] The unambiguous answer to this question would be if the USA, country where „the crisis started" both the fiscal and the monetary politics encouraged debt, and the positive answer to this question could be given for the majority of other countries, as well. Thus, there is foundation for a creation of a new frame of fiscal and monetary politics to be expected in the next period.

It is evident that the Global financial crisis will influence a serious review of the fiscal and monetary politics in order to prevent a repetition of a crisis of such scale in the following period. In the domain of the monetary politics, a gradual pattern of turn in the domain of objectives should be expected, from price stability as a basic objective of the monetary politics, towards a financial stability as the most important objective in the future of the monetary politics, with simultaneous growth of transparency and responsibility of the central banks.

When the fiscal politics is in question, the key problem is a tendency of constant growth of the public debt. Before the First World War, the public consumption was in the range from 8% to 10% GDP. [52] During the Second World War, the state spent around half of the GDP. The production and the GDP have been growing for more than a century. At the same time, the public expenses in almost all countries have been growing. During emergency situations such as wars and depreciation, the level of public consumption has increased. However, the overcoming of emergency situations has not brought a return to the level of public expenses to the previous level. Thus, it comes as no surprise that there has been a presence of tendency of bringing laws about fiscal responsibility and foundation of independent fiscal agencies lately. [53]

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## TOWARDS A NEW FRAME OF THE FISCAL POLITICS

Having in mind that the Global financial crisis brought a significant deterioration of the fiscal imbalance of a large number of countries, lately more and more countries have considered certain changes in the domain of fiscal politics, which should increase the responsibility of the creator of the fiscal politics and create sustainability of the public finances in the next period. The suggested changes usually go in two directions. One is related to the foundation of a fiscal agency or a fiscal council, and the other is related to the bringing of a fiscal rule, most often in the form of laws of fiscal responsibility, which would limit the discretion of the creator of the fiscal politics.

As for the fiscal agency (fiscal council), it is an independent body which could have different objectives. These bodies can have authority just to comment the fiscal politics, to create macroeconomic projections which can be used for the creation of fiscal frame, to supervise fiscal politics, to assist in the formulation of fiscal politics etc. These agencies most often have an objective to increase the transparency of fiscal politics, as well as to increase the «political expenses» (loss of credibility, by the author) of inadequate fiscal politics. [54]

However, these agencies bring some dilemmas starting from the question of the degree of accountability, going to the level of independence they should have with regard to the Ministry of Finance, i.e. if they undermine the independence of the ministries of finance, as well as which tasks they should perform. For the economies in transition of Southeast Europe, having in mind their history, the state of the public finances, the credibility of the creator of the economic politics, probably these bodies would be more applicable in the form of fiscal councils, which would consist of experts and whose objective would be to increase the transparency of fiscal politics. It is clear that these are new institutions which will develop in different directions, depending on the country.

Fiscal rules are institutional mechanisms with the objective to strengthen the credibility of fiscal politics, as well as fiscal discipline. Kop its and Symons define the fiscal rule as a permanent limitation of fiscal politics by the application of a simple numeric rule. [55] They have been known since the middle of the XIX century. For instance, in the middle of the XIX century in most US states where there was a golden standard, there was an obligation to lead politics of balanced budget. [56] Yet, the fiscal rules from the beginning of the 90's were used by just a

[54] IMF, (2009), Fiscal Rules—Anchoring Expectations for Sustainable Public Finances, SM/09/274, Washington.

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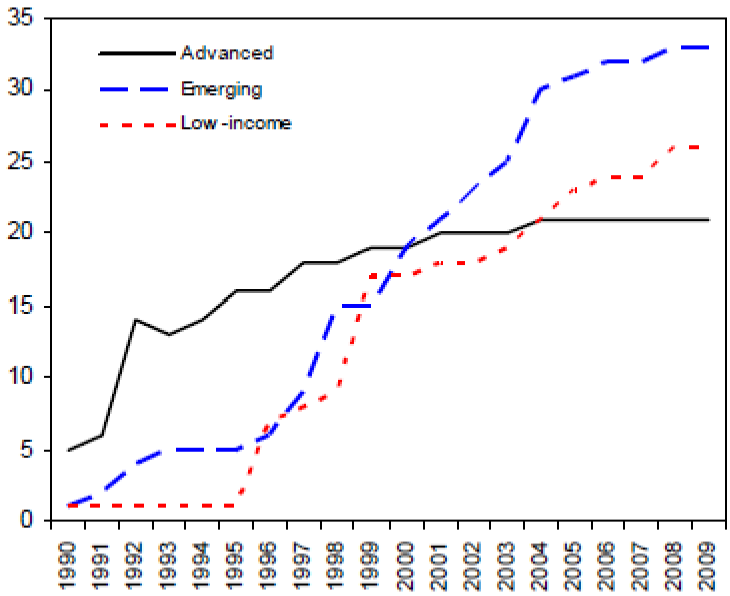
few countries in the world. From the middle of the 90's, the number of the countries which use fiscal rules has grown, and the Global financial crisis influenced the growing popularity of this instrument of economic politics. These rules can be applied on a national level or above national level, as is the case with the European Monetary Union. An IMF study has shown that some form of fiscal rule is applied by 80 countries at present, and only seven countries applied it in 1991. [57]

**Graph 1. Movement of the number of countries with fiscal rule**




*Source:* IMF, (2009), Fiscal Rules—Anchoring Expectations for Sustainable Public Finances, SM/09/274, Washington

The fiscal rules usually appear in the five forms:

- Rule of public debt which predicts how much can the maximum participation of the public debt be in the GDP;
- The budget deficit rule which limits how much can the maximum budget deficit be in relation to the GDP;
- The rule of public consumption which predicts what would the maximum amount of public consumption with regard to GDP

[57] IMF, (2009), "Fiscal Rules—Anchoring Expectations for Sustainable Public Finances", SM/09/274, Washington.

- Rule which combines public income and public expenses [58] and
- Rule of public income which predicts the maximum amount of public income, most often with regard to GDP.[59]

There is a growing number of countries which combine fiscal rules. Probably, the best known example of a combination of fiscal rules can be found in the European Monetary Union, i.e. in the collection of Maastricht criteria, which limit the budget deficit to 3 % GDP and the public debt to 60 % of GDP.

As for the economies in transition, there are fiscal rules only in the countries which have already become members of the EU, such as: Bulgaria, the Czech Republic, Estonia, Lithuania, Hungary, Poland, Slovakia and Slovenia. In many countries, the fiscal rules have been brought as part of wider reform processes, usually by bringing laws about fiscal responsibility. [60] Only a smaller number of countries have brought laws about fiscal responsibility as an alternative to fiscal rules. In order for a fiscal rule to be successful in practice, it should fulfil several conditions:

- It has to be consistent with the long-term economic objectives,
- It must not contribute to procyclic nature of the economic politics,
- It must be flexible enough so that it could be applied in different economic situations and
- It should be realistically accomplished

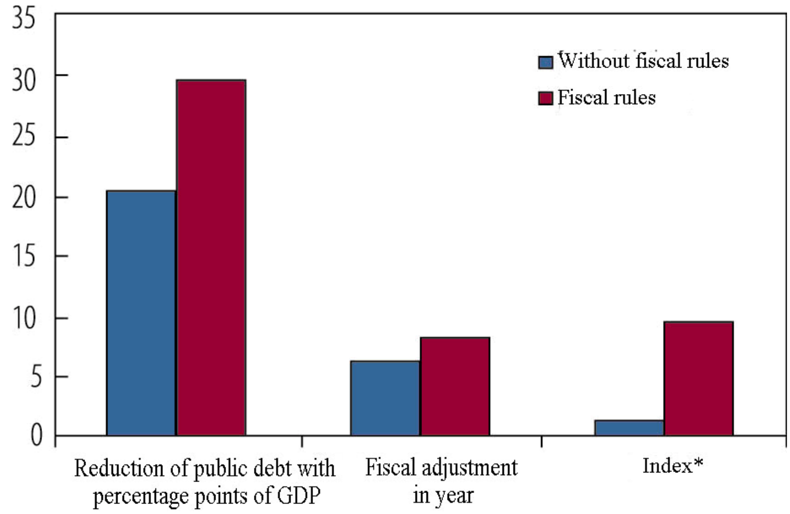
An IMF study has confirmed that fiscal rules are important in the process of implementation of fiscal consolidation and that fiscal consolidation was more successful and faster in countries which had these rules (graph 2)

[58] For instance, the application of this rule in Switzerland requires that when the growth of GDP passes 1.8 %, the Government has an obligation to create additional fiscal income, and when it is lower than 0.5 %, the Government has an obligation to increase the level of puclib consumption

[59] This rule is less rarely applied, since it does not contribute to the balance of public finance or the limitation of public consumption, and is above all aimed at the limitation of excessive taxation .

[60] IMF recommends that the fiscal rules be brought through a legal act of as high hierarchy as possible, since there is a reduction of the probability of their neglect or leaving

**Graph 2. Characteristics of Fiscal Consolidation in Countries with and without Fiscal Rules**




*Source* IMF, (2009), "Fiscal Rules—Anchoring Expectations for Sustainable Public Finances", SM/09/274, Washington

*Notice:* only countries which have managed to achieve a significant reduction of the public debt were observed

* - cumulative change of the cyclic primary deficit in the first three years of consolidation with regard to the reduction of the participation of the public debt in GDP

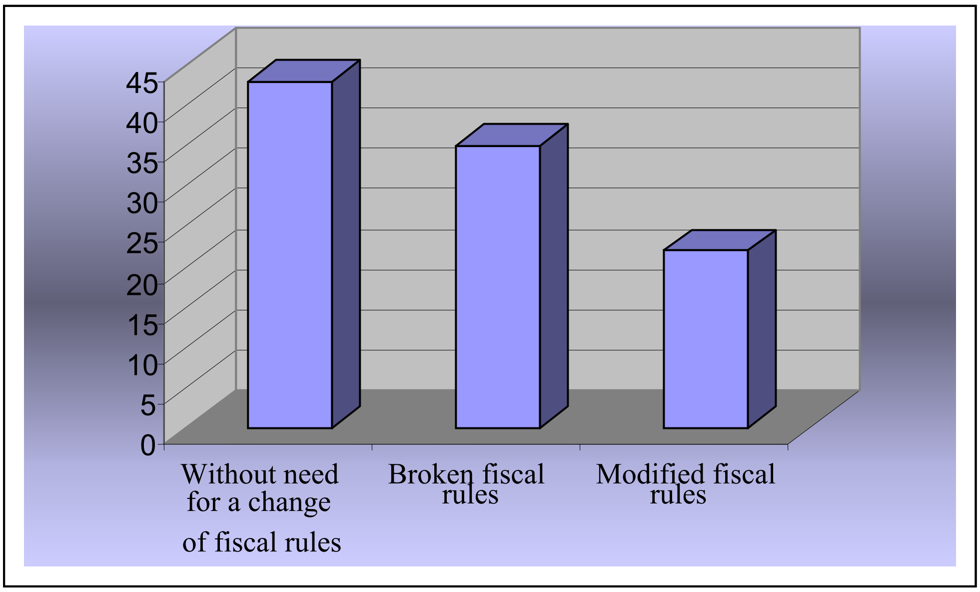
However, as for the fiscal rules and law of fiscal responsibility, we have to take into account both the advantages and disadvantages of such solutions. The advantage of this law is the fact that it prevents misuse of fiscal politics, strengthens the credibility of the entire economic politics and influences the improvement of the credit rating of the country. It should be taken into account that such a frame of fiscal politics is easier to be implemented in stable conditions, unlike crisis conditions. The key factor to success is to establish clear accountability and sanctions [61] if the given criteria from the law, or the fiscal rules, are broken.

The disadvantages of this law are that it largely reduces the manoeuvre space for leading countercyclic politics in crisis, i.e. it is very difficult to formulate a rule

[61] In practice, there are different sanctions in case of breaking fiscal rules such as: fines for the creators of fiscal politics, change of persons most responsible for leading of fiscal politics, loss of credibility, obligatory corrective action etc. However, it should be taken into account that the application of sanctions is not wide spread, since it requires a third party to implement them.

which would be suitable for all situations. A large number of countries which had fiscal rules before the Global financial crisis were forced to modify them or simply did not fulfil them.

**Graph 3. Fiscal Rules and the Crisis**




*Source:* Graph created on the basis of a questionnaire of the IMF from April 2009

So, it should come as no surprise that a certain number of countries have a so called «exit clause: in case of unpredicted exogenous shocks, while some other countries have an independent arbitrary body. [62]

Also, the manipulations during the calculation of GDP (its increase or reduction) can easily influence the fulfilment of some criteria. A potential problem is the fact that fiscal rules are most often calculated with regard to GDP, and its amount is known at the beginning of the following year. Additionally, inadequate statistical capacities of the majority of the countries open doubt if it is possible to objectively establish the actual value of GDP. Therefore, it is very difficult to formulate a rule which would be equally good in conditions of recession and expansion. Thus, there can often be a need for a modification of the rules, and frequent modifications of the rules would simply derogate the credibility of the law about fiscal responsibility. Counter argument could be that during «good

[62] Kopits, G., (2001), Fiscal Rules: Useful Policy Framework or Unnecessary ornament, IMF working paper 01/45.

times» it is necessary to be far from the boundary, and recession conditions require a boundary prescribed by some indicator. Also, a potential danger is that in conditions where there is a threat of «breaking» a fiscal rule the creators of fiscal politics would dominantly reach to reduce capital expenses, which are easiest to be «cut» in short term, and which bring negative long-term consequences.

As for the countries in the region, a law of this type, with a clear fiscal rule or rules would be welcome, having in mind that the majority of the countries from this region have witnessed misuse of fiscal politics. In order to make this frame successful, it is crucial to answer the question what would the predicted sanctions for unfulfillment of rules be, as well as to leave room in the law itself for some modifications in conditions of recession (it is important to make them clearly defined and that there would be no discretion room for their interpretation). For instance, there is a possibility to define a zone of fluctuation, so in good times there should be a strive towards the upper boundary, and in bad times there is room for lowering till the lower level of the boundary. An alternative would certainly be to introduce «exit clauses» in conditions of recessions, but there is a possibility of the problem of arbitrarity when this clause could be applied. Also, there should be an awareness of the fact that the pure fact of bringing fiscal rules and/or laws about fiscal responsibility do not guarantee a successful fiscal consolidation. Empirical data have showed that in conditions of deep recession, fiscal rules had a lower degree of efficacy.

## TOWARDS A NEW FRAME OF MONETARY POLITICS

The growth of the financial globalization present in the past few decades opened several challenges for the central banks. The first challenge relates to the dilemma of a choice of adequate regime of currency rate and monetary politics. On the other hand, the financial globalization at the same time brought a growth in the frequency of financial crisis, so the second challenge would actually be a challenge of maintaining financial stability. Now, the central bank, other than taking care about the domestic financial market, should pay special attention to its interaction with the international financial markets.

The key objective of the majority of the central banks is price stability. A debate about the objectives of the central bank is still present and it is, in large deal, a consequence of the disagreement about what the monetary politics can, and what it cannot do. Of course, central banks are not indifferent towards the objectives as employment and economic growth, but the prevailing opinion is that the biggest contribution to these objectives could be given through maintenance of macroeconomic stability. Putting some of these objectives in focus could conflict the main objective – maintenance of price stability. However, the current Global financial crisis seriously puts pressure on such opinions. The opinion that the financial stability is a much bigger challenge for the central banks than the price stability is becoming more spread. Namely, the current Crisis has showed that for the functioning of the economy and financial system, inflation is less dangerous (in case it does not go into hyperinflation) than financial instability. In inflantory conditions, the real and financial system can function, with smaller and bigger difficulties, however in conditions of financial instability, there can be a complete breakage of both the real and financial sector.

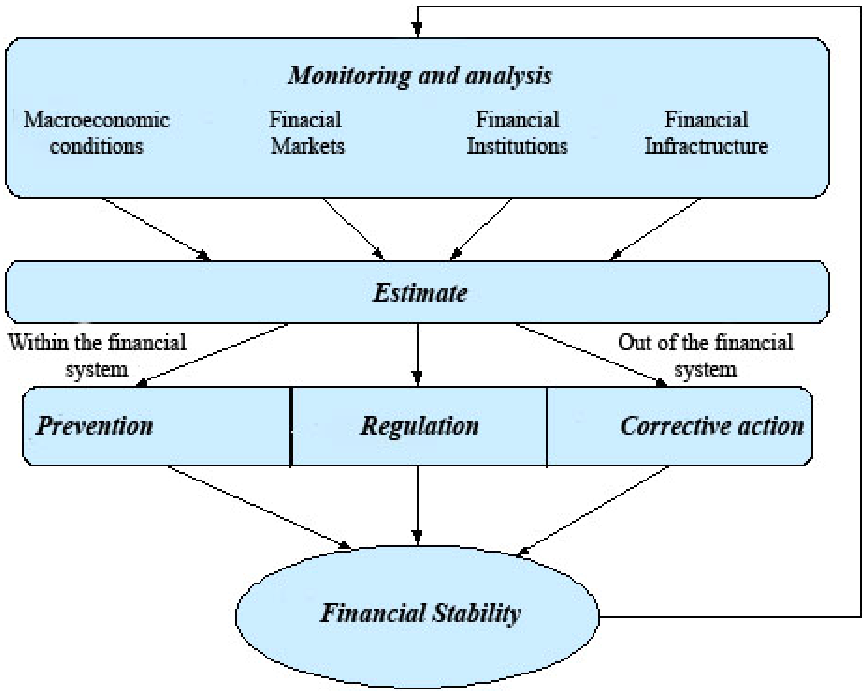
The financial stability is an objective which does not have an entirely accepted definition unlike the inflation which can not be numerically presented. Actually, as Schinasi (2006) emphasizes, today there is no single, widely accepted frame for following, estimation and maintenance of financial stability, in reality there is no single definition of financial stability. It most frequently means lack of bank crises or big fluctuations of the financial markets. Wieser (2005.) defines the financial stability as capability of the financial system to absorb different kinds of shocks without a financial crisis which would bring to multi-sector spreading of negative macroeconomic effects. Borio (2003) defines financial stability as a situation where the risk of significant losses of real GDP is limited, as a result of systematic financial quakes.

Ferguson's opinion 2003) is interesting, where he believes that only financial instability can be defined. According to him, it is a situation characterized by three factors:

- Some important securities significantly digress from what could be defined as their fair price,
- The functioning of the financial market and approval of loans is under the influence of many difficulties and
- A significant digression from aggregate demands from the production capacities of the country.

Actually, the approach of financial stability means that the creators of monetary politics analyze and by measures from monetary politics prevent all those occasions which could present a threat to the financial stability (Fabris 2009). This approach usually means two dimensions of the financial stability: micro dimension which observes risks from the aspect of individual financial institutions and macro dimension which observes risks from the aspect of the entire financial system. The objective of this two-dimensional approach is to evaluate the systematic risk well, i.e the risk of the inliquidity problem or solvency to be spread from levels of individual institutions to the entire system. The approach of maintenance of financial stability could be simply presented with the following graph.

**Graph 4. Frame for Maintenance of Macroeconomic Stability**




*Source:* Schinassy, J., 2006., «Safeguarding Financial Stability».

At present, only one central bank in the world, the Central Bank of Montenegro, has defined financial stability as its main objective. The financial stability is thus seen as public well-being and EU has developed an entire set of mechanisms to follow it and maintain it. However, the realization of this mechanism in EU has not been based on obligatory directives yet and has largely been based on voluntarism and commonly achieved understanding of the importance of maintenance of financial stability.

However, the realisation of this objective cannot be the responsibility of the central bank alone, since even central banks with the highest degree of supervisory authorities do not cover all segments of the financial system. Therefore, there are many arguments that go in favour of the hypothesis that central banks should share this objective with other institutions, i.e. that financial stability should have the treatment of «public well-being».

It is evident that t is an objective which will be accepted by a bigger and bigger number of central banks in the years to come. As Ugolini (2003.) emphasizes, it is clear that the challenges of the financial stability continue to appear and that they will continue to appear in the future no matter if the central banks are ready for them or not.

Another important aspect of change in the area of monetary politics is related to the increase of the level of transparency of the central banks. Since the 1990's, the central banks have been traditionally closed institutions and the public has heard few, strictly selected information. The words of Karl Bruner, one of the best theorists of the monetary politics during the XX century, best testify to that effect:

> *Central banks have traditionally been surrounded by weird political mystic... This mystic rests on the conviction that central banking is esoteric art. The approach to this art is reserved solely for the elite. The esoteric nature of this art rests on the inherent impossibility to explain its essence in simple words and sentences (Bofinger, 2001.).*

On the increase of transparency of the central banks, there was a significant influence of the inflatory targeting, which brought regular communication between the public and the central bank. Also, the insufficient level of transparency creates doubt if the central bank leads politics in general interest. A huge number of countries have adopted laws about freedom of information, which disable secrecy of central banks in their work and hiding documents. Still, there is always room certain information to be hidden, under the cape of protection of individual data.

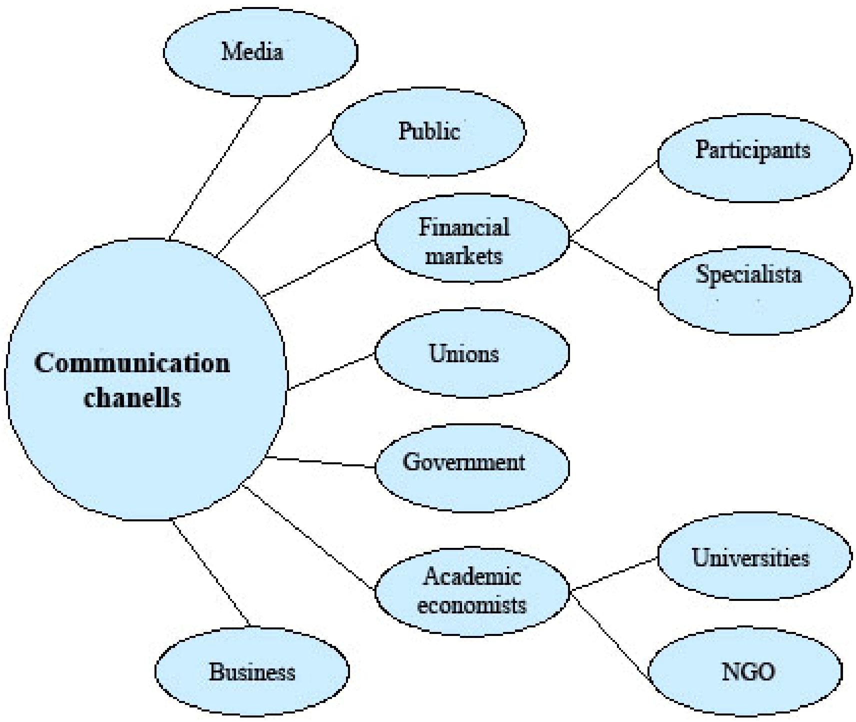
The increase of transparency in the work of the central bank can contribute to more efficient implementation of the monetary politics (Fabris, 2006). First, the information of the public about the mandate of the central bank and to which extent it can be fulfilled can increase the credibility of the central bank. Strong determination for transparent work imposes a kind of self-discipline for the creators of monetary politics and increases the probability of leading a consistent monetary politics. Also, regular communication gives directions to the financial markets. That enables the participants on the financial market to better understand the actions of the monetary politics and their influence on economic patterns and system shocks.

A great number of studies has unambigiously showed that the market reacts to statements from the central bank, and the key issue is if the market reacts in the desired direction. Actually, the potential danger is that the market would incorrectly interpret the information from the central bank. Kohn and Sack (2003. emphasize that those information for which the central bank is directly responsible have bigger influence on forming expectations. Siklos (2002.) established the existence of a connection between communication and inflatory expectations, and it is particularly present in those countries which use politics of inflantory targeting. According to Posen (2003) the curve of desired level of transparency is "U" curve, which represents that the highest degree of transparency in needed in central banks with exceptionally high and exceptionally low level of credibility.

Central banks with high credibility can fulfill almost the same effect by application of measures of monetary politics, as with the promise that the measure will be brought on the following meeting of the monetary board of the central bank. Out of that, a conclusion can be made that statements and application of instruments of monetary politics can be substitutes, only in short-term. If the central bank does not fulfil its promise, the market will notice that in mid-term at latest, and future statements will not have any credibility.

If the central bank achieves a higher degree of trust and adequate transparency in the long-term objectives with regard to inflation, it could provide the central bank with a higher degree of flexibility around the fulfilment of short-term objectives in the economic politics, since short-term deviation will not be interpreted as deviation from the long-term objective with regard to inflation.

**Graph 5. Communication Channels**




*Source* Fabris, N., (2006.), Centralno bankarstvo u teoriji i praksi, Centralna banka Crne Gore

A high number of central banks have communication strategies and special PR departments. The objective of the communication strategies is to provide understanding and support of the public for actions which are undertaken by the central bank and to increase the efficacy of the instruments of the monetary politics by reducing the uncertainty about the objectives, intentions and thoughts of the central bank. An integral part of the communication strategies is the reaction to information published in the media, which are not in line with the politics, objectives and instruments of the monetary politics, or are incorrect.

## CENTRAL BANKING IN THEORY AND PRACTICE, CENTRAL BANK OF MONTENEGRO

Along with the question of transparency, the question of accountability is interwined. The concept of accountability is not simple to be translated in our language and it essentially marked the responsibility of the central bank towards the public and the readiness to elaborate activities. Jaksic (2004) emphasized that accountability has three important features: decision-making about the most important objectives, transparency of the monetary politics and final responsibility for the monetary politics.

The accountability can have different determinants and it can be best presented by the following table.

**Table 1. Determinants of Accountability**

| Aspect of accountability | Determinants of Accountability |
|---|---|
| Ex ante | Reporting before a concrete action is undertaken |
| Ex post | Report after an action is undertaken |
| Explanatory | Giving explanations and arguments for undertaken activities |
| Financial | Presenting financial reports . |
| Performative | Presenting to what extent objectives have been fulfilled |
| Procedural | Respect for certain procedures in implementation of certain action |
| Functional | The undertaken activity to be in function of fulfilment of the objectives |
| Personal | Implementing actions which are responsibilities of individuals |
| Corrective | Removal of existing disorders |

*Source*: Modification of Authors of Categories of Accountability by Hupkens (2006) and other authors

Nowadays, there is a developed and a large number of indexes which, on the basis of different variables, measure the accountability of the central bank. Still, if the concept of accountability of the central bank is of great importance, it should not be used to endanger the independence of the central bank.

## CONCLUDING REMARKS

The global financial crisis will lead to changes in the leading of monetary and fiscal politics in the following years.

In the domain of the fiscal politics, it is more and more widely considered to introduce fiscal rules. Fiscal rules have numerous advantages, since they prevent the misuse of the fiscal politics, they strengthen the credibility of the entire economic politics, they add an element of predictability and influence the improvement of the credit rating of the country. However, their disadvantages should be taken into account as well: it is difficult to formulate a rule which would be equally efficient in «good» and «bad» times, the rules limit the room for leading countercyclic politics, they encourage statistical manipulation etc. Still, there is the impression that in countries with low level of credibility of the creators of fiscal politics, as is the case in many countries from Southeast Europe, it would be favourable to introduce rules, with clearly defined accountability in case of actual infulfillment and with a certain dosage of flexibility during the cycle, which would not be arbitrary. It is also favourable to «strengthen» the advantages of fiscal rules through the bringing of law about fiscal responsibility. Also, it is desirable to establish a fiscal council, which would first of all have an objective to increase the transparency of the fiscal politics and to follow the realization of fiscal politics.

In the domain of monetary politics, a gradual evolution of objectives is to be expected, from price stability as a main objective of the monetary politics, to financial stability as a future objective of the monetary politics. Still, the financial stability cannot be the a responsibility only of the central bank, since even central banks with highest degree of authorities cannot cover all segments of the financial markets, actually it is an objective which the central banks should share with other institutions (the leading role of the central bank is desirable). Thus, there are more and more arguments in favour of the hypothesis that financial stability should be treated as public well-being.

Having the importance of the credibility for successful leading of monetary politics in mind, which cannot be fulfilled without a high level of transparency, a continuation of the pattern of growth of the transparency of the monetary politics is desirable. With regard to the incorrectly led monetary politics of FED, one of the causes of the Global financial crisis, it could be expected that there would be growth of the accountability of the central banks in the following period.

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# CHAPTER 13. INFLATION AND ECONOMIC GROWTH - PHILLIPS CURVE IN COUNTRIES IN TRANSITION –

**Bojan DIMITRIJEVIĆ,** Educons University, Novi Sad, Serbia

***Abstract***

*Serbia has the characteristics of a country finalizing the transition process and characteristics of a developing country as well. Therefore issues related to economic growth and low inflation rate are vital for its economy. Phillips and Phillips-Okun curve analyzes the interdependence between these key macro indicators, including the unemployment rate. That is why the aim of this paper to examine whether there is a Phillips curve for countries in transition and Serbia and if it is possible to lead a rational economic policy based on it. The paper concludes that there is no relation inherent to Phillips curve, that the labour market is underdeveloped, that the vulnerability to shocks of aggregate supply is pronounced, but that the low inflation rate has a certain positive effect on the economic growth.*

***Key words:*** *transition, aggregate supply shocks, Phillips curve, inflation and economic growth, labour market*

## INTRODUCTION

Phillips curve (hereinafter P-curve), represents a standard chapter of macroeconomic theory and policy today. Its popularity and influence may be interpreted by a number of factors such as: analytical simplicity, possibility of leading economic policy with the aim of resolving basic macroeconomic problems (inflation and unemployment), comparative analysis of Keynesianism, monetarism and rational expectations school. The P-curve provides a special possibility by contributing to the labour market research, interpretation of movements on that market and behaviour of business companies. Being that through P-curve inflation and unemployment, different types and forms of both phenomena refract, it contributes to their better theoretical understanding and determination of such economic policy which will resolve these changes, or at least minimize that type of macro imbalance. That is its purpose and significance. In the theoretical development and genesis of the P-curve (and theoretical development essentially coincides with the historical), there are three basic stages:

**First – Phillips-Lipsey concept** in which there are stable, long-term, negative inflation and unemployment trade-off.

**Second – Friedman-Phillips concept** which introduces the hypothesis on "natural unemployment rate" which entails only temporary, short-term inflation and unemployment trade-off;

**Third** – relation of the New classical macroeconomics towards P-curve represents the strongest critique of the P-curve, because due to rational expectations it negates P-curve trade-off in short as well as in long term. P-curve is a vertical line there, and there are no real effects, but only inflationary: economic policy is inefficient both in long and in short term.

Although it is often contested (both theoretically and from the empirical-methodological standpoint), the P-curve is present in current researches of numerous economists, which implies its actuality and relevance.

The Phillips-Okun model represents a synthesis, an attempt to set key macroeconomic factors in functional relation and in one entirety: **domestic product – unemployment – inflation**. The model links Okun and Phillips curve and makes Phillips-Okun curve. Phillips-Okun model is not significant only from the theoretical aspect, but it is a practical tool in economy management and its guidance into desired direction.

One of the key questions for the economic development of Serbia as a country in transition and a developing country is whether there is a typical inflation and unemployment *trade-off*, as well as of inflation and economic growth, i.e. could the economic growth be improved by inflation growth, growth of domestic product and decrease of unemployment. The paper aims to answer these questions, by pointing out preconditions necessary for the existence of Phillips and Okun curve and to analyze characteristics of economies in transition and Serbian products from form of property aspect, economic system, labour market and economic policy. The paper describes aggregate supply shocks at the beginning of the transition process, key stages of this process, discomfort index in the sense of stabilization and transition costs, phases and characteristics of the Serbian economic system in the period up to year 2000 and up to year 2008, macroeconomic researches and characteristics of the labour market, as well as specifics of the P-curve for developing countries in the context of inflation-monetary growth-domestic product connection. Conclusive analyses follow at the end.

## AGGREGATE SUPPLY AND SUPPLY SHOCKS IN COUNTRIES IN TRANSITION

Before we deal in more detail with behaviour of the Phillips curve in transition, it would be convenient to relate the Theory of “Illyrian firm” with the behaviour of Phillips curve in conditions of stagflation, which has its consequences on the analysis of Phillips curve in transition. Ward, Domar, Vanek, Furubotn, Pejović, Horvat, Bajt and others wrote about theory of Illyrian firm. Starting from the fact that the target function in the self-managed company is maximization of average income per employee and that in the conditions of social ownership, self-managed company acts differently than its capitalist counterpart, several paradoxes have been noted:

- socialist company employs smaller number of workers and gives less output than the capitalist one (it means higher unemployment and less efficiency);
- increase of fixed costs instigates the production increase;
- supply reacts contrary to the theory – increase of prices leads to decrease of supply prices and vice versa; this means that the supply curve of self-managed socialist company is negatively sloped, therefore with aggregation the aggregate supply curve acts in the same manner;
- from this, an indirect conclusion can be drawn that the decrease of domestic product would be matched by increase of unemployment, that the P-curve will have positive slope and that in such conditions it is not possible to lead reasonable policy based on P-curve theory.

Civilizational failure of socialist societies in the economic sphere manifested through: decline of standard of living, declining of economic growth rate, decline of productivity and inefficiency, irrational allocation of resources, external indebtedness, real and disguised unemployment, muffled and galloping inflation and increasing technological gap in comparison to developed economies.

**There are several key causes of economic failure of socialist economies which are derived from the very logic and mechanisms of their functioning:**

- **inferiority of the collective property to private in terms of efficiency and motivation,**
- **inexistence (or very limited scope) of the market, in which the prices are only calculation-plan category, which disabled irrational allocation of resources and lead to their squandering,**

- **exhaustion of extensive factors of development and lack of intensive (modern technology, productivity, quality, competitiveness, professional motivation).**[1]

Main goal of the transition process is building of market economies which will be economically more efficient, capable to ensure the growth of living standard of its citizens and ready to enter the game of world economy. Parallel with the process of economic transition, a process of political transition i.e. establishment of parliamentarism and democratization of social institutions is taking place.

Regardless of the certain disputes about the order of transition moves, in literature, theory and in practice a consensus has been achieved that the following four phases-stages are key and that they represent the core of transition:
**I phase: Macroeconomic stabilization**. This phase provides monetary and fiscal balance, inflationary pressures are eliminated, price stability is established and conditions for economic growth are created.

**II phase: Liberalization, as follows: price liberalization, foreign trade and financial liberalization**. In this phase prices and interest rates start forming freely, equilibrium foreign exchange rate is introduced, quantitative limitations in trade are abolished and customs are decreased, monopolies in foreign trade and in the internal market are abolished. This phase means the start of building of integral market (labour market, capital market, goods and services market, foreign currency market) and creation of complete market environment and infrastructure.

**III phase: Privatization of collective property** together with solving of restitution problems (returning of the property to its previous owners).

**IV phase: Recovery of companies and banks and their transformation**

Main causes of high inflation come from condition and characteristics of economy and the previous system on one hand, as well as from necessary actions during stabilization and transition on the other. These causes are:[2]

1) **significant budget deficit during the 80's and at the beginning of transition,**
2) **monetary overhang expressed by shortage of goods, excess of money and muffled inflation,**
3) **process of liberalization which liberated the prices from control so they increased during the transition,**

[1] Madžar, Lj., In relation to that the following books of are authors are listed: "Twilight of socialist economies", 1990.
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4) **supply shock – decline of production during transition,**
5) **external shocks (Poland), due to increase of foreign exchange rate and enormous external debts,**
6) **increase of production expenses (increase of wages, high interest rates, increase of import prices, increase of prices of inputs liberated from control),**
7) **inefficient economic structure,**
8) **political factors (political instability, instable governments and early elections, strikes and pressures, struggle for the independence of the country).**

Special explanation is necessary for two factors: **first- monetary overhang and second – supply shock**.

Monetary overhang is a phenomenon very pronounced in European economies after World War II and in former socialist countries. Its manifestations are: abundance of money, controlled prices and muffled inflation, shortages and limited supply, occurrence of black market where prices are balanced (but significantly higher), enormous savings of the people. [3] In the context of quantitative theory of money there is an excess in money supply: $(M^S/P) > (M^d/P)$. **There are two possible solutions: (1) decrease of money supply through monetary reforms and (2) liberalization and the price growth**. In the first case $M^S$ is declining (balance on the monetary market) in the second case prices are rise (balance on the goods market).

After World War II almost all of European countries chose the first solution and by blockade of deposits and confiscation decreased the amount of money, avoiding the hyperinflation, as did Baltic states in the 90's. Countries in transition chose the second solution and that caused the increase of prices. Some countries gradually reduced the price control (Bulgaria, Romania), and others used stabilization programs to prevent high inflation. Poland chose **shock therapy**, which lead to sudden increase of prices and hyperinflation (like Greece and Hungary after World War II), but shortly, in 1990 it stabilized the prices with stabilization program.

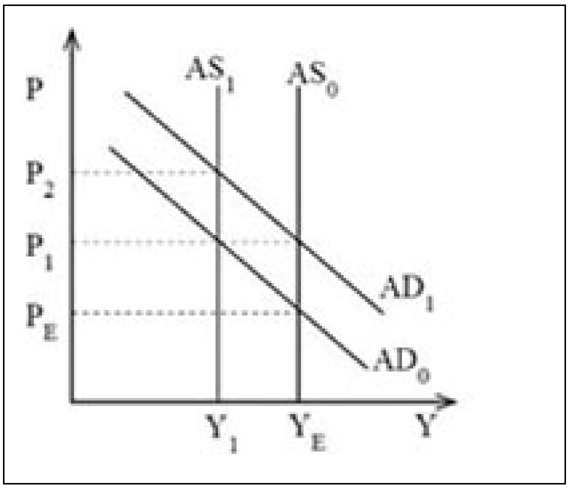
Supply shock is the consequence of several factors:

- sudden increase of prices of raw materials and production costs,

[3] Dornsbusch, R. – Wolf, H., "Monetary Overhang and Reforms in the 1940'", (1990) and Calvo, G. - Corricelli, C. "Stabilizing a Previosly Centrally Planned Economy: Poland 1990", 1992.

- market breakdown (due to disbanding of COMECON, or disintegration of the country),
- transition to foreign competitor market,
- introduction of restrictive monetary policy and abolishing of subsidies and loan, which was named *"liquidity crunch" by* Calvo and Coricelli*;* it worsened the liquidity, decreased the investments and brought down production,
- series of bankruptcies and liquidations of inefficient companies, with the growth of unemployment.

**Graph 1. Aggregate supply curve in socialist economies**

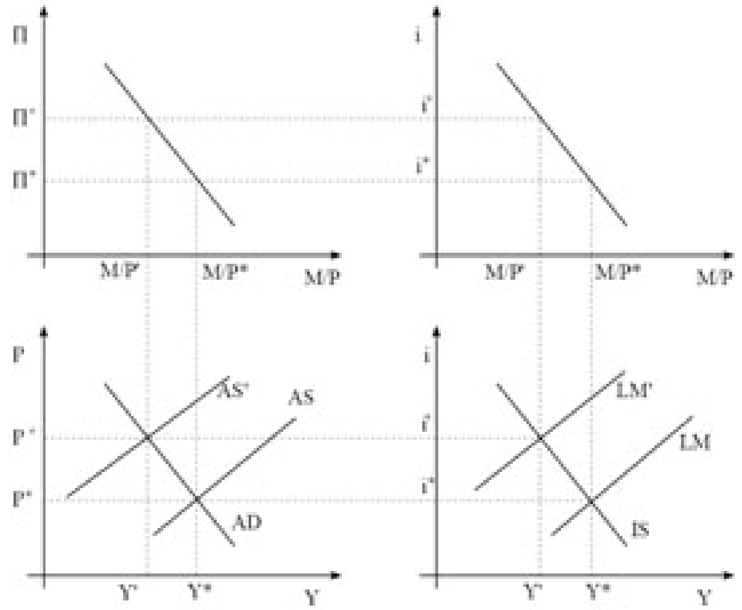



Graphically, the case of price growth can be shown in the context of AS – AD model:

In socialist economies Aggregate supply curve (*AS*) is highly price-inelastic (almost vertical). Decline of aggregate supply (supply shock) leads to price growth, from the initial balance $P_E – Y_E$ ($AD_0 – AS_0$) to the level $P_1 – Y_1$, ($AD_0 – AS_1$). If there is an increase in demand (due to fiscal expansion) to level $AD_1$, the prices rise to an even higher level ($P_2$).

This means that the inflation rate increases with the increase in budget deficit (increase of *AD* – curve) as well as with decrease of domestic product (decrease of *AS* curve). Decrease of AS curve may be illustrated by graph 2.

**Graph 2. Correlation of inflation and domestic product in socialist countries in the context of AS-AD and IS-LM model**




Initial balance is presented in the following coordinates: $Y^* - p^*$, $M/P^* - \Pi$, $M/P - i^*$, $Y^* - i^*$. If with unchanged aggregate demand aggregate supply decreases to the level of AS' we have the following sequence: decrease of Y to the level of $Y'$, $\Rightarrow$ decrease of $M/P'$ (increase of interest rate). New coordinates are: $Y' - P'$, $M/P' - i'$, and $M/P - \Pi'$. Real domestic product and real amount of money have decreased, and prices and interest rate have increased (exactly what happened in the countries in transition).

This has provided theoretical explanations and specific samples of: (a) increase of prices during process of transition, (b) enormous transition and stabilization costs. These costs are expressed by: enormous decrease of domestic product and increase of unemployment, high inflation and decrease of real wages. The origin and extent of these costs is less a consequence of stabilization and much more of the following factors of transition: a) privatizations, b) restructuring of companies and banks, c) change of complete economy structure and development strategy.

Other, at that time Yugoslav economists have also written about vertical, or negatively sloped aggregate supply and the absence of Phillips curve in our country, and this can be seen in more detail in the papers of Žižmond and Crkvenac.[4]

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[4] Žižmond, E. "Specifics of inflation in Yugoslavia"; (1989.), Crkvenac, M. "Ekonomska politika", 1997.

In the context of **discomfort index** (as the sum of inflation rate and unemployment rate) Crkvenac has constructed broader synthetic economic stability rate indicator including the following four economic factors: economic growth rate, **inflation rate, unemployment rate and share of the balance of payments in the value of gross domestic product**.[5] Formula is the following

$$IS = \left[ (r+1) + \frac{SPB}{Y} + \left( \frac{1}{p} - 1 \right) + \left( \frac{1}{u} - 1 \right) \right] 100 \qquad (1)$$

Explanation of the formula is the following:
$I_S$ = synthetic index of stability;

There is a positive correlation between the economic growth rate (***r***) and economic stability.

Share of the balance of payments in the domestic product $\left( \frac{SPB}{Y} \right)$ is also positively correlated with the index of stability.

Between the price growth rate **(p)** and unemployment growth rate (**u**) on one hand and index of stability on the other there is a negative correlation and that is why the signs in the formula are negative. **Synthetic indicator of economic stability rate** practically goes from + 10 to – 100. Positive value of the index of stability (values from 0 to 10), marks a high stability of the economy, and high negative values indicate high and increasing rate of instability of the economy. The author showed that the economy of former Yugoslavia had high negative indexes of stability which moved in the range from -14 in 1970 even up to -80 in 1987, when the first hyperinflation happened and the political instability which preceded the disintegration of the SFRY. Economies of Germany, United States and Switzerland have recorded high indexes of stability (positive ones) in the period from 1970 to 1988, and Turkey, Spain, Greece and Portugal had somewhat more unfavourable indicators.

## SERBIAN ECONOMY IN THE PERIOD 1994-2007 AND FORMING OF THE LABOUR MARKET

There are two separate periods in the development of Serbian economy.

**The first period** from 1994 to 2000 is characterized by bringing down of hyperinflation, isolated economy in the conditions of economic sanctions, decline of production and extreme economic instability.

[5] Crkvenac, M. "Economic policy", Informator, Zagreb, 1997.

**The second period** from 2000 to 2008 after the change of regime of Slobodan Milošević (October 2000) there were radical transitional reforms, establishment of macroeconomic stability, opening to the world, monetary-fiscal reform, privatizations and rapid inflow of direct foreign investments.

**Main conclusion is that in none of the two periods presence of the Phillips curve was not noted, nor was it possible to lead rational economic policy based on this theoretical concept**.

In the continuance of this presentation we will present main characteristics of the two periods, showing a short preview of macroeconomic model of Serbian economy based on which the creators of the economic policy today may manage key economic flows.

The first period from 1994 to 2000 is characterized by the following:

1) Successful implementation of orthodox stabilization program from January 1994, by which one of the highest hyperinflation in economic history was stopped.
2) There was a certain economic recovery and increase of production and wages.
3) Until the end of 1994 budget balance was realized, increase of foreign exchange reserves and relative stability of the foreign exchange rate.
4) After 1995 and until 2000, the country entered the zone of high inflation, low level of economic activity, high losses and deficits of the public sector and limited use of the market.
5) Economic activity took place in the conditions of almost total closure of the country, economic sanctions, shortages, decline of foreign trade activities, absence of privatization and direct foreign investments.
6) Budget and quasi-fiscal deficit was formed, the government was late in settling obligations towards pensioners and other social beneficiaries, and average wages were on the level below 50 DM per month.

**To conclude: economic situation was extremely tough and it took place in some sort of semi-war economy, with imbalance in all key sectors, low living standard and the risk of new hyperinflation or total collapse of financial and economic system of the country**.

The second period from October 2000, has lead to the change of political system and to radical economic reforms. There are numerous economic analysis, texts and articles. Therefore we will point out only the key characteristics of the post-stabilization period:

1. Internal balance with relatively low inflation rate, fiscal balance and monetary stability was achieved.

2. Partial external equilibrium was established with controlled deficit of the current account balance, stable foreign exchange rate and decrease of external indebtedness.
3. Gradual coming out of recession and accelerated economic growth followed.
4. Foreign trade activity was liberalized and customs were decreased, especially in the trade with countries from European Union.
5. Extensive tax reform was performed as well as the reform of pension and social system.
6. Privatization followed, using the Hungarian model i.e. sale, primarily to strategic partners (and with exception of public companies). Inflow of more than 15 billion dollars of foreign capital was realized in form of donations, loans, privatization incomes and direct foreign investments.
7. Public companies were put on “hard budget limitation”, corporatization and commercialization and prices which were in the zone of coverage of operating costs.
8. Extensive institutional reform was performed and several hundred laws were passed in various areas of economic and social life and majority of laws are in compliance with legislation of the European Union.
9. Banking sector was reformed, country’s foreign exchange reserves rose and number of foreign banks was opened.
10. During 2008 the country signed the Stabilization and Association Agreement with European Union.

In that context, Serbia joined successful transition countries (Slovenia, Hungary, Czech Republic, Poland, Baltic states), which already finished the transition, became full-blooded market economies and members of European Union. During these eight years, Serbia had relatively low inflation rates (up to 10% on an annual level), increase of domestic product which from 2004 was above 5% annually, but the unemployment rate remained extremely high, over 20% and one of the highest in Europe. Already this data implies that there is no interdependence between inflation and unemployment and that the labour market although it is starting to function (after appropriate changes in the legislation), still does not have the characteristics typical for developed market economies. We would like to point out several key characteristic of the labour market:[6]

1. There is a high rate of participation – share of the work force in total population and it is around 68%.
2. Large share of employees in informal sector, and renewal of economic growth has not led to employment growth (indication of the absence of Phillips-Okun curve).

[6] This part was done based on publication of the World Bank "Serbia and Montenegro– Republic of Serbia– Program for economic growth and employment ", December, 2004.

3. Unemployment rate is around 12% (although authors of the study point out that according to the official data which is not in compliance with the methodology of the International labour organization it is around 29%), but with large number of fictively employed.
4. Period of unemployment duration is decreasing, but it is still very high and it is 47 months.
5. After year 2000, there was an increase of wages which was significantly above the increase of productivity and GDP (which indicates that the wages are main cost generators in generation of inflation).
6. Labour market shows good flexibility if measured by flows between employment, unemployment and inactive work force.
7. There is dualism on the labour market, which is reflected in the presence of formal and informal sector, as well as in division on the market of young work force (up to 24 years and after 24 years), which shows that young people almost do not look for jobs.
8. Reformed legislature from 2001 (and in later changes in 2005), provides good basis for establishment of labour market in compliance with standards of western market economy.
9. Social partnership did not function well, unions are weak, and the process of collective negotiating is in its infancy.
10. System of benefits for unemployed is not a limitation for new jobs, but funds for disbursement of benefits are lacking.
11. Implementation of number of active employment policies is necessary, for what a more efficient work of the National Employment Agency and more budget funds are needed.
12. In the future, growth of private sector should be the main source for assimilation of unemployed work force.

## POSSIBILITY OF EXISTENCE OF PHILLIPS CURVE

On this occasion, it is interesting to consider the report of the World Bank "*Transition The First Ten Years*" from 2002 which on page 44 gives indexes of movement of employment and GDP in the period 1990-1998, for the following countries in transition: Hungary, Czech Republic, Poland, Ukraine, Russia, Kazakhstan, Bulgaria and Romania. Comparison of these indexes would approximately equal the interdependence that characterizes Okun curve (relation of domestic product and employment). Without the intention to present the graphs, as they are available in the publication, interdependence in the movement of index of employment and GDP can be clearly noticed, because the increase of GDP (or decrease), is followed by increase (or decrease) of the level of employment. **That indicates the possibility of presence of Okun curve. The study does not**

**indicate significant interdependence between inflation and increase of GDP i.e. it does not confirm the existence of strong relation typical for Phillips curve**

Economics team CES – Mecon in February 2005 made a macroeconometric model of Serbian economy and tested it for the period January 2001 – August 2004. [7] Monthly macroeconomic series of Serbian economy were tested by implementation of cointegrational relations and latest econometric methodologies, and all variables were put in logarithms. The model contains key cointegrational relations as equilibrium equations for observed variables. Some of the most significant relations in the model are:

1) nominal foreign exchange rate and employment are exogenous variables;
2) real wages are determined by productivity of the labour, and nominal wages are determined by productivity, trend and price level;
3) price level is determined by labour costs and import costs (foreign exchange rate);
4) demand for money and real foreign exchange rate are mutually determined, and wages in Euros increase when real wages increase and when foreign exchange appreciates;
5) increase of wages leads to increase of consumption and increase of import;
6) domestic product is determined by the level of import.

Good results were obtained and we point out the most significant conclusions of the author.

1. Nominal wages increase with the increase of inflation and labour productivity.
2. Basic inflation is determined by labour costs and depreciation of dinar exchange rate.
3. Real foreign exchange rate decreases with increase of real wages and causes decrease of competitiveness of economy and increase of import.
4. Inflow of foreign capital affects the increase of domestic demand.
5. Effect of wages as indicator of domestic demand on the economic activity is significantly smaller.
6. Main conclusion of the authors is that the economic activity in Serbia was determined by increase of aggregate demand – current consumption and inflow of foreign funds. Factors on the supply side did not have significant effect on the increase of economic activity. Based on this we can conclude that the interdependence inflation/unemployment is completely absent in the macroeconomic model and is not relevant for management of economic policy.

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[7] Study "Macroeconometric modeling of Serbian economy: Theoretical basis and results" (February 2005), Ekonomski anali, March, 2005.

Regular analyses published in the publication *“Macroeconomic analyses and trends & Conjectural barometer”*, by Economics Institute in Belgrade (with economic team lead by S.Stamenković and M.Kovačević) refer to the similar conclusion. Analyses show that the main elements of economic policy are in a triangle monetary – fiscal – policy of foreign economic relations, and that the key parameters of economic policy are foreign exchange rate, movement of real wages, level of budget deficit, reference interest rate and current balance of payments. Phillips curve and Okun curve do not exist in models as relevant instruments in economic policy management.

## PHILLIPS CURVE IN DEVELOPING COUNTRIES

An interesting research on possibility of existence of P-curve in developing countries was done by Modigliani and Tarantelli in an article named “A Generalization of The Phillips Curve for A Developing Country” from 1972.[8] The authors examined the existence of Phillips curve and performed evaluation based on empirical data for Italy in the period after World War II i.e. from 1958 to 1968. Italy was selected as a prototype of a country with dynamic economic development, quick change of economic, social and qualification structure of the work force and changes in the P-curve. The authors specified Holt’s model and evaluated several equations of Phillips curve with relatively good empirical results. Long-term Phillips curve was evaluated as well with the evaluation that the long-term stable inflation rate is at the level of 5%, and equilibrium unemployment rate is at the level of 6%:

Basic conclusion of the authors (based on model of empirical research) is that the expansion of demand and economical development gradually move the P-curve to the left and down towards zones with lower inflation and unemployment, which is contrary to the views of Friedman i Phelps. The reason is accelerated economic growth which raises the qualification structure of the work force, changes the behaviour of the P-curve and creates a whole family of P-curves moving to the left. Rise of the qualification structure temporarily leads to increase of wages, but also to the increase of productivity of labour which mitigates the impact on inflation and raises the competitiveness of labour. Therefore, decrease of unemployment does not lead to the increase of inflation. **Based on that, the authors conclude that in developing countries permanent reduction of unemployment below the natural rate will not accelerate inflation.**

The abovementioned research was not applicable on Yugoslavia in the period of 90’s for two reasons: (1) although our economy had characteristics of a

[8] Modigliani, F. – Tarantelli. E. "A Generalization of The Phillips curve for A Developing Country", 1972.

developing country, it did not have such dynamic and successful continuous economic growth like the Italian economy; (2) due to very limited effects of the market mechanism and absence of labour market, it was not possible to analyze the Phillips curve in the manner Modigliani and Tarantelli have done.

Somewhat bigger chances for application in conditions of Yugoslav and Serbian economy are provided by **Scandinavian model of inflation**. In fact, in our economy basically two sectors can be identified:

1) monopoly – oligopoly,
2) non-monopolistic sector.

Sectors are characterized by difference in productivity of labour and manner of forming of prices. Monopolistic sector has a higher price increase and higher wages increase, which attempts to follow the non-monopolistic sector as well, despite lower reserves for cost increase. Therefore this is a constant source of cost generated-structural inflation and it could be used for empirical analysis of Serbian economy even after year 2000. The solutions are still actual: **(a) constant control of wages; (b) strengthening of competitiveness and (c) breaking of oligopoly structure of economy.**

More detailed study on monetary and financial policy of developing countries, and on the problem of growth and stabilization was presented by Hossain A. and Chowdhury A.[9] In several chapters authors analyze theoretical and empirical approach to sources of economic growth, growth ratios, inflation and money supply, which is close to relations of Phillips curve and Phillips-Okun curve as a connection of inflation with economic growth. Moreover, issues of monetary policy and stabilization, money supply and management of monetary policy, supply shocks, monetaristic and Keynesian debate in the context of aggregate supply and aggregate demand are also discussed. We point out only a few basic conclusions of authors which may have significance for our research:

**First,** low or moderate inflation may be positively correlated with economic growth, while high inflation and hyperinflation have negative effect on the economic growth, because they increase the uncertainty and lead to leak of capital.

**Second**, there is a certain support to hypothesis of structuralists that the low inflation is desirable for economic growth, but this cannot be accepted as general rule.

**Third,** according to the empirical research developing countries are not highly sensitive to demand shocks (consumption, investments, and demand for money). With flexibility of wages and foreign exchange rate, shocks may

[9] Hossain A. and Chowdhury A. "Monetary and Financial Policies in Developing Countries", Routledge, London, 1996.

be adapted by price mechanism without active stabilization policy of the government.

**Fourth,** vulnerability is higher to supply shocks (agricultural sector, external shocks – movement of oil price and of other raw materials on the global market), although these shocks are occasional, rather than permanent.

**Fifth,** active monetary policy after negative supply shocks may be the cause of inflation and after phase of expansive monetary policy, phase of moderately restrictive economic policy should follow.

## CONCLUSION

Inflation in Serbian economy is a phenomenon of long-term presence in almost whole postwar period. As such, it quickly becomes the object of analysis and research of numerous economists in our country. In determination of types and causes of inflation there are three basic approaches:

**(1) inflation of demand, (2) structural inflation, (3) cost generated inflation.**

Although our inflation is a very complex phenomenon, with number of causes and factors, and although it needs multicausal approach, the most advocates and the strongest theoretical-empirical argumentation has the opinion according to which our inflation is mainly of cost generated character. There are two main factors that pressure the costs and start inflationary spiral:

1) wages which increase autonomously; increase of wages in monopolistic sectors is followed by increase of wages in all other sectors (which cannot cover that), to which prices and monetary policy is adjusted in the next sequence;
2) foreign exchange rate due to poor balance of payments positions, large import dependence of our economy and frequent devaluations and depreciations.

With the acceleration of inflation, in time, effect of the inflationary expectations grow as well, other factors such as excessive budgetary consumption, credit expansion and others also contribute to increase of inflation.

General conclusion is that rational economic policy cannot be lead based on the concept of Phillips and Okun curve. Attempt to stop the increase of prices by increase of unemployment would be very inefficient with enormous increase of unemployment and high social costs. Transition of our society in the direction of integral market has no alternative. In the environment of complete market with all of its mechanisms and institution, macroeconomic policy may be lead rationally and in compliance with economic theory.

Theoretical and empirical researches confirm that the Phillips curve is not inherent to developing countries and countries in transition.

Underdeveloped labour market and lack of institutional mechanisms, overemphasized monetary factors, strong influence of reserve currency, enormous significance of inflationary expectations, sensitivity to import shocks and supply shocks, inelastic curve of aggregate supply cause the absence of P-curve.

These are the reasons why the P-curve was not detected in the economy of Serbia in the period of transitional reforms from 2000 to 2008, and it was neither confirmed in other economies in transition. There is a challenge for economists to confirm its existence in the years to come when management of economy and manner of its functioning come closer to subtle mechanisms of western market economies.

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# CHAPTER 14. COLLAPSE OF (NEO-LIBERAL AND/OR FINANCIAL) CAPITALISM?

**Ivan RIBNIKAR**, Faculty of Economics, University of Ljubljana, Slovenia

The US financial crisis mechanism, its worldwide expansion and transformation into economic recession or crisis are well-known to us. Nothing significantly different did occur this time either (Reinhart, C. M. & K. S. Rogoff, 2006; Krugman, P. & R. Wells, 2010), despite possible differences in details and its global character. Growth or 'blowing up' of loans in the USA, mainly assisted by banks, as well as the so-called 'shadow banks', is, at the end of the day its main characteristic. These institutions were created by banks themselves, since they were not able to lift loans endlessly due to capital limitations and central bank oversight. Only the abovementioned shadow banks were able to do this, since there were not controlled. Shadow banks have transformed maturity period of resources through their property balance. They indebted short-term, by repurchase agreements and short-term securities issues, and entered long-term placements. Hence the name 'shadow banks'. Growth of loans, similar to increased car or detergent sale, leads to higher incomes. A fact that these loans may not be repaid was not taken into consideration. Circumstances were allegedly different and there was no need to look backwards and around at what was going on.

Behaviour of credit companies should be added up to this, which, in different ways, stimulated readiness of people to indebt, made them believe it was normal and a must for banks profit to reach from 20 to 25%, even though a long-term proprietary capital rate of return in the USA, for example, was only around 9 % annually (Sharpe & Alexander, 1990). Enormously high bankers and securities traders' bonuses were generally considered to be normal, since they allegedly, earned it by 'creating' the value. Bankers are the main target of all critics (Aglietta, 2008 and 2009; Soros, 2008; Stiglitz, 2010) and this is the only way they made up for their 'creation' of the value. However, there should an underpinning cause, even in terms of philosophy that market should arrange everything, that oversight and regulations should be maximally reduced. Let's briefly have a look at how it all happened.

We start with A. Smith, a few words on altered relations between a state and market or capital; on capitalism or market economy and morale and moral responsibility of capitalism; on financial deepening or on 'financiarisation' if we use a French word, and finally on topicality of Keynes, and Minsky and Marx.

## ADAM SMITH

Liberals and neo-liberals have their icon A. Smith, most likely justifiably, which is why we start with him. A. Smith was a moral philosopher above all. Following the book 'Moral Sentiments', he wrote 'Richness of People' (1776) and focused on criticizing at that time prevailing mercantilism. Mercantilists' main thesis was that richness of the people is in their money and that the state should support those industries or branches that exported and brought money to the state. Therefore, significant involvement of the state in economics was one of main characteristics of mercantilism, since allegedly only that way balance of payments surplus could be achieved. Although this idea of richness in money is, let us say, a nonsense, it was quite rationally explained. The money system was a 'gold standard', in which the value of gold determined the value of money, and what is even more important quantity of money could be increased only if the state had more gold. This is what it was important that growth of production and trade should be followed by growth of quantity of money. However, since gold came from aboard, and only several countries had gold mines and England was not one of them, quantity of gold could only grow if the state has balance of payments surplus. This is why the idea to produce what could be sold aboard and what provided balance of payments surplus is not that senseless.

Should this be true, it would then, understandably, refer to inconsistent economic environment. Namely, not all states could have a surplus, Nowadays, just to make a small digression, we face a similar inconsistency among countries using Euro currency. All countries should allegedly be like Germany. But, Germany needs countries different from it, (perhaps not like Greece), to be what it is. A surplus sum of countries with surplus, to go back now, equals a deficit sum of countries with deficit. A Scott John Law tried to resolve this money issue in a radical way before Smith. Scottish people did not trust them, but he managed to persuade the French in his modern idea that richness was in money, but this money did not need gold backing. He established a bank in 1720 that operated in line with his philosophy. Bank issued loans and money wholesale. The bank naturally went bankrupt, Law fled from France and not a single French bank was called a bank since then until the end of the 19th century. This is what, even today, the French have banks, from that time, called 'Société', 'Caisse', 'Comptoir', 'Crédit'. 'Banque de France' was the only exception from the rule, founded by Napoleon in 1800. He did not accept people's biases.

This is why Smith's book, who is considered to be a creator of economics or political economy, is an argument in favour of market free from unnecessary involvement of the state and against philosophy of mercantilism. When it comes to the market issue, Smith sometimes tends to go too far with his arguments, but we have to try to read him with the year of 1776 hat on. Hence, for example, there is no human natural propensity towards exchange or tare, which would be an argument in favour of free trade. Same criticism could be found in a book, published in 1944 by Karl Polanyi (Polanyi, 2001). One may read this book nowadays as if it were written just before the current crisis. Despite these and other details, Smith's book is a great text, but this is not a book founding capitalism. Capitalism is not mentioned in his discourses. Capitalism came with Marx. Although he was in favour of the market, A. Smith understood the need for country's interference; need to have a market and a state and to regulate the market. He was far from being in favour of market fundamentalism. His books confirm this. Today, for example, a Nobel Prize winner A. Sen (2009 and 2010), dealing with poverty issues and how to reduce poverty and justice issues (Sen, 2009) places him at the very top. He is a leading economist focused on moral issues in economics. He is far from being in favour of economic liberalism, much farther from it than most others.

When A. Smith is mentioned today, then he is usually referred to as an 'invisible hand', which is sufficient evidence that the market should be left self-regulated. Emma Rothschild (2001) reviewed Smith's texts and found 'invisible hand' only once mentioned in Richness of People and once again in two other discourses – the total of three times. In all three cases these words are used as an irony. When 100$^{th}$ Anniversary of Smith's book was marked, no one mentioned invisible hand. And only until recently it was not considered to be the essence of A. Smith. How did this happen?

## ALTERED RELATIONS BETWEEN A STATE AND A MARKET

Michel Albert (1991) analyzed advantages of 'modèle rhénan du capitalisme', i.e. German or German - French capitalism, as opposed to Anglo-Saxon, which, according to the author, lost the battle although better. He divided the period until the end of 1991, when his book was published, into three centuries from the relation towards capitalism viewpoints. In a century beginning with 1791, we had capitalism against state ('capitalism contre l'État'), followed by a century beginning with 1891, when we had capitalism limited by state ('capitalisme encadré par l'État'), and finally, a century beginning with 1991 with capitalism instead of state ('capitalisme à la place de l'État'). Direction of changes is clear, but this goes more for Europe and for the USA, for example, or Anglo-Saxon world. They have not undergone such huge changes. Their changes are slow and take long, but then become deeply rooted.

European ideas contributed most to the victory, conditionally speaking, of Anglo-Saxon capitalism or its ideological foundations – among other things, because the third century of M. Alberta was about to begin. This is, at least what an English historian Tony Judit (2009) argues. This is all about five people, a philosopher Karl Popper (1902-1994) and economists Ludwig von Mises (1881-1973), Friedrich von Hayek (1899-1992), Joseph Schumpeter (1883-1950) and Peter Drucker (1909-2005), coming from Vienna or nearby places. They all fled from fascism and emigrated to the USA or the UK. They all survived the World War I and its defeat, unsuccessful revolutionary attempts following it, temporary rule of socialist or left-wing parties, their failure and rise of fascistic terror. T. Judit believes that, somehow, these very clever people, came to a conclusion that, at the end of the day, incapability of left-wing parties caused rise of fascism, parties that came to power after the WWI. There are no dilemmas on intellectual level of those people. J. Schumpeter, for example, was respected despite his conservative ideas (he was a strong opponent of Keynes). K. Galbraith was the most sophisticated conservative among economists. J. Schumpeter said he himself was a conservative, but his image of an conservative did not coincided with anyone else claiming to have been conservatives (McCraw, 2007). These people were convinced, from their personal experience, that new arrival of a left-wing party to power should not be allowed. A state should accordingly be downsized as much as possible. And they set out an objective – economic liberalism should be intellectually established - a small state and little regulation in economics. K. Popper drafts an adequate political system to such an economic environment – of which the British majority voting system is a small example of. As we know, liberal democrats formed the Government with conservatives on condition of changing this voting system. And conservatives seem to have accepted this.

A 'welfare state' and social democracy, as T. Judit believes, function best in small and ethnically homogeneous countries. Should we take this into consideration then the USA do not have many chances for this to happen. However, what is interesting, coming from historians, is that, according to him, all changes in last thirty years in Anglo-Saxon world, have not been assessed as good or bad, but as efferent and productive – depending on whether they contribute to the growth of GDP. Such an opinion is not innate, but learned or indoctrinated.

## MARKET ECONOMY OR CAPITALISM, MORAL AND MORALE OF CAPITALISM

We have already mentioned that A. Smith did not use the word capitalism. He spoke about market. Capital nowadays is commonly used and market and market economy are considered to be slightly unusual. It has been generally accepted that capitalism is not neutral, but has an ideological or political connotation. This is why some talk about market and market economy. Hence, for example, the abovementioned A. Sen generally does not used the word capitalism. However, when talking about market or market economy, then two things most likely matter.

How many material needs of people should be met by market and how many by the state or any other non-market institutions? Furthermore, to what range should markets be regulated – financial markets and institutions above all? This is much more complicated than saying the smaller states, the bigger markets, the better, i.e. market is best regulated when it's self-regulated. We know how all problems until recently were dealt with market and its self-regulation. These were theses of allegedly the only true economic science. And this is axiomatic, non-historical, unsocial and non-psychological science, should we use the word science at all.

It is true that deregulation was assisted by academic economists. This was not only at Reagan's time, but before and after him, as well, at Clinton's time. M. Rocard therefore believes M. Friedman and his 13 Chicago Nobel Prize winner colleagues' theses should be judged and rejected. For what is now going on with 'economic science', M. Rocard argues, we could compare with the situation in medicine if someone should discover L. Pasteur was wrong (Rocard, 2010).

Market economy or capitalism, if someone wants to keep using the term, has its moral principles that have been respected, set aside the very beginning, since the first capital or the first wealth was created, for example, with the so-called 'enclosures' or fencing in the UK. It is characteristic for any business or any economic activity that the future is unknown; hence all or most business decisions are risky and/or uncertain. However, since it is important risky and/or uncertain business are dealt with, since the welfare of people depends on this, it is moral, if someone has undertaken such a business and has been lucky and successful, that he/she should become rich. This wealth is only a part of the wealth created. We may not agree on the issue, whether this is fair or not, but we cannot talk about immorality when it comes to the market economy or capitalism. However, moneymaking in any other way, by frauds and absence of any risk taking, for example, is not considered to be moral.

What has this financial crisis proved is, namely, the fact that bankers, traders and other financial managers, for example, made money, but failed to make any wealth, even destroyed it. This was absolutely immoral and, in a sense, brought about 'sobering up'. Should we talk about immorality, we do not refer to immorality of those people, but, although it may sound strange, immorality of the system, institutions that made this possible. People are no greedier nowadays than they used to be. The system and institutions enabled greediness come to life.

However, if we talk about moneymaking, which we cannot call immoral from the morality aspect in market economy, a great wealth on one side and poverty on the other are not acceptable by most people. J. Daniel (2009), for example, quoted Roosevelt, who at the time of the crisis in thirties, said that if there were no hope to moralize capitalism, since it was contrary to its nature, because of huge wealth on one and poverty on the other, then collectivization is the only one remaining at the end of the day. Not only is there a hope, but we know states and their economies that cannot be called immoral capitalism or market economic environment.

It might be better to talk about market economy, where not all people's needs are fulfilled through the market, but outside of it, as well, and where, even this market-related part, particularly when it comes to financial markets, is not self, but state-regulated. Regulation of financial markets or finances is generally necessary, since finances are about trading promises. Any ‘only a fool believes promises’ case should be prevented. In this case, we cannot say this is an immoral economic environment; the only moral non-market economy would be a Soviet type one.

## FINANCIAL DEEPENING OR »FINANCIARISATION«

What differentiates today’s (market) economies from those of more than ten years ago, is the difference in non-financial enterprise property structure and households, and in importance of securities and financial mediators or institutions (monetary and non-monetary). An enormous growth in financing took place, i.e. ‘financiarisation’ (Plihon, 2001), if we wish to use a French word, or ‘financialisation’ (Aglietta, 2005), if we wish to use an English one. However, what is more important, this implies monetary claims and monetary debts at the same time. Overall financial asset, i.e. sum of all claims on the left side of enterprise and residents assets balance is several times bigger than actual assets value. This also refers to debts on the other side of assets balance. This year’s GDP of the USA is, for example, around 15 billion US dollars, and value of CDS is around 64 billion, if we take only one financial instrument. GDP of the whole world is around 56 billion US dollars (Uygur, 2010).

Enterprises are usually owned by major institutional investors (different funds), which act like ‘punters’ and not like ‘proprietors’. Value concept, as we may see, is adjusted to the so-called ‘financiarisation’. In an enterprise, financial or non-financial one, value is only added (’value added’ or ‘valeur ajoutée’); ‘value creation’, nonetheless, exists only in a financial market.

Some talk about a ‘casinó’ capitalism, since securities are treated like horse races betting shop lists or roulette wining numbers. This comparison is only partly true. Roulette players, no matter how many of them or how they play, cannot influence the roulette itself – what number the ball shall stop at, for example. It is all about ‘fair play’. When it comes to betting at stock markets, players do influence securities exchange rate value and this exchange rate in return impacts business operations of the enterprise that issued securities. If this is a casino, then it’s a special casino, deprived of ‘fair play’. We have seen, how the financial crisis, playing or betting in financial markets, took hold of real economics and turned into economic crisis.

## TOPICAL CHARACTERISTIC OF KEYNES, MARX AND MINSKY

Economic theory of economic depression (Krugman, 2009) has become topical again, as well as Keynes and Marx due to return of economic crisis. This also refers to Hyman P. Minsky (1986), who was beyond the mainstream of economic thought, as well as to a less famous Benoit B. Mandelbrot (2005). Instability is a market economy feature. This is even more relevant to its financial sector. It may seem as a paradox, but the more developed financial system, the greater instability. i.e. how far the process of the so-called financial deepening reached. Financial market cannot be self-regulated.

Marx has become interesting and topical in a way even before the financial crisis broke out in September, 2008. We may say this topicality is related to globalization and issues it brings along. There is a book, written by Meghnad Desai (2002), advocating a theory that Marx would be delighted by current globalization. Another book written by Jacques Attali (2005) supports similar thesis. He was neither an expert on Marx nor Marxist, if we use this classification in the region, where once almost everyone was Marxist, and, all of a sudden, they were all gone. Marx was the first one to think in global terms, which implies taking the world as a whole. And this is why J. Attali calls him 'esprit du monde' ('spirit of the world'). There are also many other interesting papers, for example, by a well-known historian Eric Hobsbawm (2009).

It is understandable at the time of the ongoing economic crisis that answers are being looked for: what went wrong, i.e. in the first place, which ideas were wrong, since they are usually the most dangerous ones. Rereading Smith, Keynes, Minsky, and even Marx is quite logical. This, however, does not mean that market economy (or capitalism) could be abolished, although this idea could also be found. This was all a way of thinking on which ideas underpinned economic environment that brought about the biggest economic crisis after the great crisis in '30s of the twentieth century. Not only on which ideas, but how they found their way and became leading ones. These were allegedly scientifically based ideas, the fewer countries, the more markets, and that markets, even financial ones trading promises, should be as much self-regulated as possible.

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# CHAPTER 15. THE KOPERNICANIAN TUROVER OF ECONOMIC DEVELOPMENT CONCEPT IS ESSENTIONAL*

**Božo DRAŠKOVIĆ**, Institute of Economic Sciences, Serbia

***Abstract***

*The forecasted economic development based on market fundamentalism postulates, assuming that the liberalization, deregulation and general privatization together with the automatisms of market auto-regulation would led to rational recourses allocation, and consequently, to economic development, has proved to be wrong not only in the case of Serbia. The complete deregulation and privatization followed by the liberalization of domestic market and free capital inflow and outflow did not presented the positive economic and social results. After more that two decades of implementing the process of economic transition in Serbia, and particularly after the suspension of economic sanctions after the year 2000, were noticed the positive, but not sustainable trends only in a sector of GDP growth and reducing the inflation on about 6%. In all other segments the results were poor. The unemployment rate is permanently high, the foreign debt notices continual growth together with deficit in trade exchange with other countries. The share of industrial production in creating GDP keeps presenting low levels, and has been reduced to 20% of the one, evidenced in the pre transitional year 1989. The development strategy should be based on abandoning the liberal capitalism model and returning to the mixed system of private property, state interventionism and the participation of employees in firms' management. The interventionism based on responsible and enlightened, thus not corrupted state structure, is necessary.*

***Key words:*** *liberalism, autoragulative market role, state interventionism, participation, economic and social stability.*

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## INTRODUCTION

In this paper were defined three hypotheses referring to the issues of system, strategy, concept and possibilities of implementation of new strategies of economic and social development in Serbia.

First hypothesis. The development strategy of Serbia since 2000 was based on neo-liberal concept of deregulation, liberalization and privatization, in which core was the faith in economic rational almighty role of liberal market. Such a concept up until now has been proved wrong.

Second hypothesis. The economic policy starting on the fact that on the level of absolute imperative was posed the role of overall privatization and private property, as a key presumption of economic development, empirically appeared inefficient.

Third hypothesis. The inflow of direct foreign investments not accompanied by development strategy of Serbia and selective area of those investment inflows, in the past period manifested that such investment in many cases has not brought new technologies and development, but covered the necessities of multinational companies for their extension of real and financial sector of Serbian economic system.

The period of economic transition in Serbia from socialistic-market one, based on social property of the constituted economic and social system towards capitalist-market one, based on absolutism of private property, could be divided on two stages. The first one comprising the interval from 1990 to 2000 was characterized by wars and economic sanctions, and the disintegration of the Yugoslav market. The second one is the period of initiation and implementation of the experiment of market fundamentalism covering the stage from 2001 up today, that is, year 2010. In this paper, the fist period has not been analyzed, despite the fact that in it was generated new self-sown social and economic basis for the market liberalism and resources redistribution, not concerning the development.

## NEO-LIBERAL ALMIGHTY MARKET AND ALTERNATIVES OF MARKET REGULATION

In the recent almost 100 years the theoretical and empirical world was moving in vicious circle of, could be said, two utopia which being applied strictly, were excluding each other.

The first utopia is described as entrepreneurial. Theoretic views of Fredrick von Hayek and Milton Friedman, and their contemporaries, or followers characterize this one. Their access in the centre of interest and social circumstances places the entrepreneurial class based on property, and understands that free market by itself leads to continuous economic development and efficient resources distribution, and consequently, the social welfare. The current advocates of these ideas do not notice, or, even ignore the problem that unlimited, free market creates. If some of the problems comprising the market are recognized, those are inclination towards monopoly and imperfections of information on disposition of market participants. This conception did not notice other challenges. Here will be mentioned two of them. The first one is concerning the market tendencies that on it, certain participants concentrate the material possessions in the hands of minority, and that the economy starts to be socially and economically inefficient. The second challenge is related to the first one, and the problem of unequal distribution of income, or solvent-capacity demand, is resolving by developing the special segment of banking or financial market, which by credit operations enhances the demand and simultaneously additionally, in the future, makes the socially unsustainable state of the majority. This, so called market utopia starts from abstraction, which, lately, transforms into axiom: the market and its forces, “invisible hands,” “no free dinner” are absolute regulator and power that acts legally on human beings regardless their will, on the same way that physical powers affects on them. Thus, market powers are invisible, binding and equally powerful, as are the natural laws and powers, such is the gravitation. This access, lately leads towards the conclusion of “the market fundamentalism” that the market is a postulate that cannot be avoided, nor regulated, on it the intervention is useless, and particularly, the state is not the one concerned to perform such activities.

The second one is the state socialism utopia, which in the centre poses the state as a *bodyguard of* workers protecting them from capital exploitation. This utopia has its theoretical origins in the early French socialists – utopists, and lately in Carl Marx’s opus where he in the centre of his theoretic and philosophic doctrine focused the human gender. The empirical use of worker’s utopia was guide lined by state regulation and bureaucracy, assuming its form in the “state socialism” and minimized role of an individual and company, together with their participation on market. The core of social activity was located the worker’s interests, parallel with the state interests, political management and bureaucracy. This utopia tried to ignore the existence of market, individual interest and property, which were interchanged for central planning and state owned property. This concept got his breakdown in the East Europe countries at the end of XX century. The system of mixed socialistic and market economy with considerable modifications kept developing in China. The sub variant of socialistic- market system has been developed in former Yugoslavia, by introducing the system of social property and self-government. In the middle of these two extremes is Keynesian paradigm that recognizes the market and the state interventionism. It was developed based on the economic crisis' experiences from the year 1929, and the weakness of market automatism to overcome the growing crisis, unemployment, and poverty. The Keynesian approach indicates the fact that *laisez faire* is ended, or that the end has come for the system were only market is governing over itself.

Facing the empirical defeat of the state socialism idea, the social elites of the former socialistic East Europe countries accepted with both hands the idea of neoliberal capitalism, which in the very core of the economic system puts the Holy Trinity: privatization, liberalization and economy deregulation, as prerequisites of successful and socially acceptable transition of the socialistic into capitalistic economic system. The consequences of such model approval in the majority of ex socialistic countries from the social and economic point of view present the negative results. It was seen that the redistribution of social resources at the same time did not imply the development, while the unemployment and poverty together with indebtedness growth is characteristic of the transitional countries. Actually, it was presented her in its splendor the Pareto's optimum: that it is impossible to realize the redistribution of capital, that is, the means in behalf of one group standard improvement, not jeopardizing the other group of population. One, however, minority social group in transition, through the privatization has become a winner, while the absolute majority has deteriorated their position, representing a transitional loser. The greed is good for the transitional winners, but it is absolutely deteriorating for the losers.

The adopted model of economic transition on postulates of liberal capitalism was effectively theoretically defended and empirically implemented by their theoretic believers for almost two decades. Then, shock has blown. The financial and economic crisis in 2008 stroke just in the epicenter of the most liberal and most powerful economic giant it the world. The crisis was extended to the other most developed countries, and in that very year the state of those countries intervened trying to save their economies with about 3.1 billion Euros. The country was saving the private sector, scaring the advocates of the thesis to sell all, and the state interventionism was manifested through nationalization of the certain parts of the companies from the real and financial sector.

Despite all these facts, and upon poor economic and social transition results, which will be discussed later on, the political, and partially economic and social theory authors still keep on advocating the thesis on sale of all state and social owned capital, particularly the one which, in existing circumstances is efficient, the one that is still creating profit and is maintaining the certain level of employment.

The economic transition and privatization in Serbia in the period 1990-20 was realized as redistribution of resources into the hands of the minority. Transition was accomplished by poverty and unemployment growth, and standard decrease. Transition was completed by de-industrialization and foreign indebtedness growth. Transition turned to be economically and socially inefficacious, not only for the present moment, but what is more concerning, on long-term period.

The politicians are not the only one to blame for the economic and social situation in Serbia. The thinking people in the last two decades adopted pragmaticism, while, except in rare cases, the critic opinion on social happening and its consequences did not exist. This is not the case of Serbia, only, concerning the following quotation: “The economic institutes are paid by state or association money – and here of, course the optimism is very profitable, when needed. Concerning the possibilities of long term crisis stroke, one socially situated and adjusted member of economic branch, due to these reasons do not speak” [1]

## CRITICISM OF THE PRIVATIZATION, DEREGULATION, AND LIBERALIZATION

The pragmatic economic policy of nineties enhanced the “shock therapy” approach and excessive belief in absolute market power, and its self-regulating functions. The market fundamentalism appeared as contra balance to central – planning economy and their failures. The mistakes of market fundamentalism as a saver of planning economies’ inefficiency, on picturesque way were described by the following definition. "Was it because of intellectual laziness or ideological single-mindedness, what these free market fundamentalists fail to realize is that as long as the central planners were to be a jackass or fools, that far the market will be a moron. Efficient moron, but moron: left to its own funds, it will still work, mindless and mechanically [2]. “If it is left to market to solve all the problems…”then won’t be anyone to occupy with social problems.” The market fundamentalism is based on over trust to self-regulatory rational role of market. There is more than half century that J.M. Keynes far sighted, paid attention to the facts that …”the main controversy about the future of human society, al the end will be led over <u>how much room to manoeuvre should be given to instincts for making money and the love for it, as the main economic machine’s motivation force</u> “[3]. The Keynesian access of the economic system constitution requires the

[1] Max Ote, The Breakdown is Comming, Banja Luka 2009, pg 19.

[2] Jan Fransoa Rischard, High Noon Twenty Global Problems, Twenty Years to Solve Them, First publised in the United Szates by Basic Books,2002. Translation into Serbian Clio, Belgrade2008, High Noon , Twenty global Challenegs, twenty Years to be solved, pg.52

[3] Ibid.53. i Harvey Cox „The Market as God,“ Atlantyc Monthly, mart 1999.

active state role. The state, by its investment enhancement and demand management prevents economic crisis.

The neoliberal concept of economic fundamentalism implies the axiom that the market key role is to react on consumers desires, and on that desires to realize the rational and economically efficient resources allocation. The state interference at the economic flows leads to efficient resources allocation deformities. The problem, however, is in the fact that the advocates of absolute market do not percept one tiny thing – the participants on the market possessing the resources for goods and services production, do not use those resources to satisfy desires, or consumers needs, but to earn more money. The first aspect of market imperfection is "that it does not respond what people want, event not on what they need. It reacts to the money. "[4]

The second market imperfection is that the consequence is the concentration of minority economic and political power, generating progressively more and more inequality and poverty on global level. The same tendencies are present in the most developed countries, too. The mentioned statement confirmed the data from the most market oriented country in the world. In United States « ratio between the income of the richest and the poorest one fifth of the population jumped from 18:1 in 1990, to 24:1 in 2000...» the recent data indicate that 50 million of the richest in the world earn the same as 2.7 billion of the poorest".[5]

The third market imperfection is seen in tendencies of property concentration, competition suspending, and constitution of monopoly market structures in both individual countries, and globalization circumstances on world level.

The establishing of completely liberal market requires the complete privatization of state and social property, that is, capital. The initial thesis of market liberalism advocates, not to be suspected, and the one that justifies the complete and fast privatization is that state owned, or social property *a priori* is economically inefficient and, modestly speaking, less efficient in relation to the private. The right on private property is the right that gives to the owner the possibilities to benefit the effects of possessed resources. Thus, that is the right on effects (income) resources benefit. The right that exclude the others to the property profit, and, simultaneously, that right facilitate the transfer of ownership rights to other person for compensation.

Opposite to private property, the common ownership, which was the case of social property, excludes the right of an individual to benefit by himself only, the resources' effects, and the possibility to transfer the ownership rights to other

[4] Frensis Mur Lape, Džazef Kolins, Piter Roset in cooperation with Luis Esparse, Twenty Mith on Hunger in the World, Clio, Belgrade 2005. pg.221.

[5] J. F. Rischard, op quoted. prs.50 and 114.

persons for compensation. The state-owned property, like private, has its titular and the beneficiary of property effects, as well as the right to transfer ownership for compensation to other private persons. Economically efficient use of state property, opposite to the private, gives the state the possibility to benefit the economic profit. The presented difference between the private and community ownership originates the hypothesis that "If the private property is cost-effective, then the collective ownership comprises less probability that the funds would be located according to its highest practical value, and thus the output shall be lower" [6]

The transfer of ownership rights from a state owned or collective property to private persons presents in technical sense the central point of privatization term definition. However, the privatization term definition has a functional aspect too, and it could be understood as « the transfer of rights to production surplus profit of a company from public to private sector, together with accompanying changes in regulatory policy."[7] The total privatization as a process of transfer of profit rights has the far-reaching consequences on social structure of transitional countries.

The process of social and partially state owned companies' privatization implemented in Serbia was realized in two stages. The first stage comprised the period of 1990-2000, and was characterized by two aspects: the first, spontaneous privatization circles through overflow of the social and state capital in private owned. The second, distribution of majority social capital share in companies, to employees and citizens with no compensation, or sell-off with discount.

At the end of this first privatization cycle the epilogue was the following. Due to the sanctions and disintegration of former Yugoslavia, the companies lost a part of their acquisitions and selling markets for their products. Owing to hyperinflation they lost the working capital depreciated by inflation, controlled prices or the obligation to sale the goods. On that way, a part of their capital were presented to consumers or to competitive private companies which avoided this administratively posed obligation, and which have often bought their goods form social firms and controlled prices, while have sold it on market, in foreign currency.

The second privatization stage of social capital comprises the period of 2001/2010. The institutional framework of privatization is stipulated in the Law on Privatization from the year 2001, and its amendments till the year 2007[8].

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6 Louis de Alessis, Pravo na vlasništvo i privatizacija, Magazzine Pogledi, Split 1989. pg. 366.

7 George Yerrow, Privatizacija u teoriji i praksi, Magazzine Pogledi, Split 1989.pg.388.

8 Gazzette de la RS. No. 38/01, 18/03 and 45/05

The privatization took the new dimension. It became necessary. The state indirectly, with no direct nationalization proclaimed itself as *de facto* titular of the social capital majority stake. This statement is a result of the fact that during the sale of social companies by auction or tenders, 70% of capital goes directly to state treasury. In case of «privatization subject», the euphemistic name of social company by the law, sale by auction, 30% of the capital with no compensation is transferred in share to employees or ex employees. Non-transferred capital is state property. The tender method of privatization indicates the transfer of 15% capital in shares, while the rest of 15% is registered in the Privatization Register Book. The shares from this register were lately sold through financial market, and selling income is distributed in money to adult citizens having work experience in social or state owned sector. The objectives of this privatization model, favouring social revenue from the transfer of social into private capital are defined in the article 2, law on privatization, as follows:

“The privatization is based on following principles:

- Creation of conditions for economic development and social stability
- Transparency
- Flexibility
- Price formation according to market conditions”

Now, almost nine years upon the beginning of implementation of this concept, not a single one of projected objectives has been achieved. There were no development and no social stability. On contrary, the absolute worsening of social stability, strikes, unemployment, poverty growth, are the characteristics of the present situation. The only “successful” performance of this privatization model is the fact that the redistribution of the resources is completed in favour of small group now very rich families in Serbia.

Proving the hypothesis that the privatized companies *a priori,* or by definition, are economically efficient in relation to social ones, not only the political propagandist, but some scientific authors too, use certain tricks and avoided to state all the relevant facts referring to the performance of those firms.

The authors and directors of Serbian model of privatization, starting from the axiom on collective property, and consequently the firms based on it, considered it economically ineffective, jumped to the “saving” formula in order to solve the Gordian knot of the old economic structure in Serbia. This idea was the immediate privatization at any cost. The presumption of *a priori* social firms' economic inefficiency was proclaimed an axiom. By definition, axiom is undoubted fact, thus, the axiom critics do not have to be considered seriously. The hypothesis on social property ineffectiveness, converted into axiom, should have been transformed into imperative normative structure. And that was done. The theoretic preparations of social property criticism enhanced its ideological anathema, and successively, based on that, the institutional prohibition of social property was justified by the Constitution. From the Constitution was deleted the term of social property before its demission, sale off or devastation. The Constitution recognizes only private, collective, or state owned property. The Company Law [9] suspended any considerable business activities having no authorization of the Privatization Agency. Here should be quoted the article 398(a) of the mentioned Law. "The company that operates the majority of social capital may not, without prior approval of the competent agency for the privatization activities made decisions about: reduction or increase of capital, reorganization or restructuring; investment; sale of property, burdening the property, things or establish a mortgage; long-term lease, settlement with creditors, taking or approving loans, or issue guarantee, beyond the regular course of business." The legal regulations sent to workers and the social companies' management, standing in line for privatization, the bad signal that could be considered as: wait to be sold by privatization, do not do anything, and for every, even a smallest thing referring to investment and development you must get the approval of administration employed at the Privatization Agency. After 2001, by legal regulations, social firms and their employees were doomed to failure, while left to brutal competition, on market scene of growing private sector. After this entire atmosphere, it was not difficult to prove that social firms, by definition are economically ineffective. The problem of their social efficiency and inefficiency was not the issue of interest, or analysis for the advocates of the free market theory and practice.[10]

Almost ten years of privatization model implementation, and this compulsory project and prerequisite of the economic stability and development, the data cruelly indicate the completely different results from the expected.

According to the data presented by the Privatization Agency, from February, 2010, the privatization performances for the period 2002-2009 are the following:

- 3.471 social firms offered to be sold
- Sold in total 2.505 firms, or 72,17%
- 357.582 employees comprised by this privatization process
- Realized State privatization income in total 2.9 billion euro
- Contracted compulsory investment of 1.4 billion euro
- Till February 2010 it was broken 510 contracts on privatization, or 20.36 of all sales. [11]

[9] Zakon o privrednim društvima, izdanje „Poslovni biro“ d.o.o, Beograd 2005 str. 368.
[10] See paper of B. Draškovič, Ekonomska nasuprot socijalne efikasnosti preduzeča, Ekonomski vidici , Belgrade 2004.
[11] www.priv.rs

The pompous announcement of thriving economic, social and development-oriented privatization in 2001 has been turned, unfortunately, into a successful marketing trick[12], and complete disaster regarding the social development. This aspects will be discusses later on.

## DOES THE FOREIGN DIRECT INVESTMENT ENHANCE THE DEVELOPMENT?

Together with privatization and deregulation with import liberation, as well as the liberalization of financial and banking sector in Serbia, the great expectations were assumed to the direct foreign investments. The inflow of FDI and creation of favourable fiscal and macroeconomic environment was elevated to dogma level. It should be created only the ambient for the inflow of the foreign direct investments and assure the enhancement, were, and still are one of the preferring key for solving all our economic problems, concerning the creators of economic policy, and a major part of scientific public.

The hypothesis proclaimed the axiom, that the FDI in the banking and real sector will automatically generate the economic growth, development, employment, stability of the balance of payment and certainly the stable exchange rate, is faulty in one essential aspect. The basic objective of FDI and investors is not to develop the country's economy, but to extend the market position, assure natural and market resources, and realize greater profit rate and revenue on capital in relation to the one realized in their country or in the neighbourhood countries.

The second core aspect related to FDI is that in times while the greater inflow of FDI, the national currency strengthen, the illusion of consumers welfare is created, the import and foreign currency grow. Upon the decrease or inflow cessation, similar to the case of pyramidal saving banks, the opposite situation appears. The saviors or investors pull out high profits realized in activities on local market, pressure the national currency and foreign currency deposits, affecting the country balance of payment deficiency.

The foreign direct investment inflow in Serbia, comprising the acquisition of the existing state and social companies, indicates that in period 2002-2008, was realized the inflow of 16.4 billion Euro, while in Croatia the inflow was almost double, but in B and H half.

[12] The Government of the Republic of Serbia in 2001 through the Ministry for Economy and Privatization and the Minister Aleksandar Vlahović, launched extensive marketing campaign for privatization named „POČETAK ZA IMETAK" (Beginning for Having), and one of the propaganda authors was the actual Prime Minister Dr. Mirko Cvetković.

**Table 1. Foreign direct investment in Serbia 2002 –2008 and selected countries emerged after ex-Yugoslavia**

| Country | Inflow per year | | | | | | | Total FDI |
|---|---|---|---|---|---|---|---|---|
| | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** | |
| **Serbia** | **567** | **1.400** | **1.026** | **2.051** | **4.968** | **4.337** | **2.994** | **16.387** |
| Croatia | 1.100 | 2.049 | 1.079 | 1.788 | 3.457 | 4.982 | 4.383 | 31.060 |
| B and H | 265 | 381 | 704 | 613 | 718 | 2.115 | 1.009 | 7.778 |
| Macedonia | 106 | 118 | 323 | 97 | 424 | 699 | 598 | 4.337 |

*Data based on: UNCTAD, World Investment Report*

After the initial years of FDI growth in Serbia and reached maximum in the years 2006 and 2007, in 2008 the trend was decreasing and kept on decreasing in the following years.

Currently, the time has come to intensify the currency outflow in form of profit, because the investors expect income from their previous invested capital.

## TRANSITION RESULTS KEY INDICATORS

In the period after the initiation of the “new” neo-liberal concept of “shock therapy”, and after the economic sanctions since 2001 until ending in 2009, the following results have been noticed:

The state of economy, measured by GDP growth in the period 2001-2008, of 4.5 to 7.1% gives the false picture of economic growth. The domestic product in 2007 does not even reach 60% of the one in 1989.

Total country’s foreign debt, both private and public, in the last 8 years has been recording the permanent growth and actually it is close to 22 billion €, threatening to put the country into a position of Argentine scenario of inability to repay loans and economic policy “must do” dictated by the IMF “experts”.

From 1991 until now, Serbia is in the process of complete de-industrialization.

The positive macroeconomic trends in the period 2001-2008 were recorded only in reducing inflation from 40.7% to 6.8% in 2008, and 6% in 2009. The relatively positive results have been noticed in the growth of gross domestic product from 12.8 to 34.3 billion euro. However, this result is misleading because of having “unsustainable” growth based on the growth of external debt, the sale of state and public property, and partially on the inflow of foreign direct investment. The termination of FDI inflow, the completion of social and state owned property sale off, and restrictions in getting new loans possibilities from abroad in the years to come will show that GDP growth pf 2.68 times in 2008 compared to 2001 has been tricky and feet of clay. The calculation growth of GDP has been also deformed by the overvalued dinar exchange rate against the euro. For these reasons, it seemed that the growth of GDP had an extra support, based on the "favourable" wind that blew in the sails of the growth domestic product.

**Table 2. Economic development key indicators in Serbia 2001 –2008 and partially 2009.**

| | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|---|---|---|---|
| GDP, billion EUR | 12,8 | 16,0 | 17,4 | 19,1 | 20,4 | 23,5 | 29,5 | 34,3 | 14,6 |
| GDP, *per capita*, EUR | 1709 | 2138 | 2328 | 2556 | 2736 | 3174 | 4002 | 4651 | |
| GDP, real growth, in % | 5,6 | 3,9 | 2,4 | 8,3 | 5,6 | 5,2 | 6,9 | 5,42 | -3,5 |
| Retail prices, the end of period, % | 40,7 | 14,8 | 7,8 | 13,7 | 17,7 | 6,6 | 10,1 | 6,8 | 6 |
| Export, growth in % | 10 | 20 | 32 | 27 | 27 | 43 | 37,3 | 24,3 | -32,8 |
| Import, growth in % | 27 | 31 | 33 | 43 | -2 | 25,9 | 39,3 | 24 | -39 |
| Good exchange deficit, in billion.EUR | -2,8 | -3,8 | -4,1 | -5,8 | -4,8 | -5,4 | -7,1 | -8,2 | |
| Current account deficit (without donations), % BDP | -7,6 | -11,5 | -9,6 | -14,1 | -10,1 | -13,1 | -16,2 | -17,4 | |
| Exchange rate RSD/EUR | 59.7 | 61,5 | 68,3 | 79,1 | 85,5 | 79,0 | 79,2 | 88,6 | 95,89 |
| Privatization income, billion EUR | | 319,2 | 839,9 | 156,8 | 377 | 269,9 | 527,7 | 329,1 | 77 |
| FDI, net, billion EUR | 184 | 502 | 1.206 | 777 | 1.245 | 3.492 | 1.821 | 1.812 | 650 |
| Foreign debt billion EUR | 12,6 | 10,8 | 10,9 | 10,4 | 13,1 | 14,9 | 17,8 | **21,8** | 21,8 |

*Source*: RZS, Statistički godišnjak (Statistical Review) 2009. NBS, Privatization Agency, IMF, World Bank

The ongoing import and export growth in the analyzed period indicates that the economic activities has been intensified in the country, which is not in question. However, when is peeked into the import and export structure, the conclusion would be that both are negative. Serbia imported energy and consumer goods, and quite a bit of industrial plant equipment. Serbia's export depends dominantly on US Steel Serbia, in Smederevo, corn and raspberries export. Thus, the products of low level additional processing. A particular issue is that together with import liberalization grew the commodity trade deficit with other countries, from 2.8 billion euros in 2001 to 8.2 billion in 2008.

The economy, particularly in transitional countries such as Serbia, should be evaluated based on the movement of current account deficit and its share in GDP, as well as the conditions of external debt growth. In the reporting period, the deficit increased from 7.6% in 2001 to 17.4% of GDP in 2008. In the same period, the external debt has increased from 12.6 billion to 21.8 billion euro.

## De-industrialization

The economic transition in Serbia led to the de-industrialization. From 1989 to 2001, there was a decrease in participation of industry in creation of GDP from 44.8% in 1988 to 29% in 2001.The decline in the participation of industry was influenced by the introduction of economic sanctions against Yugoslavia and war events that followed the disintegration of Yugoslavia in 1991. After 2000, instead of stopping the negative trend, there was a further deterioration of the situation in the industry of Serbia, so that its share in GDP from 29% in 2001 fell to 20.2 in 2007 with the trend of further decline in the coming years.

The comparative review of the GDP growth rate and industry in Serbia for the period 2001-2009 indicates that the industry had little impact on GDP growth

**Table 3. GDP Growth Rate and Industry in Serbia 2001-2009, Constant Prices from 2002**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009* |
|---|---|---|---|---|---|---|---|---|---|
| GDP | 5,1 | 4,5 | 2,4 | 9,3 | 6,5 | 5,2 | 5,9 | 5,4 | -3,5 |
| Industry | 0,0 | 2,0 | -3,0 | 7,2 | -0,8 | 4,7 | 3,7 | 1,1 | -15,9 |

*Data for 2009 relate to the period of the first ten months*
*Source: Republic Bureau of Statistics, annuals and corresponding monthly statements*

The comparative review shows that, in this period, industrial production had one year of zero growth, and that in three years the rate was negative. In the years, when there was industry growth, the growth rate was still lower than the GDP growth rate. In some periods, the difference was from two and up to five times to industry disadvantage.

The statistical data show what, on the empirical plane in Serbia, can be seen by the superficial observer. Apart from the food industrial sector and cement, as well as black metallurgy and partly, processing of ferrous metal, all other industries are either extinct or marginalized. Serbia was left without a mechanical industry, tractors and engines, construction machinery industry as well as electronic and chemical industry.

The aim of the economic transition, with privatization and liberalization focused exclusively on the sale of assets, but not on development. The conceptual decision of economic policy makers envisaged that the market itself would allocate resources most rationally. The free market did allocate the resources in such way that Serbia has become de-industrialized, and the number of workers in this sector, from 1 million in 1990 reduced to 700 thousand in 2001 and only to 400 thousand in 2009.

## Unemployment

The above-analyzed trends in industrial production indicate that the number of employees dropped from 1 million in industry in 1990 to only 400 thousand in 2009. Therefore, reducing the number of employees in the industrial sector affected, on one hand, the increase the unemployment rate, and on the other, reaching the growth of persons who are treated as self-employment in small companies or stores.

**Table 4. The movement of employed and unemployed and the unemployment rate in Serbia in 2000 - 2009.**

| Year | Employed in 000 | Unemployed in 000 | % Unemployment |
|---|---:|---:|---:|
| 2000 | 2097 | 721,8 | 25,61 |
| 2001 | 2102 | 768,6 | 26,77 |
| 2002 | 2066 | 842,6 | 28,97 |
| 2003 | 2041 | 947,3 | 31,70 |
| 2004 | 2050 | 947,7 | 31,61 |
| 2005 | 2069 | 996,2 | 32,50 |
| 2006 | 2026 | 1005,4 | 33,17 |
| 2007 | 2002 | 949,6 | 32,17 |
| 2008 | 2000 | 824,8 | 29,20 |
| 2009 | 1860 | 830,4 | 30,87 |

*Source*: Statistics Institute, the corresponding monthly statements. The percentage of unemployed -our calculation.

The official statistics provide far less unemployment data based on labour force survey and methodologies that applies. In the presented table the unemployment rate is performed, based on the relationship between the number of persons registered as unemployed and the sum of employed and unemployed in Serbia by years. In fact, we believe that other applied methodologies on the rate of unemployment are unreliable and incomplete. Such methodologies hide the actual results, because they are based on the estimated number of working population and they register the increased number of employees based on whether they are "helping members" or if they have a job because they take a dog for a walk for two hours a day. We find that the unemployed are even those for whom the survey claim that they are employed and those who are not actively seeking a job, which can not be found, and even if they find it, they either receive a salary or a minimum wage.

If the 150 thousand people are reduced from the number of persons in 2009, which, by statistics, are registered as employed, (who do not receive their salary and are not paid taxes and contributions), then, only 1710 thousand people are actually employed. If we add the number of those who are unemployed and from 830.4 thousand to 980.4 thousand, the result is - unemployment rate in 2009 was 36.44% instead, as statistics show only 14% of unemployment.

In transition period – the period of intense privatization, the number of employees in public sector in 2004, from 44.9 thousand decreased, at the beginning of 2009 to 39.2 thousand of employees. In the same period the number of employees in the private sector increased from 802 thousand to 1226.7 thousand, while in public sector decreased from 678.9 thousand to 482.5 thousand. At the same time, the number of self-employed or those who are actually employed in small family businesses and shops decreased from 659.4 thousand in 2004 to 626.9 thousand in early 2009. Due to the crisis of small and medium enterprises, the number of persons in this sector will be reduced in the future. Thus, a number of individuals found a solution in private shops and businesses after leaving the state and community employment, but now they are affected by lack of liquidity of these companies. The statistics, as employed, includes the so-called "helping" household members and the number of these people increased from 212 thousand to 235 thousand from 2004 to 2009.

Finally, we would like to draw attention to the fact that the movement of the real rate of unemployment and real wages are key indicators of an economy and successful transition. If the unemployment rate is held at a high level or even rise, while real wages fall, we can draw a conclusion that the economic transition was unsuccessful. No indicator on getting out of the crisis is reliable, or it is perhaps, an indicator that shows the actual growth in employment and earnings, thus the socially bearable transition.

## THESIS, POSSIBLE DIRECTIONS FOR NEW SOLUTIONS

Our thesis is that "life-saving" solution to all problems of public state-owned enterprises is not in their privatization at all costs but in improving the management. One solution is the one that is used in large private corporations in the world, and that is the engagement of professional management. The separation of ownership from management rights is possible in the case of state ownership, as it is already done in the case of private corporate assets.

Finally, we should define our view of the state role. We should not seek the return to the omnipotent central planning, bureaucratic state by saving the social dimension of the society from blind power of the market. Between the extremes of the economy based on market and/or the economy based on the plan, it is possible to select high resolution, and market and state planning based on state and collective ownership. In 2003, two of the most prominent European intellectuals Jurgen Habermas and Jacques Derrida emphasized in an open letter the necessary role of the state on the future of European identity. In our opinion, the role of government should guarantee the social protection and development of "trust of Europeans in the enlightened power of the state."

The model of “owner” privatization proved unsuccessful and favoured the greed of owners, as well as the greed of the state to complete the budget by selling the company without taking into account the consequences.

It is necessary to reaffirm the participation of employees in management and ownership of companies. The participation model involves the employees and other persons that choose, together with the state, to make the revitalization of the company in order to maintain and increase employment and earnings, and preserve the capital. Through the participation, the employees become interested in the survival of the company far more than the state, and even in some cases the owners themselves.

The participation model could be applied, so that the employees, as well as persons in special competitions, based on submitted programs for each individual company, could take the control over the company creating the business and development policies of a company. The introduction of participation model is de facto the introduction of revitalizing model of the company vis-à-vis to models of bankruptcy and liquidation or privatization.

In non-privatized companies, instead of bankruptcy, they should introduce the management and ownership participation of employees and professional management. In privatized companies, where the contract on privatization is terminated, they should also introduce the employees’ participation and external and internal management. The same model should be applied in enterprises in which the state has more than 10% of the capital in the form of shares or otherwise. The participation in state-owned enterprises can be specially designed.

## CONCLUSION

The privatization in Serbia is based on the critique ideology of "insider» identification of property rights and the introduction of model “Let us sell everything and right now ('the beginning for having"), so we'll be happy, proved to be a catastrophic failure. It had to be a failure, because it was based on the wrong approach in which the state revenues from privatization were favoured and the economic development and maintaining level of employment were sacrificed. The total revenues from privatization in Serbia amount only 2.9 billion €.

The applied privatization concept has encouraged "owner" concentration of capital, greed and social irresponsibility of the new owners. The victims of enforced privatization are primarily workers, due to loss of jobs, unpaid wages, unpaid work experience, loss of health insurance. And those employees who retained their jobs are usually forced to renounce the rights to the length of working hours, the right to negotiate on working conditions, wage levels, etc., and all that because of fear of losing their jobs.

One of the biggest casualties of privatization is destroying the culture of workers participation in the management of enterprises. Privatized companies have become, dominantly- contrary to propagated expectations- economically inefficient and, by the "boss", means for drawing the last atom of property values for personal consumption and personal gain. The invitations to the rich to, (out of ethical reasons) build bridges, return a profit from tax havens and retain business in the country deviate from the core logic of capitalist behaviour. His goal and God is profit, that is, money. There, the ethical call has no result.

Development strategy, based on full liberalization and deregulation, with privatization in transition countries do not guarantee either economic or social development.

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# CHAPTER 16. WHAT IS ACTUALLY CAPITAL MARKET IN SERBIA?*

**Dejan ERIĆ**, Institute of Economic Sciences, Serbia

***Abstract***

*The main idea of this paper is to point out the significance of the capital market and the need of its future development in the Republic of Serbia. During the last few years, this segment of market economy in our country seems to slightly lag behind, which turned out to be a problem, particularly under the conditions of negative impact of global economic crisis. During the last two years, even the most developed countries re-examined their economic policies and development strategies. In searching for the answer and solutions to challenges and problems which global economic crisis brings about, some fundamental questions could be raised again. One of them which can be asked in Serbia is what actually capital market is. Impression can be made that its purpose and real importance has been forgotten, as if there is a shortage of ideas and approaches which could be used to protect it against negative impacts of the crisis, regulate it in the proper way and direct its development towards the right direction. Therefore, this paper should be understood as an attempt to briefly analyze how developed some elements of the capital market in Serbia are, so as to point out its significance and future directions of development.*

***Key words:*** *Capital Market, Financial Markets, Financial Crisis, Global Crisis, Economic Development, Regulation of financial markets*

## INTRODUCTION – CRISIS AS AN AGENT OF CHANGE

Yet one could think that the global crisis started to fade out, when in 2010 the problem with Greek debt and indications that some other countries, such as Spain, Portugal and Ireland could have similar problems, convinced us that the crisis has

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not been over yet. It could be said that the global 2007 – 2010 (?) crisis behaves as a virus. At one point you think you have found a cure or vaccine, and it mutates and appears in another, perhaps more devastating form. So it is with the crises of our time, which started with the problems of "subprime" loans and securities but soon engulfed the other segments of financial markets and financial systems of most developed countries. From the financial sector, the crisis quickly transferred to the real sector of the economy almost causing a general recession in the world which has not been recorded before. In the fight against recession, many states have used excessive fiscal mechanisms which in some cases led to a crisis of public finances and high levels of public debt.

In an effort to reduce the decline rate of economic growth, unemployment and other negative effects, governments of many countries have resorted to various measures and mechanisms, some of which were contrary to the traditional spirit of market economy. Many banks and other financial institutions, which due to wrong investment decisions suffered accrued losses, were given state aid. Often contrary to market principles, subsidies were offered, aid was provided or capital was increased by taxpayers' money, which in some cases, provided excuse for arrogant and rapacious behaviour of individual corporate directors. Many of the fundamental principles for functioning of market economy are put into question and the debate re-opened on the effectiveness of the functioning of market economy. In addition to a specific wave of nationalization of some financial institutions, in the field of finance there is an increasing trend of stronger regulation of financial systems and flows, which is quite contrary to the trends of deregulation that dominated the world during the 1990s. (*F. Fabozzi, F. Modigliani & F. Jones (1994), D. Erić (2003), ...*)

In the general chaos of searching for solutions to the major consequences of the collapse of the mortgage market, the virus of the crisis mutated several times, and was transmitted from the financial to the real sector, and then from the real sector to crisis in public finances in some countries. The negative effects of this new mutating virus at this time of crisis are still difficult to grasp. Greek syndrome is beginning to spread and future time will bring some new surprises. Professional, but also the general public has been returning to the foundations of economic science and discussions have opened again on some methods and principles of the regulation and functioning of the financial system.

In Serbia, the effects of the global crisis felt primarily through a significant reduction in foreign currency inflows - either through privatization, either through foreign direct investment, reduced exports, difficult conditions for obtaining foreign loans, but the withdrawal of foreign investors from the Belgrade Stock Exchange. In such conditions, there was a fall in domestic demand, strengthening of the spiral of illiquidity, which had led to a slowdown in overall economic activity of the country and GDP decline of about 4% in 2009. In addition, the state began to borrow in various ways, mainly through loans. Business entities have reduced the possibility to take new loans, so that the problem occurred as to how to finance economic activities. As a direct consequence of the crisis there was a rapid decline in share prices on the Belgrade Stock Exchange. In all that chaos we seem to have forgotten mechanisms and capital market instruments. For more than 6 years the Government did not change the members of the Commission for Securities, and it is more than 3 years since amendments to the law in this area have been announced. Taking all these into account, in this paper we would try to raise a simple, perhaps trivial, but fundamental issue for the Serbian economy - What is actually the capital market? In seeking answers we will try to point out the importance of this segment in the market economy and show what chances we miss due to underdevelopment of some of its elements.

This paper consists of 3 parts. Upon introduction, in the first part we will give a brief overview of regulatory reform in financial markets (and within them the capital market) in the developed countries, primarily the EU. After that, we will try to make a brief analysis of the development of certain instruments of the capital market in Serbia. In the third part, instead of conclusion, the directions of its further development would be pointed out and potential benefits that all participants of social and economic life in Serbia might have.

## ANNOUNCED REGULATORY REFORM OF FINANCIAL MARKETS IN THE EUROPEAN UNION (EU)

In the general chaos of different mutations of the global crisis, it is sometimes difficult to distinguish symptoms from its causes, and even the consequences. Governments of many countries have not reacted promptly and appropriately responded to it. Many have expected a lot from the election and arrival of Mr. Barack Obama, new American President. However, objectively speaking, for a year and a half since he took over his presidency, not much has been done to reform the U.S. financial system, in whose functionality many causes of the crisis can be found, according to some authors (*Fleckenstein, W. 2008*). A lot is expected from the adoption of new, we might say, critical Act on reestablishment of stability in the American financial system (*The American Restoring Financial Stability Act*).

The Europeans were not more successful, either. The crisis has shown all the heterogeneity of the European Union (EU). In many places it was possible to perceive the elements some kind of economic nationalism, which was reflected in the fact that for each country it was more important to protect their own interests of national markets rather than take care of the "higher" interests of "European" market. Instead of Europeanization, in some cases we have witnessed a kind of localization, especially in terms of regulating financial markets, particularly capital markets. Somehow the impression was made that the Europeans hunger with one eye on the U.S. and vice versa, but neither party made much. There are many open issues that need to be solved at the global level, such as trading derivatives (especially structured products), regulating functioning of hedge funds, over the counter trade, short sale, Basel III and IV, and so on.

There is general agreement that in addition to the announced and expected changes in the regulation and control of financial markets it is necessary to work on improving the principles and standards of corporate governance in financial institutions. At this point we must emphasize that discussions can lead as to what should be changed first – regulations which demonstrated a number of weaknesses and loops which led to a crisis or the conduct of directors and members of management boards which failed to respond timely to many elements of the deviant and at moments even arrogant behaviour. The price of that behaviour was often paid by the taxpayers.

What can we expect in terms of regulating the capital market in the territory of the EU in future? This question is not easy to give a simple answer. Ideas go in the direction of creating a so-called "single rule book", a unique collection of regulations at the EU level. Instead of directing local regulatory directives the new approach has been suggested through the unified rules and a greater obligation to their application and respect. There is the idea of creating the European Securities and Markets Authority (*ESMA http://www.europarl.europa.eu/oeil/file.jsp?id=5804652*) that would take over power of national regulators of capital market. Apart from its role in harmonization and regulation of capital markets business, ESMA would have the authority and responsibility to respond to urgent and unexpected situations. In that way it would replace the Committee of European Securities Regulators, the famous CESR (http://www.cesr-eu.org) which would contribute to increasing the level of homogeneity in the overall European financial system.

Some of the priorities of regulating the capital markets at European level in the future are the following:

- Less directives, more regulation and unified rules
- Increase transparency
- Reducing the risk in market structures
- Improving the institutional framework – creating more secure legal environment
- Better coordination of regulatory bodies and the simultaneous application of uniform rules in all countries.

Under the announced changes, many are aware of the possibility of existence of problems in the relation between regulation and complexity. Specifically, financial systems are complex by nature. Their development further increases the level of complexity. The more complex, financial systems (within them the capital markets, too) should be more regulated. The higher level of regulation the more complex financial systems become. And that is where the problem begins – too regulated systems started to become less efficient and do not allow performance of basic functions, i.e. flow of financial resources and provision of necessary capital for financing of economic activity, growth and development. Huge regulation of financial systems creates a need to periodically come up to flows and trends of deregulation. Also, one should bear in mind that excessive regulation on one segment of financial markets leads to moving together of participants in the other segments that are less regulated. This is proved by current and still ongoing global crisis, which required participants and stakeholders to return to some basic principles and issues.

## A BRIEF REVIEW OF THE CAPITAL MARKET IN SERBIA IN TERMS OF CRISIS

What happens to the capital market in Serbia? Where is Serbia in these turbulent flows of regulatory reforms? What can we expect? These are just some of the issues that plague not only professionals but also the general public, as events in the capital market have its reflection on the overall economy, as well as the standard of living of all citizens. The title of this work without the word "brief review" could be a single solid scientific study.

The right question which can be asked is whether the authorities responsible for conducting the economic policy in Serbia generally understand the real importance of capital market and its primary role. If the answer is positive, we can set another question, which may not be pleasant though - why have they done so few in its development? We have already pointed out how people in the world and Europe have been returning to some basic principles and set sometimes very trivial, but fundamental questions. Something similar we have to do here in Serbia!

To remind you, if you look at any of the basic textbooks in this area you will see that the main role of the capital market is to provide long-term funds for financing the activities of various participants in the economic and social life (*FJ Fabozzi & Modigliani F., 2003, P. Rose, 2003; L. Allen 1997*). It is a market factor which provides the much needed capital for investment through which development goals of economic entities are achieved, and thus overall economic growth and development of a country. Issuers that collect capital appear on it and they can be either economic entities or the government. In this way, there appear the two major groups of financial instruments - those that issue companies and government securities (which are sometimes referred to as risk-free). Two main groups of securities are traded on the capital market - debt instruments and stocks. In general, it can be divided into three main segments (Eric D., 2003, pp. 435-6):

- Loan market - which includes bank loans and long-term securities, debt instruments (mostly various types of bonds)
- Mortgage market – a special segment of the loan market in which trading in securities is going on based on mortgages, and
- Equity market, where stocks are mostly traded – ordinary and preferential or depository certificates (global or American – ADR, GDR).

If we start from the fundamental principles, what situation do we have now in terms of development of some of the segments in the Republic of Serbia? Let us move on.

## Development of loan market

Currently the most developed instruments of loan market in Serbia are bank loans. In addition, it should be emphasized that they do not represent the classical instruments of capital markets, especially short-term loans. Considering the great importance they have in Serbian economy we include them in the analysis, primarily to point to a possible order and potential developments in the capital market in Serbia. We emphasize that loans are currently the predominant source of financing of the Serbian economy. If we look at the data presented in Table 1 showing the total amount of loans, we can see that in the period from 2003 to the first half of 2010 there has been a remarkable expansion, in local currency, and foreign currency loans. In particular, expansion of dinar loans is remarkable, in almost all macro sector participants. Loans denominated in foreign currency have not grown so excessively, but it is noticeable from Table 1 that they are particularly increased in the government sector. Total bank loans to the private sector (companies and people) have increased from 3 billion EUR in 2003 to more than 13 billion in 2010, which represents more than 4 times increase. Of course, we have to point out that the data in Table 1 should be accepted only as an illustration, i. e. as a framework for understanding the potential development of capital market, since it is a total amount of loans, both short-term and long-term ones.

## Table 1. Total outstanding loans in Serbia – 2003-2010

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Exchange rates** | 68.3129 | 78.8850 | 85.5000 | 79.0000 | 79.2362 | 88.6010 | 95.8888 | 98.4620 | 99.6337 | 99.7604 | 99.2683 |
| **Total Banking System Dinar Loans** | | | | | | | | | | | |
| **(in million dinars, end of period)** | | | | | | | | | | | |
| | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** | | | |
| **Dinar loans disbursed to:** | | | | | | | | **Jan** | **Feb** | **Mar** | **Apr** |
| **Enterprises** | 114,759 | 166,430 | 260,115 | 312,699 | 444,250 | 634,725 | 783,959 | 801,586 | 816,702 | 830,343 | 841,934 |
| **Government** | 22,500 | 30,008 | 21,272 | 18,271 | 10,936 | 12,928 | 101,512 | 104,145 | 104,326 | 110,887 | 116,789 |
| **Households** | 29,535 | 66,512 | 132,131 | 203,598 | 306,169 | 381,961 | 418,363 | 428,471 | 434,300 | 442,599 | 446,417 |
| **Other sectors** | 5,770 | 6,395 | 8,720 | 11,610 | 16,300 | 25,615 | 28,505 | 28,922 | 29,729 | 29,906 | 29,929 |
| **Total** | 172,564 | 269,345 | 422,238 | 233,479 | 777,655 | 1,055,229 | 1,332,339 | 1,363,124 | 1,385,057 | 1,413,735 | 1,435,069 |
| **Total Banking System Foreign Currency Loans** | | | | | | | | | | | |
| **(in million dinars, end of period)** | | | | | | | | | | | |
| | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** | | | |
| **Foreign currency loans** | | | | | | | | **Jan** | **Feb** | **Mar** | **Apr** |
| **disbursed to** | | | | | | | | | | | |
| **Enterprises** | 82,560 | 98,057 | 110,660 | 68,736 | 63,724 | 76,708 | 66,895 | 71,285 | 72,410 | 74,032 | 73,945 |
| **Government** | 9,756 | 13,993 | 18,834 | 16,626 | 8,267 | 7,439 | 17,612 | 18,066 | 18,563 | 20,628 | 22,717 |
| **Households** | 4,915 | 5,272 | 6,672 | 12,527 | 12,069 | 7,102 | 8,357 | 9,547 | 10,798 | 12,903 | 12,865 |
| **Other sectors** | 97,231 | 117,322 | 136,166 | 97,889 | 84,060 | 91,249 | 92,864 | 98,898 | 101,771 | 107,563 | 109,527 |
| Total | 82,560 | 98,057 | 110,660 | 68,736 | 63,724 | 76,708 | 66,895 | 71,285 | 72,410 | 74,032 | 73,945 |
| **Total Banking System Loans to Private Sector (Enterprises + Households** | | | | | | | | | | | |
| (in million EUR, end of period) | | | | | | | | | | | |
| | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** | | | |
| | 3,320.81 | 4,195.97 | 5,881.94 | 7,405.48 | 10,274.89 | 12,340.65 | 13,236.34 | 13,216.69 | 13,282.77 | 13,502.09 | 13,723.37 |

(www.nbs.rs)

In terms of emission of government securities, above all long-term bonds, we have to emphasize that there some progress has been made so far. Yet during 2001-2002 the old savings bonds were issued. The whole operation was actually not a real issuing of bonds, but rather solving the problems inherited from the 1990's when the savings of a large number of Serbian citizens simply disappeared or melted due to the fraud of the regime and monetary turbulences. In the last few years the government have tried to develop a long-term bond segment of the market, first of all the Treasury and the Ministry of Finances, but very limited in scope.

The market for municipal bonds does not exist in Serbia. Despite the need expressed by local governments, this segment of the loan market has been completely undeveloped. Serbia is the only of all former Yugoslav republics that still does not issue municipal bonds, which is a sort of paradox and the proof of how little authorities in Serbia care for the development of capital market. Not with the intention to go into details, it is worth mentioning that municipalities in Bosnia and Herzegovina such as Laktasi and Rozaje in Montenegro have issued such bonds, but there is no municipality in Serbia that has issued them. There is a great number of papers that indicate the need for and analyze the causes of underdevelopment (*Z. Brnjas, I. Stosic, P. Dedeić, 2010*), but still there remains a bitter feeling of not doing enough effort to at least start the development of this segment of capital market.

The situation in the corporate bond market is somewhat better than in the municipal bond market. Based on the data of the Central Registry of Securities there has only been 19 issuing of debt instruments issued by companies in Serbia. However, it is sad that there is no long-term issuing (with maturity of more than 1 year) which means that all issued corporate debt instruments in Serbia are actually commercial papers. It is known that they are instruments of the money market.

The most usual type of corporate debt instrument is short-term debt security with nominal value of 10,000 RSD and fixed (rarely variable) interest rate. Another option for issuers is short-term discount debt securities with nominal value of 1,000 RSD. Nominal value of outstanding securities is 1,429.36 million of RSD, which is approximately 14 million EUR at current exchange rate, which clearly shows how small market for corporate debt is. Unfortunately, market values of debt are not available because corporate debt securities are issued by private placements and they have not been traded at the Belgrade Stock Exchange since 2005.

One of the notable examples of corporate debt securities are securities issued by Tigar AD in August 2009, and it is good illustration of corporate debt issuing on Serbian capital market generally. Value of this issuing was 1,000,000 EUR, which is rather small amount relative to the value of this company showing that Serbian companies actually issue bonds not to invest in long-term project but to finance current liabilities. Interest rate on this debt is 16%, which in that moment was 400 basis points above the risk-free rate, which could be consider as large spread in regard to rating of Tigar; this company is usually thought as one of the leading companies in Serbia in terms of solvency and long-term profitability. Also, the only buyer of this issue has been Dunav insurance company, so wider investment community was disabled to buy these high-quality papers and hedge their positions from negative movements of stock prices.

**Table 2. Corporate Bonds Issues in Serbia**

| | Name of Issuer | Currency | Value of security | Total issue | Rate | Nominal value |
|---|---|---|---|---|---|---|
| 1 | Anador konsalting | RSD | 1,000.00 | 3000 | Zero rate | 3,000,000.00 |
| 2 | Banini | RSD | 10,000.00 | 10000 | Fixed rate | 100,000,000.00 |
| 3 | DOO Titel | RSD | 10,000.00 | 11000 | Fixed rate | 110,000,000.00 |
| 4 | Galenika | RSD | 10,000.00 | 10000 | Fixed rate | 100,000,000.00 |
| 5 | Galenika | RSD | 10,000.00 | 10000 | Fixed rate | 100,000,000.00 |
| 6 | GP Auto-šop | RSD | 10,000.00 | 5000 | Fixed rate | 50,000,000.00 |
| 7 | Koncern Farmakom - Dairy | RSD | 10,000.00 | 7000 | Fixed rate | 70,000,000.00 |
| 8 | Koncern Farmakom - Dairy | RSD | 10,000.00 | 2500 | Fixed rate | 25,000,000.00 |
| 9 | Koncern Farmakom - FAS | RSD | 10,000.00 | 10000 | Fixed rate | 100,000,000.00 |
| 10 | MB Pelikan | RSD | 10,000.00 | 6000 | Fixed rate | 60,000,000.00 |
| 11 | MN Loznica | RSD | 10,000.00 | 7500 | Fixed rate | 75,000,000.00 |
| 12 | MVM Motors | RSD | 10,000.00 | 10000 | Fixed rate | 100,000,000.00 |
| 13 | Papir konfeks | RSD | 1,000.00 | 1000 | Zero rate | 1,000,000.00 |
| 14 | B92 | RSD | 10,000.00 | 10353 | Variable rate | 103,530,000.00 |
| 15 | B92 | RSD | 10,000.00 | 12447 | Fixed rate | 124,470,000.00 |
| 16 | Sava Kovačević | RSD | 10,000.00 | 10916 | Fixed rate | 109,160,000.00 |
| 17 | Tigar | RSD | 10,000.00 | 9500 | Fixed rate | 95,000,000.00 |
| 18 | Wallpaper | RSD | 1,000.00 | 3200 | Zero rate | 3,200,000.00 |
| 19 | Zajača | RSD | 10,000.00 | 10000 | Fixed rate | 100,000,000.00 |
| | | | | | **Total** | **1,429,360,000.00** |

This summer the first corporate bonds are expected to be issued. The issuer is Telefonija Company. Nominal value is two million EUR, they are due in 4 years and interest rate is 7.5 percentage points above one-year EURIBOR. At first this issuing was expected to be public, but according to last information it will end up as private placement once again putting off investors from long-term quality debt securities. Telephony is a classic example of such misunderstanding of the importance of bond market development in Serbia. Although the deal was arranged even in late 2009 the company provided four professional investors (2 insurance companies, one bank and one investment fund) the Commission for the Securities for more than 3 months was not able to make a decision so as to approve the issuing. In this way, the damage was caused to the company, institutional investors and the total capital market of the Republic of Serbia.

Although there is no doubt that issuing of bonds could enable companies to approach cheaper source of funding, the question why Serbian companies do not use them in financing, especially in the long-term, is still without clear answer. Some of the possible answers is volatility of macro environment which implies high risk premiums for long-term securities, lobbying and pressure of commercial banks on regulators, high requirements of the SEC for issuing of bonds, but also lack of professional financial managers and still non-transparent business of companies. But consequences are clear: monopolistic position of banking sector on loan market and interest rates on loans to firms which are among the highest in Europe.

### Development of mortgage market

Generally speaking, mortgage market in Serbia is in its embryonic stage of development. Certain steps were taken towards development of the primary market, which consist in defining an appropriate regulatory framework (such as the new, more efficient, Law on Execution Procedure, the new Mortgage Law), Central register of mortgages was formed as well as Credit Bureau and the unique Cadastre of real estates. In addition, as a significant step towards the development of this segment, we point out the formation and operation of the National Corporation for Housing Loan Insurance (National Mortgage Insurance Corporation - NMIC), which began operations in 2004. (modified by the model of the Canada Mortgage and Housing Corporation - CMHC). This influence of the state has had very positive effects on the development of primary mortgage market, which is manifested by the increase in the number of approved loans and reduction of interest rates on residential mortgage loans.

At the time of the emergence of mortgage market in Serbia, in the period since 2002 the interest rates were among the highest in Europe. The total amount of approved residential mortgage loans (total outstanding residential loans) increased from 89 million in 2004 to over EUR 2.4 bill in May 2010 (including loans secured by amounts NMIC 1757 bn. EUR), representing an increase of almost 26 times. The average interest rate on housing loans in May 2010 was 8.30%, which is lower than in some other countries in the region, first of all in Bulgaria (10.10%), Bosnia and Herzegovina 9.90%), Macedonia (9.70%) and Montenegro (20.9%), but much more in comparison with Slovenia (3.90%) or Germany, for example (3.20%, see data in Table 3).

**Table 3. Comparative review of interest rates on housing loans**

| | Housing loans |
|---|---|
| Croatia | 7,20% |
| B&H | 9,90% |
| Macedonia | 9,70% |
| Montenegro | 9,20% |
| Romania | 8,20% |
| Bulgaria | **10,10%** |
| Slovenia | 3,90% |
| Germany | 3,20% |
| Serbia | 8,30% |

Some of the objective obstacles to the further development of the mortgage market, both primary and secondary, are the following: macroeconomic instability (particularly in terms of the current global economic crisis), low average wages, insufficient housing supply (particularly in conditions of crisis that has hit civil engineering in Serbia), relatively high additional costs of buying the apartment, old-fashioned legislation that causes a number of complications in the real estate market (denationalization, legalization of illegally constructed buildings, a small percentage of apartments registered in the cadastre), non-regulated area of real estate brokerage, and so on.

In terms of evaluation of the development of mortgage market instruments, it can be said that there are not any. Domestic legislation does not prohibit their emission, but simply there are not enough basic elements on which these securities would be created and markets developed.

### Development of stock market

If you exclude bank loans, which do not belong to traditional instruments of the capital market, stocks are certainly the most dynamic and the most developed segment of the capital market. Currently at the Belgrade Stock Exchange there are more than 1,000 shares traded. Many of them are the result of the privatization process. However, based on the data presented in Table 4 provided by the Belgrade Stock Exchange, we can conclude that there is a significant slowdown in the volume of turnover in the last 3 years. For example, with more than 2 billion EUR of total turnover in 2007 and the total of 301 210 transactions, turnover dropped in 2009 to about 442 million (over 21% of turnover from 2007) and 77 215 transactions (about 25% of the total number of transactions from 2007). The question is what the government have done to help the participants in the capital market and to protect its development?

**Table 4. Turnover of stocks on the Belgrade Stock Exchange**

| | Turnover in RSD | Turnover in EUR | Number of transactions | Market capitalisation in RSD |
|---|---|---|---|---|
| **11/01/2010 – 31/05/2010** | | | | |
| **Stock market** | **1,820,428,169** | **18,310,777** | **7,053** | **203,176,671,285** |
| Stocks | 561,919,085 | 5,659,074 | 4,177 | 45,139,769,028 |
| Bonds of RS | 1,258,509,084 | 12,651,704 | 2,876 | 158,036,902,257 |
| **Out-of-stock market** | **6,407,332,469** | **64,411,297** | **15,989** | **645,296,565,073** |
| Stocks | 6,407,332,469 | 64,411,297 | 15,989 | 645,296,565,073 |
| **Total** | **8,227,760,638** | **82,722,074** | **23,042** | **848,473,236,358** |
| **2009** | | | | |
| **Stock market** | **7,907,864,505** | **84,206,509** | **20,868** | **208,954,463,743** |
| Stocks | 2,823,791,087 | 30,085,203 | 12,156 | 45,437,954,744 |
| Bonds of RS | 5,084,073,418 | 54,121,306 | 8,712 | 163,516,508,999 |
| **Out-of-stock market** | **33,870,627,477** | **357,769,918** | **56,347** | **723,378,242,861** |
| Stocks | 33,870,627,477 | 357,769,918 | 56,347 | 723,378,242,861 |
| **Total** | **41,778,491,982** | **441,976,426** | **77,215** | **932,332,706,604** |
| **2008** | | | | |
| **Stock market** | **9,694,724,975** | **118,921,768** | **24,397** | **162,797,797,790** |
| Stocks | 4,354,565,627 | 53,380,140 | 16,183 | 11,389,663,258 |
| Bonds of RS | 5,340,159,348 | 65,541,628 | 8,214 | 151,408,134,532 |
| **Out-of-stock market** | **62,159,051,155** | **763,533,189** | **94,604** | **753,797,049,480** |
| Stocks | 62,159,051,155 | 763,533,189 | 94,604 | 753,797,049,480 |
| **Total** | **71,853,776,130** | **882,454,957** | **119,001** | **916,594,847,270** |

| | Turnover in RSD | Turnover in EUR | Number of transactions | Market capitalisation in RSD |
|---|---|---|---|---|
| **2007** | | | | |
| **Stock market** | **21,672,279,859** | **270,561,183** | **25,758** | **196,106,096,945** |
| Stocks | 5,038,697,847 | 63,423,005 | 10,114 | 48,094,246,520 |
| Bonds of RS | 16,633,582,012 | 207,138,178 | 15,644 | 148,011,850,425 |
| **Out-of-stock market** | **143,318,586,098** | **1,789,208,339** | **275,452** | **1,244,379,247,756** |
| Stocks | 143,318,586,098 | 1,789,208,339 | 275,452 | 1,244,379,247,756 |
| **Total** | **164,990,865,957** | **2,059,769,522** | **301,210** | **1,440,485,344,701** |

Data taken from the Belgrade Stock Exchange – www.belex.co.rs and analyses by the researchers of the Institute of Economic Science and Belgrade Banking Academy in Belgrade

**Table 5. The total volume and value of new share issuing in Serbia in the period 2007-2010**

| Description | | The number of approved issues of securities | | | | The value of approved issues of securities (RSD) | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | **2007** | **2008** | **2009** | **2010 I quarter** | **2007** | **2008** | **2009** | **2010 I quarter** |
| 1 | Approved issuing of securities by public offer | 17 | 7 | 9 | 1 | 8,263,932,700 | 847,305,084 | 3,842,565,897 | 43,350,000 |
| 2 | Approved issuing of securities without public offering by legal and natural entities whose number is not bigger than 100 | - | - | | - | - | - | | - |
| 3 | Approved issuing of securities without public offering to the buyer known in advance | 27 | 21 | 27 | 3 | 16,044,602,450 | 19,734,381,290 | 21,739,986,750 | 2,991,872,020 |
| 4 | Approved issuing of securities without public offering to the shareholders | - | 21 | 25 | 2 | - | 19,049,084,650 | 16,360,063,300 | 2,181,872,020 |
| 5 | Approved issuing of securities without public offering on other grounds | 173 | 120 | 95 | 8 | 49,514,564,900 | 40,850,924,611 | 38,518,548,259 | 1,415,909,850 |
| | **Total** | **217** | **169** | **156** | **14** | **73,823,100,050** | **80,481,695,635** | **76,618,598,309** | **6,589,653,890** |

Approved issuing of securities

| Description | | The number of approved issues of securities | | | | The value of approved issues of securities (EUR) | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | **2007** | **2008** | **2009** | **2010 I quarter** | **2007** | **2008** | **2009** | **2010 I quarter** |
| 1 | Approved issuing of securities by public offer | 17 | 7 | 9 | 1 | 104,294,914 | 9,563,155 | 40,073,146 | 434,541 |
| 2 | Approved issuing of securities without public offering by legal and natural entities whose number is not bigger than 100 | - | - | | - | - | - | | - |
| 3 | Approved issuing of securities without public offering to the buyer known in advance | 27 | 21 | 27 | 3 | 202,490,812 | 222,733,167 | 226,720,814 | 29,990,578 |
| 4 | Approved issuing of securities without public offering to the shareholders | - | 21 | 25 | 2 | - | 214,998,529 | 170,614,955 | 21,871,123 |
| 5 | Approved issuing of securities without public offering on other grounds | 173 | 120 | 95 | 8 | 624,898,278 | 461,066,180 | 401,700,180 | 14,193,105 |
| | **Total** | **217** | **169** | **156** | **14** | **931,684,004** | **908,361,030** | **799,035,949** | **66,054,806** |

The data which represent the decreasing number of securities issued speak in favour of the fact that there is a sort of "cooling" and the slowdown in activity in the domestic capital market from year to year. Information can be found in Table 5, from which we can see that the number of issuing decreased from 217 to 156 in 2009, with reduced value of issuing in EUR (but not in RSD, although dinar depreciation should be taken into account).

**Development of the participants at the capital market**

In getting more or less rounded picture of the development of capital market it is necessary to point to the development of certain participants in the capital market. It is another way of how to follow the development of this segment of the market economy in Serbia. Table 6 presents the data on the total number of participants, from which we can see that in the last year (primarily due to the impact of the negative effects of the crisis) the number of broker-dealer companies (brokerage houses) reduced from 72 to 57, as well as the number of members of the Belgrade Stock Exchange from 88 to 75. Slightly increased is the number of investment funds and professionals - portfolio managers and investment advisors

**Table 6. Total number of participants at the capital market in Serbia**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| Broker-dealer companies | 72 | 61 | 57 |
| Registered banks | 20 | 21 | 20 |
| Custody banks | 12 | 13 | 12 |
| Societies for managing investment funds | 15 | 11 | 11 |
| Investment funds | 16 | 17 | 20 |
| Open | 14 | 14 | 15 |
| Closed | 2 | 2 | 2 |
| Private | 0 | 1 | 3 |
| Professional investors | 2 | 2 | 2 |
| Societies for managing pension funds | 9 | 9 | 8 |
| Pension funds | 10 | 10 | 9 |
| Brokers | 1066 | 1091 | 1092 |
| Portfolio managers | 86 | 113 | 115 |
| Investment advisors | 20 | 34 | 35 |
| Stock Exchanges | 1 | 1 | 1 |
| Members of the stock exchange | 88 | 77 | 75 |
| Market makers | 0 | 4 | 5 |

## INSTEAD OF CONCLUSION – WHAT IS BEING MISSED DUE TO UNDEVELOPED CAPITAL MARKET?

Global crisis has extremely hit the Serbian economy. It impact on the capital market has not been much written about, nor analyses conducted. This work should be understood as a small attempt to point out one area that seems to have been somehow forgotten. What is worse, not only that we have forgotten it, but we do not speak enough about it. While other re-examine previous approaches to development, we still wander. There are many questions that are open. Has Serbia experienced mental revolution in the process of transition and really embraced the model of market economy? Why there has not been done more to develop domestic capital market? Why is it allowed to become bank-centric and what the government have done? Or what has not been done yet? These are just some of the dilemmas and questions that some future generations may ask us.

The relationship is very simple – without capital there are no investments, without investments there is no significant growth and development, especially not sustainable one and certainly not in the long run. Under the conditions of low domestic savings, it is necessary to turn to external sources of funding. Revenues from privatization, grants and foreign direct investments have declined, some even dried up with the increase of crisis. Therefore, there is a slowdown (decline) in economic growth. What next? How to continue? Is it good to expect only banks and the banking system to be suppliers of capital?

The development of mechanisms and instruments of capital market can bring a number of positive effects. Below, we will point out a couple of significant benefits that the development of certain financial instruments of capital market would bring.

I – Development of long-term government bond market, i. e. treasury bonds would have several advantages:

- Financing budget deficit, especially in the long run, especially for development projects.
- As an instrument of monetary policy which should be more development-oriented, especially as the negative impacts of the crisis are strong.
- The basis for a more realistic assessment of the risk at the capital market - namely the long-term government securities are usually considered low-risk securities (not to say riskless). Interest rate established through market mechanism would be the benchmark for the formation of all other rates and thus the real cost of capital.

II – Development of municipal bond market would provide at least two things:

- Implementation of the development function at the local level, i.e. local governments level, which would encourage more balanced economic growth and development.
- Policy instrument of local authorities - which could have a much more real economic autonomy than it is the case now.

III - Development of the mortgage bond market could bring the following:

- Increased liquidity for certain forms of assets which are by definition illiquid.
- Spread of the spectrum of investment alternatives for institutional investors.
- Increase the standard of living.
- The possible direction of development could be a special statutory regulation of mortgage bond issuing, which would provide alternative to financing banks which operate in Serbia. Issuers of these securities in Serbia could be existing commercial banks (individually or in collaboration with CMHC), and potential investors could be commercial banks, insurance companies, pension funds, mutual funds, international investors and others.

IV– Corporate bond market development:

- The possibility of transfer of risk
- Diversification of sources of financing for companies
- Reducing the cost of debt, and therefore the weighted average rate of cost of capital (WACC).
- Development of qualitative financial instruments for many institutional investors in the domestic capital market. If this segment had been developed, the crisis would not have affected participants at the Belgrade Stock Exchange in that way (stock price decline during 2009 was higher than 70%).

V – The development of stock market:

- Promotion of the concept of the local market - where the capital is first collected in the country and then opportunities are searched for to issue shares on stock markets in developed countries.
- Raising levels and improving practices of corporate governance and promotion of greater efficiency and effectiveness of operations.

The development of capital market is an extremely important issue and involves a very serious and responsible approach. At one period a lot has been done in Serbia so as to build up legislation and development of financial institutions, but also it can be noted that in the last 3-4 years very little has been done to ensure further development of the capital market. There are no new legal regulations, the development of institutions is slow, there are no new instruments and the turnover of the existing instruments has been reduced. All these facts must be understood as an important warning. Crises come and go, but wise men and nations, even in the most difficult time have a vision and try to define the right decisions for future development. Do we have the vision of development of the capital market in Serbia? Do we know its real significance? What can we do in terms of its future development? These are questions which future generations may ask us. In order not to be ashamed, we had better ask these questions ourselves and try to do something which would bring about concrete results.

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# CHAPTER 17. INDEBTED EUROZONE MEMBERS, FISCAL DISCIPLINE AND FINANCIAL MARKETS

**Ivana MANDYSOVÀ**, University of Pardubice, Faculty of Economics and Administration, Czech Republic

***Abstract***

*This study is focused on the financial markets role in connection with indebted countries of Europe and eurozone. The government debts in public finance, access to the financial markets, bonds, as well as export or domestic demand orientation and economic growth are considered. Study answers questions: What should be the European Commission and state governments steps regarding fiscal policy tightening and budget control in order to get euro and state economies on the standard footing? How to improve position of indebted countries on the financial and investment markets?*

***Key words****: Eurozone, fiscal discipline, deficit, bailout package, domestic demand, financial markets, bonds, budget control*

## THEORY CONCEPTS

Friedrich von **Hayek** [6] [7] sets the framework necessary for a critical analysis of prevailing theories of justice and of the conditions which a constitution securing personal liberty would have to satisfy. Milton **Friedman** [4] argued against government intervention in fiscal policy. Friedman opposed government regulation of many types he describes substitution on restricted debt instruments. He had resisted Keynesian orthodoxy and believed in very limited government and free markets. Friedman advocated policies such as <u>voluntarily military</u>, freely <u>floating exchange rates</u>. He investigates impact of fiscal restraints on the state budgets, effects of fiscal aggregate constrained by the rules and impact on non-constrained fiscal positions. He describes substitution on restricted debt instruments.

**Bronchard´s** [1] work illuminates to what extent rights of priority have been established among different classes of creditors in the course of the reorganization of debt of insolvent states. Bondholders have frequently appealed to their governments to support their efforts to effect a settlement with a defaulting foreign state. Response can be none too sympathetic. Bondholders purchase their bonds voluntarily at their own risk. Bondholders keep being informed of the progress of negotiations with the debtor.

James **Tobin** [11] provides list of economic explanations including coverage of the mechanisms of the Federal Reserve and how its policies affect investment activity via interest rates and the credit offered to private borrowers.

**McGrane** [8] by focusing on unpaid early debts of certain states sheds light on the problems confronting foreign investors in the collection of debts due them when repudiated by whole communities. Attention is given to the political and economic background of those debts, to the inducements held out to investors to purchase the state securities, to the part played by the press of debtor and creditor countries in aiding or obstructing the final debt settlements, and to the economic and international repercussions of these debts. Revealed are the evils of weak banking systems, the dangers inherent in the too rapid development of public works, the methods employed in the marketing of these states' securities, the political and economic atmosphere in which repudiation doctrines were generated, and the part played by the press and by the courts in mobilizing public opinion, either for or against the payment of debts.

**Wynne** [13] shows case studies prepared primarily to provide basic material for the analysis of the problems and practices that have developed from the experiences of foreign bondholders with insolvent states.

Alberta **Sbragia** [10] investigates capital investment and the constraints imposed on governments by needing to borrow for such investment. She deals with state cases in comparative context. She was invited to direct a project in European Union focusing on federalism and intergovernmental politics.

**Hagen** and **Harden** [5] argue, that, in the in the run up to the Euro, the fiscal rules of Maastricht led to significant fiscal operations, which improved the official figures but had no effect on the actual fiscal position of the government. The bottom line of this research is that fiscal rules have an effect on the fiscal aggregates to which they refer. However, governments try to compensate for the loss of flexibility due to the rule by shifting fiscal activities from restricted to non-restricted instruments.

**Dafflon** [2] provides a list of accounting tricks used by governments to converge to EMU. He shows that Manual on government debts and deficits and its the methodology rules of the European system of accounts are weak and insufficient. Many countries have used tricks to qualify and maintain for EMU membership.

## INTRODUCTION

Thanks to Europe and International Monetary Fund the indebted Greece state has paid back bond of 8,50 billion EUR. It has been confirmed, that bailout package having been thrown to Athens by the international community seems to work. The remaining question is: How long? The German Prime Minister Angela Merkel has declared that Eurozone by the 750 billion Euro bailout package has bought the time. But if it does not act fast, crisis will come back. What is necessary to do on the level of Monetary Union? Greek crisis is put off, problems do not end, Greece is just a tip of an iceberg. Greece is as a “small bank” whose problems could strike at the foundation of financial system confidence. Bigger countries could be as a “bankrupted bank” leading to the collapse of the system.

The eurozone has experienced during the last few days one of the biggest tests of its existence. There is irresoluteness on one hand, but finally long-awaited signs that Europe has finally decided to take action. But we need to ask how successful it has it been? Europe has gone from a period where almost all of ECB and policy makers were saying that the situation is not that bad to some realization that it actually is. They have confessed that there really is quite a dangerous environment. We have seen the riots in Greece and the loss of life in Greece. The concern is or the concern was that if Spain and Portugal get to the scenario that they cannot go out and borrow on financial markets anymore, the European Union would need emergency funding for them and then that would be a huge problem for the eurozone. Therefore it’s better to try to head it off.

The ECB is changing its attitude with this. The ECB went from being at the last top management meeting arguing they did not need to buy bonds - it was not even discussed, but within 4 days actually going out there and being on the market to buy bonds. It really highlights the concerns and the fast moves that we have seen in market conditions The concern would be if they had let the market keep going on then the effect would be that undisciplined countries would not be able to borrow in the markets. So aggressive action and intervention was needed. It has been highlighted that they have been quick to appreciate the severity of the crisis now, and hopefully what we have in place is breathing room for these governments to actually allow them to implement a fiscal policy tightening, if required in order to get the euro and the economies on the standard footing.

## PROBLEM FORMULATION

The most important element of European Monetary Union is establishment of Euro, the single European currency. In the past the monetary integration has been started by fixed exchange rates, later the Euro, new currency was reached (1999).

The main aim of single currency is to maintain price stability. Central banking system belongs to the monetary system as well. It comprises of new central bank based in Frankfurt/Germany which together with national central banks of the member stated constitutes the new monetary authority. The integration of fiscal policy has not been attempted. [3]

The Treaty on European Union signed in Maastricht 1992 is the framework for the creation of single currency. Member states wishing to join eurozone must meet the so-called convergence criteria which form the nucleus of the Treaty.

The criteria:

1. inflation of no more than 1.5 percentage points above the average rate of the three EU member states with the lowest inflation over the previous year.
2. A national budget deficit at or below 3 percent of gross domestic product (GDP).
3. National public debt not exceeding 60 percent of gross domestic product. A country with a higher level of debt can still adopt the euro provided its debt level is falling steadily.
4. Long-term interest rates should be no more than two percentage points above the rate in the three EU countries with the lowest inflation over the previous year.
5. The national currency is required to enter the ERM 2 exchange rate mechanism two years prior to entry. [12]

The most important and examined by this article are considered the government debt and especially government budget deficit.

Monetary union is one of the European policy instruments, but fiscal policy remains national responsibility. Specific problem of countries can no longer be resolved by exchange rates. It has been shown as reality that some member states abuse their fiscal policy to free-ride on their own and it endangers monetary balance of the Eurozone. Monetary union rules have let governments to hide deficits by using a kind of creative accounting.

The European Commission has been pointing out the situation that has been brewing for years. It has been looking into the divergences for a long time and policy consensus is desired among Member States to tackle the problem. Current problems are just the most visible manifestation of different competitive positions and current account balances of each European Union member state. Countries like Germany, Luxembourg, Finland, Denmark and Sweden has accumulated surpluses but another countries like Ireland, United Kingdom, Greece, Spain and Portugal have accumulated very large deficits.

**Table 1. Eurozone and the European Union GDP, government deficit and debt**

| | | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| **Euro area (EA16)** | | | | | |
| GDP market prices (mp) | (million euro) | 8 553 600 | 9 003 902 | 9 258 895 | 8 977 933 |
| Government deficit (-) / surplus (+) | (million euro) | -112 048 | -55 723 | -181 176 | -565 111 |
| | (% of GDP) | -1.3 | -0.6 | -2.0 | -6.3 |
| Government expenditure | (% of GDP) | 46.7 | 46.0 | 46.8 | 50.7 |
| Government revenue | (% of GDP) | 45.3 | 45.4 | 44.9 | 44.4 |
| Government debt | (million euro) | 5 842 888 | 5 940 433 | 6 424 615 | 7 062 625 |
| | (% of GDP) | 68.3 | 66.0 | 69.4 | 78.7 |
| **EU27** | | | | | |
| GDP mp | (million euro) | 11 682 471 | 12 364 567 | 12 500 094 | 11 804 734 |
| Government deficit (-) / surplus (+) | (million euro) | -167 687 | -103 584 | -285 685 | -801 866 |
| | (% of GDP) | -1.4 | -0.8 | -2.3 | -6.8 |
| Government expenditure | (% of GDP) | 46.3 | 45.7 | 46.9 | 50.7 |
| Government revenue | (% of GDP) | 44.9 | 44.9 | 44.6 | 44.0 |
| Government debt | (million euro) | 7 172 706 | 7 265 256 | 7 697 027 | 8 690 304 |
| | (% of GDP) | 61.4 | 58.8 | 61.6 | 73.6 |

*Source:* Eurostat, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22042010-BP/EN/2-22042010-BP-EN.PDF

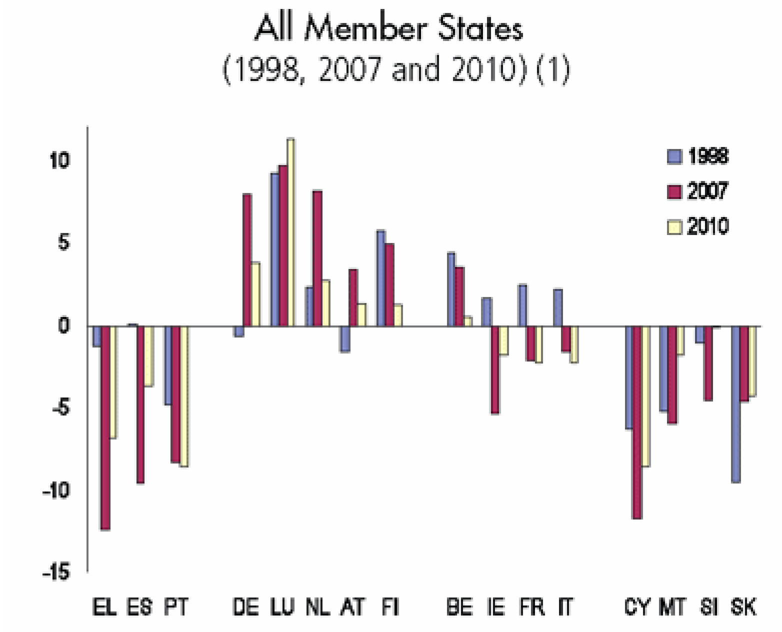
In 2009, the government deficit and government debt of both the eurozone (16 countries) and the EU 27 increase compared with 2008, while GDP fell. In the eurozone the government deficit to GDP ration increase from 2,0 % in 2008 to 6,3 % in 2009, and in the EU 27 from 2,3 % to 6,8 %. in the eurozone the government debt to GDP ration increased from 69,4 % at the end of 2008 to 78.7 % at the end of 2009, and in the EU 27 from 61,6 % to 73,6 %.

Seeing the Member States results, in 2009 the largest government deficits in percentage of GDP were recorded by Ireland (- 14,3 %), Greece (- 13,6 %), the United Kingdom (- 11,5 %), Spain (- 11,2 %), Portugal (- 9,4 %), Latvia (- 9,0 %), Lithuania (- 8,9 %), Romania ( -8,3 %), France (- 7,5 %) and Poland (- 7,1 %).

No Member State registered a government surplus in 2009. The lowest deficits were recorded by Sweden (- 0,5 %), Luxembourg (- 0,7 %), Estonia (- 1,7 %). In all, 25 Member States recorded a worsening in their government balance relative to GDP in 2009 compared with 2008, and two (Estonia and Malta) an improvement.

Looking at the results we can see that countries do not meet the second criterion as they face national budget deficits. Countries, like Ireland and Greece, united Kingdom, Spain and Portugal must tackle a staggering debt mountain. The criteria concerned with the budget deficit and long-term government debts bring a lot of discussions among experts and politicians. From the very beginning there are concerns like: Is the criteria relevant? Does one criterion fit all countries? This merits more examination as it restricts the freedom of member countries in management of their economic and monetary policies. It could have undesirable effect on the country economics and its regional development.

**Figure1. Current account positions, all Member states, Net lending (+) or net borrowing (-)**



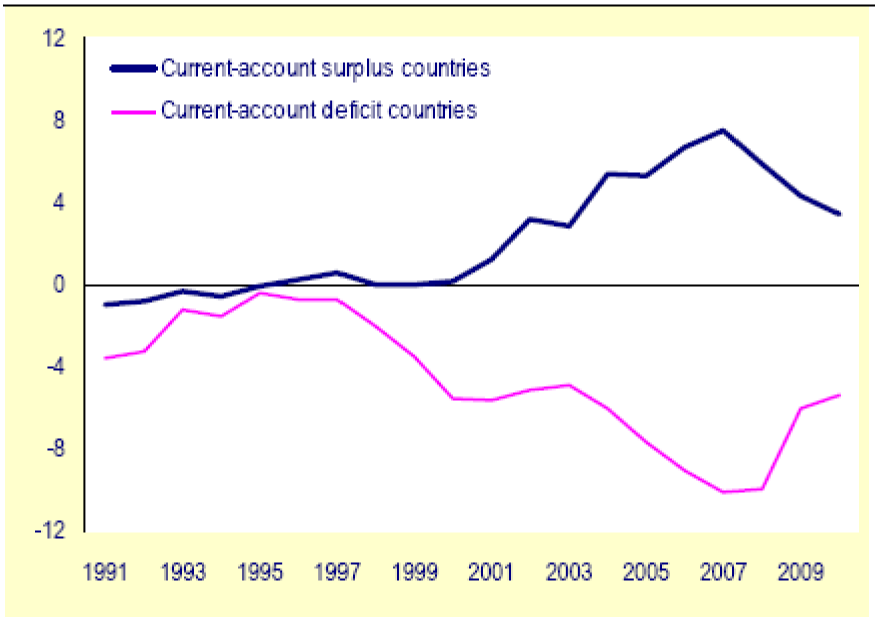

*Source:* European Commission, http://ec.europa.eu/economy_finance/publications/qr_euro_area/2010/pdf/qrea201001en.pdf

## PROBLEM ANALYSIS AND SOLUTIONS

There may appear both positive and negative externalities caused by various national fiscal systems, lack of discipline in debt deficit on one hand together with monetary on the other hand. Therefore in case of country like Greece appears to have problem, it might endanger the functioning of Eurozone and in that case European Institutions have to intervene with steps regarding budgetary and fiscal policy. If we look in history, Werner Report (1970) already mentioned control of national budgets and tax harmonization and unification of fiscal policies. No tax harmonization and common budgets shows to lead to social tensions threatening the Eurozone and European integration principles.

European Union searches for the balance of Single market with mobility of goods, labour, capital and services. Regional labour markets show imperfections leading to unemployment. Regional cyclic-crisis decreases regional income per capita. Tied fiscal policy gains pivotal stabilization role as there is no national monetary and exchange rate policy to repulse asymmetric shocks. Fiscal policy has been constrained by debt and deficit criteria. On other hand there are set limits on how much countries could spend on macro economic and anti-cyclical crisis measures. Exceeding limits leads to penalties. This centralized common stabilization policy aims to prevent asymmetric shocks, but it should go with parallel with the monetary union.

**Figure 2. Current account positions, eurozone surplus and deficit countries (1991-2010, in % of GDP)**




*Source :* European Commission, http://ec.europa.eu/economy_finance/publications/qr_euro_area/2010/pdf/qrea201001en.pdf

*Comments:* Surplus countries are Denmark, Luxembourgh, Netherlands, Austria, Finland, deficit countries are Ireland, Greece, Estonia, Cyprus, Portugal.

There are eurozone members jeopardizing EMU stability. Problematic eurozone members have been well documented. They are Portugal, Ireland, Greece, Spain and, in certain respect, we can also add Italy to the list. Italy has got very high debt levels but beyond its deficit is much lower, close to 5 %. So the rating agencies have greater confidence that fiscal policy can be shifted to get their deficit close to zero. So Italy is less of a concern.

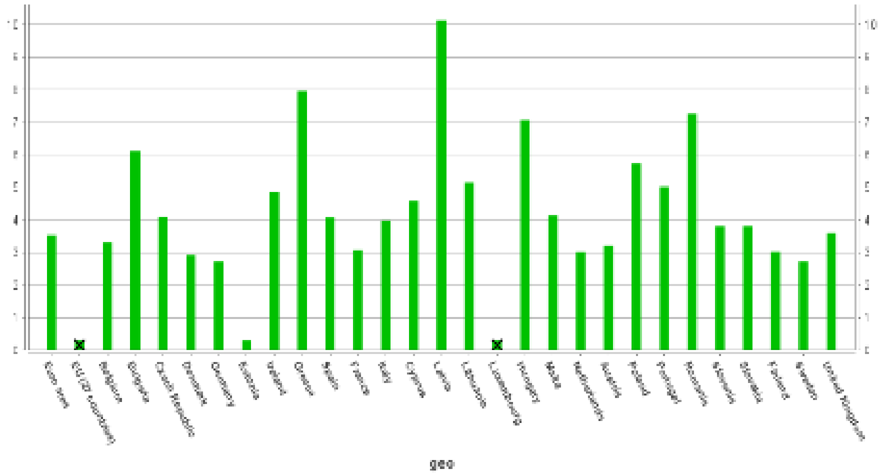
Globally the big concern is the United Kingdom and the USA because they have got deficits the same size as Spain excessive of 10 % . At the moment the USA is doing nothing about fiscal policy tightening and their deficit is getting bigger and bigger. At least in the United Kingdom they are moving to update their fiscal policies. The United Kingdom would need to have other taxes go up as well, and the new United Kingdom government has already suggested that they are going to be pretty aggressive regarding their fiscal policy, by cutting spending by 6 billion pounds during the next six months, announcing a new budget, and that the British people will see more taxes rise, the VAT more than likely, and sales taxes going up as well. So it is clear that fiscal policy is tightening too and we can also mention growth in the British economy as well. The United Kingdom is relatively ok in its position for investors. The USA can get its deficit lower and at the moment in the USA there is confidence because their economy is growing rapidly - we have seen growth in excess of 3 % over the last four quarters.

We have seen Spain and Portugal announcing the new fiscal saving measures: Spain for example, cut public sector wages by 5 %, Portugal introduces higher income taxes and higher VAT. Taking actions like these is good news but they need to have an economic growth as well. Now the first quarter GDP numbers in Spain show growth after period of significant contraction. Portugal also has rebounded quite shortly.

Reluctance to react to Greek problems earlier has cost the eurozone a lot of energy, time and money. If the eurozone had done more things earlier, if countries had moved earlier they would not have needed to have done quite so much. Spain, for instance, announced it is going to cut their fiscal deficit by 5 % of GDP in January, yet, it had taken them until May before they actually announced how they are going to do it. If they had done certain steps in this four or five month period, the decisions that they are now implementing would not have been quite so bad and so painful. The delay we have seen has probably cost the eurozone economy money. Finally, eurozone representatives realize, that if this is going to go on, there will be a risk that current problems will influence the initiated economic growth. This, consequently, would increase the risk that the required measures will be very complicated.

The bailout package prepared for indebted countries of the eurozone must be sufficient and persuasive enough to calm Europe down or another panic would brew. In Greece, ten years yields over 12 % were coming dramatically to over 8 % now. Spain and Portugal and Ireland have also seen that they cut their bonds rates. It makes them approximate to German bond rates. But at the moment we have not seen these countries test the market by issuing new bonds and that is going to be the key test: Can they actually get the demand in the market out of that?

**Figure 3. Long term government bond yields, Monthly average**

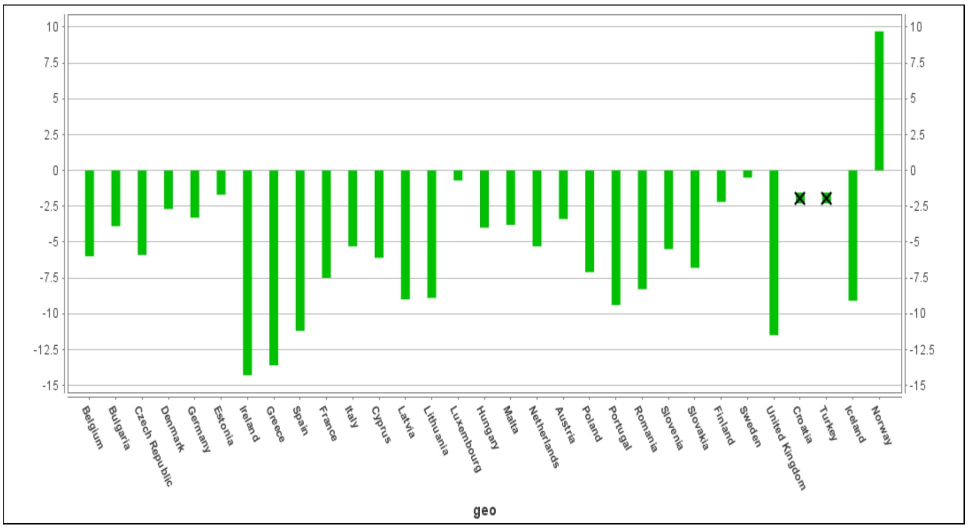


*Source:* Eurostat, http://epp.eurostat.ec.europa.eu/tgm/graph.do?tab=graph&plugin=0&language=en&pcode=teimf050&toolbox=type

Indebted countries have got "loan guaranties", and they have got basically bilateral loan agreement deals to borrow from other EMU members and from IMF. So they have got a source of funding but ideally they will not need them and they will be going to the market to get this money. This is really now the confidence measure. If this rescue operation provides confidence then Spain has a source of funding, therefore the default risk is much smaller. The private lenders would come in and investors would buy the government bonds and that will be great positive signal. That would be the ideal solution and hopefully that is the case!

The confidence is very fragile. If investors do not believe this is going to be a medium term solution, if they don't believe that fiscal policy is going to be tightened aggressively enough to avoid default risk, then they will avoid bonds of problematic countries and this situation rears it's ugly ahead further down the line, then again investors are not going to be on the market. It is a very fine line that it is out there and it is going to be a test of next coming weeks that these governments get their debts away. It would mean balancing on the edge. Positive reaction to the bailout package introduction is a good sign. Another indicator will be whether indebted countries' governments succeed in selling bonds during the coming weeks.

**Figure 4. General government deficit (-) and surplus (+), Percentage of GDP, Million EUR, % of GDP**

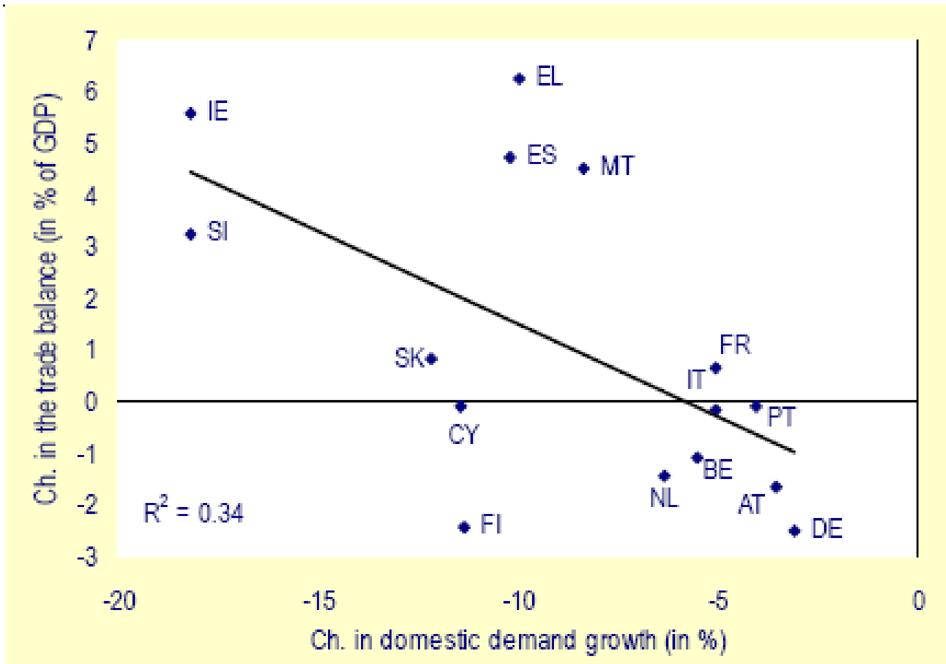



*Source:* European Commission, http://epp.eurostat.ec.europa.eu/tgm/graph.do?tab=graph&plugin=0&pcode=teina200&language=en&toolbox=data

Steps taken by ECB have immediate character and indebted countries have to do them to prevent market punishment as it has happened in Greece. But structural changes are necessary as well. The eurozone has got very different economies in it. Germany is very much export-orientated and German Chancellor Merkel has suggested that Germany wants to keep it that way. Maybe in the interest of the eurozone perhaps Germany should be looking to boost domestic demand.

This would make that much more of balanced economy independent in world events and impacts. Whereas in the other countries which have had problematic economies which have been very domestically focused, we have seen that strong domestic demand was boosted by debt over the last decades, which lead to bubbles in the economy. In many of these deficit countries capital inflows fuelled asset price bubbles rather than productive investment and situation has got worsen due to inappropriate fiscal policy. Large capital inflows led to and unsustainable accumulation of household and corporate debt. Like in Spain, for instance, where it had it's peak in the construction and real estate boom – this is probably going to be changed moving less away from domestic to becoming more export-oriented.

**Figure 5. Changes in domestic demand and in the trade balance, eurozone countries (2007-2010)**




*Source:* European Commission, http://ec.europa.eu/economy_finance/publications/qr_euro_area/2010/pdf/qrea201001en.pdf

There are lots of dynamics going on within the eurozone and also globally as well: The United Kingdom for example, again like Spain, has been very domestically growth driven. It will have to be changed as well. The United Kingdom case is different because it has an independent currency and that has depreciated markedly down 25 % in trade weighted bases. So export is going to be more competitive and thus in the United Kingdom case trade becomes more important and fills the space of weak consumer spending growth.

With no monetary policy instrument the state must be more active in fiscal policy use. The problem is that Portugal, Spain and Greece cannot devalue, they cannot make their exports and trade positions more favorable. They have to go through more a painful period where we see deflation spiral within these economies to try to make them more competitive within the eurozone.

## CURRENT AND FUTURE TRENDS

National economies remain different and they face macro-economic disturbances or financial crisis on them own. We will see the growth dynamic shift particularly in the eurozone. We used to see Mediterranean countries out perform the European core of Germany, France, Benelux. Whereas now these cornerstones of the European economy like Germany is particularly outperforming the indebted European countries as they get to grips with their debt burden. They cannot rely on domestic demand so much as they had before; this will require some changes that will influence the economy. They have to switch much more to investment and trade. There will be big dynamic changes there by switching from the consumer spending side to trade, and potential growth as well.

We expect significant changes to take place. Emerging markets will overcome other markets due to their own productivity, and developed markets have to cope with their debts and an aging population, and that is going to cost huge amounts of money as well. So we will see taxes go up and that will also slow the growth.

I suspect coordination of further steps and deeper integration will be necessary. The monetary union without the fiscal union – that is what most countries wanted but it is getting increasingly apparent that you cannot allow some countries to be reckless and live off of other countries, those countries will not tolerate this. Germany and France, which are bearing the burden largely of these loans that Spain, Portugal and Greece have gotten, will be demanding greater control, management, regulation and strictness when intervening in the budgets of other countries. For instance we will see in the future that it will be possible to punish countries more strictly if their public deficit exceeds 3% of their GDP. And this is the argument for Brussels to have budgets approved centrally because you cannot have it where one country is permanently bailing out other undisciplined members; they just will not tolerate it. It has also shown as fact that Spain and Portugal have to get approval of their policy initiatives in order to get access to these loans and guarantees. We are waiting to see greater management of each country's fiscal position and greater boundaries, and penalties if countries exceed these limits.

A long-expected European Federation is possible in connection to the crisis. Also, the investor Gates had mentioned this. On one hand it is necessary to assure that the European Union works the way it should work, on the other hand, inhabitants of each of the member states should consider agreeing. The current problems that the eurozone has been going through has contributed to the inhabitants of each country becoming alienated to one another. There arises the question of why should the inhabitants of one state support the inhabitants of another state. So maybe the Greek crisis demonstrated the need of bigger integration and at the same time is preventing it. It is an interesting situation and politicians have to approach it very carefully. For instance, Chancellor Merkel supported the loan to Greece, and as a result of this she has lost some of her influence on the domestic political scene. German voters were not happy about the fact that they have to save financially irresponsible and fiscally reckless countries. This is the reason why I do think that there will be stricter controls in place and the willingness of politicians to support integration and to get closer will just be a step behind it.

It is likely that countries will acknowledge that there is a bigger need for fiscal co-ordination, but it will probably not turn out in the end, countries will not come closer. Similarly, they cannot accept the same point of view towards possible future European Monetary Union membership for non-euro countries (if these non-eurozone countries want to). Greece was not the initial member of eurozone; now everybody can see that Greek integration has caused problems, and this can lead to them being convinced that it is necessary to make judgments on future actions more carefully. It is necessary for time to pass for the initial shock to wear off, and during this time each member will follow the others, so Spain will analyze German's budget, Germany that of Portugal's, and so on. This can complicate the effort to find a common way and a common joint solution because everyone will be checking on each other and have doubts on whether or not what the other one is doing is correct. People will look and say, are these numbers correct, are they doing the right thing? Let's imagine the situation if Germany tells Spain that they cannot spend so much on education or on health care and hospitals, that they need to stop that; what would happen then? This is going to be very bad news in terms the Europe works. It would be incredibly difficult and it would hugely complicate relations between countries inside the European Union. So we will probably wait to see monetary policies loosened, and this would balance the negative impact of the measures taken in the fiscal sphere.

Politicians say that they will decide on the speed the countries will get rid of their debts, and they say that everything is in their hands. But it is not the case, the **markets are those who will decide**, because if a country does not get rid of it's debt quickly enough, markets will be afraid of bankruptcy, and won't be willing to lend to the country. So it is the market who says how much and when the country can borrow, markets will also determine at what price to borrow.

Globalization of international financial flows means that governments cannot any more rely on financing all state debt from local domestic banks. If foreign investors' bonds start to sell out, it will push up their prices and make massive increasing in borrowing costs, thus making it more costly for countries to borrow from foreign markets. What's more, if a government doesn't have it's deficit under control, then nobody will lend to them, and then the question of "how much" would simply be irrelevant. It means that markets will enforce discipline. States would then have to turn to private investors, and would have to borrow money from them, thus they must make themselves stand out to investors to make them more attractive for investment, because at this moment there will be many who want to borrow and investors will have a big choice.

Without the single currency, the member states would have gone through exchange rates crises and the adjustment shocks would have been bigger. The eurozone however has discipline written into it's laws but markets will enforce a responsible attitude simply because there are markets, who will in the end determine how much you will be able to borrow, and for how much.

For countries Spain, Portugal and the United Kingdom, it was a kind of waking up. They were suddenly aware that you cannot just sit ideally by and hope things get better, you actually have to take action, otherwise the markets will punish you. If the markets punish you and you cannot come and borrow, then cuts will be even more painful further down the line. And so it is much more wiser to make cuts to spending and increase taxes earlier, rather than later; cuts to budgets are inevitable. It is better to make smaller cuts sooner than bigger rather much more painful cuts which will be enforced later. [9]

Catching-up countries need inflows of foreign investments so it may be ok for them to provide currents account deficits for a period of time. Countries in Central and Eastern Europe are trying to avoid market punishment and there is the question whether they could succeed. They are starting from a better position because they haven't got the same deficits and debts to the same extent. But the risk is if they don't take action, if they do not do anything but just rely on economic growth and if they believe that this economic growth will take care of their state deficit and actually lower it, the markets would punish them again. Because if there are getting 5 or 6% yields on 10-year Spanish government bonds which are now guaranteed by the European Union and the International Monetary Fund, then investments to Eastern European bonds suddenly lose their attractiveness. It is the market, and it is necessary to be the most interesting as possible to the investor. This means that to keep fiscal discipline and to be ready if the markets will require higher premiums on their loans.

Obviously there remain concerns about Greece, which is still contracting very markedly and the whole aid package we have seen over last days was designed to shield the European Union countries and rest of economies from what was happening in Greece. The shield to provide confidence for the financial markets. Basically the International Monetary Fund and the European Union "can afford" Greece, but they "cannot afford" Spain and Portugal and other economies to rise default risk.

## CONCLUSION

If global economic slows down, the impact would mean all the negatives related with this, although it is not likely that we will return to a global recession. What is more likely is a period of very weak economic growth. We have seen the recovery of these countries now. Major economies are now reporting a positive economic growth rate. That is obviously good news. Now fiscal tightening is coming through. And that is going to constrain the speed of this recovery. But to offset this I would suggest that interest rates remain low, because in an ordinary recovery you would be seeing interest rates rising in anticipation of inflation pressures. This time it is going to be the fiscal policy is going to do the tightening. So to offset the pain from this fiscal tightening, I would suggest the monitoring policy lines to be very low.

In the USA, the United Kingdom, and the eurozone we cannot expect interest rates rising any time soon. I think in the eurozone case it may be the second half of next year, in the United Kingdom the second quarter possibly next year. The USA is growing much more quickly than all of those economies so potentially they may see their interest rates rise a little bit sooner.

The situation may threaten the economic stability and the cohesiveness of eurozone but the European Union as a whole now has the chance to improve economic surveillance and policy coordination. The current situation may turn out to be opportunity for the eurozone and the European Union as a whole.

**The equilibrium can be restored by adequate central budget (or centralizing local budgets as the firs step.** Harmonized fiscal system should be adopted as it is connected with regional discrepancies and they need to be prevented. Central budget means centralization of taxes and spending, the fiscal part. It would mean in practice to transfer resources from the surplus country to the deficit one. But this attitude can hardly be supported by officials and politicians. Convergence of budgetary and fiscal policy is the solution but path is going to be long and winding.

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# CHAPTER 18. IS IT REALLY NECESSARY TO DEVELOP FINANCE?

**Jean-Paul GUICHARD**, University of Nice – Sophia Antipolis, France

## A « NAÏVE » QUESTION

At any time and place, casting doubt on the supposed utility of finance by asking the question might be surprising. The question could be stated differently: is developing finance, that is to say, developing the banking and financial sector, necessary for growth? One answer comes immediately to mind: yes, of course, as is the case for the each economic sector. The development of the automobile industry is good for growth! An economy is growing if its economic sectors are developing, whether in manufacturing industries or in services, and all sectors fulfil the criterion of utility. Hence, the thing is simple; in a word, there is no need for mathematic models: developing finance is part and parcel of economic development and any sector-based progress, including in that of finance, is good for global growth.

In spite of that, as we all know, economists often like to ask uninteresting questions, which have no purpose; is it the automobile sector that determines economic growth or indeed growth that determines the development of the automotive industry? With good, common sense, we could say: a little of both! And the same thing can be said for the financial sector. Some analysts would have us observe that there is an established hierarchy of economic activities, there are "fundamental" goods or services and others that are not such, and finance belongs to the first category. All the same, any technical progress (any gain in productivity) that affects a sector of activity, be it fundamental or not, increases the efficiency of the entire system of production; of course, that concerns "financial innovations", the most striking feature of finance over the last few years. Despite the crisis, the greatest majority of economists, financiers and other "experts" think, as the President of the Bank of France recently expressed it, "that financial innovations have been and are a good thing"; opinions to the contrary, such as those expressed by Henri Bourguinat and Eric Briys in a recent book, "The Arrogance of Finance"[1], are by far in the minority.

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1 Henri Bourguinat, Eric Briys, « L'arrogance de la finance » (« Comment la théorie financière a produit le krach »), [« The Arrogance of Finance » (« How Financial Theory Produced the Crash »)], La Découverte, Paris, 2009.

Economists who ask the question of the link between finance and growth emphasize that finance is a sector unlike all the others: there is money, a very special good and there is also the State, which is, in spite of everything, very present. One must act in such a manner that the agents needing to borrow can benefit from the savings of those who do not spend all of their income; and even more, there must be monetary creation. Allocation of credit must be efficient; those who have the best projects must be able to obtain the necessary financing; and so that things can work this way, the State must play its own role; notably, it must not organise for its own benefit "financial repression", synonymous with an inefficient resources' allocation. These last years, "financial innovations" has been in fashion in the developed countries whereas in other countries, it used to be "financial liberalisation"…

There is no question here of denying the great merits of finance, which, let us recall, offers eminent services: financing sectors promoting progress, recycling the financial resources of those countries enjoying a trade balance surplus towards those with a trade deficit, risk management[2], transfers of wealth over time, monetary creation. However, the theme of financial liberalisation expresses, to a great measure, very precise economic concepts: it is both "long live competitivity" and "long live international trade development" and, in contrast, a double "No" to state dominance and protectionism.

Most authors who take an interest in the "link" between economic growth and financial development consider that the latter has a positive impact on growth; they mobilise to demonstrate the validity of this "hypothesis", the econometric tools consisting in making growth indicators regress– especially the rate of growth – on "financial development" indicators, and so, overtime, for a great number of countries, large or small, rich or poor. We point out that this manner of working, which is in no way theoretical, but which, on the contrary, is purely empirical, is not free from criticism or, at the very least, of raising questions.

The question is how can we evaluate "financial development"? Many indicators can be considered; nonetheless, one of them seems worthy of being privileged: the amount of credit given to private economic agents on GDP; this indicator has the advantage of taking into consideration the essential function of the banking/finance sector: credit. In the considerations that follow, this will be the essential variable of financial development.

The methodology that has just been evoked implicitly assumes that all countries must have more or less similar paths, which is not at all obvious! In addition, there is also the idea, which is also implicit, that the fact that a financial system is

2 The question of market efficiency will not be taken up here as the present author does not subscribe to it.

more or less developed could not result from the choice of economic strategy adopted; the fact that a given financial system is weakly developed should not be the consequence of "backwardness" in development or of institutional inflexibility that should therefore be suppressed…since financial development is supposed to be good for growth and progress! How could there ever be a "responsible" economic strategy that would deliberately give up developing the financial system and, consequently, abandon progress itself?

Yet it is precisely this last point that poses a problem. We shall see in the discussion here below that some countries, in view of stimulating their growth, find it advantageous to develop their financial sector, but we shall also see that other countries, with the same objective of stimulating their growth, find it advantageous not to develop their financial sector, or, more exactly, to only develop it weakly. In sum, financial development could be good for growth in certain cases and bad for growth in others (and independently so of the question of "irresponsible" financial innovations [3] !). If such were the case, then a "problematic position» of the sort «development favours (or else holds back) growth» would make absolutely no sense, as would all the studies that were undertaken in this perspective!

But why should financial sector development result in a highly different significance and different implications depending on the countries under consideration? To comprehend this point, it is now necessary to analyse the implications of trade imbalances in the growth of the different countries around the world.

## DEMAND, INDEBTEDNESS AND FOREIGN TRADE

In two forthcoming articles,[4] Antoine Brunet and I show that the growth of a country responds to two currents: on the one hand, stimulation of domestic demand due to development of residents' net indebtedness, and on the other hand, the foreign trade balance, which is an expression of the incidence of foreign demand (and possible indebtedness of foreign economic agents). Analytically, it can be expressed as follows:

3 The question of the "sorcerer's apprentices" of finance is not directly central to the present analysis; however, the fact that the latter were freely able to apply their calamitous mathematical tools is no accident…

4 Antoine Brunet, « A pertinent key for analysis to correctly measure contributions to growth in gross domestic product » (to be published in the review « Panoeconomicus »). Jean-Paul Guichard, « Indebtedness and mercantilism » (also to be published in the review « Panoeconomicus »)

$$GDP_n = TDD_n + FTB_n$$

or $TDD_n$ and $FTB_n$ are, respectively, total domestic demand and the foreign trade balance during quarter (n).

From one period to another, the net indebtedness of the economic agents, ($TDD_n - GDP_{n-1}$), expresses the fact that during the current quarter, the agents are perhaps spending more than they earned in the preceding quarter. We could thus write:

$$GDP_n - GDP_{n-1} = (TDD_n - GDP_{n-1}) + FTB_n$$

Or else, the rate of growth:

$$\Delta GDP/GDP_{n-1} = (TDD_n - GDP_{n-1})/GDP_{n-1} + (FTB_n)/GDP_{n-1.}$$

The growth rate thus appears as the sum of two terms:

- Net indebtedness to GDP ratio, which we can call the degree of stimulation of domestic demand;
- The Foreign Trade Balance to GDP ratio; if it is positive, it gives rise to a currency inflows, which expresses foreign indebtedness.

If the trade relations between nations were balanced, for each country, the foreign trade balance would oscillate around zero. The growth of the different economies would then be the result of stimulating domestic demand by indebtedness; an indebtedness regulated in such a manner as to avoid inflationist episodes, yet allow sufficiently strong growth. Unfortunately, things do not quite work out that way! International trade undergoes very grave imbalances; during long periods, some countries have a foreign trade surplus while other countries record recurring deficits.

If, as a result of the strategy that it has implemented, the Government of the country manages to assure that country enjoys renewed trade surpluses, it is playing a winning game in global economic competition. Indeed, the trade surpluses constitute a considerable advantage: thanks to them, it is not necessary to stimulate domestic demand strongly by indebtedness, thus protecting the country from the unpleasant outcomes susceptible to arise from too strong appeal of domestic demand. Growth, based on recurring trade surpluses, can be strong: it is the mercantilist model illustrated, in particular, by Japan between 1950 and 1990.

An economy whose foreign trade balance would be 6% of its GDP and whose quarterly growth would be 2% (8% annually) would thus have current domestic spending systematically lower (4% of GDP) than its income from the preceding quarter. If foreign demand should temporarily fall, for example following an economic crisis in its customer countries, the mercantilist country, which has low indebtedness due to the very strategy that it has implemented, is then in a position to compensate for this lack of foreign demand by having forceful recourse to indebtedness to stimulate domestic demand and thus maintain growth at its former level.

A totally different matter is the situation of a non-mercantilist country recording repeated deficits, and which is subject to the effects of the mercantilist policies followed by other countries. To maintain a weakly positive growth rate, it is obliged to compensate its negative foreign trade balance by current domestic demand that must always be higher than the preceding quarter's income; growth is thus carried ever more greatly on the back of indebtedness, both domestic and foreign. If the foreign situation of such a country deteriorates, the will to maintain a minimum growth rate will then oblige it to stimulate domestic demand even more, which can only result, at least in the end, in grave consequences: indebtedness can not grow indefinitely…

The current dynamics of the global economy is thus organised around an opposition between "mercantilist" countries with a positive foreign trade balance and whose ratio of stimulation of domestic demand is generally negative[5], on the one hand, and « non-mercantilist » countries whose foreign trade balance is negative and whose domestic demand is positive, on the other hand.

Given that there are two ratios that can be positive or negative, the preceding classification can perhaps be enriched by two other groups. First of all, there is the group whose two ratios are positive; that is a relatively rare situation that corresponds with countries undergoing a changeover: "mercantilist" countries which become "non-mercantilist" and conversely[6]. Next, there is the group, whose two ratios are negative, and whose rate of growth is necessarily negative: obviously, they are countries in crisis; this situation is notably that of the "former East Bloc countries" which, in the 1990s, were called countries "in transition"; this situation is also that of countries that today are subject to the crisis, as is the case of France.

The important element of the classification that has just been described is, of course, the duality between « mercantilist » and « non-mercantilist » countries, which can be illustrated, in the years preceding the current crisis, by China and the United States. That said, we can now face the question of the development of the financial sector in relation to economic growth.

5 To these countries, mercantilist due to the economic strategy that their respective States have put into practice, we must add those countries which, thanks to their major natural resources, are « naturally » mercantilist, most notably in the case of the oil-producing countries.

6 We must emphasize the fact: countries that have a foreign trade surplus are having during long periods and vice-versa for countries in deficit. Hence, it is rare that a country passes from one category to the other.

## ECONOMIC STRATEGY AND THE DEVELOPMENT OF FINANCE

As we have seen, except for those countries enjoying vast natural resources, the fact that a country can record trade surpluses year after year is not due to serendipity: in general, it results from a strategy which, in one way or another, can be identified as a form of protectionism. This is notably the case of those countries that succeed, through monetary manipulation, in maintaining a grossly undervalued exchange rate, as was the case of Japan until 1985. The mercantilist strategy is based of foreign surpluses: the ratio of foreign trade (the foreign trade balance to GDP) is largely positive; that situation allows the ratio of domestic demand stimulation (i.e., the difference between domestic spending in the current quarter and the income of the preceding quarter to GDP) to be negative, and even clearly negative, even when annual growth is strong. In the fictive numerical example just cited here above, quarterly growth of 2% (8% yearly) is expressed as the sum of the two ratios: the ratio of domestic demand stimulation, which is -4% and that of foreign trade, which is 6%[7]. In a regular fashion, quarter after quarter, domestic spending in the current quarter is lower than the income of the previous quarter; savings are strong, and it is not necessary to stimulate credit. Better still, strong savings and the export of capital are part of the strategy of a mercantilist country; consequently, it is not necessary, nor even desirable, for the financial system to be highly developed. A sophisticated financial system is necessary when the goal is to stimulate domestic demand thanks to credit: that is not at all the case of a mercantilist country.

We can thus understand why prior to the1990s, Japan's financial and banking sector was not very developed; during the same period, the same is true of Germany, another notoriously mercantilist country. And we can also understand why contemporary China, the principal mercantilist country, is endowed with a bureaucratic banking structure that is probably not very effective: the very strong Chinese growth is based on foreign trade surpluses in goods and strong domestic savings, which allows for exporting capital, which in turn, permits the continued under-evaluation of the national currency and therefore, consistent foreign trade surpluses. One obviously must not believe that the fact of having strong savings prevents the domestic demand of a country with a strong trade surplus from growing: China is seeing its domestic demand grow at approximately the same rhythm as its GDP…

If savings are strong in the mercantilist countries, in contrast, they are negative in those non-mercantilist countries with major foreign deficits. In these countries, such as the United States or Great Britain, the GDP growth could only be slightly

7 Orders of such magnitude are in conformity with the growth that Japan enjoyed in the 1960s.

positive in the beginning of 2009, thanks to strong stimulation of domestic demand due to indebtedness. Thus, in the case of the United States from 2003 to 2006, the ratio of foreign trade was -6% while that of stimulating domestic spending was +6.75%, thereby allowing quarterly growth of 0.75%, making an annual rate of 3%. So that, quarter after quarter, the economic agents could spend more that they had earned and in such proportions, it was necessary to do everything possible for credit to be widely distributed by the banks, and for that, it was necessary to keep the interest rates as low as possible; it was also necessary that all or nearly all classes of the population could take on debt. Indeed, the interest rates were maintained by Mr. Greenspan at a very low level without its raising the least problem for financing the budget deficit: effectively, it was possible for the United States to maintain a very low level of bond market rates by replacing much of the monetary payment for the Chinese trade surpluses with the purchase of “treasury bonds”.

Thus, the credit to households, whether as consumer credit or real estate credit, could be extended, thanks to its relatively modest cost; this was, however, not enough: more was needed, and “painless” formulas had to be found, enabling the insolvent classes of the population to go into debt, too. It took a lot of imagination: very shrewd minds invented the “innovations” of sophisticated finance.

For fifteen years or so, the financial sector, measured by the volume of credit given to private economic agents, has particularly developed in countries with a foreign trade balance largely in deficit, the United States and Great Britain above all, where it was necessary to strongly stimulate domestic demand in order to obtain a non-negative growth rate.

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In résumé, countries with a mercantilist policy that achieve major trade surpluses need anything but sophisticated finance: the growth rate of their GDP, which is strong, is paired with weak development in their banking and financial sectors[8]. Those countries which, on the contrary, are locked into a policy of accepting foreign deficits and stimulating their domestic demand need a highly developed and perfected financial sector to remain so: the rather mediocre growth rate of their GDP therefore goes along with strong development in their banking and financial sectors.

8 These countries have a highly developed industrial sector that constitutes the basis of their trade surpluses and a relatively modest banking/financial sector.

# CHAPTER 19. REINDUSTRIALIZATION, BALANCED SPATIAL DEVELOPMENT AND FINANCIAL INDUSTRY

**Sofija ADŽIĆ**, Faculty of Economics, Subotica, Serbia

***Abstract***

*Starting orientation of this paper is that on the base of new model of economic growth and development in Serbia present the development industrial organization of national economy and realization the strategy of reindustrialization accordingly to the European concept of endogenous and sustainable development. Development based on knowledge and creating good conditions for balanced spatial development as the basis for effective private investment in export industries, which represent the essence of this concept - in the past three decades in Serbia several times has been promoted as the main development orientation. Implementation has not started for several reasons, one of which is in the foreground - the cultural and political tendency to easily define and to abandon the decisions, without going into the essence of socio-economic barriers that make impossible their implementation. On the other hand, in the new model of economic growth and development of Serbia is necessary to incorporate the lessons of the global financial and economic crisis and post crisis depression. In this context, solutions for the development of industrial organization of national economy and strategy of reindustrialization must be sought within the terms of the new model of economic growth and development in which the preponderances are classic principles of business, mezzo and macro economic stability - increasing the employment of labour and capital, establishing the balance in the foreign economic relations and respect for the principle of hard budget constraints in all areas of public, entrepreneurial and corporate governance. This means that the focus of a new model of economic growth and development of Serbia must be in the field of structural policy in function of revitalizing of developmental functions of depressed urban and rural areas. In this context, structural policy should have two groups of attributes. The first includes the attributes for creating the conditions for endogenization of technological progress in the organizational structure of national production - organizational systems, and the other the attributes that will induce the financial industry on crediting of export-oriented businesses. In this context, the processed material is divided into four parts. In the first part are presented the synthetic results of analysis of characteristics of the national production - organizational* *system in the context of its historical development and implications of structural policies in the function of empower Serbia for the implementation of the European concept of endogenous and sustainable development. In the second part are presented the basic determinants of industrial organization of national economy and strategy of the reindustrialization of Serbia with the intention to determine the basic term of structural policy in the function of regeneration the development functions of depressed urban and rural areas. In the third part are processed three basic development alternatives with an emphasis on phenomena that encourage or block the implementation of the proposed concept of structural policy. The fourth part deals with the problem of development of loan market to finance the export business.*

***Key words:*** *Serbia, European concept of endogenous and sustainable development, Industrial organization of the national economy, Strategy of reindustrialization, Structural policy, Loan market for export business*

## INTRODUCTION

The subject of this study is to analyze the conditions for the implementation of the European concept of endogenous and sustainable economic, social, cultural and environmental development in the function of balanced spatial development of Serbia. The base of this concept is a triangle of paradigm: ***successful economy - creative society - innovative economy***[1]. According to this concept, the main

[1] The basis of a ***successful economy*** is a well-functioning economic system in favor of all his subjects. This means ensuring conditions for sustainable production and employment and distribution of newly created value to all members of society. For details, see Adžić, S. (2006), *Privredni sistem i ekonomska politika*, Ekonomski fakultet, Subotica, pp. 137-140.

The concept of the development of ***creative society*** and ***innovative economy*** is based on strengthening of research and technological potential of productive binding of education, scientific research activities, production of public goods and services of public administration in a way that ensures effective acquisition of new knowledge and skills, the diffusion and implementation of new technology as key factors to accelerate the economic, social and cultural development in modern market economies. Of course, the terms creative society and innovative economy must be considered in a pluralistic concept. Creative society and innovative economy are just one of the (sub) system of total national economic, social and cultural systems. In any real socio-economic system - a creative society and innovative economy operate parallel with other socio-economic (sub) systems, but what essentially marks the modern societies and economies, is their key role in structuring factors of economic development, growth (or decline ) of competitiveness, employment and quality of life. For details, see Adžić, S. (2006), "Kreativno društvo, inovativna privreda i tranzicija – Studija slučaja za Vojvodinu", sources (national, regional, local) development is in-site generated technological and business (primarily organizational, marketing and financial) innovation that lead to the development of new and improvement of performance of all existing actors, activities and procedures within the production, financial, business and institutional system. The concept is performed based on the seeking for solutions, how to within the European Union, apropos based on common criteria, finding answers to challenges of global reconfiguration of civilization on the principles of industrial organization (national, regional, local) economy - within the triangle of paradigm: (1) ***Educated people*** - of which every individual should have knowledge and skills that can find employment in accordance with his formal qualifications in the relevant segment of the domestic or global labour market, (2) ***Developed industry*** - which based on a combination of development of their own and creative implementation of foreign technology provide the realization of key socio-economic conditions of stability and long-term sustainable economic, social, cultural and environmental development - ***that each national (regional, local) economies have to spend as much as it produced, invest within their accumulation, and take as many credits as much is given, and all in between events are only episodes that lead to the fulfillment of this goal*** and (3) ***Modern socio-economical system*** in which the policy (at national, regional, local level) is a key factor that ensures a high mobility of business and technical innovation and a good frame for the productive enterprise and development privatization, as a basis that underlies the modern economy.

The process of socio-economic transformation on the basis of the development of industrial organization of the national economy is followed by reindustrialization. The term itself mark the process of transformation of economic structure based on development of large-scale machine industry and application of industrial methods and means of work in other productive and non-productive sectors, and

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*Socijalni kapital i društvena integracija*, Filozofski fakultet u Novom Sadu, Odsek za sociologiju, Novi Sad, pp 315-339.

The main task of their implementation is that all members of society who want that, get the job. The basis of the implementation is a pragmatic economic policy that is based on the thesis that the creation of its attributes, instead of blind support of an intellectually seductive theoretical concept or recommendations of the international political and economic organizations, there is a need for a better understanding of the problem, appropriate regulation and control of its implementation for the purpose of shortening the period of reduction of economic activity, but also an orientation to neutralize those socially unacceptable phenomenon in times of rising of economic activity, which undoubtedly act on the later appearance of its reduction, i.e. reducing the personal distress and difficulties caused by unemployment which is caused by cyclical trends in economic activity. For details, see: Adžić, S. (2006), *Privredni sistem i ekonomska politika*, Ekonomski fakultet, Subotica, pp. 140-144.

in an appropriate manner in non-economic sectors[2]. As a result, in industry are involved, in addition to traditional activities: extractive industries, manufacturing industries, productions and distributions of water, electricity and gas and activities, such as agro-industrial complex, financial industry, business services industry (service industry) and tourism industry[3]. In this context, the phenomenon of reindustrialization binds, primarily, to change of the basic development paradigm, according to which the phenomenon of successful development is no longer in the possession of natural resources and capital in the function of the mass processing of natural materials into standardized products, but more and more dependent on the available technology, education and motivation of the workforce, efficiency of investment and skills of providing the cooperation with key partners in the chain of reproduction (the suppliers of energy, raw materials, intermediate goods, capital and business services, on the one hand, and consumers and users, on the other side). In this context, realization the strategy of reindustrialization can not

[2] The main features of reindustrialization are:

First, about the year 2025 can be expect the completion of the process of building a new global production system in which technology and human capital are the most important inputs, while the most important outputs are already (partially) visible: quality, diversity, innovation, growth of service content, global access, stored regional and cultural specificity.

Second, non price competitiveness will become significant as the price - and they are provide by the integration of functions and tasks, which were separated in the framework of traditional industrial organizational structure. The new competition is based on the development of network structure of suppliers, subcontractors, producers, distributors, educational, scientific research, financial and other economic and non-economic organizations in the wider, international level.

Third, the process of (partial) dematerialization of production, as a result of: (1) exhaustion of the form of mass industrial production, (2) changes in the quality of life in which the quantity gradually substitutes with the quality and diversity of consumption, (3) transition from meeting the primary (existential) needs to the needs of higher level, (4) termination of the conquest of nature by reducing the energy and raw material intensity of production, and (5) reduction of waste - as a base (synthetic) indicator of conflicting between industrial production and nature;

Fourth, the process of globalization and the interaction of cultures living and working based on the exponential growth of communication and cooperation at the global level. Therefore, quality (internal) of global communication is one of the basic conditions for equal co-operation and evaluation of national (regional, local) factors of production and development.

[3] For details see Collection of works (2003), *Industries in Europe: Competition, Trends and Policy Issues*, Edward Elgar. Publishing In the industries are included: (1) agricultural industry (in terms of agro-industrial complex - the author's note), pp. 26-54, (2) air transport, pp. 260-286, (3) financial services (financial industry), pp. 287-219, (4) business services (service industry), pp. 320-346, and (5) tourism (tourism industry), pp. 377-409.

be reduced to the industrial policy (especially not the one that is based on subsidies and provision of quasi-monopoly position in the market), but must be supported by a complex of institutional reforms and various forms of partial economic, development, education and social policy.

At the global level and in European Union, number of ideas and public policies were initiated for re configuration of socio-economic structure on the principles of industrial organization (national, regional, local) economy and realization the strategies of reindustrialization. At this point not going into wider analysis, there is no doubt that successfully realized only those that were consistent with the needs and capabilities of the ruling and upcoming socio-economic environment (in which acts parts of production, financial, commercial and institutional systems)[4].

Explicitly dealing with theoretical and practical problems of development of industrial organization of the Serbian economy has not a longer tradition. This is especially surprising if note more than three decades of presence of commitment

[4] Thus, for example, Finland at the beginning of the last decade of last century initiated and successfully realized a strategy of building an industrial organization of national (with strong regional and local characteristics) economy, and a strategy of reindustrialization.
Because of the noticeable lag most of the member states in the development of industrial organization of economy and realization of strategy of reindustrialization, the common institutions in March 2000 promoted the so-called Lisbon agenda in order to European Union by 2010 become the most competitive global economy with respect of very high social, cultural and environmental standards. In order to create conditions for the in-cite (regional and local - author's note) endogenous and sustainable development, in phase of preparing for the budget period 2007- 2013 the direct connection is made of goals of the Lisbon agenda of March 2000 with the content of objectives and actions of Regional, Structural and Cohesion policy of the European Union. However, it turned out that it was not enough because there was not substantial progress in the development of industrial organization and reindustrialization in most national economies of member states. Because of this, in the beginning of March 2010 was launched a simplified version of the Lisbon agenda of March 2000. under the name ***EUROPE 2020***, which insisted on the three basic paradigms: (1) ***Smart growth*** (development of the economy based on knowledge and innovation), (2) ***Sustainable growth*** (promotion of resource efficient, environmentally cleaner and more competitive economy) and (3) ***Inclusive growth*** (stimulating the economy with high employment, which will brought a social and territorial cohesion), on the principles of decentralization, cooperation and collaboration of public and private factors and, above all, improvement of public regulation. Not going into wider elaboration, problems and number of controversies that have accompanied and follow these two projects indicate that the development of industrial organization of the national economy and reindustrialization are very complex and challenging problem, even for societies and economies that are at a much higher level of development of Serbia.

of key political and professional actors for greater role of new technology and entrepreneurship in the socio-economic development of Serbia. However, the economic analysis are inexorable and show that Serbia is on a permanent basis faced with a kind of shape of development crisis - which marks two paradigms that mark distinct, but closely linked socio-economic phenomena.

The first is ***transitionism***. Not going into detailed explanations, transitionism indicates a complex and multidimensional phenomenon that includes, in addition to economical, also geopolitical, historical, anthropological and cultural aspects. The economical aspect is marked by problems caused by unfinished the four characteristic processes (post) socialist transition. - ***privatization, macroeconomic stabilization, institutional reforms and reindustrialization***. Its primary feature is ***post transition stagflation*** - the discrepancy between real and financial economies (dominated by the banking system focused on lending to the population and ongoing business activities, primarily in the sector of not exchange goods), impotent (with regard to development - note the author) real economy, vulnerable macro- economic stability, underdevelopment of economic institutions and the high regulatory risk.

The second is ***the paradox of institutional and technological change with no (real) change*** - in Serbia, there are relatively large institutional, technological, financial and human resources, and efforts for their improvement, but there is no new industry, nor increase the efficiency of existing ones.

In the context of these two paradoxes, I will try to explain the creation and retention of factors that block the development of industrial organization of national economy and the realization of strategies of reindustrialization in Serbia, as well as a ways to overcome them. On the other hand, the experience of three national projects to overcome the development crisis in Serbia[5] , and also the

[5] In terms of science methodology, year 1980 marks the beginning of the stagflation crisis in Serbia. After three decades, it can be mark as the beginning of a downward phase of long economic cycle. During this period, three models of structural policies were launched to overcome it. The first model (which from historical aspect can be treated as a structural policy in function of (post) socialist transition, especially in light of the fact that its elaboration and promotion in time (but not in content) almost coincides with the so-called Chinese model of socialist transition, which brought it to the status of the global economic player) was launched in the form of so-called ***Long-term program of economic stabilization*** (LPES) in 1982/1984. The second is activated in 1989/1990 in form of so-called Marković's project of ***soft restoration of capitalism***, which is applied with some modifications, until 2000. After the radical change of political power holders at the end of 2000th the third model of structural policy was launched on the recommendations of the international political and economic organizations. The results of applications of these three models indicate that adequate solutions for the reconstruction of sustainable development in Serbia are not found. The application of

substantial changes in the global financial and production system that will inevitably follow, suggest that the solutions must be sought within the frame of a new concept of structural policy in which the focus must be on the objectives of uniform (balanced) spatial development in function of revitalization of developing functions of depressed urban and rural areas. In the case of Serbia, as well as a small and underdeveloped countries with devastated production system and great economic and social imbalances, the content and hierarchy of the objectives of the new model of structural policy must rely on the classical postulates of business, mezzo and macro-economic stability in which the main priorities are - increase of labour employment and capital, establishing the balance in the foreign economic relations and respect for the principle of hard budget constraints in all areas of public, entrepreneurial and corporate governance, in the dynamic context of the destruction of old and creation of new socio-economic structure in the function of revitalizing the old and developing of new export business and industries.

In order to operationally these requirements, there is a need to focus of the structural policy is on mechanism, which will in initiating and promoting change in the structure of national production - organizational systems create conditions for endogenization of technological progress at the national, regional and local levels as the main factors for ensuring sustainable development from which in next step will be done the aims and mechanisms of the strategy (national) of reindustrialization. Because something like this can be explored and understood only in the context of regular behavior, the paper I will use, primarily, the ideas and concepts that have their stronghold in the general theory of dynamics of complex systems - in order of seeking answers to two questions: (1) “Which of three basic production – organizational models: Industrial districts, Clusters or Poles of generic growth, would be the most effective for realization of (national) strategy of reindustrialization on the principle of equal (balanced) territorial development?” and (2) “How to create a socio-economic environment that will encourage a financial industry on the development of market of credits for financing export business?”.

Accordingly, researching the ways to outline the proposal of contents of the objectives and the actions of structural policy in function of creating conditions for the development of industrial organization of national economy and realization of reindustrialization strategy of Serbia in function of balanced spatial

three different models of structural policies in the past three decades have a very similar results compared to the initial state - after a temporary improvements, again come to the fore the key limiting factors of development: an imbalance between the real and financial economies, weak internal development propulsion of real economy, vulnerable to micro, mezzo and macro-economic stability and poorly functioning of economic (market) and public institutions for the regulation of the economy and economic development.

development is divided into four parts. In the first part are presented the synthetic results of research of characteristics of the national production - organizational systems in the context of its historical development and implications on structural policy in the function of training Serbia for the implementation of the European concept of endogenous and sustainable development. In the second part are exposed the basic determinants of development of industrial organization of national economy and strategy of reindustrialization of Serbia with the intention to determine the basic frame of structural policy in the function of renewing of development functions of depressed urban and rural areas. In the third part are exposed the three basic development alternatives and the policy of their realization with the emphasis on phenomena that encourage or block the realization of the proposed concept of structural policy. In the fourth part is presented the problem of development of the market of credit for financing the development and export business.

## DYNAMICS AND CHARACTERISTICS OF PRODUCTION – ORGANIZATIONAL SYSTEM AND ITS IMPLICATIONS ON REINDUSTRIALIZATION AND BALANCED SPATIAL DEVELOPMENT

### The dynamics of development of production - organizational system from 1947th until 1989

Prior to review of the current characteristics of the production-organizational systems there is a need to give a brief overview of the models on which basis was realized the industrialization of Serbia in the period from 1947. up to 1989, more precisely to 1980 when was completed the formation of production - organizational structure of national economy with which entered the phase of the restoration of capitalism. Industrialization of Serbia in this period took place, mainly, according to the model of industrial districts. My research indicates that by the end of the 60s of the last century in Serbia (without the territory of the Autonomous Province of Kosovo and Metohija) was set up 26 industrial districts. In these industrial districts is possible to identify 22 other industrial centers of medium-sized and 114 small industrial centers. Thus the total number of industrial cities in Serbia (without the territory of the Autonomous Province of Kosovo and Metohija) before the transition can be estimated at about 160. Within these industrial districts operated about 67 major national or sub-regional business systems on the principle of vertical merge facilities, mainly performed in the period since 1965. to 1980., which from the aspect of today's knowledge had a function of clusters (Table 1). Creating of industrial districts and industrial centers in addition to the logically complete structure of production capacities followed by the development, such as appropriate logistical capacities (roads, railways, river and canal network, ports, warehouses, commercial enterprises in wholesale and foreign trade enterprises) also as appropriate educational capacity (primarily, VET for industrial and other productive occupations in accordance with the specificities of structure of production of concrete industrial districts).

**Table 1. Industrial districts and key clusters in Serbia in 1989.**

| Industrial district | The basic structure of the key clusters | | | | | |
|---|---|---|---|---|---|---|
| | Energy cluster | Agro-industrial cluster | Electro-metal cluster | Cluster for production of chemical and pharmaceutical products | Cluster for production and processing of textiles, leather, rubber, wood and furniture | Construction cluster |
| 1. | 2. | 3. | 4. | 5. | 6. | 7. |
| Čačak | | | + | | | + |
| Beograd[1)] | + | + | +(3) | + | + | +(4) |
| Bor | | | + | + | | |
| Jagodina | | | + | | | + |
| Kragujevac | | | + | | | + |
| Kraljevo | | | + | | | + |
| Kruševac | | + | + | + | + | + |
| Niš[1)] | | | +(2) | | + | + |
| Novi Sad | + | + | + | | + | + |
| Leskovac | | | | | + | + |
| Kikinda | + | + | | | | + |
| Novi Pazar | | | | | + | |
| Pančevo | + | + | + | + | | + |
| Pirot | | | | | + | + |
| Požarevac | + | + | | | | + |
| Smederevo | | | + | | | + |
| Sremska Mitrovica | | + | | | | |
| Sombor | | + | | | | |
| Subotica | | + | + | | | + |
| Šabac | | + | | + | | |
| Užice | | | + | | | + |
| Valjevo | | | + | | | + |
| Vranje | | | + | | + | + |
| Vrbas | | + | | | | |
| Vršac | | + | | | | |
| Zrenjanin | + | + | + | | + | + |

1) For Belgrade and Niš numbers in parentheses indicate the number of clusters in the said industries. In other industrial districts in specified activities operated only one cluster.

In Serbia, after 1945 there was an explicit idea about establishing poles of generic development, based on the development of strong and international competent research and educational institutions. The first was the establishment of the Institute of Nuclear Sciences in Vinča and complex of various institutes for different purposes in Belgrade. At the end of the fifties of last century, was initiated a project of establishing of new poles of generic growth – establishing of the University of Novi Sad, Niš and Kragujevac with structure of faculty adapted to the needs of the environment. However, as in the case of Belgrade, did not succeed in their transformation into centers of global excellence and development and high-technology transfers.

The process of industrialization of Serbia was followed also by many weaknesses. The key limitation is certainly the fact that the national production - organizational system developed in the framework of mass, energy, material and labour-intensive production based on imitation of foreign technologies (primarily, importing of equipment and purchasing of licenses) and the dominant role of political (communist) elite in their structuring and development. The consequences of this approach that feel to date are: (1) poor accumulated experiences from the ***best industry practice,*** mainly due to tolerance of high irrationality of resource use, (2) deeply ingrained habits (especially in the management structures) to high external and internal protection and non-competitive efficiency and (3) value system and social relationships that block in cite the generating and implementing of business and technology innovation. The market of goods (which is in contrast to other European (post) socialist countries, now members of EU-27, functioned in the former Socialist Federal Republic of Yugoslavia) there was no transmitter signal that would indicate to actors of organizational systems - What and under what conditions should produce in order to be competitive? The main signals were coming from the supply side, and even then was offered mostly what one has and without search for a new one. Therefore, the key actors in national production - organizational systems behaved as a typical groups with special interest (distribution-oriented coalitions)[6]. And

[6] The term marks a group of special interests - which with uniting provides improve of their position in the distribution of social products and resources without adequate personal contributions to their maintenance and increase. The basic socio-economic characteristics of distributive-based coalitions are: (1) a tendency towards the development of monopoly of political, social and economic structures, (2) loss of interest in adaptation to social, economic and cultural changes in the environment, (3) tendency to (mish)use of administrative – hierarchical rather than market mechanisms of evaluation and allocation, and (4) tendency to encourage the development of distribution-based coalition at the lower levels of socio-economic organization, to thus mask the true intentions of actors of key groups of special interest. Causes and consequences of development and actions of distributive - oriented coalitions in Serbia see: Adžić, S. i Popović, D. (2005), "Fiskalni sistem i fiskalna politika – njihov

where these groups rule there is no business and technological innovations, but all efforts are oriented to preserve the position.

**Transition and socio-economic crisis in Serbia and its implications on the real economy and spatial development**

In Serbia, after 20 years of the restoration of capitalism and the four business cycles was achieved only about 70% of GDP from 1989, or about 65% of GDP from before transition maximum of 1986[7]. The highest price was paid by real sector and spatial development. Many elderly, especially (formerly) an export industries have disappeared, and no new is created. Volume of industrial production and employment in Serbia in 2009 is about 45% before transition maximum achieved in 1986/1987. With this, the industry is practically reduced to three activities: the production of food and beverages, production of construction materials and energy, on which can not build the (economic) basis for the inclusion of Serbia in the process of European integration. In agriculture is recorded a smaller decline in production, but the scissors of price in 2009 endanger its self reproduction. More serious consequences are in the field of spatial development. Practically the all investment activity and distribution of the results of development after 2000 are allocated to Belgrade and Novi Sad.

There are different views on the fundamental causes of the failure of Serbia to create the conditions for the revitalization of production of the real economy and sustainable development. The dominant view is that search for causes in geopolitical cataclysm caused by the disintegration of the Socialist Federal

doprinos unapređenju konkurentnosti privrede: Slučaj Srbije". *Ekonomija/Economics*, br 1, pp. 173 – 200.

[7] Although it is clear that, in this context, is difficult to talk about the success of the national model of macro management transition and economic policy after 2000. , there is a tendency in political and in part of expert public to mask that fact. Politicians does not looks back on it, because for them 2000 is the base year, while ignoring that the actual volume of industrial production is less than the level in 1997/98. A significant part of experts represents the thesis that it is not important, because the comparison to the previous situation and position Serbia had in the former Socialist Federal Republic of Yugoslavia has no (scientific) sense. In fact, their standpoint is that the economy of Serbia today is something else related to the position of the country from which arose. It is undoubtedly true, but the recovery of industry and overcome the volume of production in successful European (post) socialist countries has been achieved with appropriate structural changes, not on the same structure of production, technology and employment. Since, the period from 2000 covers two investment cycles, which are consistent with one of the most dynamic period of development of the global economy and international trade, and foreign trade, as we know did not miss till the end of II quarter of 2008, this statement is scientifically unsustainable.

Republic of Yugoslavia and Serbia's failure to include in this context to the process of integration with the European Union. To that the current political elite join the overflow of effects of global financial and economic crisis. Not denying the influence and significance of these factors, in my opinion, the main cause of the failure of Serbia to create conditions for sustainable development is the fact that neither the restoration of capitalism (1990/1991) neither the transition to a democratic political system (at the end of 2000) did not created conditions for endogenization of technological development in the institutional structure, because they did not remove the key socio-economic barriers that immobilize the development and improvement of production enterprises and block the generation, implementation and economic valorization of business and technological innovations.

**Basic characterization of the current national production-organizational system and its environment**

At this point I will work out the characterization of parameters of the national production -organizational system and its environment, which are important for the proposed concept of structural policy, whether acting as stimulus, either as limiting factors in creating conditions for the implementation of the European concept of endogenous and sustainable development. Let start, first from the achieved results of reforms of market and public institutions, and changes in the content the attributes of economic policy after 2000 were carried out:

First, Reforms of the banking system - according to the recommendations of international economic and political organizations. The reform provided the creation of a new stable and profitable banking system which more or less is respected the principles of hard budget limitations and avoiding a moral hazard. However, it seems that these measures are realized, first of all, suit to the foreign factors, in other words to foreign banks, which are using the vacuum created by liquidation of the four largest national banks took over the biggest part of the credit market. This hypothesis is indirectly confirmed with the outbreak of the global financial and economic crisis, which has shown - that the international protagonists whose interests represent those organizations, did not apply this model when some of their key financial institutions found themselves in front of collapse. On the other hand, in 2009 the state with own shares on the market of valuable papers led to a partial out of private sector from the credit market in Serbia.

Second, Rigid monetary policy. Only a partial success is accomplished stamping of inflationary pressures, primarily because of the way of using funds obtained through privatization (overflow in current consumption and not in the realization of projects of revitalization, modernization and new construction of physical infrastructure) and delays in preparation and realization of project of development of industrial organization of national economy and reindustrialization of Serbia.

Third, Privatization of the inherit enterprises in the competitive sector - according to the model of sale to external investors. To remain a relatively small number of non-privatized enterprises, primarily due to an inability to within the institutionally regulated model of privatization find a whatsoever kind of customers. However, the overflow of effects of global financial and economic crisis has demonstrated that privatization is carried out at the cost of their development blockade - which true dimensions and effects began to manifest in the beginning of IV quarter of 2009.

Fourth, Partial liberalization of prices and manage one's affairs the monopoly enterprises and, enterprises for the production of public goods. However, the key changes in sector of public consumption and restructuring of public enterprises which operate in the regime of natural or administrative monopoly are missing.

On the other hand, I will try to specifically give the key limiting factors occurred in the period after 1990, and their implications to the realization of the objectives of the proposed concept of structural policy:

First, Existing industrial districts and clusters is practically disappeared. In the analysis of this phenomenon must be taken into consideration the fact that the majority lost the development function still around 1980. But what is worrying is the fact that finding their replacements is without success.

Second, Evident is a failure in the development of national (production) of the entrepreneurial spirit, both on the level of group and individual, and on the entire socio-economic system. The largest number of expressed entrepreneurial initiative was completed in the sphere of production not exchangeable goods (wholesale and retail trade, real estate, construction), and very little in agriculture, manufacturing industry and export trade.

Third, It is visible (almost completely) the absence of a whole range of market and public institutions necessary for the realization of structural policy on the basis of generating and implementing of business and technical innovation. The domestic investment potential is missing, there is no institution of Ventura capital, no bank has in the business portfolio financing of development with innovation of generated enterprises, government programs for budget support of transfer of technologies from research system into new production initiatives are insufficient with unclear and imprecise results.

Fourth, Strategic coordination mechanisms remained undeveloped, despite numerous reforms of market infrastructure and infrastructure for public regulation of industry and economic development. The consequences are: (1) a short time horizon of decision-making (power of short-term), (2) high subject discount rates (dominance of tactics over strategy), (3) market does not encourage the collaboration, cooperation, trust, commitment and caution, and (4) public intervention does not promote the cooperation since it is based on unconditional cooperation with the dominant political option.

Fifth, On the national market, there is no demand of major users, while the interactions producer-user are weak and sporadic. The army has practically halted the demand for new technological solutions, the electrical industry send the requirements with prior warning that the payments are uncertain, telecommunications do not count on the participation of domestic technologies, while the large public, utilities and manufacturing systems occupied with issues of basic survival.

Sixth, STIOET (Science - Technology - Information - Organization - Education - Telecommunications) infrastructure is in relatively decent condition and better quality than in other countries with similar level of development. However, the structure of STIOET infrastructure (system) is unproductive. The bands with industry are underdeveloped, sporadic and linear because of small pressure on enterprises – advancing the internal components of STIOET increase the capability of implementation of business and technical innovations. The performed reconstruction (privatization, rationalization, implementation of European standards in education and science, modernization, networking and programming), which had the task to change the attitude toward economic valorization of innovations and their contribution to socio-economic development have been unsuccessful. The key is that the internal connections between actors of STIOET infrastructure are very weak and not able to exercise stronger pressure on the real economy with competitive offer of appropriate personnel and new technologies.

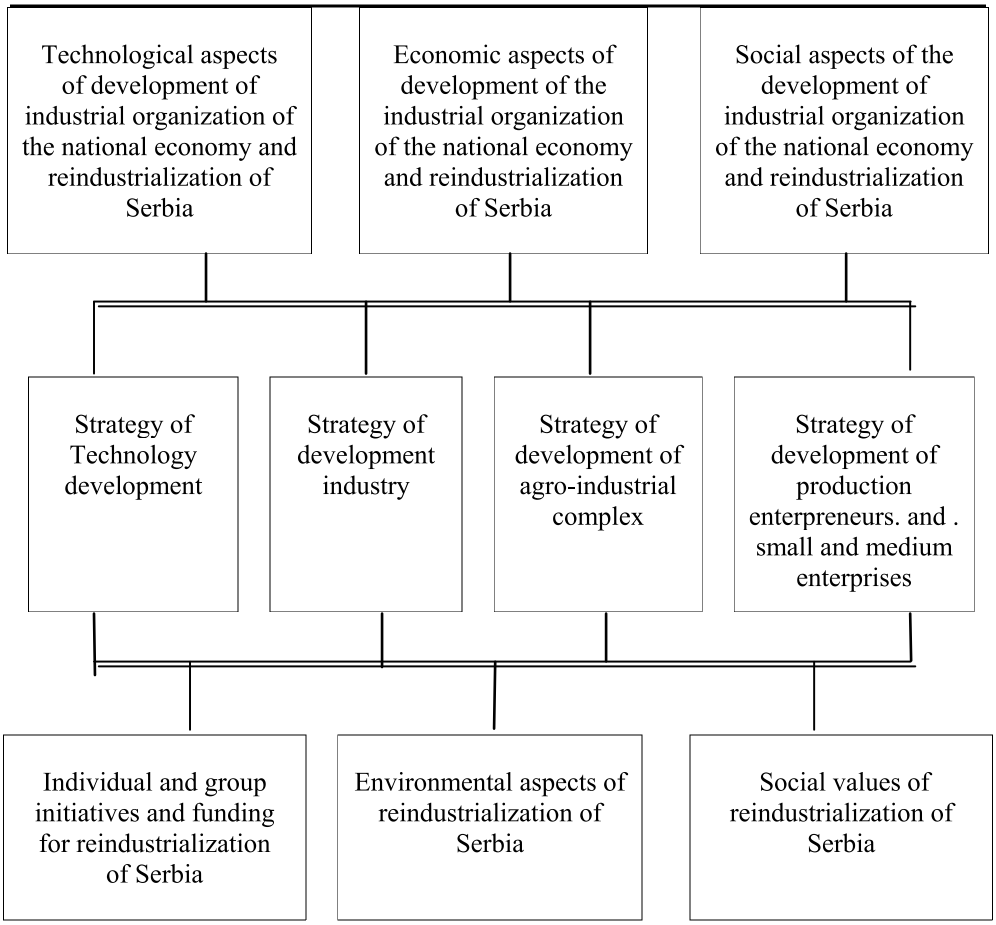
In the exposed context, the national production - organizational system and its environment are not able to perform the function of mechanism of realization of the objectives of structural policies on the European concept of endogenous and sustainable development. The analysis shows that the basic human, physical and normative parts (components) of these systems, mostly in order, taking into account the state of predictor's circumstances. However, the entire structure is inadequate, and therefore can not express their (development) potentials. The current structure is the result of domination of interests of non-competitive and lack of understanding of the core of problem of modern development. The essence of this problem is in the fact that, although Serbia is undoubtedly a democratic country where more and more dominate the private sector, can not expect progress in structural reforms in function of creating conditions for sustainable development if does not introduce the substantial control of the executive and judicial authorities in terms of provide a greater public interest in the realization of the reforms of economic institutions and business, mezzo and macro-economic policies. The basis is, of course, finding a rational and effective political solutions for the practical implementation of the key achievements of economic theory in the last decade of the last century – endogenization of technological progress in the institutional structure as the main factors for ensuring the sustainable development.

## BASIC DETERMINANTS OF DEVELOPMENT OF INDUSTRIAL ORGANIZATION OF NATIONAL ECONOMY AND STRATEGIES OF REINDUSTRIALIZATION OF SERBIA AND STRUCTURAL POLICY

There is no doubt that the definition of general socio-economic framework for the coordination of individual and group initiatives and resources in function of the development of national versions of the industrial organization of the economy and the realization of strategy of reindustrialization of Serbia towards the European concept of endogenous and sustainable development - a complex and complicated problem. It is absolutely certain, without further elaboration, that the revitalization and improvement of the competitiveness of processes, products, and (economic) entities in the real economy in final jurisdiction comes down to the process of global commercialization based on the dynamic creation and development: (1) economically sustainable production enterprises and agricultural farms by exogenous standards of global economy, (2) appropriate market infrastructure and specialized circles of commercial and financial capital interested to provide profit through export business activities, and (3) infrastructure for regulation of development - which will, through public and private administrative, educational, developmental-research, production, traffic and financial activities ensure a relatively stable and stimulating conditions for the effective functioning of the process of reproduction of export industries and jobs.

According to this thesis, the basic role of structural policy in the initiation and realization of the development of national versions of the industrial organization of the economy and the realization of strategy of reindustrialization of Serbia is to bring together and direct the various economic, technological and social (primarily political, social and cultural) phenomena (Scheme 1). In this context, structural policy in function of balanced spatial development (of Serbia) is socially organized and institutionally regulated process of cooperative coordination of decision on macro level, on the one hand, and on mezzo and micro level, on the other hand, so that through the development and implementation of business and technology innovations and new forms of social and economic organization and division of labour provide a internationally competent level of quality and price of material goods. The main requirement is to form the production - organizational structure of the real economy enterprises and farms that have: (1) macro, mezzo and micro organizational structure and management system capable of efficient production and distribution of high quality material goods in the harsh and unequal international competition, (2) appropriate physical resources and personnel, (3) a healthy financial structure, and (4) flexibility, which allows fast and efficient response to changes in the natural, internal and external socio-economic environment.

**Scheme 1. Strategy of development of industrial organization of national economy and realization the strategy of reindustrialization of Serbia**




In the exposed context, the solution of content the attributes of structural policy in the function of balanced spatial development of Serbia should seek in the adequate combination of primary production - organizational models. Industrial clusters should be a tool for realization of basic national goals, especially in the area of improving the competitiveness of the total (national) production structure on which will further build onto optimal use of (all) space with appropriate resources. Revitalization of the development functions of Industrial districts should be a tool for the realization of sub-regional and local development goals, especially solving problems of high unemployment, revitalization, modernization and new construction of lacking physical infrastructure, implementation of the concept of sustainable development and creating conditions for internal and external inter-regional and cross-border cooperation at sub-regional and local levels. Model of Poles of generic growth should be a means of linking research and education with the project of development of industrial organization of national economy and realization of strategies of reindustrialization, primarily in the direction of improving the production enterprise and raising the quality of human capital at internationally competitive levels. If all of these requirements lead into operational level can be concluded that the main objectives of structural policy in the function of balanced spatial development of Serbia:

First, Rehabilitation of developmental functions of 26 mentioned Industrial districts and 136 medium and small industrial centers - revitalization (at least) one of the inherited or establishing a new sub-regional or micro cluster. The basis, in terms of concretize the attributes of structural policy should be the compilation and realization of individual projects of revitalization of existing and new construction of industrial zones in industrial districts, and medium and small industrial centers. At the same time the scientifically recommended policy is that the focus be on the mechanisms of support for public-private projects of revitalization of functions of existing industrial zones.

Second, Development four Poles of generic growth - in Belgrade, Novi Sad, Kragujevac, and Niš. The basis of development should be the compilation and realization of the project of building a network consisting of: (1) specialized technology parks with corresponding business (entrepreneurial) incubators, (2) high-tech industrial zones, and (3) existing enterprises in which business portfolio is the production in domain of high technology or intended to capture with its own resources the corresponding productions. Of course, their construction is not limited to the territory of mentioned cities, but it is possible in other areas in their surroundings - where creating the stimulating conditions for life and work ensure adequate human resources with highest and internationally competitive skills and capabilities. This is also the most complex and most difficult task for structural policy, but without it there is no effective and sustainable involvement of Serbia in the process of European integration.

In the context of overall limits, sizing the objectives of structural policy need to be made for a period of at least one business cycle (four to five years, but only after getting out of the crisis in accordance with a scientifically valid set-up that its definition is according the point of return to the level of production from (last) before crisis period, which in the case of Serbia is still far away from before transition maximum). The second assumption is that the solutions for the rehabilitation of the role of the industrial district in economic development, clusterization and establishing of poles of generic growth must look for from below, in other words in-cite, on the basis of collaboration and cooperation of public and private factors.

## THREE RIVAL DEVELOPMENT ALTERNATIVES AND THEIR IMPLICATIONS ON STRUCTURAL POLICY

In the case of Serbia can be identified three possible rival alternatives for the development of industrial organization of the national economy and the realization the strategy of reindustrialization. These are: (1) complete the process of fordistic industrialization, (2) radical modernization of existing production systems, and (3) the development of creative society and innovative economy based on national, regional, sub-regional and local initiatives and wide cooperation and interactive collaboration. Let's see what is - theirs implications on structuring of the contents the attributes of structural policy in the function of balanced spatial development.

The first alternative is deeply embedded in existing national production, financial, commercial and institutional system, and in implicit form in the current economic and development policy. Its realization is based on the politics of small wages and low prices for basic (national) inputs (with this gravitate to attain so-so internal and external competitiveness) and acquisition of capital and technologies from external sources, primarily with encumber of economic subjects abroad. Since its implementation does not requires a larger national effort (in terms of sacrifice of spending in favour of greater investment), this alternative is consistent with the existing key parameters of political and business culture and economic interests built into the existing production systems and the financial industry. The biggest limitations to continue its implementation are two factors. The first and long-term is the existing human capital and new that creates a relatively developed system of higher education - which are already surplus in the existing production system. The surplus of higher educated (growth rate indicates that Serbia will in the near future face the unemployment of about 100,000 persons with higher education), and creative resorting to two options - foreign exile or finding places within some interest (political) group, of course, under circumstances of obsolescence of knowledge and professional and productive entrepreneurial passivisation. Another, no less serious problem are the reflexes of the internal and external (global) economic crisis and after crisis stagflation which are reflected in the radical reduction of freedom of access to external financial resources and target segments of the global labour market - for now, with unforeseeable development, economic and social consequences. In any case, it can be expected to come on the scene the third option, with which will the higher educated and creative try to direct their frustration towards the active action toward abandonment of the first alternative and the transition to the implementation of the second and third alternatives.

The second alternative is accomplished by entering the national production systems in transnational business systems in order to ensure competitive access to global markets and rapid technological and business modernization. This alternative allows the activation of what was left of the inherited resources (in short term) and available human resources (in medium term), and also a larger (national) production systems (in medium term) become the focal point of development and modernization of micro, small and medium-sized enterprises. On the other hand, their appearance on a larger scale will affected integrating on today very distinct and self closed productions, finances, educations, researches, public administrations, etc. In this way would be created (new) development structures and provide a faster transfer of new technologies and (partial) outsourcing of development risks. Other way, in terms of increasing the efficiency of the proposed concept of structural policy, the implementation of this alternative is (despite some risk) is preferred, primarily as a mechanism of transition from the current situation to the third alternative. And, here's act two main limiting factors. The first is that the basic condition for implementation - providing investment and ownership attractive, stable and guaranteed business conditions. Another no less important factor is the fact that this development option more or less is accepted by all countries in closer and wider environment, so there is a large and sharp competition in attracting this type of development. In this context, the existing economic interests (which are more for maintenance than for radical change of current situation), the ruling political and ideological orientation toward fordistic concept of (re) industrialization, cultural parameters (which are strongly opposed to values, such as: quality, accuracy, cooperation, productive interactivity, etc.) and general macroeconomic and social instability and uncertainty are not act stimulating on its implementation.

In order to reach the third (science preferred) alternative, it is necessary to: (1) a consistent understanding of the problems of modern development, (2) new, active and responsible role of the executive authorities and local governments in the public regulation of industry and economic development, (3) developed STIOET infrastructure oriented to the needs of the real economy, (4) balanced action of market, strategic-cooperative and hierarchical mechanisms of regulation of economic life, (5) neutralizing activity of distribution-oriented coalitions, (6) wider acceptance of risk, (7) creating the conditions for a balance between individual and common interests, and (8) bigger motivation of employees and other populations for lifelong learning, particularly in the area where works. Ultimately, its implementation is conditioned by social and political innovations in terms of constitution of a democratic, but above all, responsible society for the environment and next generations, not parasite system of institutions, freedom of choice of any type while preserving the basic ethnic and spiritual values. In this context, the development (in terms of development of industrial organization of national economy and realization of strategy of reindustrialization - note the author) is based on national, regional, sub-regional and local specificities, supported by STIOET infrastructure, induced with entrepreneur or strategic cooperative initiative, and shaped by competition and cooperation that exclude the protection of monopoly interests of any kind. The main inputs in this development alternative are of high quality human resources and innovative social, especially political institutions. The best way to it is through the second alternative. This alternative is the furthest from the present situation.

In the exposed context two main conclusions can draw relevant for the determination of the concept of structural policy in the function of balanced spatial development of Serbia:

First, there must be a clear and precise ***socio-economical vision***, which explicitly defines: (1) core values (guiding principles and rules and culture of life and work - in terms of acceptance of innovation, as the main factors of balanced spatial development of Serbia), which are inviolable and expression of basic beliefs established by consensus of all relevant options, (2) the purpose, which clearly expresses the main reasons for existence of certain socio-economic system (in terms of regionalization and decentralization of Serbia - note the author) and (3) mission, which expresses a clear and motivating goal how to provide a conditions for living and working according to European standards for the population of Serbia.

Second, science, at least in the dominant understanding of its essence, can not successfully develop methods and mechanisms to resolve the problem of determining the socio-economic vision, especially those which, as in this case, based on the adaptation of existing and developing of new institutions in the function of creating a good conditions for the generation, implementation and economic valorization of innovations. With this the fundamental issues of formulation of attributes of structural policy in function of balanced spatial development of Serbia are left to the voluntarism of politicians. Accordingly, the problem of improving the efficiency of public regulation of the process of smoother spatial distribution of the effects of national reindustrialization is primarily a matter of human creation, and its essence is in understanding the risk behind every (public) decision. Therefore, the contents of the reforms of public regulation in the function of development of industrial organization of national economy and realization of strategy of reindustrialization according to the (European) concept of endogenous and sustainable development must be based on the implementation of management principles in action of national (regional and local) state in the economic, educational and administrative sphere. Its main function is to provide a overcoming of result of limitations in the (internal) individual monitoring of the position of company or farm in the global economic system structured by the concept of sustainable development, creative society and innovative economy. This notion assumes widely defined and tightly structured consensus of the most important partners - enterprises, farms (integrated in associations), banks, unions, public and scientific research institutions in order to create a culture of cooperation, solidarity and trust.

## FINANCIAL INDUSTRY AND STRUCTURAL POLICY

Realization of the proposed concept of structural policy in function of creating conditions for balanced spatial development depends primarily on the dynamics of development of export business. Furthermore the author is of the opinion that its base, at least in terms of structural policy in function of balanced spatial development of Serbia, should be a small and medium-sized producing enterprises incorporated in the sub-regional, or local export clusters. The fundamental solution is in a good market of credits, which successfully allocate the saving to the most productive business and investment projects in the export business. The current situation in this market is the high interest rates and weak offer of credits for financing the business and investment activities in the sphere of export industries and jobs. Where is the source of the problem to poor offer of credits for export business in Serbia? There are many explanations - high macroeconomic uncertainty, large differences between active and passive interests, lack of savings (in terms of accumulation, and productive engagement of the capital - but no doubt that the population of Serbia has a relatively large thesaurisation savings) and the inability to offer to lenders an adequate guarantee. In my opinion, should not expect to overcome these problems by themselves, when properly resolve the current macroeconomic problems. Therefore, solutions for improving market of credits for export business should be sought in the common activities of banks and export business stakeholders in its development, maintenance and regulation.

The main thesis of the author is that the market of credit for export business can not function without trust. This thesis was performed in the context of response to a complex question: "Does look for the overcome of failure in development of market of credits for export business in introduction of new laws, regulations, restrictions and administration, or it will be the additional source of new costs that ultimately pay borrowers and in that way remove from the market of credits, or look for solutions in self-regulation, where the state should with own actions create a favourable climate for development of export business and culture of trust? ". According to this thesis, my opinion is that the problem of development of the market of credit for export business in Serbia should be considered in the context of three related phenomena - the creation, improving and defense of common interests of banks and export business in the realization of the following activities: (1) promotion and development of business culture in which timely fulfillment of all financial obligations has a key position, (2) encircle the legal - institutional infrastructure for the implementation of technical collateral lending of equipment and reproductive material, (3) promotion and development of new techniques for estimate the creditworthiness of export business, especially in the segment of small and medium-sized enterprises on the basis of precise and clear standards, (4) finding new solutions to the (very risky) financing of export projects based on generating and implementing of high-tech and (5) promotion of new forms of financing the transfer of private property rights.

But, let's see - what is essential for the proposed concept of structural policy. There is no doubt that the financial industry, particularly the banking sector in Serbia until the end of II quarter of 2008 had a very rapid growth. The main drivers of development of financial industry were foreign banks, which brought a new business culture and mentality which transfer in daily business. Range of their influence move in a wide range - from deep systematic, strict business plans and strong control of the headquarters, to high-risk appetite for the quick capture of the market, with a high degree of letting of key decisions to the local government. In the context of a dynamic growth of debt of population and orientation of entrepreneurs on operations on the rapidly growing real estate market, the bigger interest of banks to finance the business and development of export business in Serbia is missing, the best evidence is the fact that most of these projects was done (and do) under the patronage of the government or international specialized financial institutions, in particular the European spa for reconstruction and development which with these measures wanted to extend a very thin social-economic base of capitalism in Serbia. However, after taking over almost the entire national banking system and ending the period of rapid, easy and high return on capital, inevitably followed by entry into the trench competitive struggle for the maintenance and improvement of market position – in which is to be expected that the private business in the field of export industries and jobs will get a bigger chances.

During this we must be aware that the market of credit for export business in countries in transition such as Serbia, in many ways different from those in modern market economies and not just because of the fact that only in the first decade of this century, created the basic institutional conditions for performance. The causes are much deeper and more complex and go back to the very basics functioning of the total socio-economic system in Serbia, which is reflected in the persistent maintenance and development of various distributive-oriented coalitions that on the long-term block the productive development, and phenomena such as economic freedoms - openness, a stable currency, low taxes and low regulation gives a quite different real meaning from those that prevail in modern market economies. Therefore, the state with its numerous and uncoordinated actions based on the (unsuccessful) replicas of institutional reforms and implementation of techniques modeled on the European environment has failed to initiate the problem of credit market development for export business from the dead end. It is clear that the interests of creditors must be legally defended and implemented and in Serbia not doing it as it should, but it is not enough. In this context, some specific conclusions can be draw out, which are valid for actual socio-economic moment of Serbia and market development for export credit business.

First, Investment lending to private businesses should focus on small and medium-sized producing enterprises oriented toward import.

Second, System of credits for export business should have four (sub) systems: (1) the system for financing the current reproduction. Its main function is to provide to small or medium company a purchase of necessary raw materials, reproduction materials and other inputs that will enable increase of productivity and economic efficiency in relation to the situation when the loan is not implemented, (2) the system of credits for bridging over the appearance of unexpected problems in cash flows that are outside of control of entrepreneurs, (3) the system of loans for investment, primarily for the purchase of new equipment and transport vehicles, and (4) the system of credits for efficient, regular and timely transfer of ownerships on small and medium-sized enterprises.

Third, Decisions for development of credit market for export business should be sought on the basis of projects of cooperation between banks and associations of private businesses with minimal public intervention and regulation on projects: (1) development of necessary institutional support and business culture and ethics for the implementation of techniques of collateral equipment lending and reproductive material, (2) finding the solutions that will enable the rational reduction of risk in lending to small and medium enterprises based on generating and implementing of high technology (where should also include the state but on the joint initiative and proposal of actors of export businesses and banks) and, (3) promotion of new forms of crediting the transfer of ownership in small business.

Fourth, In order to create conditions for the efficient functioning of credit markets for export business it is necessary that the banks which wishing to operate in this market significantly improve the relevant services and introduce new techniques for valuation of creditworthiness. The base should be the continuous efforts in educating of potential users in the application of techniques of making business plans and providing conditions for effective valuation of their credibility.

## CONCLUSION

Starting from the finding that the new models of economic growth and development of Serbia must be based on the concept of the development of industrial organization of national economy and realization the strategy of reindustrialization - based on changes in structure of national production - organizational systems with respect to national, regional and local specificities, there is a need that in support to own resources, creative and working potentials create conditions for their comprehensive valorization allocating in those sectors, enterprises, farms and business that have the best chance in the global and European division of labour. To this, first of all, it is necessary to turn the whole area of Serbia in a pleasant place for the manufacturing enterprise, life and work (especially workers with the highest qualifications and abilities, which should ensure sustainability of projects of clusterization and development of high technology industries in global competition) and private (productive) investment.

Crucial importance for the realization less with material or economic nature (primarily, the availability of adequate physical, educational and financial infrastructure), mostly are cultural nature (the development of cultural pattern in which the priorities - the confidence, accuracy, giving great importance to work as a basic source for existence of the individual and its family and the future - in terms of adequate compensation for sacrifice the consumption in present time at the expense of productive investment in new businesses), and mostly are defined by choice of an appropriate model of structural policy suite to development of new export business and industries based on private initiative and resources. This means that institutional reforms and economic policy in Serbia, must, on the one hand, put into operation the limitations of power of distributive-oriented coalitions and fighting the mechanisms of corruption in public and corporate regulation, and on the other hand, in function of improving of living and working conditions of all population, primarily by creating a good physical, financial and social infrastructure of comfort for the production entrepreneurs and private investment.

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# CHAPTER 20. EU BANKING INTEGRATION IN LIGHT OF THE NEW SUPERVISORY ARCHITECTURE IN EUROPE

**Vincent ŠOLTEŚ, Natália VAŠKOVÁ,**
Faculty of Economics, Technical University of Košice, Slovakia

***Abstract***

*European financial integration brings economic benefits for each member state and its citizens. Liberalized capital flows enable better allocation of capital and diversification of the economy. Such openness of the market enhances economic growth, provides consumers with numerous options, and thus stimulates consumption. The banking sector is the core of the EU financial markets as it provides the necessary capital for the economy. Cross-border banking represents several benefits for banks: it enables them to achieve economies of scale (and scope), diversify their business activities, and, last but not least, to spread risk. The increased competition on an integrated market leads to an improvement in the efficiency of financial institutions, better banking practices and a wider selection of services for the consumer. As the global financial crisis of 2007-2009 has slowed down the financial integration in Europe and uncovered the weaknesses in its regulation and supervision, it is necessary to design a better, consistent set of rules in these areas to prevent future exposures to crises by increasing financial stability.*

***Key words:*** *financial integration, banking integration, regulation, supervision, Euro area*

## INTRODUCTION

Despite the recent slow-down in its development caused by the global financial crisis of 2007-2009, the financial system has undergone dramatic changes in the past decades. The markets have grown, their integration has been increasing, and, naturally, competition has intensified. [15]

Although banks used to be dominant in providing credit for the market in the past, the close ties between banking and the capital markets are a distinguishing mark of a modern financial system. Being the providers of credit in the financial system, financial intermediaries are an important element of the system. As securitization[1] and innovated financial instruments had been providing substantial funding for the global economy before the crisis, the core of financial intermediation moved from commercial banks to the *shadow banking system*[2]. However, with the practice of securitization, quality of loans started to deteriorate. Credit risks were passed from the lender, who originated the loan, to the investor, and the conflict of interest within credit rating agencies further decreased the quality of such securitized loans. As demonstrated by the crisis, it is crucial for monetary policy to regulate credit supply. [1]

It has become harder for businesses to access credit after the crisis as the market was trying to recover from the shake-up. And, consequently, reduced bank lending has had negative effects on real economies. For a healthy economy a healthy financial system is a necessity, therefore, financial stability within EU must be regained and maintained. It is crucial to adopt such regulatory and supervisory measures which will not only make the financial system less vulnerable to potential future turbulences, but allow for further progress in financial integration, which is necessary to ensure Europe's competitiveness in a highly competitive global economy.

## EUROPEAN FINANCIAL INTEGRATION

Financial openness of the economy boosts economic growth, enhances consumption and risk sharing, and reduces volatility of consumption growth. [2] Evidence has been provided that banking integration leads to more synchronised business cycles[3] at the country level. [11] Cross-border banking improves economic performance by channelling productive capital towards the most efficient firms and thus reduces risks of crises which have their origin in mispriced investment risk. [7]

Diversification in banking systems leads to a better absorbance of shocks and strengthened financial stability. On the other hand, in opened economies, banks which are engaged in cross-border activities can serve as channels for systemic risk spreading.

The degree of the European banking markets integration has increased over the past decade, but the global financial crisis has affected the markets badly. The

[1] Debts bundled with other assets and sold as complex securities; securitization took off during the 1980s when collaterized mortgage obligations (CMOs) were developed

[2] Shadow banking system is a system of financial intermediaries (e.g. hedge funds) that are involved in the creation of credit across global financial markets; its members are not subject to regulatory oversight

[3] as measured by GDP, employment and income growth

factors that had contributed to the onset of the crisis (e.g. increased lending, funding risks), as well as the consequences of the crisis (government support, regulatory initiatives within national borders and a setback in banks' and investors' appetite) have led to a slow-down in the development of the European banking markets. Increased interdependence of the EU economies resulted in a high-speed contagion after the onset of the crisis. European financial market integration requires a well designed, consistent framework in the area of regulation and supervision in order to foster financial stability of the market and improve cross-border competition, which will enhance efficiency and competitiveness of the European financial sector. [3]

There is now an urgent need for a new framework which will not only remove the weaknesses of the existing regulatory and supervisory architecture, but, as mentioned above, improve the business environment for cross-border banks and thus take the integration further.

## European Banking Integration

The banking sector in Europe is the core of its financial markets as banks provide financing for the market and bank loans account for almost 50 % of the EU capital markets. As a sustainable economic growth and increasing job opportunities are the key objectives of the Lisbon Strategy, provision of loans for small and medium-sized enterprises is very important. Liberalization of capital flows has enabled searching for economies of scope and scale in banking, too. In Europe, cross-border banking activity, which remains a major driver of integration in this field, is concentrated around large banking groups which increase competition, "*...channel innovation in financial products and services across borders and promote the use of the most efficient banking practices in the EU"*. [3, p. 31]

In Europe, wholesale banking is more integrated than retail banking, although the global financial crisis has slowed down the integration process in this area, too. It is believed that once the economic conditions improve, the trend towards a deeper financial integration in EU will continue.

The development of cross-border activities in financial services provision within the Euro area indicates the progress of financial integration (see Figure 1). Financial integration has progressed more in wholesale (inter-bank) services and securities activities since the establishment of Monetary Union[4]. Integration in retail banking is slower. With the onset of the crisis, cross-border provision of financial services has, naturally, reduced and banks have focused on domestic transactions more. Reasons for a slower integration in retail banking include [3]:

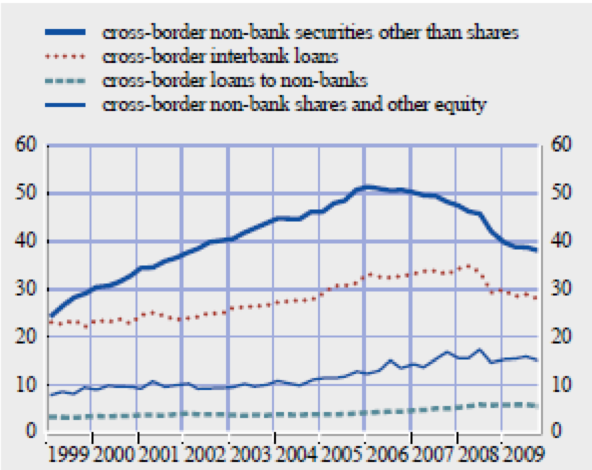
[4] In 1999

- importance of proximity to the customer
- importance of a relationship with the customer
- language barriers
- legal, regulatory and information-related barriers to entry.

However, technical progress and the integration of financial infrastructures can speed up the integration process in retail banking as well. The application of SEPA[5] instruments can improve the pace of integration in this area. "*SEPA is an initiative aimed at achieving a fully integrated market for retail payment services in the Euro area with no distinction between cross-border and national payments*". [3, p.87] The possibility to make cashless payments in Euro within the Euro area as easily as at the national level will certainly be beneficial to customers, as well as to the integration process. [3]

In terms of cross-border financial services provision, banking integration through foreign subsidiaries and branches has been increasing. Their share of total banking assets in 2008 was more than one quarter, with subsidiaries leading over branches. As for cross-border ownership, domestic institutions dominate in EU-15 and foreign ownership dominates in the member states which joined the EU throughout 2004-2007 (with almost 90 % of foreign assets held in subsidiaries). [3]

**Figure 1. Cross-border provision of financial services in the Euro area – assets**




Note: Cross-border activity is expressed as a percentage of the total provision of financial services in the euro area.

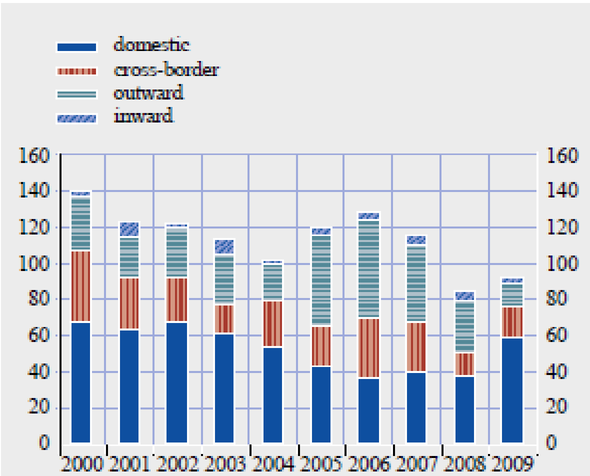
*Source:* [3]

[5] The Single Euro Payments Area

Although there has been great uncertainty in financial markets after the initiation of the global crisis, mergers and acquisitions (M&A) have continued to take place, with the focus more on domestic transactions. After the crisis, most banks have refocused on their core activities and markets and delayed their cross-border plans, which means that most M&A have been the results of "*survival motivation*" or divestments. The involvement of governments in this sector, as a stabilisation measure, also contributed to the change towards the domestic focus. Figures 2 and 3 show the number and value of bank M&A transactions[6] divided into domestic, cross-border intra-euro area, cross-border extra-euro area and outward transactions. Figure 4 indicates the number and value of cross-border bank M&A in the Euro area only. [3]

As seen in Figure 4, in 2008 the value of cross-border bank M&A in the Euro area was still increasing. As a consequence of the crisis, these activities had dropped throughout 2009, although the number of transactions was still relatively high. [3]

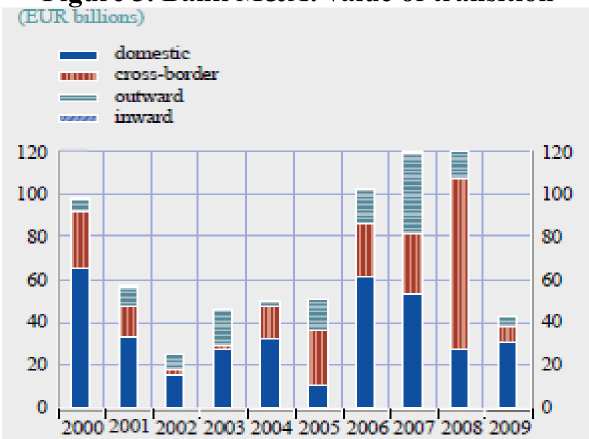
**Figure 2. Bank M&A: member of transition**




Notes: M&As include both controlling and minority stakes. For some of the deals, the value is not reported. Cross-border M&As refer to intra-EU27 transactions involving a non-domestic acquirer. Inward refers to an M&A by a non-EU27 bank in the EU27 and outward indicates M&As of EU27 banks outside the EU27.

[6] Deals involving EU governments accounted for 70 % of total value of EU financial services M&A in 2008 [5]

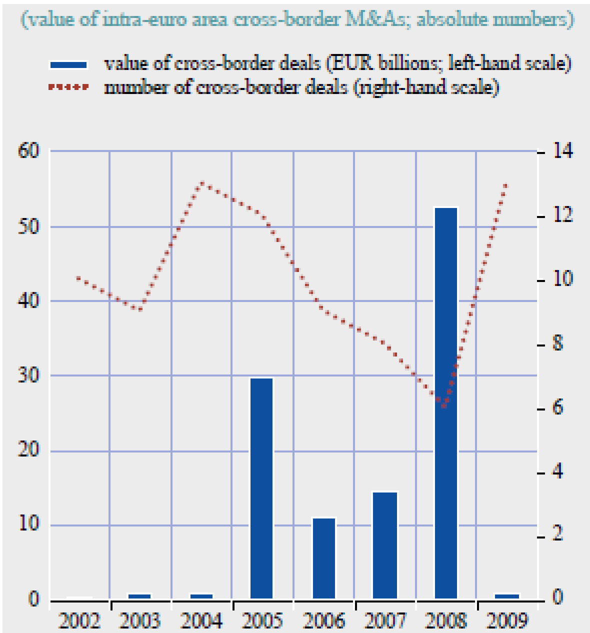
**Figure 3. Bank M&A: value of transition**




Notes: M&As include both controlling and minority stakes. For some of the deals, the value is not reported. Cross-border M&As refer to intra-EU27 transactions involving a non-domestic acquirer. Inward refers to an M&A by a non-EU27 bank in the EU27 and outward indicates M&As of EU27 banks outside the EU27.

*Source:* [3]

**Figure 4. Euro area cross-border bank M&A activity**




*Source:* [3]

In order to enhance the efficiency of the European banking sector, integration in the EU banking markets must be taken further. This can be achieved by improving the conditions for cross-border service provision, which will promote healthy competition, and introducing and implementing a new EU supervisory architecture.

### European Financial Integration – Present and Future

Through financial integration EU can achieve sustainable economic growth. Although the process of integration has yet to be completed, undeniable progress has already been achieved.

With the introduction of Euro, exchange risk in cross-border financial activities through much of the EU has been eliminated, which leads to a conclusion that the Euro "*..has acted as a powerful catalyst to finance market integration in Europe*". [3] Although several initiatives have pushed financial integration in Europe further (see Table 1), there still are problems with the implementation of EU legislation at national level and supervision is yet to be fully coordinated.

**Table 1. Review of major developments in EU supervisory cooperation (towards banking integration)**

| **Initiative** | **Objective** | **Result** |
|---|---|---|
| *The Single European Act*<br>*The 2nd Banking Directive* | Creation of the Single Market for banks | Single Market for Banks created |
| *Financial Services Action Plan*<br>*Lamfalussy process* | Harmonisation of EU regulatory and supervisory framework | Contribution to harmonisation of EU regulatory and supervisory framework |
| *Establishment of colleges of supervisors for large cross-border banks* | Cooperation and coordination among supervisory authorities (supervision of global cross-border banking groups) | Contribution to supervisory cooperation and information exchange |
| *Memorandum of Understanding on crisis management (between EU supervisory authorities)* | Facilitation of crisis management | Flexible framework for crisis prevention and management |

*Source:* own design based on the data in [3]

The issue of reshaping the financial architecture in Europe was the key issue in 2009. The objective to establish a single market in financial services, increasing number of the Euro zone member states, and the rapid progress in information technology have contributed to the progress in European financial integration. "*At present, this process has reached a stage where cross-border financial flows are substantial, where the number of cross-border financial groups in the European Union is important and where interest rates and prices of financial assets have converged over a longer time period"*. [5, p.50]

Although the level of financial integration in EU is high, the objective is to monitor cross-border risks more effectively, ensure commensuration of remuneration structures in the financial industry with risks, strengthen and increase the quality of capital buffers, and enhance standardization and transparency at the derivative markets. [5]

## NEW FRAMEWORK FOR SUPERVISION IN EU

The global crisis has uncovered weaknesses of the existing framework for regulation and supervision in EU. The ECB swiftly provided liquidity to the EU inter-bank market but a common framework for crisis management was missing, which resulted in several negative spill-over effects on member states. In order to maintain financial stability across Europe and worldwide, it is necessary to develop a new framework, which would not only help prevent future crises but, at the same time, help increase efficiency of the financial system, foster integration, increase the quality of the services provided and safeguard the consumer.

The de Larosière Group Report of February 2009 recommends steps to be taken in order to correct ***regulatory and supervisory weaknesses*** of the present system. As far as banking is concerned, the following recommendations are made in the report [12]:

- *fundamental review of Basel 2 rules* including:
  - gradual increase in minimum capital requirements
  - reduction of pro-cyclicality by e.g. dynamic provisioning
  - stricter rules for off-balance sheet items
  - tighter norms on liquidity management
  - strengthened rules for banks' internal control and risk management
- recommendations for *EU*:
  - common definition of regulatory capital including clarification of which hybrid instruments should be considered "Tier 1 capital"

- strengthened CESR[7] in charge of registering and supervising CRAs[8]
- review of CRAs' business model and its financing
- significant reduction of the use of ratings in financial regulation (over time)
- transformation of rating for structured products (distinct codes)
- increased due diligence and judgement (investors)
- wider reflection of the mark-to-market principle
- solutions to the issues concerning complex products
- accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment
- transparent methodology for the valuation of assets in illiquid markets where mark-to-market cannot be applied
- strengthened oversight and governance structure of IASB[9]
- extended regulation to all firms or entities conducting financial activities of a potentially systemic nature
- improved transparency in all financial markets (in EU and internationally)
- introduction of appropriate capital requirements on banks owning or operating a hedge fund.

The newly proposed supervisory architecture in Europe (see Figure 1) is based on two areas of supervision: micro-prudential and macro-prudential supervision. The European Systemic Risk Council (ESRC) decides on the macro-prudential policy and provides risks warnings to EU supervisory, whereas at the micro-prudential supervision level, the European System of Financial Supervision, consisting of 3 authorities (European Banking Authority, European Insurance Authority and European Securities Authority), would provide legally binding mediation between national-level supervisors, adopt supervisory standards and technical decisions, coordinate colleges and supervisors and license and supervise specific EU institutions. [12]

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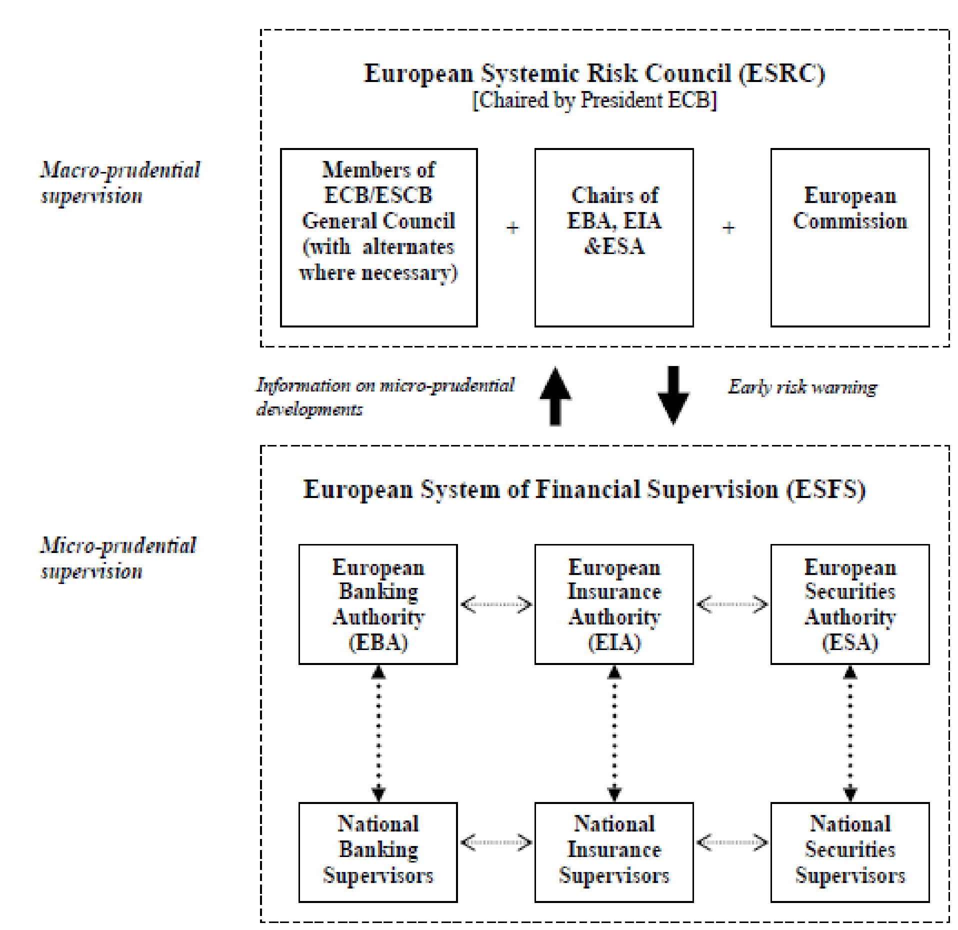
[7] CESR – The Committee of European Securities Regulators
[8] CRAs – Credit Rating Agencies
[9] International Accounting Standards Board

**Figure 5. A new European framework for Safeguarding Financial Stability**




*Source:* [12]

## CONCLUSION

Although the European financial markets were severely hit by the global financial crisis of 2007-2009, the conditions in the EU banking had improved throughout 2009 as a result of recovered financial markets, economic stimulus packages launched by individual member states, and positive developments in the business cycle. Prompt actions taken by the ECB and the governments of member states managed to restore confidence in the EU banking sector and thus contributed to its recovery.

The causes of the global crisis have been studied thoroughly and recommendations of researchers, academics and financial industry professionals have been made for a new framework for financial supervision in Europe.

The crisis has had a profound negative effect on financial integration in EU. Efficiency of the European economies has been affected badly, too. The indicators of cross-border activities in banking have shown a substantial decline in cross-border M&A. Financial markets of EU had started to stabilise in the second half of 2009 and the problems of European banks with liquidity seem to have been solved. If this positive trend continues, the financial system will fully recover and financial integration can continue at a higher speed. The intense reform of the financial system, which has already taken off, can take the European financial integration to the next level.

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# CHAPTER 21. COMPETITIVENESS RULES APPLICATION IN BANKING SECTOR

**Dijana MARKOVIĆ-BAJALOVIĆ**, Faculty of Law East Sarajevo BiH,
President of the Board for Competitiveness Protection of Republic of Serbia

## RELATION OF COMPETITIVENESS RULES AND REGULATIONS DICTATING BANKING BUSINESS

Banking sector is traditionally subjected to severe state regulative and there are several reasons for it. Neat functioning of banking sector is of core essence for functioning of economics as whole. Banking sector plays the role of the mediator between those who have money (investors, depositors) and those who need money. Price of loan (interest rate and other costs for granting loans) directly influences level of goods production costs that is delivering services. The amount of money invested by banks in economy is in directly connected to inflation rate, economy growth and other macro-economic goals. Bank business is additionally burdened by specific risks. Bank inability to respond to its obligations may cause avalanche effect and- chain insolvency of the other banks and, as a final consequence, downfall of monetary system of a certain country. Therefore, state regulation of banking sector has double goal: directing bank business toward accomplishing of desired macro-economic goals and control of their operating in order to prevent destabilization of financial system.

Government regulation of a certain economy sector is an antipode to free market competition. If market attitude is dictated by imperative legal rights, there is no possibility for market participants to make their business decisions. That is the key reason why for many centuries in developed countries of the world, banking sector was considered to be excluded from appliance of competition rules, which are by definition only applied on free (unregulated) market attitude.

### American Law

Precedent was made in the USA in 1963 in case of *Philadelphia National Bank*[1]. The case subject was a fusion of the second and the third biggest bank in the Philadelphia district and neighbouring areas. Right after several Federal

[1] 374 U.S. 321 1963.

Authorities, among them were the Board of Governors, Federal Reserve System and Federal Corporation for deposit insurance, have expressed their opinion that competitiveness on relevant market would be decreased by intended fusion, Comptroller *of Currency* has allowed fusion. State, represented by a public prosecutor, has filed a lawsuit, claiming that fusion is not complying with Section 7 of Clayton's Act that generally prohibits concentrations which significantly decrease competition. Defendants, among other thing, emphasised objection that banking business in the USA is subjected to a very extensive state regulative. By the Law on Bank Fusions from 1960[2] it was assumed that State Authorities in charge of bank operation control take into consideration competition aspects as well when granting bank fusion. The USA Supreme Court rejected the objection and considered that intention of the Congress, during review of Clayton's Act done in 1950, was to fill the voids in original legal text so that it covers all concentration forms, and that, *argumentum a contrario,* its intention was not to exclude bank concentrations from law enforcment field. Court sided with prosecutors and prohibited concentration.

New decisions of the same court corrected this stand, returning it again in direction of excluding of regulated activities from general rules of competition. In *Trinco*[3] *case,* the Supreme Court of the USA rejected the possibility of applying general norms of anti-monopoly rules to the field of telecommunication because the American Law on Telecommunications from 1966 contains a regulatory structure for preventing breach of competition. When such structure exists, says the Court, use of additional application of anti-monopoly rules would be too small to justify it. Vice versa, if sector regulative does not secure competition protection, application of the anti-monopoly rules is justified.

Evolution of the American Law is continued with the verdict in *Credit Suisse*[4] case. The subject of the case was an agreement of the biggest American institutional investors to manipulate the market price of shares issued by public offer, which represented, according to the prosecutor's statement, breach of antimonopoly regulations. The defendants denied that securities trade is the subject of regulating sector regulative and that legal remedy for alleged violation should be looked for in that area. American *Securities and Exchange Commission*

[2] *Bank Mergers Act 1960*

[3] *Verizon Communication v. Law Office Curtis V. Trinko, LLP*, 540 US 398, 2004. The case was litigated due to the suit filed by Trinco law office on the behalf of client group of the A.T.T. Company against the local telecommunication operator, *Verizon Communication* company for low quality servicing of telecommunication apparatuses of A.T.T. Company and for giving privileges to their clients. Although court of original jurisdiction and court of appeals have brought the verdict in favour of the prosecutor

[4] *Credit Suisse Securities (USA) L.L.C. & Credit Suisse Boston LLC, et. al. v. Glen Billing, et. al.*, 551 US 1157, 2007.

*(SEC)* supported the defendants by submitting the opinion that application of the antimonopoly regulations in this area would be in conflict with the regulative which sets the public offer of the securities. The Supreme Court stand in this case goes in the opposite direction from the previous stand. It is of no significance that Congress did not explicitly excluded particular economy sector from the sphere of antimonopoly norms application. By establishment of sector regulator - for Securities and Exchange Commission implicitly is excluded possibility to protect participants on securities market through lawsuit filed on the ground of antimonopoly regulations if their application would be in conflict with effect of law of established frame for functioning of that market.

In spite of evident evolution of American Law toward giving immunity to the economy sectors regulated by competition rules, absolute immunity is still not established. Participants at the regulated market must prove that the application of antimonopoly regulations would endanger functioning of the sector regulative and that competition protection is not secured by sector regulations.

## European Law

The question of excluding banking sector from general competition rules was also considered in the European Law, in *Zuechner v. Bayerische Vereinsbank*[5] case. The prosecutor filed a lawsuit against German bank contesting compensation amount for transferring money of their clients to Italy, considering that it breaches competition rules from the Treaty Establishing the EC. One of the arguments which sued bank emphasised was that the banks, regarding the nature of their services and special role in money transfer, are the enterprises "entrusted to perform the service of general economy interest" in terms of Article 86 paragraph 2 of the Establishment Agreement[6], and therefore they are excluded from sphere of application of Articles 81 and 82. Court of Justice rejected this argument. The court considered that the fact, that the bank play key role in transferring money of their clients, itself is not enough to justify the exclusion of competition rules application. It is necessary to prove that performing of this service was entrusted to the banks by the Public Government and that application of the competition rules would endanger its performing. The stand of the European Court is confirmed in the case *Verband der Sachversicherers v. Commission*[7] where it has been emphasised that there is no explicit regulation of the Establishment Agreement which would exclude insurance activity from the sphere of

[5] C 172/80, 1981, ECR 2021

[6] With the enforcement of the Lisbon Treaty (Treaty on European Union Functioning) pre-numbering of the Establishment Agreement Articles has been done, so now former Article 86 is now Article 106

[7] C 45/85, 1987, ECR 405

competition rules application. in the absence of such regulation, competition rules are applied to insurance activity as equally as to other economy activities.

The practice of European Authorities has been established to generally apply competition rules also to the activities for which exists sector regulative. Conduct in accordance with sector regulative may, despite, represent competition breach if sector regulative leaves space to independent action of the participants on the market.[8]

## Domestic Law

Law regulative in the field of banking business in Republic of Serbia is specific because it also explicitly regulates behaviors of the banks limiting competition. By the Article 7 of the Law on Banks[9] it is prohibited for the banks to conclude agreements which especially omit, limit and violates competition and abuse dominant position or to implement concentration which significantly omit, limit and violates competition specially by creating that is strengthening dominant position on financial market. Law entrusted the jurisdiction to the National Bank of Serbia to determine competition violation and to take measures accordingly and determined its jurisdiction to closely regulate conditions and the way to determine competition violation. Finally, the Law stipulates that the National Bank of Serbia gives consent to the concentration that bank conducts on financial market.

Above mentioned regulations represented *lex specialis* compared to the previously valid Law on Competition Protection[10]. By these regulations the behavior of the banks which could constitute a breach of competition in the form of abuse of dominant position was excluded from the jurisdiction sphere of the

[8] *Deutsche Telecom* COMP/37451 case which as a subject had abuse of dominant position of this German company in *price* or *margin-squeeze* forms. The company charged high prices to their competitors for the service of using cable infrastructure and at the same time charged low prices to end-users of telecommunication services. Through this it increased competitors' costs and decreased their revenue in order to eliminate them from the market. Company's defense was based on the claim that German sector regulator had already regulated maximal pricing for its services, and therefore its behavior is excluded from the general competition rules. European Commission called upon the Court of Justice stand expressed in the *Commission and France v. Ladbroke Racing* case, joined cases сједињени случајеви C 359/95 and 379/95, 1997, ECR I-6225. If sector regulative leaves a certain freedom of market behavior to the company in question, this behavior must be subjected to competition rules. Decision of the commission was verified by the Court of Justice.

[9] *Official Gazette RS*, No. 107/2005

[10] *Official Gazette RS*, No. 79/2005

Commission for Competition Protection. Having that in mind, Commission has sustained from determining breach of competition in the form of abuse of dominant position and agreement which significantly omit, limits and violate competition[11]. Regarding concentration control, banks have turned to Commission on regular basis with the request for concentration approval which takes place in the banking sector, despite the explicit Law regulation which grants jurisdiction to NBY in that field.

The intention of the legislator undoubtedly was to promote competition in the banking sector by granting jurisdiction to the sector regulator NBY to sanction the behavior of banks which limit competition, assuming that sector regulator knows better situation on the financial market.

Absence of such legal solution reflects in lack of institutional capacity of NBY to apply competition rules in the banking sector. Knowing situation on the financial market does not necessarily mean ability to recognize behaviors that could endanger competition on the market. Therefore, probably, legislator has predicted possibility for NBY to seek opinion from the Commission which does its jurisdiction from the Article 7 of the Law on Banks.

NBY has not used its legal authorizations yes, so in practice, except in the area of concentration control [12] banks were free to apply behaviors which limit competition.

Has situation changed with the introduction of new Law on Competition Protection?[13]

The law does not contain regulations which define its attitude toward the Law on Banks. Regulation of Paragraph1, Article 3 on personal implementation, does not predict implementation of the Law to “all legal and individual entities who directly or indirectly, constantly, occasionally or once participate in turnover of goods, that is services independently of their legal status, property form or citizenship that is national origin.

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[11] The Commission has initiated proceeding in order to determine agreement existence which limits competition on the market of fast money transfer without opening an account, against representative of *Western Union* Company and 18 domestic companies. Deciding on appeals of the banks on the verdict to initiate proceeding, the Commission has suspended the proceeding against the banks

[12] All requests to implement concentration in the banking sector submitted to the Commission were granted. The question is what would happen if the Commission for Competition Protection prohibits or grant on probation some concentration in this sector. Great possibility is that the court , in the lawsuit of dissatisfied concentration participants would invalidate the decision of the Commission due to its real incompetence.

[13] *Official Gazette RS*, No. 51/2009

In compliance with old and generally accepted legal rule *lex posterior derogat legi priori*, it could be concluded with the regulation of the Article 3 of the new law on competition protection, the regulation of the Article 7 is derogated. Thence it follows that the Commission for Competition Protection, according to legal authorizations, has the authority to determine breaches of competition done by the banks.

The above statement can be also supported with the other arguments. Stabilization and Association Agreement between the EU and Serbia[14] (hereafter SAA) is ratified by Republic of Serbia in 2008. The Interim Agreement on Trade and Trade-related matters between the EU and Republic of Serbia[15] (hereafter Interim Agreement on Trade) began to be implemented on both parts since November 2009[16].

Article 38 of the Interim Agreement on Trade which is identical with Article 73 of the SAA, prohibits, among other things, agreements between companies, company merger decisions and compliant practice between companies whose goal is either preventing consequences, limiting or violating competition, as well as abuse of dominant position by one or more companies on the all or on major part of the Union and Serbia territories. Parties are obligated evaluate to evaluate every action contrary to this Article on the grounds of criterion resulting from the application of the competition rules that are applied in the Community, especially from the Articles 81 and 82 EC Agreement and interpreting instruments adopted by the Institutions of the Community[17]. There are identical regulations in the Article 19 of Central European Free Trade Agreement (CEFTA 2006)[18].

With the above mentioned regulations Serbia has taken the international obligation to implement competition rules as formulated in Articles 81 and82 of the EC Agreement[19] and to and to interpret them in accordance with acts enforced by the Council, Commission and the Court of Justice, provided that behaviors to which this rules apply may influence trade between EC and Serbia that is between the members of CEFTA and Serbia.

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[14] The Law on Ratification of the Stabilization and Association Agreement between the European Community and its members, on one side, and Republic of Serbia on the other side, *Official Gazette RS*,- International Agreements No. 83/2008

[15] *Official Gazette RS*,- International Agreements No. 83/2008

[16] Data of the way toward full membership of the Republic of Serbia are available on the Web page: *http://ec.europa.eu/enlargement/potential-candidates/serbia/relation/index_en.htm*

[17] Article 38, paragraph 2 of the Interim Trade Agreement

[18] *Official Gazette RS*,- International Agreements No. 88/2007

[19] By *The Treaty on the Functioning of the European Union*, O.J. C115/2008 pre-numbering of the initial contract Articles, so now Articles 81 and 82 are numerated as 101 and 102

In compliance with the above mentioned stands of the European Commission and the Court of Justice, competition rules from the Law on Competition Protection would apply in the areas where banks behavior is not regulated by imperative regulations of the Law on Banks, subordinate regulations based on this and other regulations which regulate business on financial market.

Finally, systematic interpretation gives ground for the stand that the Law on Competition Protection also applies to bank activities. It is undisputed that the Law is applied to other participants on financial market, such as, for example, insurance companies or investment funds[20]. Excluding banks as one category of participants on financial market from the Law sphere would not, therefore, be justified.

[20] The Commissions has repeatedly identified competition violations done by insurance companies and its authorization has never been disputed by other categories of market participants

# CHAPTER 22. FISCAL RESPONSIBILITY AND PUBLIC DEBT*

**Mališa ĐUKIĆ**, Belgrade Banking Academy, Serbia
**Srdjan REDŽEPAGIĆ**, Institute of Economic Sciences, Serbia

***Abstract***

*In the European Monetary Union, the sustainability of a fiscal deficit and public debt is to be achieved by respecting the convergence criteria that were defined by the Maastricht Treaty. The global financial crisis as well as the fiscal measures implemented by a number of governments to mitigate the effects of crisis contributed to the growing interest in fiscal responsibility rules. With regards to the IMF – Serbia negotiations over the fourth Stand-by arrangement revision, drafting, adoption and implementation of the Law on fiscal responsibility was one of the key topics that were discussed. The purpose of this paper is to draw one's attention to the need of adopting and implementing the fiscal responsibility concept in Serbia in order to avoid over indebtedness.*

## INTRODUCTION

Fiscal policy makers are to be limited by fiscal rules that are to clearly define and numerically express the indicators of fiscal limits. The European Union fiscal framework that was adopted in the Treaty of Maastricht sets the fiscal deficit/GDP ratio to a maximum of 3% as well as the public debt/GDP ratio to a maximum of 60%. The Stability and Growth Pact complements the convergence criteria and serves as a preventive fiscal framework for smooth functioning of European Monetary Union. The purpose of the preventive measures is to avoid the creation of excess budget deficit.

The aim of implementing the fiscal responsibility concept is to maintain the real value of public debt. Consequently, the nominal growth of public debt must be in line with the annual inflation rate. Assuming that the GDP is growing in real terms, the implementation of the fiscal responsibility rules would mean a decline

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in public debt-to-GDP ratio. Apart from defining indicators based on which the dynamics of public debt-to-GDP ratio would be monitored, the laws related to the fiscal responsibility need to state ways of achieving the objectives. In practice, this would mean a reform of fiscal planning process.

Following the emergence of the global financial crisis, majority of transition countries and especially the EU candidate countries face similar problems one of which is the growing public debt. The levels of budget deficit and public debt are defined in the Maastricht Treaty as the "dimensions" important for the overall functioning of the economy.

## PRIMARY DEFICIT AND PUBLIC DEBT

The sustainability of fiscal deficit depends on the GDP growth, real interest rates, real exchange rate as well as the public debt of the country that should be sustainable on long run. Excluding the possibility of financing the public expenditures by printing money, the budget deficit can be defined as the sum of primary deficit and real interest rate (rD) that is paid on the outstanding public debt. The primary deficit is defined as the difference between fiscal revenues (T) and public expenditures excluding the interest paid for servicing the public debt (G).

$$\Delta D = G - T + rD$$

In order to finance the budget deficit, one country's government needs to increase its public debt by the amount of ΔD. Blanchard (2003) expresses the public debt servicing by the following formula.

$$r\,(D/Y) = \Delta(D/Y) + (T - G)/Y + g\,(D/Y)$$

Stabilisation of public debt/GDP ratio requires that the change of public debt/GDP ratio ($\Delta(D/Y)$) is equal to zero. Blanchard sets $\Delta(D/Y) = 0$ and calculates the general tax rate to stabilise the public debt. If the general tax rate is above the tax rate needed to stabilise the public debt, public debt/GDP ratio will increase and vice versa.

The spread between tax rate needed to stabilise the public debt and the general tax rate could be an indicator of public debt sustainability. Blanchard tax rate implies the importance of analysing the primary deficit as well as the necessity to put in line the fiscal revenues with the public expenditures excluding the interest rate.

Sustainable tax rate (Blanchard, 1993) can be explained by the tax rate which allows that the present value of primary surpluses is large enough to be able to finance the public debt. This can be expressed by the following formula.

$$B_0 = \int_0^{\infty} S^*(t) e^{-rt} dt = \int_0^{\infty} \left[T^* - g_t\right] e^{-rt} dt$$

from which it follows

$$T^* = r\left[B_0 + \int_0^{\infty} g_t e^{-rt} dt\right]$$

Consequently the difference between a sustainable tax rates and tax rates constitute the current level of fiscal sustainability, observed in a single economy.

**Table 1. Public debt/GDP and primary deficit/GDP in eight post socialist countries (from 1995 to 2009)**

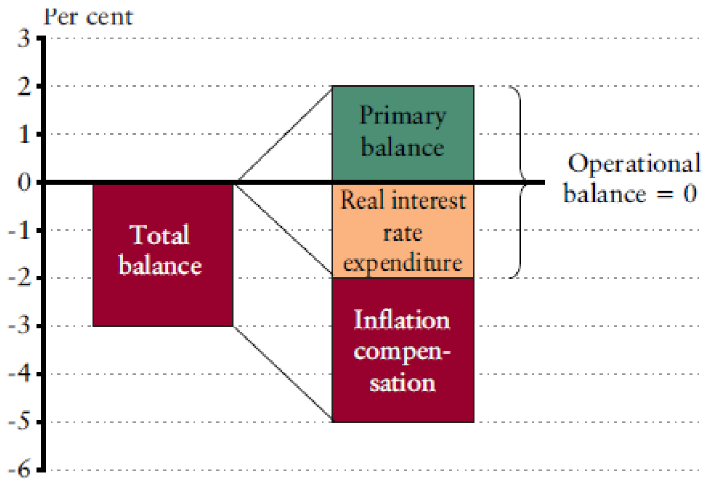
| | **Bulgaria** | **Czech Republic** | **Estonia** | **Hungary** | **Lithuania** | **Poland** | **Romania** | **Slovakia** |
|---|---|---|---|---|---|---|---|---|
| **Public debt/GDP** | | | | | | | | |
| Mean | 49,30 | 23,70 | 5,00 | 61,40 | 11,70 | 43,20 | 18,50 | 36,70 |
| Maximum value | 105,10 | 30,50 | 8,80 | 71,70 | 14,50 | 47,60 | 25,00 | 50,20 |
| Minimum value | 12,90 | 12,50 | 2,00 | 52,10 | 6,40 | 35,80 | 12,40 | 22,00 |
| **Primary deficit/GDP** | | | | | | | | |
| Mean | -1,20 | 4,70 | -0,70 | 6,10 | 0,90 | 4,00 | 2,80 | 5,10 |
| Maximum value | 3,40 | 13,40 | 3,60 | 9,20 | 3,90 | 6,30 | 4,60 | 12,20 |
| Minimum value | -5,30 | 2,70 | -3,60 | 2,90 | -1,40 | 1,00 | 1,40 | 1,80 |

*Source: Izak (2009)*

Izak (2009) analysed the relationship between the public debt interest rate and public debt/GDP and primary deficit/GDP in post socialist countries that are the European Union members and concludes that the existence of the primary surplus implied the decrease in interest rate on public debt thereby affecting the public finance of the observed country.

To reduce a real growth of public debt, a country should satisfy the following conditions; 1) the country needs to have a primary surplus and 2) the primary surplus should be equal to or greater than the interest rate on public debt which is also refereed to as the operational balance (Graph 1). The existence of the operational balance is an opportunity to reduce the public debt/GDP ratio, while the existence of the operational deficit implies an increase in public debt/GDP ratio.

**Graph 1. Operational Balance**




*Source: Hungarian National Bank*

## PUBLIC DEBT IN EUROPE

In managing the overall economic policy of each country, it is necessary with particular attention to follow a policy of public debt. Public debt, except that it is used to finance the deficit is an instrument of economic policy that has a fiscal and monetary function and as such has a certain impact on economic development. In the literature, different definitions of public debt are known, but what is certainly, a need to keep in mind, is that it is necessary to have a public debt that would have more positive than negative effects on the economy of a country. Coordination of the monetary and fiscal policy is necessary so that the funds originated from borrowing are invested in projects that have development activities of an economy, because otherwise the policy of public debt is a serious risk factor that can undermine economic development. Bearing this in mind it is clear that the policy of the public debt reflects the links between monetary and fiscal policy. Nowadays, public debt policy in all countries of the European Union (including the countries of the euro area) is very important part of the overall financial markets and represents the most significant area for drafting and implementation of monetary policy of each European Union member state.

In 2009, the public debt of member states of the euro area and EU countries amounted to respectively 78.7% and 73.6% of GDP. For the next analysis it is necessary to point out that the euro zone includes 16 member countries: Belgium, Greece, Spain, France, Ireland, Italy, Cyprus, Luxembourg, Malta, Netherlands, Austria, Portugal, Slovenia and Finland. In the following table, the euro zone also includes data for Cyprus, Malta, Slovenia and Slovakia for the entire analyzed period, while Slovenia has become the first member of the euro area in January 2007, and Cyprus and Malta on the 1st January 2008, while Slovakia is a member from the 1st of January 2009.

**Table 2. The main economic indicators in the euro area and the EU**

| | | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|
| **Euro zone (16 countries)** | | | | | |
| GDP | (million of Euros) | 8 553 600 | 9 003 902 | 9 258 895 | 8 977 933 |
| Budget deficit | (million of Euros) | -112 048 | -55 723 | -181 176 | -565 111 |
| | (% GDP) | -1,3 | -0,6 | -2,0 | -6,3 |
| Public expenditure | (% GDP) | 46,7 | 46,0 | 46,8 | 50,7 |
| Public revenues | (% GDP) | 45,3 | 45,4 | 44,9 | 44,4 |
| Public debt | (million of Euros) | 5 842 888 | 5 940 433 | 6 424 615 | 7 062 625 |
| | (% GDP) | 68,3 | 66,0 | 69,4 | 78,7 |
| **European union (27 countries)** | | | | | |
| GDP | (million of Euros) | 11 682 471 | 12 364 567 | 12 500 094 | 11 804 734 |
| Budget deficit | (million of Euros) | -167 687 | -103 584 | -285 685 | -801 866 |
| | (% GDP) | -1,4 | -0,8 | -2,3 | -6,8 |
| Public expenditure | (% GDP) | 46,3 | 45,7 | 46,9 | 50,7 |
| Public revenues | (% GDP) | 44,9 | 44,9 | 44,6 | 44,0 |
| Public debt | (million of Euros) | 7 172 706 | 7 265 256 | 7 697 027 | 8 690 304 |
| | (% GDP) | 61,4 | 58,8 | 61,6 | 73,6 |

*Source: European Commission, Eurostat, 2010*

According to the latest data from the European Commission, the budget deficit relative to GDP in 2009 year reached the highest (negative) level of the period analyzed in the following countries: Ireland (-14.3%), Greece (-13.6%), United Kingdom (-11.5%), Spain (-11.2%), Portugal (-9.4%), Latvia (-9.0%), Lithuania (-8.9%), Romania (-8.3%), France (-7.5%) and Poland (-7, 1%). The lowest recorded budget deficit in the analyzed period was in Sweden (-0.5%), Luxembourg (-0.7%) and Estonia (-1.7%). At the end of 2009, the lowest level of public debt expressed as a percentage relative to GDP were Estonia (7.2%), Luxembourg (14.5%), Bulgaria (14.8%), Romania (23.7%), Lithuania (29 , 3%) and the Czech Republic (35.4%). In 2009, the twelve member states recorded a public debt that was higher than 60% of GDP: Italy (115.8%), Greece (115.1%), Belgium (96.7%), Hungary (78.3% ), France (77.6%), Portugal (76.8%), Germany (73.2%), Malta (69.1%), United Kingdom (68.1%), Austria (66.5%) , Ireland (64.0%) and Netherlands (60.9%). According to data for 2009, public expenditure in the euro zone represented 50.7% of GDP while public revenues consisted of 44.4%. The EU Member States public expenditure comprised 50.7% while public revenues represented 44.0% of GDP. Between the 2008 and 2009 the public expenditures have increased both in the area of EU countries and in the zone of euro area member countries, while public revenues in the both groups of countries analyzed reduced.

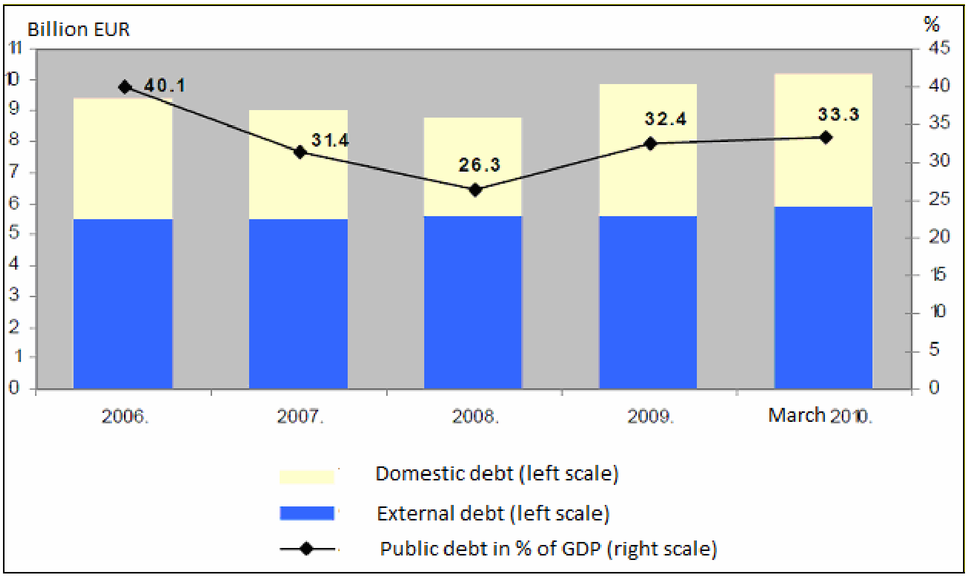
## PUBLIC DEBT IN SERBIA

When it comes to the politics of public debt of Serbia, according to the latest official data for the Republic of Serbia, which is published by the National Bank of Serbia, our country's public debt amounted to 10.2 billion Euros at the end of the first quarter of 2010th year, representing 33.3% of GDP (see Graph 2). Please note that the official statistics of public debt does not include the obligations of the Republic of Serbia according to the International Monetary Fund by the use of resources allocation of special drawing in the amount of 424.6 million Euros (388.4 million special drawing rights)[1].

The public debt of the Republic of Serbia, expressed as a percentage of GDP, in the reporting period (2006-2010) recorded a significant decline in 2008 compared to 2006 by about 8.13% while now reached a level of 32.4% of GDP and stayed stable 2009 and during the first quarter of 2010. However, one should bear in mind that the sudden increase in the share of public debt to GDP in 2009 in large part a result of falling GDP, and depreciation of a currency, and that the absolute amount of debt 319.5 million in the first quarter of 2010 is quite high[2].

[1] National Bank of Serbia: „Analiza duga Republike Srbije“, March 2010
[2] By the latest data of the National Bank of Serbia.

**Graph 2. The public debt of the Republic of Serbia**




*Source: Ministry of Finance of the republic of Serbia, 2010*

**Table 3, The Consolidated Public Revenues, Expenditures and Deficit in Serbia (% GDP)**

| | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| Public revenues | 42,9 | 43,8 | 42,4 | 41,1 | 38,8 |
| Public expenditures | 41,9 | 45,4 | 44,3 | 43,5 | 43,3 |
| - current expenditures excluding interest | 38,1 | 39,8 | 38,8 | 39,1 | 39,0 |
| - interest payments | 1,0 | 1,5 | 0,8 | 0,6 | 1,0 |
| - public investments | 2,7 | 4,1 | 4,7 | 3,8 | 3,4 |
| Deficit | 1,0 | -1,6 | -1,9 | -2,5 | -4,5 |
| Primary deficit | 2,1 | -0,1 | -1,1 | -1,8 | -3,6 |

*Source: Ministry of Finance of Republic of Serbia and FREN*

From 2005 to 2009, the difference between the consolidated public revenues and public expenditures implies the existence of primary surplus only in 2005 when the total amount of primary surplus was greater than the interest on public debt. From 2006 to 2009, thee primary deficit was rising from 0,1% of GDP in 2006 to 3,6% of GDP in 2009. The increase of primary deficit as well as the relationship between the primary deficit and expenditures on interest payments implies a significant increase in public debt/GDP ratio in Serbia.

## FISCAL RESPONSIBILITY – THE CASE OF HUNGARY

In the context of European integrations and taking into account the strategic goal of Serbia to become a European Union member country, we analysed the concept and the application of the fiscal responsibility in Hungary, a country which is an EU member and is on the way to become a EMU member. In November 2008, Hungarian parliament adopted the Law on fiscal responsibility in order to reduce its public debt to a level that would sustainable long term.

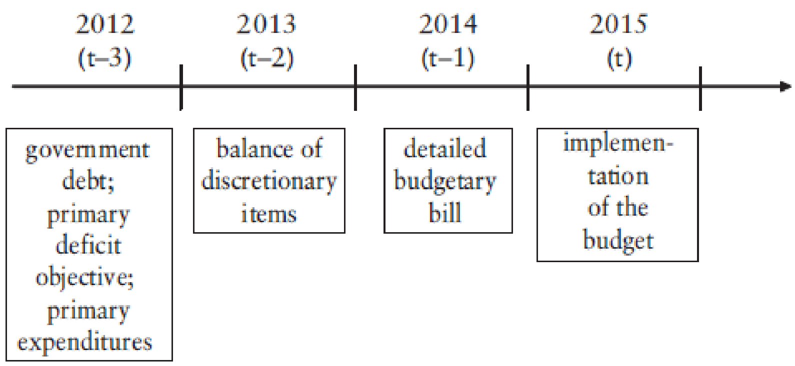
According to the Law on fiscal responsibility, the budget law must define a primary balance target two years ahead and the target cannot be a deficit, in other words the budget law needs to set an objective of achieving a primary surplus two years ahead. At the end of the second year ahead, the real value of state debt should not exceed the level of debt at the end of the first year following the year for which the budget was drafted. the budget law must define to what extent primary central state spending can change in real value in the second year ahead, from the previous year. In case that the primary balance is expected to be better than the targeted one, the difference must be put in a special fund. The government must propose tax cuts in line with the available resources in this fund. On the other hand, the government must submit a supplementary budget to parliament ff the expected primary surplus is lower than the target by more than 0,2 percent of GDP.

The Fiscal Council, a three member body was set up which makes macroeconomic forecasts, technical budget projections, and estimates for the budget impact of various legislation in parliament. The members of the Fiscal council are appointed by the President of the Republic, the Governor of the central bank and the head of the State Audit Office. The Fiscal Council prepares methodological instructions for fiscal planning, forecasts and impact of fiscal measures.

By adopting the Law on fiscal responsibility, the government obliged itself to keep the real growth rate of expenditures excluding the interest expenditures in years 2010 and 2011 below 50% of the planned GDP growth rate. The government also set the goal of reduce the budget deficit in 2010 and 2011 in line with the convergence criteria of the Maastricht Treaty.

With regards to the fiscal planning, the primary budget balance target for 2015 must be set as early as in 2012 in such a way that the value of the end-2015 government debt exceeds the lower of either the debt expected for end-2014 or the year 2011 fiscal debt by the rate of inflation at most. Relative to year 2011, the total public debt in year 2015 can be increased only by the rate of inflation from 2011 to 2015. The Law on fiscal responsibility obliges the government to define a maximum amount of increase in real value of public expenditures in year 2014 for year 2015.

**Illustration 1. The process of planning the budget for year 2015**




*Source: Hungarian National Bank*

Depending on the macroeconomic forecasts, the sum of mandatory budget items (pensions, transfers) and discretionary public expenditures (public wages, expenditures for goods and services, subsidies, social security, capital transactions) for year 2015 must be defined so that the primary surplus is in line with the target that was define a year earlier. Relative to year 2014, real growth rate of public expenditures excluding interest in year 2015 must be in line with the conditions set in year 2012.

## CONCLUSION

From year 2005 to year 2009, the public revenues and expenditures of Serbia imply the existence of the primary surplus only in year 2005 when the primary surplus was greater than the interest expenditures. From 2006 to 2009, a rising primary deficit was recorded, namely, in year 2006, primary deficit-to-GDP ratio was 0,1% while in 2009 the ratio reached 3,6% of GDP. This implies a significant increase in debt-to-GDP ratio of Serbia as well as the scenario of creating excess public debt. Adopting regulations related to the fiscal responsibility should set the limits to public spending and real value of public debt. To avoid over indebtedness, experiences from neighbouring Hungary could be quite useful especially in the area of fiscal planning. Setting up Fiscal Council which should consist of experts in public finance and macroeconomics would contribute to successful implementation of the fiscal responsibility concept. Taking into account the strategic goal of Serbia to become a European Union member country, adaptation and implementation of fiscal rules would mean that Serbia would fulfil certain conditions define by the convergence criteria.

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# CHAPTER 23. ECONOMIC POLICY MEASURES IN THE CASE OF ILLIQUID ECONOMY

**Zoran GRUBIŠIĆ**, Belgrade Banking Academy, Serbia
**Duško BODROŽA**, Institute of Economic Sciences, Serbia

## LIQUIDITY POSITION OF SERBIAN ECONOMY

The short analysis about our economic liquidity is: banking sector is highly liquid, while the chain of illiquidity has attacked real sector. The first effect of global crises in September 2008 was losing confidentiality in financial institutions which could be concluded upon deposit withdrawals from banking sector, huge fall of stock exchange indexes, decrease in wealth of institutional investors and overall retracting of big investors from Serbian financial market. The secondary effect came through pessimistic expectations led by decrease in demand for goods and services. The consequence was lower profitability which affected unemployment rate in real sector to jump. Logically, due to the recession, the new macroeconomic balance has been achieved at the lower level with negative GDP growth rate of -3.5% in 2009. In this moment, the biggest threat comes from the increase in loans' delays in both corporate and retail sectors which could led the crisis from real to financial sector.

The next table shows the increase in small businesses seizures in 2009.

**Table 1. Review of suspended small business and amount of cash under suspension**

| Date | Number of suspended SB | Amount of cash under suspension |
|---|---|---|
| 1. january 2008 | 45.608 | 146.407.376.895,59 |
| 1. december 2008 | 55.751 | 189.442.206.385,51 |
| 1. january 2009 | 56.605 | 206.917.160.158,05 |
| 1. february 2009 | 57.645 | 211.055.503.361,21 |
| 1. march 2009. | 58.657 | 217.266.635.769,61 |
| 31. march 2009 | 59.333 | 230.725.131.076,84 |
| 30. april 2009 | 59.821 | 252.730.321.087,34 |
| 29. may 2009 | 60.554 | 255.860.703.421,36 |

| | | |
|---|---|---|
| 30. june 2009 | 61.285 | 262.006.462.811,07 |
| 31. july 2009 | 62.081 | 270.688.404.217,97 |
| 31. august 2009 | 63.021 | 280.302.153.642,35 |
| 30. september 2009 | 64.292 | 286.398.989.266,29 |
| Index: 30. september 2009/ 31. August 2009. | 102,02 | 102,18 |
| Index: 30. septembar 2009/ 01. january 2009. | 113,58 | 138,41 |

*Source: NBS - The department for enforced collection of claims*

**Table 2. Suspended SM on 30.06.2010, 3 years (>=1066 days)**

| | |
|---|---|
| SBRA data | 293 |
| Statistical data | 19 |
| **TOTAL** | 312 |

*Source: NBS - The department for enforced collection of claims*

Even the trend is positive in 2009, one should be careful when interpreting results. It is not uncommon for entrepreneurs, due to the poor legislation in Serbia, which have liquidity problems to establish new firm and formally let the old firm in seizure. Here should be mentioned that Serbian government has been putting a lot of effort, in a sense of institutional framework, to make those directors responsible which purposely let firms in seizures in order to avoid liabilities to be paid.

Nevertheless, it is clear that Serbian economy has liquidity problems and the government had to undertake certain actions.

If we take into consideration the percentage of current accounts which are in seizure, it is obvious those in seizure for 30 days have decreased, but there is substantial growth in current account seizures above 30 days.

The situation looks even worse if we consider amount of loans given to corporate clients, past due liabilities with maturity over 90 days and delayed liabilities.

**Table 3. Blocked current account**

| **Description** | **31.12.2008** | **31.3.2009** | **30.6.2009** | **30.9.2009** |
|---|---|---|---|---|
| **Legal entities** | | | | |
| Number of current accounts | 423.190 | 434.485 | 453.781 | 462.758 |
| Current account blocked up to 30 days in% | 1,7 | 1,6 | 1,4 | 1,2 |
| Current account blocked more than 30 days, in% | 11,6 | 12,6 | 13,7 | 14,5 |
| **Enterpreneurs** | | | | |
| Number of current accounts | 475.553 | 482.133 | 488.045 | 493.753 |
| Current account blocked up to 30 days in% | 1,3 | 1,1 | 1 | 1,0 |
| Current account blocked more than 30 days, in% | 13,8 | 14,5 | 15,2 | 15,6 |

*Source:* Credit Bureau of the Association of Banks

**Table 4. State debt and bank loans outstanding obligations over 90 days**

| **Description** | **31.12.2008** | **31.3.2009** | **30.6.2009** | **30.9.2009** |
|---|---|---|---|---|
| **Legal entities** | | | | |
| The amount of outstanding debt in mill RSD | 806.356,9 | 876.170,3 | 847.404,9 | 889.377,56 |
| Delay to the rest of the debt, in % | 4,6 | 6,0 | 8,0 | 8,3 |
| Number of loans in delay, in % | 6,1 | 7,8 | 9,8 | 11,0 |
| **Enterpreneurs** | | | | |
| The amount of outstanding debt in mill RSD | 45.896,16 | 47.327,52 | 45.444,02 | 44.226,85 |
| Delay to the rest of the debt, in % | 1,9 | 2,5 | 3,7 | 4,5 |
| Delay to the rest of the debt, in % | 3,5 | 4,5 | 5,9 | 6,7 |

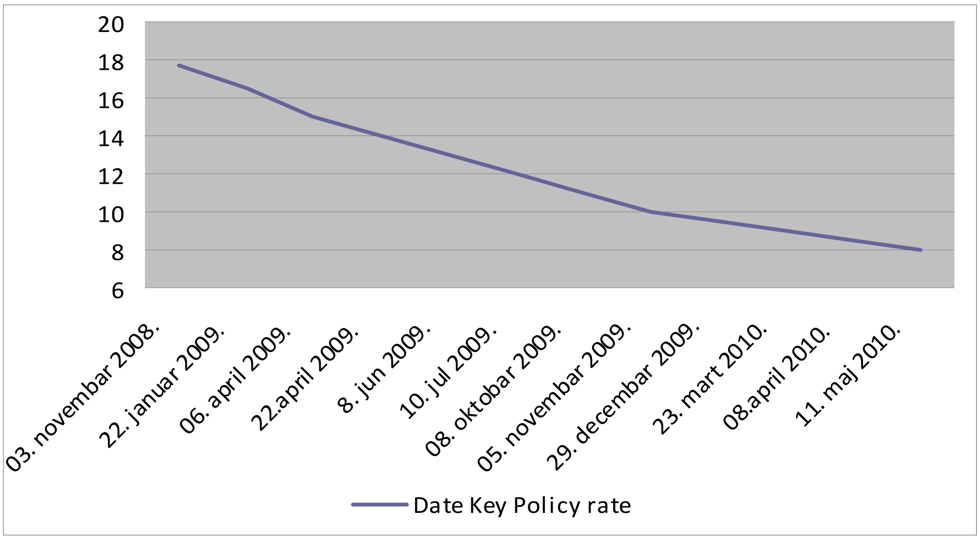
*Source:* Credit Bureau of the Association of Banks

It is obvious that amount of delayed debt has increased with respect to remaining debt across quarters. This proportion has almost doubled in nine months.

## ECONOMIC POLICY MEASURES TO SOLVE ILLIQUIDITY PROBLEMS

We could wonder why there is such a high liquidity in banking sector even that real sector struggles with illiquidity. The answer is how banks make risk assessments. Due to the high risk free rates in Serbian economy, banks have lacked interest to give loans to illiquid companies and expose to higher risk. Banks usually comment this as the lack of appropriate projects and uncertainty whom to give loans. At the beginning of 2009, key police rate was 17.75% and treasury bills with rate of 17%. These rates were not sustainable in the state of recession and the central bank did a god job by lowering key police rate down to 8%. We should mention here good results of stress testing carried out by the central bank which showed that even the worst scenarios in real sector would not affect liquidity of banks. The next graph shows key police rate (2-week repo rate) performance over the last period.

**Figure 1. Moving of the NBS interest rate**




*Source: NBS*

If we consider the structure of loans in banking sector given to state and private sector the situation becomes clearer.

**Table 5. The structure of credit loans to commercial banks and state**

| Months | Corporate loans (in million) | | State loans (in million) | |
|---|---|---|---|---|
| | RSD | Foreign currency | RSD | Foreign currency |
| January 2009 | 660,3 | 83,7 | 13 | 7,8 |
| August 2009 | 729,5 | 80,5 | 74,3 | 8,1 |
| January 2010 | 801,5 | 69,9 | 104,1 | 18,1 |

*Source: NBS*

Banking sector has noticeably supplied more loans to the state due to the lower risk. This is accompanied with subsidies given by the state for different types of loans. In the last year the state provided about 1.1 billion of Euros in loans to corporate and retail sectors by subsiding interests with 55 millions of Euros which represents 0.15% of Serbian GDP. The next table shows that corporate sector took 11000 loans for liquidity problems which amounted to almost 1 billion of dinars.

**Table 6. Approved loans for liquidity in 2009.**

| Type of loan | No. of loans | Amount in mil. EUR |
|---|---|---|
| Liquidity loans with currency clause | 10.810 | 856,9 |
| Liquidity loans in RSD | 863 | 79,1 |
| TOTAL | 11.673 | 936 |

*Source: NBS*

The same interest for these loans has continued in this year. Banks explain that the demand will continue to rise due to the lower interest rates and lack of cash.

Nevertheless the biggest problem lies in the potential growth of bad loans. According to the data of Association of Serbian banks problems with down payments have increased at the beginning of 2010. On average more than 8% of corporate clients are not able to repay loans on time. This amounts to about 84.6 billions of dinars in delay. Some expectations show that bad loans could rise to 12-15% which represents the growth of 80% with the respect to the current state. Looking at others' experiences, bad loans have increased above 25% of total loans in bad times. By comparing these to our situation, we can see that statistically we are in the good shape, but rapid growth of delayed down payments represents big concern.

One of the last government measures to tackle crises is subsiding consumers' loans with interest rate of 7 to 9% in dinars. The idea is to overcome liquidity problems in economy by increasing aggregate demand. The problem is that these loans could be used for purchasing foreign goods and for travelling abroad.

The last government measures focus on small and medium companies. The state has provided 90 billions of dinars in loans for liquidity and investments purposes. Beside this, companies have free use of 45 million of Euros in different loans from foreign credit lines, while the Fund of republic of Serbia has provided 24 billions of dinars. This becomes obvious if take into account that SMEs shares 75% of GDP and have about one million of employees. One of the reasons for focusing to SMEs is that they are more able to take loans due to the lower indebtedness.

By analyzing all these measures and subsided loans, including loans for liquidity and investment purposes, the only problem is rise in the total debt, especially rise in the public debt. The public debt was 35% of GDP at the end of last year, while one year ago the public debt was 27% of GDP. Again we can state it is concerning, but the growing trend is the one we should worry about. The state should more consider to whom they offer subsided loans for liquidity. It is of crucial importance to provide these loans to stable and solvent companies which are able to overcome liquidity problems in the economy.

The next table summarizes all measures taken by Serbian government to tackle the global economic crises.

**Table 7. Measures of the Government of the RS for alleviating negative effects of the global financial crisis in Serbia**

| TYPE OF LOAN | Financing structure | Terms | Purpose | Total amount of loan |
|---|---|---|---|---|
| SUBSIDIZED LOANS FOR LIQUIDITY MAINTENANCE AND FINANCING OF DURABLE WORKING ASSETS | - RSD 2 billion in government interest subsidies<br>- RSD 80 billion from bank lending (total support planned: RSD 80 billion)<br>(total support planned: RSD 80 billion) | - Interest rate up to 5.5% p.a. (1 m EURIBOR + 3%)<br>- Repayment period up to 12 months<br>- Currency clause | - At least 50% of interest subsidies is allocated to export loans<br>- The rest is allocated to interest subsidies in respect of loans for other business activities, of which up to 30% may be used for rescheduling of loans with the same bank | - Entrepreneurial shop: up to EUR 20,000<br>- Small-sized enterprise (up to 50 employees): up to EUR 50,000do 50 000EUR<br>- Medium-sized enterprise (50-250 employees): up to EUR 0.5 million<br>- Large enterprise (more than 250 employees): up to EUR 2 million |
| INVESTMENT LOANS WITH PARTICIPATION OF THE DEVELOPMENT FUND | - The Development Fund provides RSD 5 billion to cover 30% of each loan<br>- Banks lend RSD 12 billion to cover 70% of each loan (the Guarantee Fund guarantees 75% of bank's loan)<br>(total support planned: RSD 17 billion) | - interest rate up to 3 m EURIBOR + 4% p.a.<br>- Repayment period: 3-5 years<br>- Grace period: 6-12 months<br>- 3-month repayment after expiry of grace period<br>- Currency clause | - For investment co-financing | - Entrepreneurial shop: up to EUR 30,000<br>- Small-sized enterprise (up to 50 employees): up to EUR 0.2 million<br>- Medium-sized enterprise (50-250 employees): up to EUR 1.5 million<br>- Large enterprise (more than 250 employees): up to EUR 4 million |

| TYPE OF LOAN | Financing structure | Terms | Purpose | Total amount of loan |
|---|---|---|---|---|
| SUBSIDIZED CONSUMER LOANS AND FINANCIAL LEASING FOR PURCHASE OF DOMESTIC PRODUCTS | - The state provides RSD 1 billion in interest subsidies<br>- Banks and leasing companies invest RSD 20 billion in loans and financial leasing<br>- (total support planned: RSD 20 billion)) | - Fixed interest rate up to 4.5% p.a., for "Punto" produced in Kragujevac, and up to 6% p.a. for other products<br>- Fixed interest rate up to 4.5% p.a., for "Punto" produced in Kragujevac, and up to 6% p.a. for other products<br>- Currency clause | - Currency clause | |
| Currency clause | - EIB: EUR 250 million<br>- KfW: EUR 100 millionEBRD: 100 mln EUR<br>- EBRD: EUR 100 million<br>- Loan of the Italian Government: EUR 30 million<br>(total support planned: EUR 480 million (c. RSD 45 billion)) | -Under the terms more favourable than the prevailing market terms | - For SMEs | |

*Source: NBS*

## References

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[2] www.merr.gov.rs
[3] www.ubs-asb.com
[4] www.stat.gov.rs
[5] www.apr.gov.rs
[6] www.kamatica.com

# CHAPTER 24. SUBSIDIZED LOANS FOR ECONOMIC RECOVERY: A SHIP IN THE SHALLOW WATER OF THE RECESSION

**Vlastimir VUKOVIĆ**, Institute of Economic Sciences, Serbia

***Abstract***

*Global recession imposed a basic question on the governments of most countries: how to stimulate aggregate demand? Expansionary monetary policy of low interest rates and increased public spending was the first to respond to major challenges of the crisis - a contraction of GDP and rising unemployment. However, the effects of anti-recession measures are in line with the expectations: recovery of personal consumption and investment is very slow and gradual increase in aggregate production is not accompanied by employment growth (IMF). Offering cheap money and massive fiscal stimulus is obviously not enough to create "waves of optimism" (Keynes) and "swiftly stimulate demand and boost consumer confidence" (European Commission). Consequently, the demand for loans is being reduced, despite low interest rates. Domestic economy is facing the opposite problem; atypical of most other transition countries and that problem are "the highest interest rates in the region" (NBS). That is why the Serbian government resorted to unusual measures - subsidies of household and corporate loans. This work is devoted to the analysis of the impact of subsidized loans to the economic recovery of the country.*

***Key words:*** *global recession, aggregate demand, fiscal stimulus, subsidized loans, economic recovery, transition*

## IDEA

The direct cause of the recession is a decline in aggregate demand. Therefore, the basic goal of the economic policy is stopping the decline and encouraging growth and the transfer from the contraction stage in the expansion stage. Encouraging of aggregate demand has been usually done in two ways: central banks have reduced interest rates (monetary policy measures) and governments have stimulative fiscal actions (fiscal policy measures). Reference interest rates have been already reduced in advanced economies to the level from 0% to 1%. In such circumstances, global "*fiscal stimulus is essential now to support aggregate demand and restore economic growth"* (Freedman et al., 2009).

However, the effects anti-recession measures are in line with the expectations: recovery of personal consumption and investment is very slow, and gradual increase in aggregate production is not accompanied by employment growth (IMF, 2010). Offering cheap money and massive fiscal stimulus is obviously not enough to create "*waves of optimism"* (Keynes), and "*swiftly stimulate demand and boost consumer confidence"* (European Commission, 2008). Consequently, it reduces the demand for loans, despite low interest rates.

Domestic economy is facing the opposite problem, atypical of most other transition countries, such as "*the highest interest rates in the region"* (NBS, 2010). That is why the Serbian government resorted to unusual measures – bank subsidies to corporate and household loans.[1] Fiscal subsidies cover a portion of the interest rates on loans[2], which reduces lending interest rates of banks and make loans attractive to a potential borrower.

By the *Plan for the economic stability of Serbia*, which the Government adopted in April 2009, *Stimulative Package* predicted subsidized loans for the economy (for liquidity and investment with lower interest rates by almost a half compared to the current market interest rates) and consumer loans to citizens. Reducing interest rates on bank loans up to the half of the market level is predicted by the *Package of measures for relieving the negative effects of the global economic crisis in Serbia in 2010.* The main objective is to preserve jobs and provide a slight economic growth, with the help of cheaper corporate and household loans. The program of measures is based on activating significant "sleeping" loan potential of banks, with the minimal budget (Ministry of Economy and Regional Development).

By the amendment to the above mentioned package of measures, executed at the end of March this year, in addition to local currency consumer loans for the purchase of domestic products and services, dinar cash loans were covered by these subsidies too. According to the creators, *"the aim of approving new dinar loans is to increase the purchasing power of citizens, stimulate domestic demand, economic growth, strengthen the domestic currency and boost the domestic production"* (www.merr.gov.rs).

[1] Public sector support to excessively indebted households by mortgage loans in the USA and other countries has been focused on the rescheduling of liabilities (longer terms, lower annuity, grace period), and the protection of the substantial minimum of debtor's property.

[2] This analysis did not include dinar guarantees of the Fund for the Development of the Republic of Serbia for subsidized corporate bank loans, as well as subsidized housing loans.

The importance and a number of the official goals point to the motives and expectations under the author's idea of subsidized loans. The hierarchy of objectives is derived from the general macroeconomic framework, despite the conflicting objectives (e.g. the stimulation of domestic demand by loans with currency clause and the strengthening of the domestic currency).

## MODELS

From the time of the Great Depression, government spending for investments in infrastructure has the primary significance to stimulate aggregate demand. However, the current crisis is marked by fiscal incentives towards the financial sector, primarily banks. "*A number of European lenders averted outright bankruptcy thanks to direct support from the public sector"* (BIS, 2009). Hence it can be concluded how important were the fiscal measures in both stabilizing the financial system, and regaining the consumer confidence and the recovery of aggregate demand.

The current crisis calls for two main sets of policy measures. First, measures to repair the financial system. Second, measures to increase demand and restore confidence (Spilimbergo et al., 2008). However, the strict separation of these measures is difficult because of the marked interdependence. An illustrative example of this is the example of the EU countries, which provided the banks with the direct financial support in the amount greater than the quarter of EU GDP (!), using a wide range of measures.[3] Classification of these measures to the first or second group represents a problem, because they affect the revitalization of the financial system and as well as the restoration of confidence and demand.

Considering the solvency and liquidity of local banks were not affected by the global financial crisis, primarily due to extremely high capitalization or extremely low capital multiplier (IMF, 2010a), domestic economic policy-makers focused on fiscal measures to stimulate aggregate demand. Subsidies of bank loans to domestic corporations and households for specific purposes is one of the measures in the arsenal, although there is not any officially listed example of a similar measure in other countries.

[3] Support for the Euro Zone banking system included three main groups of measures: 1) guarantees for bank liabilities (including raised coverage of their deposit insurance schemes to the new maximum of EUR 50,000 per deposit account), 2) capital injections (re-capitalization) and 3) transferring the assets or asset insurance schemes. Injecting capital through the acquisition of preference shares or other hybrid instruments had the essential importance, which fulfilled the conditions for Tier 1 capital (ECB, 2009).

## FRAMEWORK

*The Framework of Measures*, adopted in late 2008 by the Government of Serbia, was rested on the assumption that basic characteristic of that time macroeconomic position of Serbia was the overheated demand, financed by foreign inflows.[4] Hence it is understandable that at the beginning of the crisis measures for stimulating aggregate demand were not foreseen, with the exception of the infrastructure projects and measures for increasing liquidity and exports.

Several months later, an assessment of overheated aggregate demand was revised, so that the Government had already predicted a special *Stimulative package* by a special *Plan for the economic stability of Serbia* in April 2009, which included subsidized corporate loans (for liquidity and investment). Since GDP decreased by 3% that same year, despite all the measures implemented, Government's next move was the *Programme of measures for mitigating negative effects of the global economic crisis in the Republic of Serbia in 2010*. At the end of March this year, these measures were supplemented by subsidized citizen cash loans and the expansion of consumer loans to a larger number of domestic products and services (cars, tractors and trucks, domestic furniture, building materials, household appliance and similar products were included, as well as travel arrangements in the country).

The most severe result of the last year's fall in aggregate growth is the growth of already high unemployment rate (from 13.6% to 16.1% by a Survey). Recession was characterized by marked reduction in all forms of consumption - personal, investment and net exports, except for public consumption, so the budget deficit increased from 1.8% to 3.4% of GDP. At the same time, the process of disinflation was continued, which had reduced an annual growth rate of the general price level below 5%. The current account deficit was reduced by 3.5 times, mainly due to reduced imports, while foreign exchange reserves at the end of last year reached a record 10.6 billion Euros. Euroization culminated, as the amount of foreign currency deposits exceeded two-thirds of the total monetary

[4] "The long term macroeconomic position of Serbia is characterized by a distinct balance of payments deficit resulting from the foreign trade deficit. This indicates three basic facts: (1) In Serbia, spending is far greater than production and the excess spending is financed by foreign sources (foreign investment – Greenfield, or securing additional capital, loans – mostly private, remittances, etc.) (2) Excessive spending is closely linked to overheated demand, i.e. ultimately to excessive liquidity on the market, and (3) High GDP growth is closely related to high demand generated by foreign funds (of different kinds) but also by funds from local sources. Having this in mind, it means that the beginning of the economic crisis in developed countries was evolving under different circumstances when compared to circumstances in Serbia." (Government of RS, 2008)

aggregate M3 (NBS, 2010). The macroeconomic environment sketched Government continued with more intensive and comprehensive bank credit subsidies for underlined use and users.

## NORMS

Subsidization of interest rates is normatively regulated by government regulations relating to loans: a) for investment, b) for liquidity, permanent working capital and export business and c) for durable consumer goods, including financial leasing.[5] These regulations closely define specific uses of loans, the individual and the total amount of loans, benchmarks, and the proportions of subsidizing interest rates, customers, deadlines and other relevant conditions for obtaining subsidies.

Consumer loans, as already noted, are intended for domestic products and services, while cash loans have cash and social component, considering the amount of subsidized interest rates depends on the amount of the borrower's income. Users can be employed, pensioners and registered agricultural households. Discriminated people are non-registered farmers and the unemployed, regardless of the guarantee and collateral that could provide.

Benchmark interest rate is the three-month EURIBOR, while loans may possess a currency clause or not, of which also depends on the level of subsidies. Republic Fund for Development, under certain conditions, may guarantee corporate loans.

Loan term for cash loans to citizens is three years, with a one-year grace period (for *Zastava* cars loan term is seven years). The maximum amount of cash loans is 300,000 dinars, while consumer loans are limited only by borrower's creditworthiness. The amounts of corporate loans also depend on the purpose, as well as the size of the enterprises (small, medium, large).

[5] Regulation on conditions for interest rate subsidies for loans for investment in 2010 (a), Regulation on conditions for interest rate subsidies for loans for liquidity and financing permanent working capital and export business in 2010, (b) Regulation on conditions and criteria for subsidizing interest rates for consumer loans and loans for companies or financial leasing, the acquisition of certain durable consumer goods in 2010 (c) for previous 2009 the regulation was adopted with the same name as already mentioned regulations, while the Regulation on the conditions of use subsidiary loans for investments with guarantees of the Guarantee Fund in 2009 was intended for co-financing 30% of all bank loans that meet the predicted conditions.

## PLACING

The total volume of subsidized corporate bank loans and citizen loans in 2009 amounted to about 1.1 billion Euros, while it was spent 55 million Euros for subsidizing interest rates. The structure of loans by customers and purposes is not presented, but the total amount gives a reasoning official conclusion that the application of these measures during 2009 showed good results in the fight against recession (www.merr.gov.rs).

According to the Central Bank analyses for 2009, the share of subsidized loans in total loans ranged averagely about 10%, based on which it was estimated that they had a greater impact on the volume of loans approved (NBS, 2010). The degree of substitution between new and subsidized loans, and their net impact on the total loan amount was not estimated. If one bears in mind the extremely slow lending to companies and residents and the expansion of bank loans in the state last year, there is a high degree of substitution of new loans by subsidized loans. Consequently, their actual contribution to total loans is significantly lower than the 11% of nominal growth.

Thanks to the available data on the amount of subsidized loans by users and purposes during the first five months of this year (Table 1) ranges and effects of these loans can be estimated.

**Table 1. Subsidized loans in 2010 (from 25$^{th}$ May) in millions of Euros**

| Kind of loan | Number of loans | Total loans | Structure (%) |
|---|---|---|---|
| **Total loans to companies** | **7.568** | **611,6** | **83,3** |
| *Liquidity loans* | *7.245* | *581,2* | *79,1* |
| *Investment loans* | *323* | *30,4* | *4,2* |
| **Total loans to citizens** | **48.450** | **122,8** | **16,7** |
| *Consumer loans for cars* | *4.091* | *28,0* | *3,8* |
| *Other consumer loans* | *7.160* | *34,7* | *4,7* |
| *Cash loans* | *37.199* | *60,1* | *8,2* |
| **Total subsidized loans** | **46.018** | **734,4** | **100,0** |

*Source: Ministry of Economy and Regional Development Announcement (www.merr.gov.rs)*

At first glance it is evident that loans to companies dominate with more than 83% of total loans, which means that these companies usually finance consumption of intermediate, not final products and services. However, the predominant share of liquidity loans (79.1%) and cash loans (8.2%), a total of 87.3%, indicate that most of the subsidized loans is used for paying the existing obligations! At the same time it is necessary to bear in mind that the cash loans are granted to citizens only from early April. Given the extreme illiquidity and sub-monetization (EBRD, 2009), it can be estimated that the structure of subsidized loans in the second half of this year, will not undergo major changes. Negligible share of investment loans (4.2%) confirms that investment spending is still inhibited. Small amounts of consumer loans lead to the conclusion that consumer spending remains under pressure of recession pessimism and uncertainty.

Compared to the previous period, this year's subsidized loans (up to 25th May) reached approximately two-thirds of last year's similar loans and 9.6% of the level of all loans to companies and citizens at the end of 2009 (NBS, 2010). However, the net impact of these loans can only be estimated on the basis of changes in the volume of total bank loans to the private sector. Real growth in total loans to companies in the first quarter of this year amounted to 2.4% and 2.2% for households (NBS, 2010a), which indicates a negligible incentive effects and a high level of substitution of unsubsidized loans to subsidized (about 70%).[6] Likewise, without state subsidy, level of total real loan to the private sector in 2009 and 2010 would be noticeably lower than in 2008. Thus we can conclude that subsidized loan is not driven by the demand for bank loans, but thanks to them, approximately the same volume of loans was held in placing, during the current recession.

## RESULT

The influence of fiscal stimulus to the economic recovery is measured by fiscal multiplier.[7] Relationship between changes in GDP and relative growth of subsidized loans would be a multiplier of this fiscal stimulus. Since the aggregate domestic production in 2009 decreased by 3%, the relevant multiplier has obviously been negative. Subsidized loans have not relieved the contraction of economic activity, which can be testified by their structure.[8] It remains to improve the liquidity of the private sector, as the undisputed influence of these subsidies.

In the first quarter of this year, according to the flash estimate of SORS, GDP achieved growth of 1% over the same period last year, which is by the official

[6] Typical example is taking subsidized loan for liquidity or cash loan to solve a previous bank loan.

[7] Term fiscal multiplier is defined as the ratio of the change in GDP to the change in the size of the fiscal instrument or the change in the fiscal balance (Freedman et al., 2009).

[8] The economic policy time lags are irrelevant in this case.

definition the proof of overcoming the recession.[9] "*Notable increase in public consumption and contraction of the trade deficit in Q1 provided positive contributions to GDP growth, thus managing to offset the effects of declining investment and personal consumption"* (NBS, 2010a). Further decline in the investment and consumer spending is a sufficient evidence of negligible impact of subsidized loans on domestic aggregate demand, because the investment and consumer loans represent the framework of subsidies from the very beginning. As a reminder, stimulation of domestic aggregate demand was emphasized as the primary goal.

The structure of subsidized loans indicates that they were not significant for the growth of exports in the first quarter of this year, while exports in the last year suffered a significant decline due to reduction of foreign demand. Target strengthening of the domestic currency was made absurd by subsidized loans that allowed the domination of loans with currency clause. It is obvious that these loans and foreign exchange risk are in the end always tumbled on companies and citizens – borrowers.

The most important result of budget subsidies of bank interests is to prevent a more dramatic decline on the domestic loan market, although this goal is not the officially confirmed. However, the support for the loan market has not resulted in lower interest rates on unsubsidized loans. On the contrary, "*the interest rates on corporate and household loans rose in the year to February. The lending interest rates in March remained higher relative to end-2009.*" (NBS, 2010a) The process of disinflation has made the interest rate on loans even higher in real terms. Hence, the analyzed government subsidies have an undisputable positive effect on the profitability of banks - lenders!

The state indebtedness had a crucial influence on stopping the decline in loan markets last year (NBS, 2010), but this did not lead to any squeezing of private borrowers. Loan potential of the domestic banking sector has allowed much greater volume of private sector lending. Only creditworthy borrowers were missing!

In addition to macroeconomic performance, microeconomic performance is also important - availability of credit, lower prices for customers, reducing costs and other. However, there is a hidden negative effect in subsidizing interest rates to the borrowers. It's a trap of favorable conditions of lending (*debt trap*), which may lead the borrowers to make wrong decisions in times of recession, starting from the loan application.[10] Loan indebtedness in the stage of contraction in

[9] Flash estimate of GDP for the first quarter in 2010, Statistical Office of the Republic of Serbia (30th April, 2010)

[10] Trap of favorable conditions of lending (*debt trap*) is characteristic for subsidized loans intended for regional development, considering the economic lagging of the region

aggregate demand carries a high risk for debtor, because the possibility of returning are drastically low - falling sales, lower prices, accumulating the losses, rising unemployment, reduced wages, and so on. Low interest rates and other benefits, such as a longer grace period, could lead the borrower to ignore the risk of recession and take a favorable loan that they probably will not be able to return. The described effect on the macro level, contributes to the growth of NPLs. "*The share of NPLs rose by 0.7pp relative to end-2009 and reached 9.3% in March"* (NBS, 2010a). So far the impact of subsidized loans is still favorable because of a one-year grace period. The consequences of careless indebtedness will emerge in this and next year, although the data on the amount of the unreturned loans will never be published.[11]

In the end, it can be concluded that most goals were not met. The biggest result of the subsidized loans is to improve liquidity and reduce the cost of financing the private sector, companies and households.

## LESSONS

The main lesson is that the monetary problems cannot be solved by fiscal measures. Expensive loans, thanks to subsidies become even more expensive, because the fiscal incentives reduce the inter-banking competition. Demand for loans will inevitably fall into recession (Vuković, 2009), regardless of subsidized interest rates and longer grace periods. Subsidies cannot be used to bridge other restrictions on domestic credit markets and general economic development - euroization, exchange rate volatility and the resulting foreign exchange risk, distrust of the national currency, despite the high foreign exchange reserves, sub-monetization, predisposed inflation, too high real interest rates on loans and so on. These issues put Serbia in the group of financially unstable countries, which the investors avoid, and financial speculators prefer.

The positive effect of loan growth in aggregate output is treated as an axiom. In addition, the findings suggest that not only changes in the reference interest rates and demand for loans are important for the ratio of loan and output, but other factors are important too, such as bank loan supply, balance sheet position of borrowers, and risk perception in the economy (Bondt et al., 2010). The last mentioned factor has the strongest effect in the times of recession.

often has all of the characteristics of the recession – declining aggregate demand, declining production, unemployment growth, limited investments, etc.

[11] Fund for the Development of the Republic of Serbia treats this data on unreturned loans as a top secret.

The empirical literature provides numerous evidence that the fiscal policy in developing countries is procyclic (Kandil and Morsy, 2010), in contrast to developed countries where it is anti-cyclic (Ilzetzki and Vegh, 2008). The argument is that at the time the expansion of public spending increases in proportion to the budget revenues, while the contraction narrows due to inadequate budgetary resources. Developed countries deal with the problem of budget deficit by borrowing in the domestic and foreign capital markets. Credibility and effectiveness of fiscal policy in developing countries is conditioned by the amount of available foreign exchange reserves (Kandil and Morsy, 2010). According to these findings, the transition countries do not have major budget options for fiscal incentives.

Summary of the findings presented in this analysis imposes a general conclusion: subsidized loans have marginal importance for the economic recovery of the country. The impact of these loans is limited by the depth of the recession and cannot meet unrealistic expectations.

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# CHAPTER 25. DINAR'S FX RATE PARADIGM

**Branko ŽIVANOVIĆ, Milena KOVAČEVIĆ**,
Belgrade Banking Academy, Serbia
**Milan ŠAKOTIĆ**, Komercijalna banka a.d. Beograd, Faculty of Management, BK University, Serbia

***Abstract***

*The adequate foreign exchange rate model of the national currency represents the most controversial issue in the domestic economic theory and practice. There has been perseverance for the fixed exchange rate of RSD, counting on its "stability" for a long time. This model was successful only for a short time, leaving the structural deviations in the national economy in a long run.*

*During the 2000s, RSD fluctuations were seen as one of the biggest achievements of the national economic and monetary policy. For the most time this fluctuation was recognized as managed floating although there was a minor speculation for a short time about the free floating and beginnings of RSD full convertibility. However, the significant FX risks put quality and efficiency of current RSD FX regime in a focus again. As alternative appearing intervening models – dollarisation and currency board and hybrid models recognized as crawling peg. Finally in managing RSD /EUR pair volatility FX derivatives could be successful. swaps are first in a field – just introduced by the NBS.*

*During the 2000s, the RSD fluctuations were seen as one of the biggest achievements of the national economic and monetary policy. Most of the time these fluctuations were recognized as managed floating although there was a minor speculation for a short time about the free floating and beginnings of RSD full convertibility. The appearance of significant FX risk puts quality and efficiency of current RSD FX regime in a focus again. As alternatives to current FX RSD regime, some intervening models are appearing – dollarization, currency board and hybrid models known as crawling peg. Finally FX derivatives could be successful in managing RSD /EUR pair volatility. Swaps are first in the field – just introduced by the NBS.*

***Key words:*** *FX rate, national currency, managed floating, FX reserves, crawling peg, currency board, dollarisation, FX derivatives*

## INTRODUCTION

The focus of this paper is an issue of an adequate RSD foreign exchange regime. This research investigates different types of FX models, classified in several groups: conservative, intervening and hybrid models. The conservative models of the national currency FX rate are pure, fixed and fluctuating (flexible). The research should point out positive and negative aspects of two extremely different models and test results of their potential implementation in the national economy

The implementation of intervening models will be investigated too. The aspects of currency board and dollarisation will be shed a light on. The emphasis will be on dollarisation through the form of EUR implementation instead of RSD in the national economy.

The paper will take a critical prospective on current RSD FX regime, so called managed floating. The effects on nominal RSD FX rate, level and structure of FX reserves and NBS interventions will be discussed. The very tough issue is a question what to do with so called managed floating which seems as fake floating. As a possible alternative emerging there is FX hybrid recognizable as crawling peg.

Finally, introducing FX swaps by the NBS is welcomed and the research will try to create a kind of model for stabilizing RSD volatility combining with FX derivatives. The model will include FX swaps and forwards and their usage simultaneously at the domestic inter banking foreign exchange market.

## CONSERVATIVE EXCHANGE RATE MODELS AS AN ALTERNATIVE SOLUTION TO THE FOREIGN EXCHANGE RATE REGIME OF RSD

Fixed and floating, as orthodox models of foreign-exchange rate regime are natural alternatives to the current FX RSD regime. The models will be starting point of the research.

### Flexible exhage rate

Flexible Exchange Rate - free floating requires the fulfillment of a few clearly defined conditions to such a foreign exchange rate regime could be applied in the national economy. "Free floating" exchange rate implies a minimum presence of central monetary authorities and governments (state authority in general) in the interbank foreign exchange market, and the existence of a relatively balanced external finance, the convertibility of national currencies as well as a developed structure of national financial markets.

Namely, the exchange rate are formed freely on the market, under the influence of foreign exchange supply and demand with mild and very discreet interventions of the NBS which is based on liquidity motives and possible exogenous shocks.

A number of authors and schools approached the flexible exchange rate from clean monetaristic stand point: Frenkel, Kouri, Mussa and the Chicago School with Freedmen. The monetary approach best explains the model of flexible prices (Flexibile-Price Monetary Model), which according to MacDonald and the Taylor (1992:2-8), is based on two equal assumptions: purchasing power parity (PPP) and the parallel existence of two stable monetary functions - the functions of money demand in the domicile and international markets. Cash demand (its logarithm) is to be dependent on the real national income (its logarithm), the average price level *p* (its logarithm) the current level of interest rates *r* (logarithm of its functions). The increase in domestic output in the money supply as opposed to volume will appreciate the national currency. In contrast, the growth of domicile interest rates will depreciate the the national currency. However, in the short term, the high domicile interest rates will lead to interest arbitration and a carry trade, which will again appreciate the national currency according to the model Mundell/Fleming - Stock Flow implications of differential interest rate changes (1968).

On the other hand, Blandel, Wignal and Masson (1985:132) discuss the negative consequences of large fluctuations and their impact on the economic system. Erratic fluctuations in relative prices including fluctuations of real exchange rate may be undesirable and cause negative effects on economic activity. As a key issue they state level of compliance with the selected course (the fundamental) equilibrium in the national economy.

Williamson (1983:14) states that even in the most developed industrial countries, exchange rates are significantly and permanently outside the lines of "fundamental equilibrium". Currency fluctuations of leading industrial countries are driven by the "invisible hand", using the currency dumping thus making it competitively lower in comparison to the national currencies of countries largest trading partner. (Samuelson - *Policy depletion neighbours*). Dumping strategy of national currencies in trade purposes and the need for a certain level, looking from the aspect of internal balance, indicates that the above-mentioned countries hold the type of fixed exchange rate target in the shadow.

Based on the foregoing, perfect fluctuation is not a realistic option for the Serbian economy neither is it recommended. Firstly, the model excludes the CB's corrective action to prevent unwanted fluctuations. Secondly, the economy would be critically subjected to exogenous shocks, which outcome would be hard to predict, therefore the most likely scenario would be a withdraw from the RSD asset and blown up demand for foreign currency.

**Fixed exchange rate**

Model of the fixed exchange rate is not the right option for current FX rate regime transformation and market de facto would not have accepted it. The fixed exchange rate is characteristic for the regulated foreign exchange markets that are typical for former socialist economies – transitional economies as well as for the undeveloped countries (Rabrenovic, Zivanovic, Simic, 1997:48) are of opinion that the main characteristic of such "market" mechanisms is a permanent lagging of the foreign currencies supply (S) after their demand (D),

$$(S \prec D). \tag{1}$$

We will present the demand for a foreign currency as

$$q = f(p). \tag{2}$$

However, we can also present the price of the foreign currency as a demand function

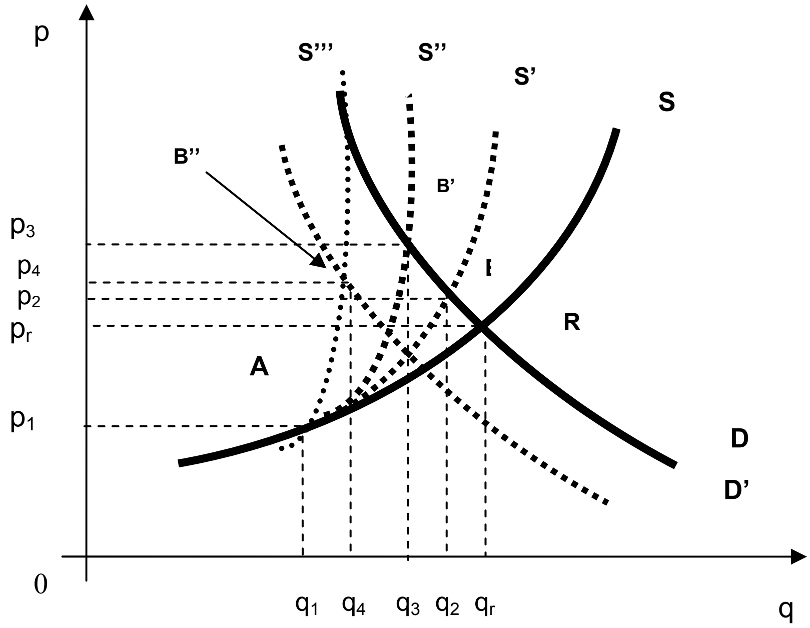
$$p = f'(q). \tag{3}$$

In this case, the balanced currency rate $p_r$ is going to be on the cross section of the above functions $f(p)$ and $f(q)$.

The balanced currency rate $p_r$ is a theoretical currency rate which, as a result of the autonomous courses of the supply and demand of the observed currency, is the closest to the exchange rate in unregulated foreign exchange market (although it differs even from it in some degree).

However, this law does not seem to be good at all in regulated foreign exchange markets. State authorities estimate that situation in the domestic foreign exchange market, at the level of the exchange rate $p_r$, would be in collision with national economic objectives. Wishing to provide internal (domestic) economic balance, the authorities announce the price of the domestic currency achieving the cited objectives (through its fixed currency rate).

**Figure 1. Creation of parallel FX rates in regulated FX markets**




*Source: Rabrenović, Simić, Živanović (1997:48)*

Most frequently such currency rate is overrated

$$p_1 \prec p_r . \tag{4}$$

Up to the level $q_1$ the central bank will intercede at the official exchange rate, but it will not be able to satisfy the total demand for foreign currency $D(0, q_r)$.

The low price of foreign currency causes the disproportion between the supply and demand in the range $AR(q_1, q_r)$.

As a consequence of the unsatisfied total demand, black (illegal) foreign exchange market begins to work. As the trading in this market includes a risk, there is a special kind of expenses in the form of risk-premium, which is reflected in the reaction of the supply curve $(S)$. The reaction consists of the lowering of FX supply curve price elasticity $(El_s)$, i.e. increase of the foreign currency price at the illegal market segment

$$p_2 \succ p_r \succ p_1 \tag{5}$$

This case can be taken as a classical example of the counter-productive act of the government, considering that now for a higher price $p_2$ than the former real one $p_r$ (the level of the theoretical exchange rate $q = f^{'}(r)$, Figure 2.) the economy sector gets smaller amount of the foreign currency

$$q_1 \prec q_r . \tag{6}$$

The final prices of the producers, whose products have a built-in export component, are higher for the amount of the risk premium, if they get foreign currencies in the black market. That affects the increase of the average price level causing inflationary sequences in national economy. If, furthermore, we take into consideration the transactions in the black market that are not taxed, the budget receipts will decrease too. Unfortunately, this is not at all the end of the chain of the negative effects of such government act. Namely, the largest consequences are reflected in draining of the income in sectors favoured by the government, as some sectors get a foreign currency at the price $p_1$, while the unfavoured sectors buy it in the illegal market at the considerably higher price $p_2$. All the above causes making of the imperfect price system and distort economic structures in medium and long terms. (Rabrenovic, Zivanovic, Simic, 1997:48)

If the government decides to eliminate the black market, and consequently make an extra pressure on sellers, it will only result in even less elastic supply curve $\left(S^{"}\right)$:

$$El_{s^{"}} \prec El_{s^{'}} \prec El_s \tag{7}$$

and higher risk premium

$$RB \prec RB' . \tag{8}$$

The pressure towards sellers only leads to the higher price $p_3$, increasing the previous error. Although the state controls and punishes the sellers more easily, only with the pressure on buyers (simultaneous pressure) it can make the size of the black foreign exchange market smaller. (Rabrenovic, Zivanovic, Simic, 1997:49).

Main points of model application analysis in domicile economy such as substantially overvalued exchange rate, price distortions, increase balance of payment deficit, structural deviations (export disincentives), impact of FX reserves and the emergence of parallel foreign exchange market - explicitly points to the unacceptability of this model.

## THE NEED FOR IMPLEMENTATION OF INTERVENING MODELS AND THE NATIONAL CURRENCY SUBSTITUTION

The **currency board** is an alternative to the Central Bank however it is much easier and cheaper to implement. It is recommended to a country with high inflation and significant currency volatility to implement this model. With the currency board, inflation and interest rates are approximately the same as in the anchor-currency country which is perceived acceptable for foreign investments. It is a monetary authority with the sole function of issuing notes and coins convertible into a foreign anchor currency at a fixed rate.

Setting currency board as a monetary authority is adequate for small and fragile economies. According to Kovacevic (2003) currency board arrangement in Bosnia and Herzegovina is achieving undoubted results. The stability of the local currency and transparency in CBBH operations are contributing significantly both to the development of the banking sector and to development of confidence in banking institutions. More to the point, significant increase was recorded in domestic currency deposits. They rose from 16% of total deposits in 1997 to 45% by March 2003 (BAM 3.7 billion)

Serbia and former Yugoslavia did not implement a currency board when there was an urge for its implementation during periods of hyperinflation followed with constant devaluation and denomination of dinar. Bearing in mind that since 2000. the inflation and exchange rate of RSD have been under control, implementing currency board now would be sufficed and counterproductive. Reasons for this assertion are following: 1) the NBS would not be able to conduct independent monetary policy; 2) the NBS would lack discretionary powers to exert influences on interest rates through discount rates; 3) Lack of possible altering of exchange rate to adjust to external shocks; 4) the NBS would not act as a banking sector lender of last resort; 5) Complete abstinence of receiving cumulative discounted profit and positive effects from issuing national money; 6) Finally, the currency board does not stimulate growth; on contrary, it limits it due to the fact that it does not cover M1 and M2 aggregates, which represent the sources of long-term investments.

**Dollarisation** in a form of euro implementation in the financial national monetary system would undoubtedly lead to the following benefits: lower transaction costs, the country risk premium on foreign borrowing decrease, lower inflation and risk of future inflation, greater economic openness and transparency. However, euroisation is not a real option now due to the European Union stance.

# THE POSSIBILITY OF USING A HYBRID MODEL OF FOREIGN EXCHANGE AND FINANCIAL DERIVATIVES TO STABILIZE THE RSD VOLATILITY

## Managed floating

The type of managed floating currently used in Serbian economy is inadequate, due to the fact that the standard managed floating regime assumes that the exchange rate of domestic currency should not target a certain level but to prevent excessive and uncontrolled daily fluctuations. The authors are concerned that we currently have a fixed RSD exchange rate in the shadow, not the regular regime of managed floating exchange rate of RSD. Central monetary authorities did not publish this formally, but it was more than obvious that they have been defending a certain level of FX rate of a dinar, which was easily predictable. The targeted level of FX rate was approximately 80 RSD/EUR during 2007. It reached 90 RSD/EUR in 2008, finally, 100 RSD/EUR for the last and this year representing the last line of defense of penetration, which would utterly endanger the legitimacy of the managed float exchange rate regime - which is happening at the moment.

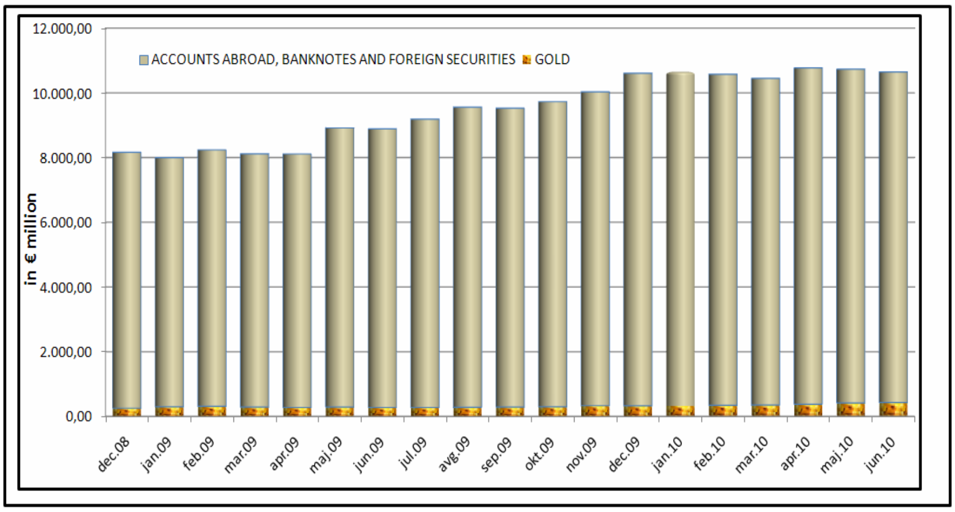
The actual concept of a foreign exchange rate regime RSD is inadequate for several reasons: exchange rate is very sensitive but sustainable only thanks to the interventions of the NBS, and not on the basis of the economic growth and exports; it entirely depends on the level of national foreign exchange reserves at the disposal of NBS which are hardly renewable resources; the rate is sensitive to such an extent that even some interest groups are able to destabilize it on the basis of speculative interventions on our shallow foreign exchange market.

It is undoubtedly clear to market transactors that Serbian CB prefers fixed FX RSD in the shade, and it is defending it persistently by interventions from domestic foreign exchange reserves. It is also clear that this FX is not realistic, as it is balanced in the short run and it is absolutely uncertain how long the CB will be able to defend the targeted level of FX rate of the national currency (fixed FX RSD in the shadow).

The current exchange rate regime of RSD has led to the following consequences regarding the intervention of the NBS, the level of foreign exchange reserves and a volatility of a pair of RSD / EUR.

**The NBS interventions -** In the last quarter of 2009 highly sensitive period has started which is characterized by enormous pressure on the domicile currency. In the last month of 2009 the NBS intervened with significant amounts, on average 50 million EUR per month with an aim of keeping the targeted exchange rate of RSD fixed in the shadow. At some point the NBS had to intervene with up to 100 million EUR on a daily basis to prevent the overshooting of psychological margin of 100 RSD/EUR what would be the final end of proclaimed dinars managed float regime and a definite sign of wrong conduct of monetary policy. Unfortunately this situation happened and we are facing its consequences. Frequent and rising interventions, unfortunately, are rare instruments of achieving the stability of FX rate. If the NBS continues with the current trend of interventions with the aim of maintaining stability of RSD it is certain that we are going to have a sharp drop of foreign reserve, which are hard to renew.

**Figure 2: Annual interventions by NBS, 2008-Q2/2010**

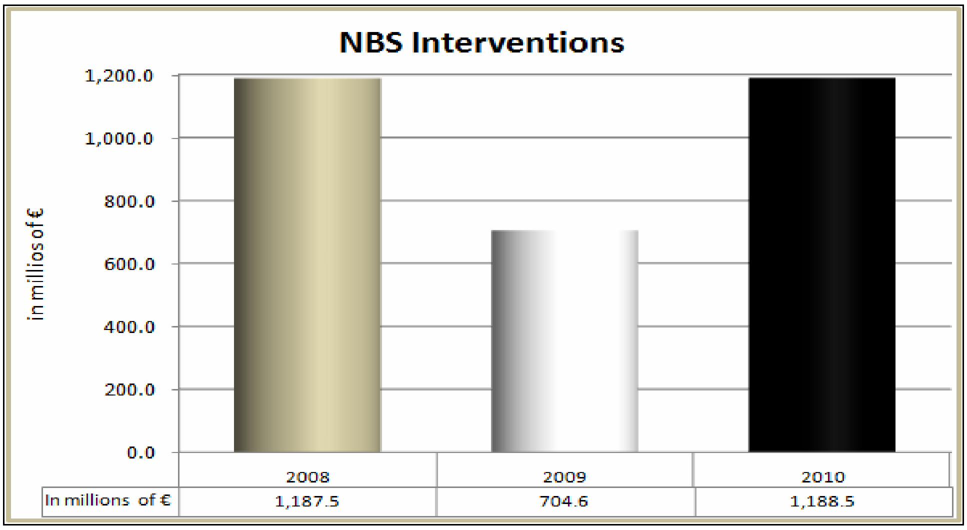



*Source: National bank of Serbia*

Foreign reserves - Despite the enormous interventions that took place during the 2010, there has not been a significant drop in foreign reserves. On contrary, there was an increase of the foreign reserves in April of 180 million EUR due to a withdrawal of stand-by arrangement concluded with the IMF. Unfortunately, the increase was not the result of the economic growth or export. At first, national foreign reserves seem reasonably high and stable, covering money supply (M1) occasionally over 400 percent (Jan 2010. 442%). However, the gist of the problem is the structure of the foreign reserves which are very fragile and are greatly a result of the monetary measures.

The most valuable amount, net foreign assets, equals approximately 6 billion EUR (Jan 2010. - 6,47 billion EUR, Feb - 6,71 billion EUR, March - 6,18 billion EUR – source: the NBS). The remaining amount is the result of withdrawal of a standby arrangement with IMF of 1,2 billion EUR and banking reserves that are currently amounting to 3,1 billion EUR. The fact is that there have been drops in foreign reserves as a result of periodical aggressive NBS interventions. However, their permanent renewal is from foreign borrowing and banking reserves.

**Figure 3. FX Reserves of NBS, 2009-Q2/2010.**




*Source: National bank of Serbia*

Exchange rate consequences - The consequences of conducting the so-called managed floating exchange rate regime on FX RSD level are various. Distinct volatility of the exchange rate has emerged in the last quarter of 2008 and it was obvious then that dinar would penetrate the psychological barrier of 100 RSD/EUR . The continuous depreciation happening until now seems like a modest decline but on contratary, it is a significant drop, bearing in mind the amount of interventions that have been conducted by the NBS.

Average annual depreciation for the seven year period equals 6,90%. If we exclude 2006 when dinar appreciated against the euro for 7,60%, we can conclude that the average annual depreciation equalled 8,97%. Since the EURO introduction the total depreciation equals 67,65% - June 2010. (source the NBS)

In the last six months of 2010, dinar has depreciated against the euro for 7,67%. Impact on dinar started at the beginning of the year and accumulated during May, when the NBS had to intervene on a foreign exchange market in the amount of 359 million EUR which brings the total sum of 1.118,5 million EUR since the beginning of the year. Despite the aggressive interventions on the foreign exchange market not much has been achieved, dinar is still depreciating against euro. (source: the NBS)

### Crawling peg

Moderate fixed exchange rate (crawling PEG) is a hybrid of fixed exchange regime. The main feature of "crawling peg" is the devaluation / revaluation of national currency in exactly defined time intervals. Basic model uses a formula for defining intensity mini-devaluation:

$$\frac{dy_i}{dx_i}, \qquad (i = 1, 2, ..., n); \tag{9}$$

which base is defined by quantitative changes in certain macroeconomic conditions (change in the current inflation rate - basic function). Conversion factor is usually determined by the current inflation, and its differential to the anchor currency (mostly EUR and USD). "Creeper" is a sleeping exchange rate and conversion factor is active only at the end of the defined time interval.

This model achieves the best results in economies that depend to a great extent on imports and foreign direct investment (FDI) by creating a predictable and stable currency environment in which foreign investors in any future time can project the real value of their investments. Stable currency and FDI would alleviate the inflationary sequences and increase the attractiveness of the national currency.

There are several modalities of implementation of „crawling pegr" foreign exchange rate regime:

1. Monetary authority announces the future value of the exchange rate for the period up to one year where the adjustment was performed based on certain intervals, ie. on a weekly, monthly and quarterly basis. Projections are made based on observations of selected macroeconomic indicators and their comparison with the economy of the anchor currency.
2. Adjustment of consumer price index (CPI) of the domicile economy with the economy of the anchor currency.
3. Monetary authority maintains a fixed exchange rate in which they set a margin by which it can go up or down percentage wise against some hard currency (BBC concept - Williamson 1996).

The authors' stand point is that one of the preferred domestic FX regimes would be a crawling peg module with equal time interval depreciation preferably in small amounts. The domestic currency (RSD) exchange rate would be qualitatively pegged to euro. Equal time intervals would include quarterly RSD depreciations. The depreciation value and its interval would be targeted and announced in advance as an expected differential between a current increase of domestic and euro zone inflation. Eventual corrective factor would be the level of domestic foreign exchange reserves, precisely the net asset level of domestic foreign exchange reserves. The advantage of the advanced announcement is in the prevention of RSD speculations. Market transactors would be aware and deeply convinced in the level of the forward exchange rate, the quarter one. Permanent devaluations would in the beginning score bigger value intervals, but with the time and more stable market occasions, the negative anticipation in terms of RSD forward exchange rate would be disappearing. Eliminating a psychological effect related to expected RSD FX would cool down the overheated domestic FX market and stabilize the exchange rate in the longer run.

## SWAP'S ROLE IN HYBRID-DER.VATIVES MIX WITH THE AIM OF STABILIZING FX .SD VOLATILITY

Swap, a classic hedging instrument that is typical for investment and commercial banks, is becoming more popular in central banking. Central banks use it to maintain foreign currency liquidity of the commercial banking system and even more to control the volatility of the exchange rate of national currency.

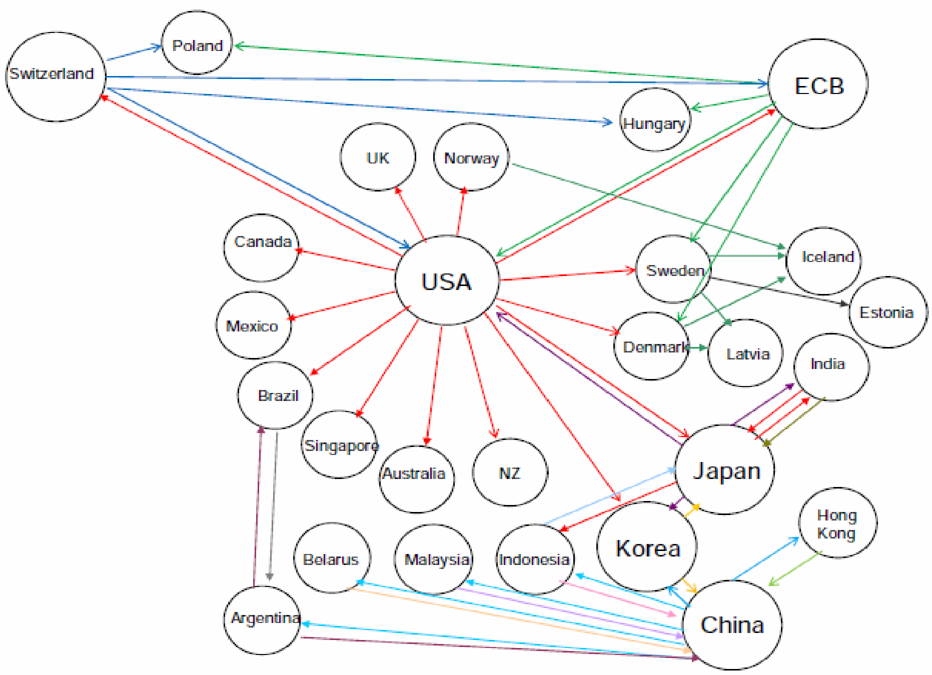
Fed was the first to establish the swap lines in December 2007 with the European Central Bank and Swiss National Bank. By contracts of reciprocal currency arrangements (swap lines) the Fed increased the capacity of other central banks in order to supply dollar assets to commercial banks in which they are in short position. With central banks as intermediaries, the Fed expanded geographic presence and dollar liquidity as a key trading and reserve currency.

Over the central banks, the Fed is supplying the system of commercial banks worldwide, providing a constant high presence of U.S. dollar in world markets, reducing the amount of credit risk, earning on an additional issuing of the national currency and creating conditions for the "dirty" floating.

The following networks were established: FED network, Euro network, network of the Swiss franc, Asian and Latin American network.

The number and size of the swap lines has been constantly increasing. However, after the fall of Lehman Brothers a multilateral agreement was achieved between the Fed and several central banks (ECB, Switzerland, Japan and the United Kingdom) on the abolition of upper limits of established swap lines. This deal creates new opportunities for expansion of these currency derivatives (Moessner, Allen 2010:29).

**Figure 4. Fed networks**




*Source: Moessner, Allen (2010:27)*

With reference to this model the NBS "shyly" has introduced a similar swap mechanism on the domicile inter banking market in order to stabilize domestic markets and reduce foreign exchange volatility of RSD. By direct trading, the NBS sells EUR to USD on the one side, and buys EUR for the USD on the other side. The package includes simultaneous spot and forward transactions. At the same time, the NBS announces a spot sale / purchase of foreign currency rate EUR / RSD and forward purchase / sales for the same stock exchange. Swap arrangements are organizated as auctions, directly as a bilateral arrangement. The NBS realized through auctions all previous arrangements with commercial banks. The review of total auctions by the NBS is given in Table 1.

**Table 1. Swap Auctions**

| Date of auction | Spot rate | NBS purchase-EUR | Swap points | NBS sold EUR | Swap points |
|---|---|---|---|---|---|
| 06.04.2010 | 99.5206 | 10.000.000,00 | 18.907 | 9.200.000,00 | 17.676 |
| 13.04.2010 | 99.6091 | 10.000.000,00 | 17.634 | 10.000.000,00 | 17.618 |
| 20.04.2010 | 99.4712 | 10.000.000,00 | 18.062 | 10.000.000,00 | 17.024 |
| 27.04.2010 | 99.2121 | 10.000.000,00 | 17.696 | 10.000.000,00 | 16.932 |
| 04.05.2010 | 99.1480 | 2.500.000,00 | 17.760 | 10.000.000,00 | 15.196 |
| 11.05.2010 | 99.9222 | 10.000.000,00 | 15.316 | 10.000.000,00 | 13.550 |
| 18.05.2010 | 100.9846 | 30.000.000,00 | 13.775 | 30.000.000,00 | 14.766 |
| 25.05.2010 | 102.5068 | 10.000.000,00 | 14.112 | 10.000.000,00 | 14.680 |
| 01.06.2010 | 102.5979 | 10.000.000,00 | 15.511 | 10.000.000,00 | 17.366 |
| 08.06.2010 | 103.3427 | 10.000.000,00 | 15.892 | 0,00 | |

*Source: National bank of Serbia*

The recent swap trading volume is more than a modest and its impact on the pair volatility of RSD/ EUR is insignificant. In order to eliminate the impacts on the RSD and stabilization of the national currency the NBS needs to come up with a concrete simultaneous swap line in combination with the forward. Currency derivative mix model would provide the following:

1. Increase currency liquidity of the commercial banking sector;
2. Neutralize the psychological factor of the national depletion of foreign exchange reserves;
3. Neutralize the psychological factor of uncontrolled erosion of purchasing power of the national currency;
4. Start the process of gaining confidence in a national currency as a stable and predictable over the medium term;
5. Have a full control of the currency risk and negative effects on the economic environment in the period of three, six and nine months.

## CONCLUDING REMARKS

Implementation of the conservative foreign exchange regime would be a retrograde solution with a high cost of adjustment. Extreme solution of introducing classical fixed foreign exchange rate regime regardless of the starting level of devaluation would lead to: 1) rapid exorbitance (overvaluation) of RSD; 2) prevent administratively the outflow of foreign currency reserves of NBS; 3) cause a collapse of the inter banking market and the appearance of parallel informal foreign exchange markets. Other counterparts of classical bipolar division of foreign exchange are a pure flexible exchange rate RSD, which is not recommended too. Bearing in mind that Serbian economy is weak and still untransformed and with this performance and the level of foreign reserves not ready for equal participation in the international market this would lead to unnecessary exposure to external shocks.

The formal and full dollarization of the national economy in the form of substitution of RSD in EUR is an optimal long-term solution but in the near future these assumptions cannot be fulfilled. The currency board would lead to unnecessary administration and control, and additionally hinder on already modest investment activity.

The proposed variant of a moderate fixed exchange rate would be a good choice. "Crawling peg" would to a great extent stabilize oscillations of RSD and remove "yo-yo" effect. Its main drawback would be the absence of market driven conditions. Pre-announced and firmly nailed pair of RSD / EUR for a period of three and six months would open space for speculative outflow of foreign exchange reserves and their reallocation to alternative markets in the region by carry trade effects.

Opening more room at the inter banking market for currency derivatives in the direction of the NBS would have almost identical effects as well as the introduction of "crawling" RSD exchange rate, but in more market driven aspect with possible periodic revisions. This model would involve the establishment of swap lines, at unconditional disposal to commercial banks in the amount of one billion EUR for a continuous period of three months. Simultaneously the NBS would offer forward a package line also in the amount of one billion EUR for a continuous period of three months. The swap line would have a neutral effect on the level of current foreign exchange reserves of the NBS. The forward package would reduce their risk, but not below the level that provides the technical part of the agreement with the IMF. On the other hand, the forward would used the market approach send a clear signal to commercial banks and stabilize the volatility of RSD, removing short-term psychological effects and unnecessary panic for excessive foreign exchange demand. What the proposed hybrids would not be able to provide is the optimum economic structure that would create high-quality resources to fill the long-term foreign currency reserves, which is not the hybrids role but would in turn create conditions for it.

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# CHAPTER 26. THE IMPACT OF THE BUDGET'S EXPENDITURE STRUCTURE ON LONG-TERM ECONOMIC GROWTH – THEORY AND EMPIRICAL EVIDENCE IN VIEW OF THE HUNGARIAN DATA

**Adrienn ERÖS**, Institute of Economic Theory, University of Miskolc, Hungary[1]

***Abstract***

*The paper deals with the long run growth effects of fiscal policy, focusing on the budget's expenditure side. First the measurement of economic growth is discussed, followed by a summary of the literature of economic growth. The two main streams of growth models (neoclassical and endogenous growth theory) will be introduced, followed by a deeper discussion of theoretical models and empirical testing of government expenditures' long run growth impact. After the review of the relevant literature the methodology of the empirical research and the results of the analysis will be introduced. We test the statements of the literature on a dataset of Hungary in the 15 year long time period after the changing of the Regime.*

## INTRODUCTION

The primary aim of economic policy is to achieve as great and as general welfare as possible. The only way to achieve the long-term growth of welfare is to ensure the intense but sustainable development of the economy. This is why it is a key issue to study economic growth. Most of the growth theory studies are prepared in this spirit, which leaves all aspects besides growth out of the scope of attention, while the aim of economic policy is to increase welfare. However, we think that this contradiction is only seeming, and it depends on the selection of the time horizon, as the level of consumption cannot be permanently detached from the level of output. It is probably starting out from this idea that the majority of researchers opt on the maximization of the growth rate of output rather than consumption (welfare). In this paper we are going to analyse in greater depth the ways and methods fiscal policy, and more precisely the expenditure structure of the budget can influence the long run growth rate of the economy.

[1] The paper was accomplished with the help of 76870/2009 OTKA research project

## THE ROLE OF THE STATE IN FORMING LONG RUN ECONOMIC GROWTH

One of the most debated questions of economics is whether the pace of long run economic growth can be influenced by economic policies. The (long run) steady state growth rate of the economy is determined by two exogenous factors according to **neoclassical theory**, the growth rate of the economically active population and the pace of technological progress. As these factors are independent of the decisions of economic actors, fiscal policy can not influence the long run growth rate of the economy. Governments are able to influence distinct economic factors, though, only to a limited extent and only temporarily. Government policies can only affect the level of the output, but not the steady state growth rate. It is important to mention that "these temporal beneficial effects can be felt as long as even twenty years in some cases".[2]

„**Endogenous growth** is long-run growth at a rate determined by forces that are internal to the economic system, particularly those forces governing the opportunities and incentives to create technological change."[3] This theory is of utmost importance for giving space to fiscal policy in influencing economic growth. „According to the endogenous theory of growth the rate of long run economic growth depends on such governmental activities like taxation, the protection of law and order, supplying infrastructure, defence of immaterial goods, and the regulation of international trade, capital markets and other segments of the economy. That's why governments can have a wide range of possibilities to influence long run economic growth both in positive and negative directions."[4]

## ANALYSING ECONOMIC GROWTH

The effect of the various expenditure types on growth perspectives is different. Some theories, for example Barro's model, published in 1988 differentiated between productive and consumption expenditures. Productive expenditure are inputs for the companies of the private sector, so these work as incentives to increase output, while consumption (unproductive) expenditure enhance the welfare of the population but do not influence the long run growth rate of the economy, or even decrease it by the necessity to raise taxes in order to finance them, and the high share of taxes in GDP decrease efficiency and are obstacles to economic growth.

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[2] Gemmel, 2001. 2. pp.
[3] Howitt, 2006. 1. pp.
[4] Barro, 2005. 17. pp.

Productive expenditures contain several different types of expenditures. One of the most important of these is the development of physical infrastructure, as this serves as an input for the private sector, decreasing the costs of production and works as an incentive for private investments. However in many cases public investments are not decided on based on economic but on political reasons, so they are not always at the optimal level. Too much public investment is not beneficial for economic growth either as the marginal utility of public capital decreases, and funds spent this way might have had a better use in other fields (or left in private hands).

Education is also a significant sum in all modern states' budgets. It is an important element in of the accumulation of human capital, just like health care, developed states also spend huge amounts of funds on, even though the causal relationship in case of the latter is not clear. It can also happen that those who have higher standards of living can afford to spend more on health care. Of course it can also happen (and this would be interesting to know from the perspective of the analysis of economic growth) that better health status is a factor of the accumulation of human capital. The expenses on the supporting research and development is also considered as productive expenditure.

The next question to examine is whether empirical analyses confirm the expectations based on the literature.

The empirical analysis pursued by Easterly and Rebelo (1993) confirm the positive growth effects of public investment. They found a strong, positive relationship between economic growth and public services, logistics and telecommunication investments.

Barro[5] in his study published in 1989 found a strong negative relationship between the level of public consumption (public consumption without education and defense expenditures) and the long run growth rate of the economy based on the empirical analysis of 98 countries' economic performance in the time period between 1960 and 1985. He chose to omit expenditure on defense and education from public consumption because he considered these rather as similar to public investment, as they affect the productivity of the private sector and the security of property rights, so influencing private investments. As he found positive but insignificant relationship between public investment and economic growth, he concluded that smaller state sector indicates higher growth rate. In another study of his, Barro distributed public expenditure to five sub-categories. The growth effect of governmental consumption proved to have a significant negative growth effect, while public investment proved to have significant positive influence. He was not able to track significant relationship between the growth rate and either

[5] Barro (1989)

education- or defense expenses (these finding contradicted his expectations, as education and health care contribute to the accumulation of human capital so he expected these items to have a positive growth effect). Transfers (social security and welfare expenses) were distributed to the fifth sub-category and regression analysis showed their positive growth effects, while at the same these items had negative effects in investments. This hints at a diverse causal relationship in Barro's opinion, meaning that a higher growth rate of the economy indicates higher social expenses and the reasoning is not the other way around (which be of interest for us).

It is a relevant question to determine the reasons behind the contradiction in the behavior of transfers. Transfer programs pursue their impact on the long run growth rate of the economy through various channels. These mechanisms can influence the economic performance of the country in both negative and positive ways. To mention some of the positive impacts, transfers can work as incentives for entrepreneurship as people can be braver in starting risky activities knowing that the social net is going to save them. They can start a new business, take on jobs in more risky industries, move to other regions or learn a rare type of profession. At the same time transfers also have a negative impact on the long run growth rate of the economy, as they can drive the economic actors to take unreasonable risk, and by decreasing the risk of the individuals they can lead to the decrease in safety savings. All these processes lead to the state spending more and more on unproductive objectives. Transfers given to non-competitive branches of industry can also cost much and by maintaining the inefficient activities lead to a drop in productivity and economic growth.

The study of Devarajan, Swaroop and Zou (1996)[6] is also worth mentioning. In the first part of their paper the authors extend Barro's model, based on a balanced budget, in a way which enables the inclusion of different types of productive and unproductive expenditures. They optimize the share of these (within a given sum of the budget) compared to each other, based on their relative productivity. They came to the conclusion that the allocation of too much funds to productive fields also leads to a fall-back in the growth rate of the economy. The reasons behind is that the average productivity of productive expenditure are high in the equilibrium but in order to maximize steady state growth rate the marginal products should be equalized.

The authors show in the second, empirical part if their study that the above introduced, generally accepted fiscal effects (the positive growth effects of capital investments and negative impact of flow type of expenditures) ar right only in case of developed countries. For developing countries exactly the opposite effects work. When considering the functional distribution of expenditures we receive the

[6] Devarajan, Swaroop and Zou (1996)

same, surprising results. Increasing the share of productive expenditure (infrastructure, health care and education) has negative or non-significant impact on the growth rate of the economy. According to the results of study the advice usually given to developing countries to increase the share of investment in the budget is not founded empirically.

Summarizing the findings of the literature both theoretical models and empirical studies showed positive (but not always significant) relationship between the rate of economic growth and productive expenditures, while in case of unproductive expenditures opinions differ both in terms of the direction and the strength of the relationship. According to the opinion of this paper's author Barro's statement (1989) is right, according to which the not the higher share of transfer payments enhance the rate of economic growth but the causal relationship is the other way around. The more favorable economic performance makes it possible for richer states to satisfy the demand of their inhabitants for welfare services.

Thus, to sum up, we can state that the majority of both the theoretical models and the empirical studies have discovered a positive correlation between the rate of long-term growth and productive expenditure (although the results are not significant according to each and every empirical study), while they generally attribute a neutral effect to unproductive expenditures.

## METHODOLOGY OF EMPIRICAL STUDIES

The time horizon of the study comprises of fifteen years. The shift in the political system (i.e. the fall of the Berlin Wall in 1989) brought about such a fundamental turn in the life of the country which renders it senseless to look back at the decades preceding 1990. This fifteen-year period gives us a narrow time horizon for the examination of long-term growth but a number of empirical studies have relied on the analysis of a similar, fifteen-twenty-year period, so we regard this as acceptable.

In the empirical tests, it is important to separate the long- and short-term effects of the individual measures. The most widely applied method is to break down the time-series of data to five- or three-year periods and the correlations between the five-year average values are analyzed. In order to make as many observations as possible, we will apply moving averages, as we have seen in other studies in the technical literature.[7]

We need statistical data for performing the calculations. However, when we evaluate our conclusions drawn from these, we always have to be aware that the

[7] Devarajan et al, 1996, p. 322

Hungarian budgetary data are not to be regarded as absolutely reliable in the first half of the period under review. Although ad hoc manipulation ceased to be applied after the shift in the political system, certain systematic distortions still occurred until 1998.[8]

The sources of the data that we have used are as follows: we apply two variables for the measurement of the evolution of real income.[9]We use consolidated data from the general government level as fiscal variables in our analysis. Revenue data are taken from the OECD database. Functional classification of the government expenditure can either not be found in international databases (SourceOECD), or contains data only for 2003 and 2004 (Eurostat). These data can only be found in PM ÁPMSO - ÁHIR database, still, the aggregate expenditure of this time-series is different from that of international databases, as (it was compiled on cash-flow basis). To make thing even more difficult, the difference between the distinct years' data is not systematic, in some periods it can reach even 4-5 percentage points (as a share of GDP), while in others only merely more than half a percentage point. We chose to use inner scaling to solve this problem, and secure the comparability of expenditure and revenue data.

Before conducting any further statistical analyses, we have to examine whether their results are acceptable with adequate certainty. For this, we have to test the level of integration of the time series (by applying the extended Dickey–Fuller test of the statistical software EViews). Such types of testing basically give reliable answers to the question in the case of time series of the adequate length (samples consisting of a high number of elements). In the case of the extended Dickey–Fuller-test, the critical values were defined for 20 observations, however, due to the objective reasons listed above, we only had short periods available for the study (in the case of most variables, we could only build on 8–12 observations - because of the method of using moving averages). It is exactly because of this that we had reservations before performing the test. In spite of this, in a significant proportion we came to the conclusion that our time series calculated with the moving averaging method are stationary, based on which the further tests can be performed. Where the result was contrary to this (i.e. we accepted the Ho Hypothesis, according to which the time series are integrated), our result was not so far from acceptable (the critical value) either, it was only higher than that (it was relevant on the 15–20–25 percent significance level). On the basis of the tests, we ultimately came to the conclusion that they do not suggest that we should not conduct the planned analyses with our datasets, and should not draw conclusions from these, although it will be justified to handle the results with a certain level of reservation due to the brevity of the time series.

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[8] Stiglitz,(2000), p. 63

[9] OECD Factbook 2006, Economic, Environmental and Social Statistics, ISBN 92-64-03561-3, © OECD 2006

## EMPIRICAL TESTING ON HUNGARIAN DATASETS

The methods to be applied in this test are rather simple, however, if we use the introductory thoughts of the 2003 Tanzi and Schuknecht study, "rather than adding a new, econometric chapter (which is questionable, similarly to the earlier ones) to the technical literature of this subject, we will conduct a simpler but hopefully still informative analysis".[10] This choice is also justified by the fact that this way our findings will be comparable with the international technical literature. However, in judging such a complex issue as the effect of fiscal policy on the rate of long-term economic growth, "a system with such a low dimension can only be regarded as the »marginalization« of a model with several variables, from which only limited conclusions can be drawn."[11]

Based on the Hungarian data we find a significant negative relationship between the long run economic growth rate and the share of **productive expenditures** in GDP (see table 1, row 8). This result does not match with the mainstream of the literature. The reason behind this contradiction can be the parallel change in the structure of the budget and the share of public expenditures in GDP. The latter decreased by 8 percentage points during the analysed period while the share of productive expenditures in GDP dropped only by 2 percenatge points, so their weight within the aggregate expenditures increased by approximately 2 percentage points. The decrease in the share of productive expenditures in GDP was only parallel in time with the increase of the growth rate of the economy, but we can suppose there is no causal relationship between the two phenomena.

Going into greater detail of the types of expenditures that are considered to be productive in the literature we can also make interesting conclusions. In terms of *general public services* we were not able to identify significant relationship with economic growth, even though the relationship is shown to be a positive one by the results (see table 1 row 1). *Expenses on defense, housing, health care and education* are in a significant negative relationship with the growth rate of the economy (see table 1 row 2). Expenses on *public safety* are in a slight negative relationship with the growth rate (see table 1 row 3).

There is only one type of productive expenditures which behaves in the way we expect them based on the models and previous empirical studies, *environmental expenses* (see table 1 row 4), which are in a significant positive relationship with the long run average growth rate of the economy.

[10] Tanzi – Schuknecht (2003), p. 16
[11] Mellár (2001), p. 578

**Table 1. Two-variable correlations between the variables of the budget and the measures of economic growth**

| 3 and 5 year moving average of the avriables | | | 5 year moving average | | 3 year moving average | |
|---|---|---|---|---|---|---|
| | | | Average growth rate of real GDP | Economic growth*** | Average growth rate of real GDP | Economic growth*** |
| **1** | Exp.on **general public services** as a share of GDP | Pearson corr. | ,479 | ,433 | ,124 | ,185 |
| | | Sig. (2 tailed) | ,115 | ,183 | ,673 | ,545 |
| | | N | 12 | 11 | 14 | 13 |
| **2** | Exp.on **defense** as a share of GDP | Pearson corr. | -,933(**) | -,914(**) | -,892(**) | -,787(**) |
| | | Sig. (2 tailed) | ,000 | ,000 | ,000 | ,001 |
| | | N | 12 | 11 | 14 | 13 |
| **3** | Exp.on **public safety** as a share of GDP | Pearson corr. | -,511 | -,640(*) | -,654(*) | -,612(*) |
| | | Sig. (2 tailed) | ,090 | ,034 | ,011 | ,026 |
| | | N | 12 | 11 | 14 | 13 |
| **4** | Exp.on **environment** as a share of GDP | Pearson corr. | ,803(**) | ,855(**) | ,654(*) | ,682(*) |
| | | Sig. (2 tailed) | ,002 | ,001 | ,011 | ,010 |
| | | N | 12 | 11 | 14 | 13 |
| **5** | Exp.on **housing** as a share of GDP | Pearson corr. | -,927(**) | -,962(**) | -,911(**) | -,951(**) |
| | | Sig. (2 tailed) | ,000 | ,000 | ,000 | ,000 |
| | | N | 12 | 11 | 14 | 13 |
| **6** | Exp.on **health care** as a share of GDP | Pearson corr. | -,971(**) | -,981(**) | -,877(**) | -,795(**) |
| | | Sig. (2 tailed) | ,000 | ,000 | ,000 | ,001 |
| | | N | 12 | 11 | 14 | 13 |
| **7** | Exp.on **education** as a share of GDP | Pearson corr. | -,843(**) | -,923(**) | -,790(**) | -,769(**) |
| | | Sig. (2 tailed) | ,001 | ,000 | ,001 | ,002 |
| | | N | 12 | 11 | 14 | 13 |
| **8** | **Producive** exp. as a share of GDP | Pearson corr. | -,842(**) | -,888(**) | -,854(**) | -,786(**) |
| | | Sig. (2 tailed) | ,001 | ,000 | ,000 | ,001 |
| | | N | 12 | 11 | 14 | 13 |
| **9** | Exp.on **economic services** as a share of GDP | Pearson corr. | -,410 | -,552 | -,413 | -,406 |
| | | Sig. (2 tailed) | ,185 | ,078 | ,143 | ,169 |
| | | N | 12 | 11 | 14 | 13 |
| 10 | Exp.on **free time services** as a share of GDP | Pearson corr. | -,963(**) | -,965(**) | -,894(**) | -,851(**) |
| | | Sig. (2 tailed) | ,000 | ,000 | ,000 | ,000 |
| | | N | 12 | 11 | 14 | 13 |

| | | | | | | |
|---|---|---|---|---|---|---|
| 11 | Exp.on **social safety and welfare** as a share of GDP | Pearson corr. | -,976(**) | -,989(**) | -,918(**) | -,881(**) |
| | | Sig. (2 tailed) | ,000 | ,000 | ,000 | ,000 |
| | | N | 12 | 11 | 14 | 13 |
| 12 | **Unproductive expenditure** as a share of GDP | Pearson corr. | -,946(**) | -,976(**) | -,891(**) | -,856(**) |
| | | Sig. (2 tailed) | ,000 | ,000 | ,000 | ,000 |
| | | N | 12 | 11 | 14 | 13 |
| 13 | **Other expenditures** as a share of GDP | Pearson corr. | -,360 | -,266 | -,102 | -,057 |
| | | Sig. (2 tailed) | ,251 | ,429 | ,729 | ,854 |
| | | N | 12 | 11 | 14 | 13 |

*Notes:* *** The growth rate per capita real GDP on PPP, **Correlation is significant at the significance level **0.01** (2 tailed test), *Correlation is significant at the significance level **0.05** (2 tailed test)

*Source:* own calculations

According to the models and empirical studies **unproductive expenditures** should be have no long run growth effects. This forecast is not supported by the Hungarian dataset either, as these refer to a significant negative relationship between the growth rate of the economy ad the share of unproductive expenditure in GDP (see table 1 row 12). Distributing the category of unproductive expenditures to sub-types, we find similar relationships.

Expenses on economic services are in an insignificant, but negative relationship with the growth rate, which is in line with our expectations based on the literature (see table 1 row 9). The share of expenses on *free time and cultural services* in GDP is in a strong, significant negative relationship with the growth rate. Expenses on social security and welfare are also in a significant negative relationship with the growth rate.

The category of **other revenue**[12] contains several elements. The proportion of none of these to the GDP is in a significant relationship with the growth rate, as the Hungarian data suggest (see table 1, row 13).

## CONCLUSIONS

In the study, we discussed the fundamental and disputed issue of whether there is any correlation between fiscal policy and long-term economic growth, and if so, how strong this relationship is. There are frequently voiced arguments for the "omnipotence" of economic policy, and that the state can do anything that it

[12] They are not integrated in the case of the time series of other revenue.

wants. In the age of *Keynes,* it seemed to be logical that crises can only be overcome by state involvement, while classical economists say that in crisis-free periods, state involvement will disort market balance.[13] A number of experts emphasize that the state should interfere with the operation of the economy to the slightest possible extent, in most cases adding that the primary goal (once the situation is as it is, and in today's world, mixed economies, where the state and the market exist side by side, are natural) is to maintain the equilibrium of the budget and to reduce the volume of the state debt.

According to the neoclassical growth theory, the rate of long-term economic growth is explicable by two exogenous variables, namely technological development and the growth rate of the economically active population. Thus, budgetary policy may only have a temporary impact on the rate of growth, although it definitively influences the achieved standard of welfare. As opposed to this, endogenous growth theory states that fiscal policy can also influence the long-term rate of economic growth. We assume that there is a correlation between the rate of long-term economic growth and the individual elements of tax policy, and in Hungary, but the type of these correlations is not always in harmony with the generally accepted tendencies described in the theoretical models and the empirical studies referring to the developed states.

Based on the correlation and regression studies, we can conclude, by way of a summary, that the calculated results have proven our expectations developed in the course of studying the theoretical and empirical technical literature with regard to certain variables, while they have not with regard to others.

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# CHAPTER 27. FOREIGN DIRECT INVESTMENTS IN SERBIA & COUNTRIES OF CENTRAL AND EASTERN EUROPE (Trends, Experiences, Expectations)*

**Slavenko GRGUREVIĆ**, Institute of Economic Sciences, Serbia

***Abstract***

*The foreign direct investments grew five times in the period between 2003-2008, that is, from 30 billion U.S. dollars to 155 millions in Central and Eastern Europe. Russia is a country that attracts the most foreign investments. The investments grew from 8 billion US dollars, as they amounted in 2003, to over 70 billion dollars in 2008. The world economic crisis and recession have influenced the decline of foreign direct investments in Central and Eastern Europe. The FDI inflows in 2009 was reduced by 50% compared to 2008 throughout the region. The conclusion is that the share of FDI in GDP is higher in the countries of Central and Eastern Europe that have higher income per capita, lower labour costs in manufacturing, lower investors' risk, measured by credit risk for investments and are closer to potential EU membership.*

## INTRODUCTION

Through foreign direct investment (FDI) in foreign countries, the companies deploy their production or other business functions in order to ensure the most favorable conditions for the supply of raw materials, energy and labour, that is, to provide the most profitable marketing of their products. FDI are primarily related to multinational companies which invest abroad in the form of direct investment and express permanent interest and presence in the markets of other countries. The spread of parent companies to the markets of other countries, involves a complete investment package that includes not only capital but technology, marketing, management skills, access to markets and other benefits.

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The important feature of FDI is that they allow the transfer and exchange of, so called, the intangible assets of knowledge, which, in a different way could not be transferred because of lack of market, that can provide the knowledge holder an adequate compensation for the advantage that possesses. In this way, FDI becomes the most reliable and most powerful channel for technology transfer component that forms the basis of modern manufacturing growth and development.

The specificity of FDI is reflected in the fact that they involve a venture capital or risk usually associated with the transfer of technology, management, managerial skills from one country to another. This type of capital is not very flexible and adequate investments should be viewed as unreasonable and irreversible. The FDI also represent the production relocation in the international scale because they are largely defined by branch.

The impact of FDI on foreign trade of specific home country and on international trade is multiple. The countries receiving FDI see in them the positive effects that are reflected in the activation of unused resources, increasing of employment of existing capacity, growth in labour employment, rising of the technological level and competitiveness of local companies. The negative effects can be ignored although the uncontrolled inflow of FDI may undermine or destroy certain sectors of the domestic economy, or lead to market monopolization. Through FDI, instead of traditional export, the production from the home country is transferred abroad and thus substitutes a part of export.

The commodity export coefficients of home countries decline, whereas the production and marketing of their branches abroad rise. This does not mean that these countries have reduced their participation in international trade. They have only changed the form of appearances on the international market. In addition to the positive effects, production transfer abroad may lead to a reduction in jobs and employment in the home country. Regardless to this fact, developing countries in transition can not be imagined without FDI. Their size and structure depend on the selective economic policies toward FDI in transition countries.

## FDI TRENDS [1]

The region of Central and Eastern Europe experienced the collapse of the inflow of FDI in 2009. This happened after a fivefold increase in the period 2003-2008.

The global economic crisis and recession caused the FDI collapse. The consequences of the recession are not the same in all countries of the region.

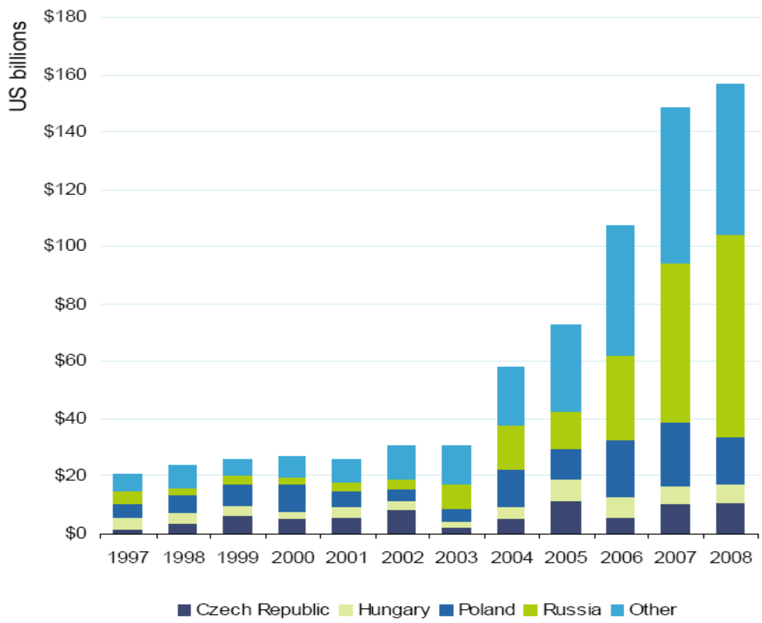
[1] Data is result of PwC's Research

Estonia, Latvia and Lithuania had double figures in the economic production in 2009: in Bulgaria and the Czech Republic the decline in production less than 5% is expected. In Poland, the economic growth in 2009 is forecasted.

The differences between countries in 2009 are more than expressed in terms of FDI inflows. From year to year, growth of FDI is different from country to country. In 2009 Slovakia recorded growth of 55% and Latvia of 71%.

The influx of FDI in Central and Eastern Europe have significantly increased in the last 10 years. The growth has been modest at first glance; FDI grew from $ 20 billion as they amounted to 1997 to $ 30 billion in 2003. Since then, inflows grew more than five times in five years, and in 2008 they reached a level of $ 155 billion (see chart 1). The income growth coincides with the accession of the Baltic and Central European countries of the EU in 2004.

**Chart 1. FDI inflows to the countries of Central and Eastern Europe (nominal)**




*Source:Price waterhouse Coopers (PwC's))*

Russia is the region with the largest FDI inflow in 2008. FDI inflows increased from less than $ 5 billion as of 1997 to more than 70 billion USD in 2008.

Another interesting trend during this period was the growth of small countries in Central and Eastern Europe as an attractive destination for FDI. These countries, including Bulgaria, Croatia, Latvia and Slovenia, did not attract much FDI before 2003, but since 2004 the inflow of FDI recorded enormous growth.

Czech Republic, Poland and Hungary were the main destinations for FDI in mid-nineties. In these countries FDI growth was also noticeable but in much smaller amounts than in other countries in the region.

The existing world economic crisis and the recession directly coincide with the FDI decline in Central and Eastern Europe. In 2009 FDI inflows in Central and Eastern Europe were 50% lower than in 2008. In all countries, except Slovakia, FDI inflows decreased in 2009, and some countries were more affected than others.

From 1997 to 2008 Russia was the country with the highest FDI inflows in relation to the countries of Central and Eastern Europe with 29% of total FDI inflows, related to this region. Russia faced with 48% fall of FDI inflows in 2009. This was caused by the collapse of investments in the real estate sector and heavy industry. In 2008, these sectors participated in half of the FDI inflow in Russia.

In 2008 there were a number of major investments in Russia, including 4.5 billion in Quality Energy Petro Holding International. At the same time, in 2008 more than $ 1 billion were invested in real estate. In 2009, FDI inflows in these two key sectors were omitted.

After Russia, Poland is the country with the largest FDI in Central and Eastern Europe. In 2009, FDI inflows in Poland decreased more than the regional average. As in Russia, coal, oil, natural gas and real estate were the key sectors of FDI in Poland. In combination with the financial services sector, these sectors attracted more than half of all FDI in Poland. Financial services sector was at the center of a global decline in 2009. In 2009, FDI in Poland were reduced by 67% in the real estate sector, 74% in the heavy industry sector and 86% in the financial services sector.

Czech Republic, which, in the past, participated with 10% of all FDI in the region, in 2009 recorded a decline in FDI, which was less than the region average. In 2008, most of the FDI were coming from the automotive industry. Investments by Daimler, Volkswagen, Peugeot and Citroen amounted almost $ 1 billion. The real estate sector and alternative energy were other key sectors of FDI in 2008. In 2009, total FDI in the Czech Republic decreased by 19%. In 2009 FDI in real estate and alternative energy decreased by about 30% and 65% in the automotive industry.

Slovakia is unique in relation to the analyzed countries because the FDI in Slovakia increased by 55% in 2009. This growth was driven by the published investment in the amount of USD 2.3 billion in real estate sector by Tri Graint. This solo investment was a part of more than 40% of total Slovak FDI in 2009.

Latvia and Slovenia (with a small share in the region) experienced the greatest decline in FDI inflows in 2009 of 7!% And 70%.

The analysis of individual countries led to the conclusion how important was the real estate sector and heavy industry in attracting FDI in the region of Central and Eastern Europe. This conclusion was based on data collected from countries in Central and Eastern Europe, where these two sectors participated with more than a third of total FDI inflows in the period 2003-2009 (see Table 1).

In 2009, the total FDI in the real estate sector decreased by 71% in the countries of Central and Eastern Europe. This probably affected the suppliers of these sectors. FDI inflows in the building materials and wood production decreased by 60% and 68%. Car sales fall across the world was also reflected in the decline of FDI: investments in the automotive equipment decreased by 67% in 2009 and in automotive spare parts 81%.

**Table 1. FDI Trends in Twenty Big Sectors**

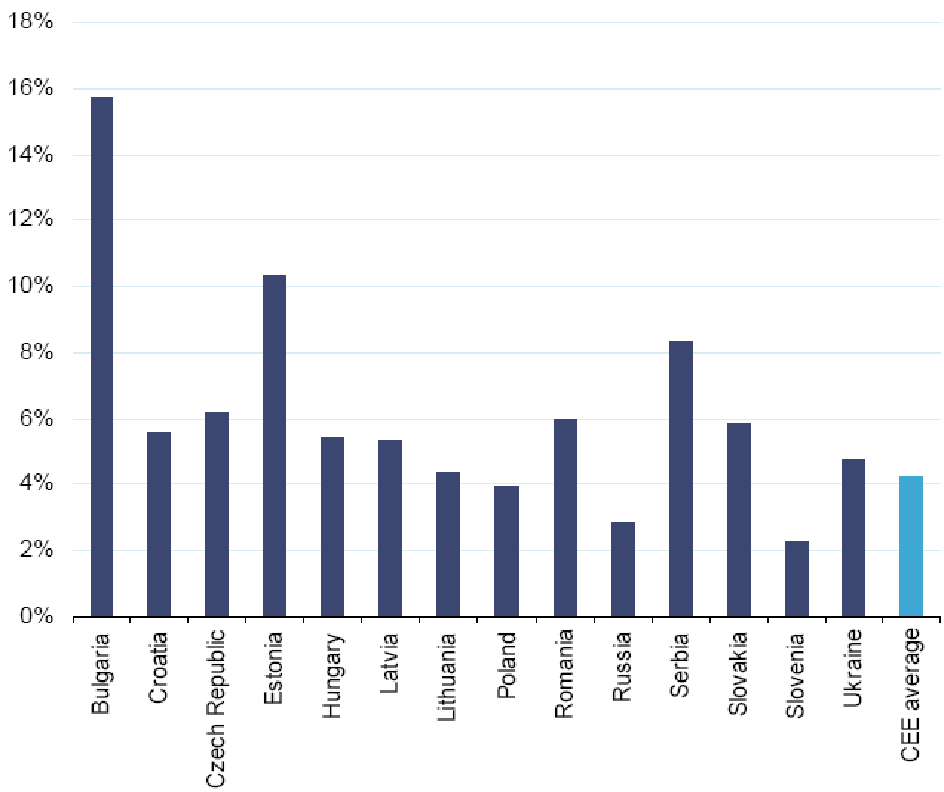
| **Sector** | **Annual changes in FDI inflows in 2009** | **The regional share of FDI inflows, 2003-2009** |
|---|---:|---:|
| Real Estate | -71% | 25% |
| Coal, Oil and Natural Gas | -52% | 13% |
| Transport | -34% | 6% |
| Renewable Energy | -31% | 6% |
| Automation Equipment | -67% | 5% |
| Metals | -70% | 5% |
| Food and Tobacco | -16% | 5% |
| Building Materials | -60% | 5% |
| Wood Production | -68% | 4% |
| Components for Automation | -81% | 3% |
| Paper, Printing and Packaging | -49% | 3% |
| Electronics | 43% | 2% |
| Food Production | -52% | 2% |
| Electronic Devices for Public Consumption | -82% | 2% |
| Tourism | -17% | 2% |
| Communications | 14% | 1% |
| Machinery | -34% | 1% |
| Warehouses | -42% | 1% |
| Chemistry | -171% | 1% |
| Tire Industry | -79% | 1% |

*Source:Price waterhouse Coopers*

Not all sectors showed decline in FDI inflows in 2009. The value of FDI in alternative energy rose last year beside the inflows in the sector of electronic components. In 2009, the chemical sector, although it had a relatively little involvement in the FDI inflow in Central and Eastern Europe, recorded an increase in the FDI of 171%. The biggest impact was Mitsubishi investment in Russia for $ 1 billion.

FDI inflows in Central and Eastern Europe was about 4% of GDP in the period 1997-2008. Bulgaria, Estonia and Serbia showed higher levels, Russia and Slovenia were below average (see Figure 2).

**Figure 2. Average Share of FDI in GDP for the Period (1997-2008)**




*Source:Price waterhouse Coopers*

FDI share in GDP in Central and Eastern Europe is higher in countries with:

- Higher income per capita;
- Lower costs of production (including the effect of exchange rate on the production cost in euros)

- Lower risk investment measured by credit risk premium on investments,
- Potential membership in the EU.

Among these factors in the PwC analysis, it specially stands out "membership or potential membership in the EU." This fact may be important to encourage FDI- through reform of institutions and the adjustment of the market (potential) members of the EU market, which will affect the increase in economic stability and thus the inflow of FDI in these countries.

The conclusion is that the recession affected the decline in FDI in Central and Eastern Europe as well as on increasing credit risk and on decline in income per capita, which certainly influenced the withdrawal of investors. Forasmuch the scale of the recession, it is expected that only in 2012 he FDI will be at the level from 2008.

## INSTEAD OF CONCLUSION

For more than a decade, FDI inflow was an important indicator of the success of reforms in the transition countries of Central and Eastern Europe. The creation of a supportive business environment and selective approach to FDI in these countries contributed to raising the general level and quality of development. However, the global economic crisis and recession have significantly influenced the reduction in the inflow of FDI. Thus, they jeopardize economic growth. However, the interdependence of economies of Central and Eastern Europe and the rest of the world that face the devastating effects of the growing global economic crisis (beside the destructive consequences) - has a positive dimension. The awareness that the fate of big and powerful, small and "weak" is equally uncertain if we ignore the fact that the knowledge that seeks freedom of choice and development of people is a key factor in the future prosperity of mankind.

# CHAPTER 28. FINANCING PUBLIC PRIVATE PARTNERSHIP PROJECTS

**Renata PINDŽO**, Ministry for Economy and Regional Development, Republic of Serbia

***Abstract***

*Construction of the missing infrastructure whether it is about road network, railways, hospitals or schools, can certainly be a new generator of overall economic growth and development of a country. Traditionally, financing of infrastructure projects meant budget expenditure, borrowing from commercial banks and issuance of bonds (State, Municipal). However, in terms of budgetary constraints, the public sector includes more and more of private capital, especially when it comes to capital investment projects. Allocation of risk, financial structuring of projects and transparent procedures are critical for the successful implementation of the public and private sectors partnership projects. There are several methods of financing PPP projects, with project financing and forfeiting being the most obvious ones in last few years. Also, financing structure of PPP projects can be recourse or non-recourse, based on the availability model or model of demand.*

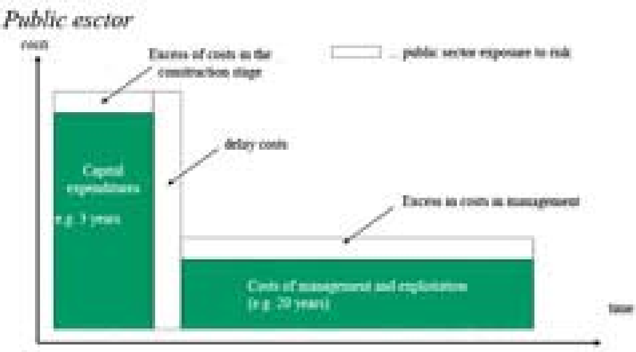
***Key words:*** *public private partnership, risk allocation, project financing, forfeiting, recourse financing, non-recourse financing*

## INTRODUCTION

Today, most countries, especially when it comes to countries in transition, are facing lack or inadequate quality of infrastructure facilities and services in the domain of the public sector. The evidence for these claims are all around us: undeveloped or damaged existing road network, bridges in need of restructuring, the lack of schools and renovation of the existing ones, building capacities for recycling waste, improving water supply and sewerage networks, the lack or the need to renovate health facilities (hospitals, health centers), construction of schools, kindergartens or their renovation, etc.

In the past, the public sector mainly relied on the state and its institutions. Traditionally, financing of infrastructure projects included the public sector borrowing from commercial banks or issuing bonds. We distinguish two types of bonds: government bonds and municipal bonds. Municipal bonds are debt securities where the local government agrees to return within a certain period borrowed funds with a particular interest. Their purpose is identical to government bonds, but their proceeds are invested into projects of local and regional importance, while government bonds fund projects of national and state interests. After provision of financial resources, public sector announces public call especially for the construction work, particularly for management, and for the involvement of operators. Essentially, the entire procurement process is conducted by those employed in the public sector which has been insufficiently effective and transparent so far, especially in countries in transition. The traditional method of financing in the public sector may lead to a significant exposure to different types of risk: excessive cost in building, breaking the construction deadlines, excess in costs of management, etc. Very often it happens that funds provided by public sector borrowing from commercial banks or issuing bonds are directed not only to the implementation of the project, but also to finance other activities, and cover other costs. On the other hand, the fact is that the public sector can borrow from banks and financial institutions under the best conditions (in developed countries, risk-free interest rates). The question is why has the public sector (government, local government) decided to cooperate with the private sector, when there is a possibility of borrowing from banks and financial institutions under the best conditions (in developed countries, risk-free interest rates)? First of all, because the practice has shown that the private sector can more quickly mobilize financial resources, then that it is far more efficient in the design stage as well as in control of the capital, which results in a significantly lower cost of capital.

**Figure 1. Exposure to risk of public sector in traditional way of financing**



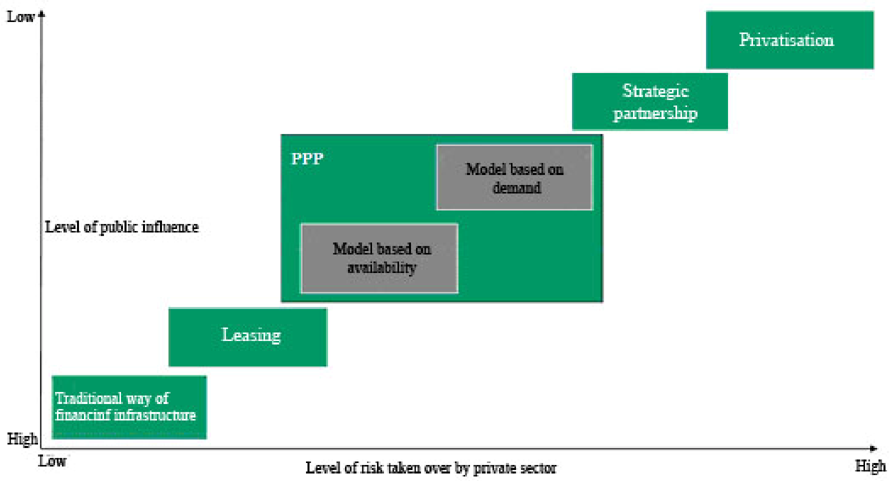

*Source: Financing Public Private Partnerships, Joint Vienna Institute, 2009*

In recent years, under the influence of different factors and needs, partnership of public and private sector has been developing in implementing projects of common, public interest. State changes its role and leaves, in part or in whole, activities of public interest to private sector.

## MODELS OF PARTNERSHIP OF PUBLIC AND PRIVATE SECTOR

There are several definitions which refer to the involvement of private capital in infrastructure activities. The most commonly accepted name is the partnership of public and private sectors (known as Public-Private Partnership - PPP), and is defined as long-term contractual relationship between the public sector (government, local government) and private companies. The contract defines the knowledge, resources and property, of both public and private sector in the provision of services or construction of facilities intended for general use. There are many opportunities for involving the private sector in financing and operational management in areas that traditionally were operated only by the public sector. Consequently, PPP structure can be viewed as a modern way of resolving the growing demand for facilities and services of public interest (infrastructure) through involvement of private capital.

**Figure 2. Models of partnership of public and private sector**




*Source: Financing Public Private Partnerships, Joint Vienna Institute, 2009*

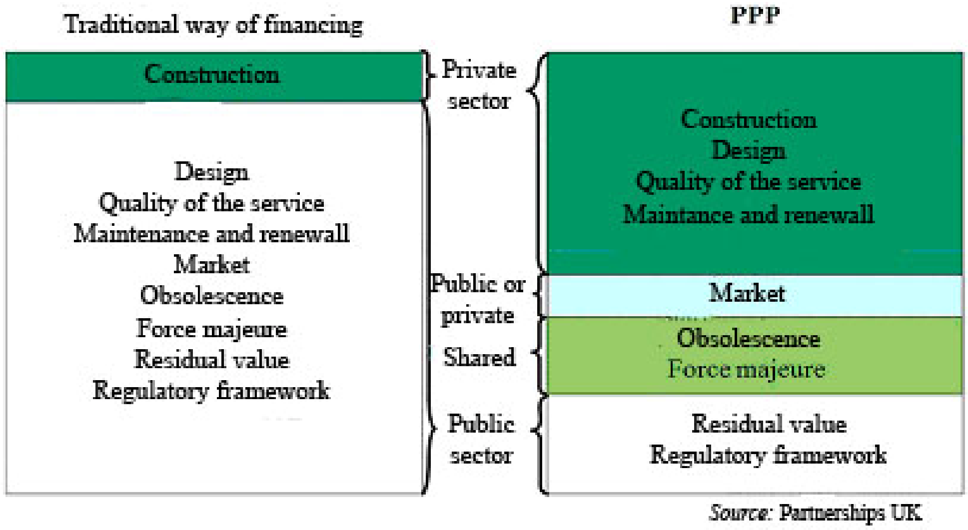
PPP structures may vary and are generally classified into two main groups: BOT structure and DBO structure, located between the two extremes. The first extreme is the traditional structure (contracting services, management contracting, leasing, joint ventures), which indicates a situation in which only the public sector takes full responsibility and risks in the financing, construction and operational management in the activities of public interest. The other extreme is related to a situation in which all these activities are carried out by private sector which at the same time are under its sole responsibility. The process of transferring ownership from the state to the private sector is called the disinvestment process and includes sale procedure. Disinvestment can be approached in many ways, and it can be complete or partial. Models of cooperation between the public and private partnerships differ in the way of financing and allocation of risk.

## TRADITIONAL WAYS OF FINANCING OF INFRASTRUCTURE VS. PPP

The success of financing of infrastructure projects, no matter whether it is the traditional way of financing or partnership of public and private sectors, is based on careful analysis of all types of risks related to the project that may arise during the economic life. Different types of risk may appear in the stage of construction, while the project has not yet been able to generate cash flow, or in the operational phase, i.e. at the stage of exploitation of the very (subject of) project (for example, after putting into operation of the facility or facilities). Risk can be defined as the probability that an adverse event would occur as a result of another event, i.e. the risk that certain events, adverse effects, poor practices and / or unused opportunities could negatively affect the realization of the goal (or in this case the project). If we compare the risk exposure of the public sector in the traditional way of financing and in PPP projects, we see (Figure 3) that the public sector is more exposed to risk in the traditional way of financing, i.e., in the PPP project there is significantly higher dispersion and division of risks between the public and the private sector. "Golden rule" of PPP projects means that each risk should be allocated to that participant (partner) that can manage it in the best way.

Risk assessment is a critical factor in the realization of PPP projects as a key factor for evaluating the ability of the project to repay debts (loans), cover costs, and for the payment of dividends to shareholders. Designed and expected cash flow generated by the project is under the strong influence of risk and if risks are adequately assessed and anticipated, there is a reduction in cash flow, i.e. the deficit. If cash flow is not sufficient for the payment of creditors, the project was technically unsuccessful, and is threatened by premature ending.

**Figure 3. Comparison of risk exposure in traditional way of financing and PPP**




*Source: Financing Public Private Partnerships, Joint Vienna Institute, 2009*

When the public sector determines the necessity and economic feasibility of investment in infrastructure, we need to consider whether it is profitable to debit public sector directly or develop partnership between the public and private sectors. Calculation of the public sector comparator (known as *Public Sector Comparator*) allows comparison of the cost of traditional public procurement for investments in infrastructure and total project costs by the public and the private sector (*Whole Life Costs*), and the selection of appropriate PPP structures. Also, it is important that each project establishes a value for money, which is calculated as a combination of the cost of projects of public and private sectors. Then it is important to allocate risks and benefits of new infrastructure facility which should be the basis for the selection of the PPP bid which provides public sector the best value for money

The decision as to whether the infrastructure project would be implemented through cooperation between the public and the private sector or the traditional way (the public procurement system), depends on a number of factors, not only from the public sector's commitment to this way of involving private capital, as well as its ability to manage this process, but also to the following: if the private sector has sufficient capacity to deliver such a complex project to the end

- If the private sector is sufficiently motivated for this kind of cooperation,
- If such a project can provide adequate value for money for both parties concerned?

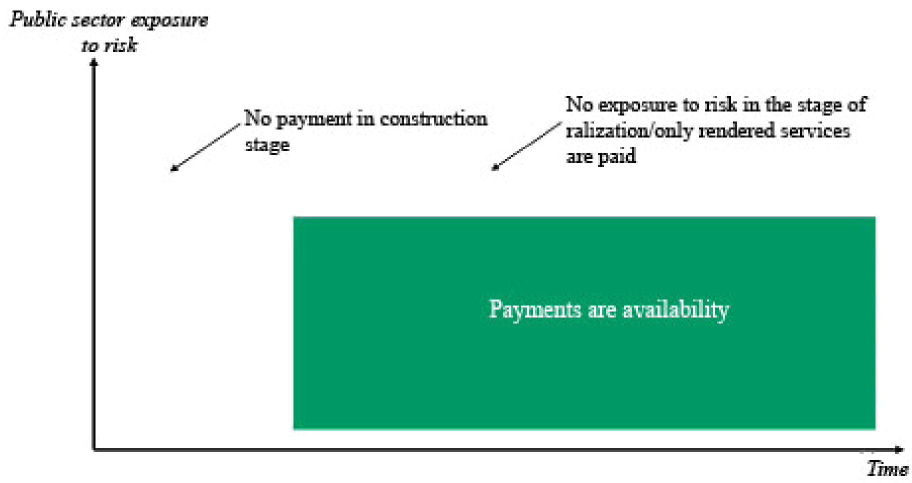
Before the announcement of public invitation for the selection of private investors, public sector (government, local government) should make a specific analysis required for making decisions on the selection of appropriate PPP structures

The partnership of public and private sectors is characterized by cash flows over the long term, and value for money is conditioned by the time when the money is credited or paid. There are several ways in which public sector can provide cost-effectiveness of investment in infrastructure. In making decisions about investments in infrastructural activities, the public sector needs to identify the potential costs and expected benefits of the investment, including indirect effects, to perform cost-benefit analysis, which is crucial for determining the discount rate to be applied to projections of future cash flows (benefits and costs), and to calculate the economic rate of return on capital (economic rate of return on capital which is in contrast to the so-called financial rate of return on capital, which refers to the direct return on invested investment, including other, primarily economic, indicators. In addition to the above, long-term financial benefits, new or renovated existing infrastructure facilities should provide additional benefits, primarily for users of public sector services (e.g. new buildings reduce maintenance costs, because they replace several old ones, newly constructed road infrastructure is time saving and improves health of the population, because driving in old conditions must be slow and cautious, and the new terms improve overall security, etc.).. Side effects of investment in infrastructure can be both positive and negative, and include among others: general economic incentives for development, the effects on security and general health of the population and the impact on the environment. The benefits and side effects should be subject to analysis and comparison with the cost of building the infrastructure facilities, providing finance for these costs - by collecting taxes, public sector borrowing or PPP structure, and what is irrelevant in this context, the economic benefits of an investment project should be separate, independent of the chosen method of investment. For these purposes, the public sector applies the discounted cash flow method and the method of rate of return on capital.

On the scale of the public influence and the level of risk in terms of financing, PPP projects occupy middle positions. There are two basic models of financing PPP projects:

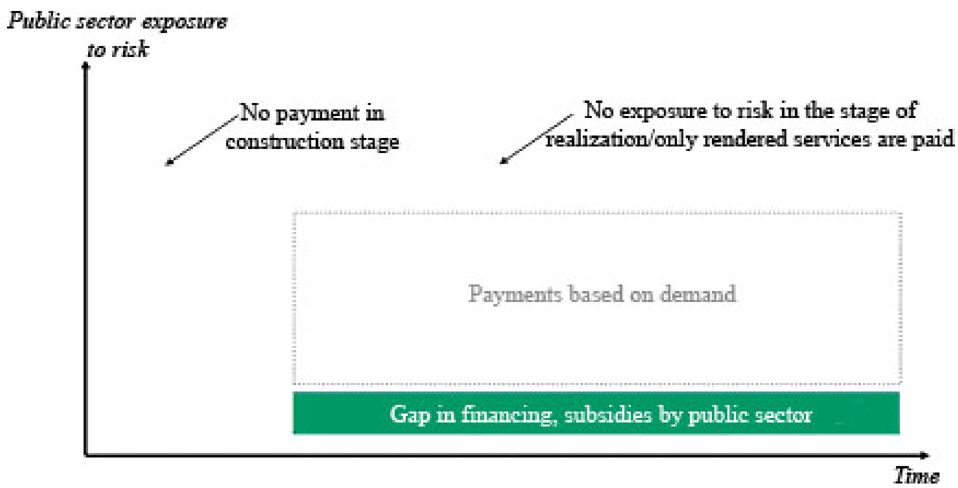
1. The model based on availability (Figure 4) involves paying an engineering company by the public sector in advance of the agreed amount (monthly or annually) for services provided or plant used.
2. Model based on demand (Figure 5) implies that the project company charges services directly from the final user (e.g. toll collection on highways directly from the beneficiaries in toll houses).

**Figure 4. Public sector risk – model based on availability**




*Source: Financing Public Private Partnerships, Joint Vienna Institute, 2009*

**Figure 5. Public sector risk – model based on demand**




*Source: Financing Public Private Partnerships, Joint Vienna Institute, 2009*

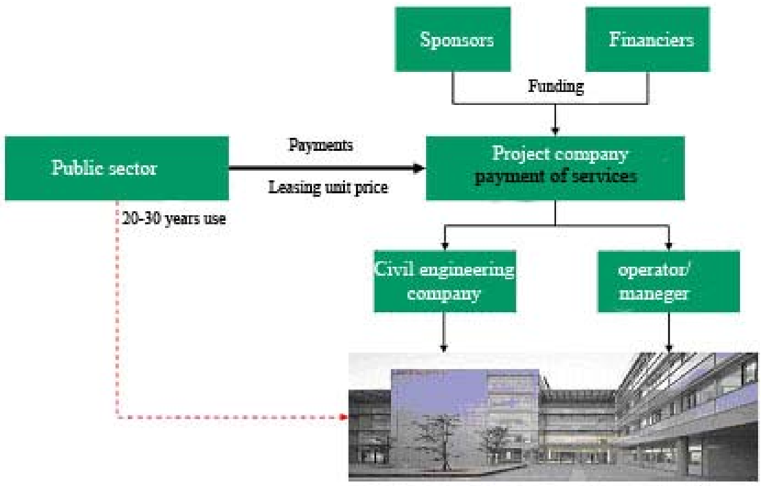
Both models are characterized by the fact that the public sector is not exposed to risks in the construction stage (fully transferred to the private sector), while in the realization stage only services provided are paid (in the case of models based on availability). Recent experiences show that especially when it comes to developed countries, model based on availability is increasingly used, while in developing countries many insist on a model based on demand. In the latter, the state occurs as a guarantee to the concessionaire, that if demand is lower than projected, the difference in profit will be covered by state subsidies. The best example of this is building of a motorway in Hungary, where the model based on demand was originally applied when the concessionaire counted on a flow of a certain, projected number of cars that will be charged a certain amount of toll. The high toll made drivers in Hungary to bypass highway, and the concessionaire recorded loss at the beginning and required amendment of the original contract and its replacement for the contract based on availability. Hungarian government has agreed to it and according to the new contract began paying the annual fee to the concessionaire.

## FINANCING PARTNERSHIP OF PUBLIC AND PRIVATE SECTOR

Extremely important step in choosing adequate PPP structure is the assessment of the threshold price acceptability of the project, and determination of the optimum methods and sources of funding. Bearing in mind the fact that the project company sponsors are not necessarily financiers, apart from their own capital, the most significant sources of financing are the following: bank loans, the funds granted by international financial institutions and issuing bonds. Commercial banks grant long-term loans to an engineering company, while investors in bonds buy (usually long-term investors like insurance companies and pension funds) debt securities (tradable debt instruments) issued by the project company. Also, it is important to note that there is a difference between the funding provided in part (known as non-recourse finance) and fully secured financing (known as recourse finance) of the public and private sector partnership project. Provided partial funding (usually provided by mortgage) is a financing in which there is no obligation that the borrower personal property to guarantee the full amount of the loan. In other words this means that if you fall into delinquent loan or is it impossible to pay off more regularly, will charge the borrower sells the mortgage. Usually, the value of loan-to-value ratio is 80% - 90%, which means that a loan would be granted of 80% - 90% of the mortgage. This is a mid variation between loans that are 100% guaranteed and fully non-collateralized ones. Fully secured financing provides that if a problem occurs in repayment, the lender receives full payment in the amount of the total value of loan approved on the basis of all the assets of the borrower, not only to the extent of what is considered as an instrument of security (collateral). From the aspect of ways of financing projects, the partnership of public and private sectors, project financing and forfeiting is most common in recent years.

The simplest definition of project financing is that it includes the funding of new projects to be implemented through the establishment of project companies (known as Special Purpose Vehicle-SPV), which does not have its own source of funding or it is very limited. Project financing is characterized primarily by the fact that the creditors themselves take a much larger part of the risk of the business enterprise, and that it is strictly related to the financing of the project itself with no expectation that sponsors (government, public sector or private investors) provide the project debt or at least not in its entirety. Project financing is commonly used for capital-intensive projects, with relatively expected cash inflows, in the countries where the risk rate is higher than average, with relatively long-term sources of financing and implementing the detailed protection clause in the agreement. In this case, it is usually partially secured financing.

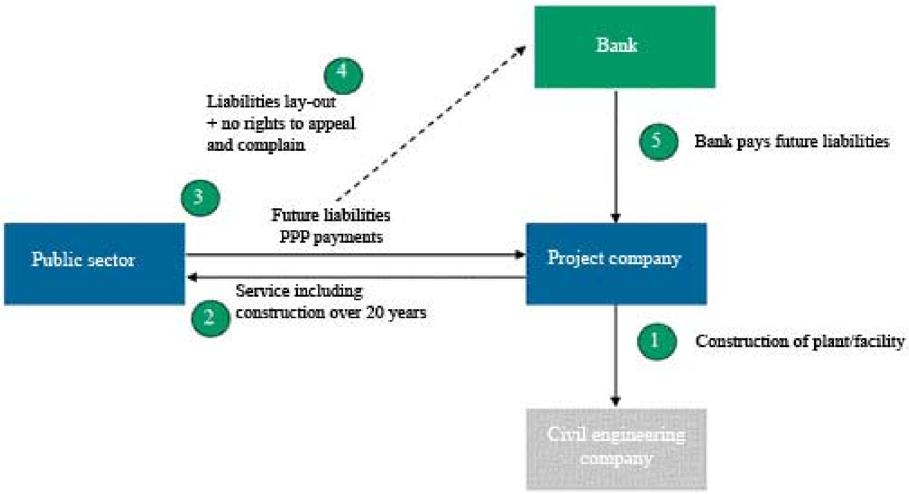
**Figure 6. Model of project financing**




*Source: Financing Public Private Partnerships, Joint Vienna Institute, 2009*

On the other hand, forfeiting is a fully secured financing in which banks buy future payments of the public sector towards an engineering company, which leads to lower rates of risk and lower margins. Public sector announces call for public bidding for construction, management and financing of a particular subject of the contract and a single contract is signed. The risk is largely allocated to private sector using the availability model. By applying this model, the public sector has no right to appeal. Experience has shown that forfeiting is a cheaper way of financing the public sector in relation to project financing. The choice of the model would depend on required allocation of risk in order to enable full realization of the project.

**Figure 7. Detailed structure of forfeiting model**




*Source: Financing Public Private Partnerships, Joint Vienna Institute, 2009*

If we analyze the structure of project financing of the partnership between the public and the private sector by type of funding sources, we see that the ration between their own and borrowed capital is 20% : 80% in international scope. In developed countries, the relationship between own and borrowed capital is 10% : 90%, forfeiting model is more applied, and partnership is based on availability model. In transition countries and developing countries, the ratio between own and borrowed capital is 40% : 60%, and demand-based model is mostly used.

Project financing is not based on the classical method of payment to the customer (the investor), but relies on the object to be built, its potential of independent existence at the market and its potential to achieve the necessary income to repay loans (debts). This funding means that lenders analyze the cash flow of investment in order to evaluate the possibility of return on investment, without the involvement of other primary investors (sponsors), or the public sector in compensation of the lack of investment. Project financing is a complex capital structure, which to some extent disperse risk between customer, contractor and financier. Such financial arrangements require investing of their own capital in the form of role (equity), and loans of banks and financial institutions (Loan refers to money borrowed from banks and other financial institutions. Fixed repayment period is defined as well as the level of interest rates paid on principal. Creditors have a right of first instance (senior claim) for the collection of receivables from income and assets of the project.) "bridge" financing (short term bridging finance to cover the needs that occur between these stages of financing /

credit for liquidity), project financing by issuing bonds and other capital market instruments, subordinated loans (long-term loan - an obligation that has first priority in repayment, and expressed by amortized cost applying the effective interest method), mezzanine capital (arrangement which refers to particular projects, has the status of subordinated loan, interest rates are related to risks involved and the right to conversion), grants and subsidies (international institutions or government).

After the outbreak of the global financial crisis, the question has arisen what would happen to already running PPP projects, i.e., whether they have any future? The answer lies largely in the public sector and international financial institutions, which are usually the majority shareholders and guarantors of the banks. The new era has begun in which flexibility of different PPP models would be tested several times. The situation has "made" public sector to take practical measures to ensure financing of PPP projects:

I acceptance of a lower level (as well as shorter time of coverage) of financial guarantee by the applicant in a public tender instead of commonly used model which included the obligation of secured financing (known as "underwriters") for a period of at least 6 months;

II. Various activities to ensure maximum competitiveness in terms of lending, which may include competition after determining the best bidder

III. Approval of capital subsidies for projects of large value (from 500 million to 1 billion USD), but the subsidies cannot be the predominant source of funding. The minimum requirement is that the level of the approved subsidy is equal to approved credit funds

IV. Finding new sources loan secured sources of funding or a counter-model as a possible way to increase the capacity of the market and lower the cost of capital.

V. increase the value of the guarantee to cover long-term liabilities of the public sector in PPP projects

Each financial model is conditioned by the following: the demands of the public sector in terms of time period in which the PPP contract is entered into and defining the profile of benefits, the requirements of lenders in terms of conditions and the plan of repayment of the borrowed funds, the requirements regarding the coverage ratios of lenders, rates of return on capital and complex mutual effects of all these criteria.

## CONCLUSION

For the successful implementation of PPP projects, it is necessary to provide appropriate legal framework and the relevant regulatory requirements including transparency, equal opportunities for all relevant private companies and respecting competition rules in awarding the concession. The partnership of public and private sectors recorded significant advantages over traditional methods of contracting: the use and improvement of managerial expertise, efficiency, transfer of technological know-how, the inflow of foreign capital, a demonstration effect for foreign investors (lower risk rate of a country), efficiency increase in operations of other companies in the sector of infrastructure, the positive attitude of international financial and development institutions, incentives to the development of domestic capital markets, and more. However, given the extremely complex structure of the PPP projects, it is necessary to determine whether the PPP structure provides better value for money, which is the optimum combination of the total costs of the PPP project and the expected quality in order to meet the needs of end users, compared to traditional methods of contracting and financing.

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# CHAPTER 29. FREE ZONE – LEADER OF ENTRPRENEURSHIP

**Mersida SUĆESKA**, Faculty of Criminal Science, Criminology and Security Studies of the University of Sarajevo, Bosnia and Herzegovina

Specially marked areas / parts of a state territory of neutral status, regulated by Act, with appropriate business infrastructure, within which economic activities are being performed under more favourable conditions, are named «free zone». With emphasized export ambitions, zones are located in vicinity of great railway junctions, sea and river piers, airports and other traffic roads from which fast delivery of goods to the buyers and consumers is made easier.

Good traffic connections with the environment is essential requirement of economic and business functioning of a zone as an pushing leader, initiating, organizing and leading the contest for realizing objectives and programmes of economic and social development. In terms of trade, free zone is neutral denationalized area open for all types of goods and services regardless of their production origin.

## BUSINESS ENTITY

Within the context of the title topic, free zone is an organizational business entity structured as a composite corporation into which particular goods enter as INPUT, and which is being subjected to various improvements, treatment, finishing, processing, finalizing and packaging, and delivered/transported to the end consumers. So profiled and legally regulated free zone is a company *sui generis*, with a series of benefits used, as distinguished from a standard corporation. The most important benefits which are being offered by free zone may be classified into several groups:

1. Neither customs duties nor import/export fees are to be paid for entry of goods in a free zone and for exit of finished and processed products from free zone,
2. The zone members / zone users do not pay taxes or other burdens / charges of stay in the zone nor aliment them with a discount,
3. Invoicing and collection in free zone is being performed in agreed manner and freely, without any conditioning.

Just like an enterprise, free zone may be specialized for particular type of products (roasting, grinding, packing of, for example, and coffee) or a conglomerate with several parallel business contents covering production, trade, tourism and so on. On the other hand, a free zone may be organized in a modified form as a **transit zone**. It is that organizational phenomenon when, within the free zone, concession is granted to an entity/state for a particular number of years.

There are still more modifications and combinations occurred by including technological factors within the free zone, as recently applied in the practice of the east Europe countries, and connected with low development level of these countries. Already this is a signal that free zones may be used for improvement of economic development and for increasing export. In fact, production in free zones of many countries paved them way for their inclusion in the world trade. Economic history recorded that some countries, isolated for foreign trade transactions, realized export expansion, increased the level of usage of the installed production capacities and achieved higher employment level just through free zones[1] locating in them production, trade and service capacities of the local and foreign investors. The network of free zones has contributed to the increase of market competitiveness of the country in which the zones are located, and to the growth of its transactions share on the world market.

Enterprises located in free zone realize restructuring and improvement of its business activities, faster transfer of high know-how, innovation of the production procedures for the purpose of acceleration of the economic development, with customs, tax, informatics' and other benefits.

## SYNERGY EFFECTS

**Primary objective of free zone is more accelerated economic development and encouragement of employment, thus achieving the effects of social development. According to our assessment, it is in the zone that exist the germ of export orientation for economy of Bosnia and Herzegovina and the magnet for attracting foreign investments. For Bosnia and Herzegovina, Serbia, as well as other transition countries, free zone is *modus Vivendi* / the unique opportunity for wider and successful inclusion in the European market and world exchange of goods, work and capital, and through the free zone, local enterprises come into contact with foreign companies and in business cooperation with affirmed partners they strengthen their position on the global market. It is just from such cooperation that synergetic effects should follow on economic development of the host country.**

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[1] *Specially fenced area in a state.*

## DEVELOPMENT RESOURCE OF THE TRANSITION COUNTRIES

Free zone in the context of this analysis is viewed as a resource of the transition countries on which a national economic policy determines its economic development[2]. The observation will be fruitful if it encourages all the government levels (state, regional, cantonal, local) to use the free zone as a specific resource for development of entrepreneurship. The zone acts as yeast for swelling of micro economy as a base for the growth of macro economy. It means that the free zone may be used as an instrument of the local and national economic development with the trend of expansion into Europe and the world. The level of the international exchange realized through the free zones is in growth owing to the numeric increase of the zones and improvement of their forms[3]. Sometimes, it was free ports and towns, and today, they are organized in the form of free customs zones on more than 1000 locations throughout the Planet.

Free zone acts as an incubator for more rapid growing with decreasing of charges in the form of benefits deserves to be included in the development strategy[4]. According to the Draft Development Strategy of Free Zones of Serbia from 2010 to 2015 a combination of a free zone and industrial park was built-in, as it is visible on the following Figure no.1

In this way Industrial Park and Free Zone enable a flexible mode of operation. Users use facilities depending on their needs, they may hire the existing area for work with the local market or build a building without paying local taxes to the municipality in a part of industrial park intended for the local market. If their business operations are connected with import of reproduction material, products and services, they may perform their activities in the regime allowed by the Act on Free Zones, so that in this way, the location obtains an additional attractiveness for making investments.

Symbolically said, it is laboratory for revitalization of economic system with low level of investments. According to approximate assessments, ten-year savings in the reproduction charges, i.e. operative charges in a free zone, may build a zone

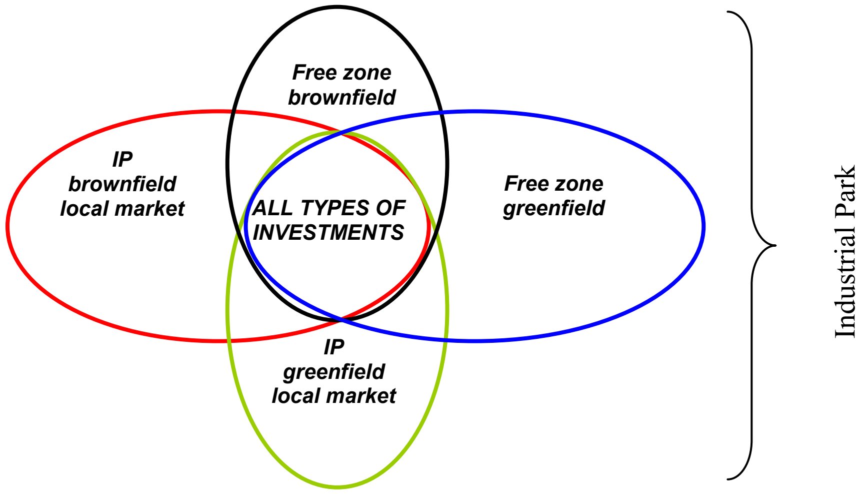
[2] *In more details: Sućeska, Mersida, Slobodne zone i privredni razvoj (Free zones and Economic Development), Sarajevo, Faculty of Criminal Sciences, 2006.*

[3] *Sović, Jozo, Upravljački nadzor poslovanja preduzeća (Managing Supervision of Enterprise Business Activity), Sarajevo, Faculty of Criminal Sciencies, 2000, p. 77*

[4] *For example, according to the source SEEbiz/Beta, the Commercial Chamber of Serbia published the suggestion that it is necessary to realize connection of free zones and industrial parks for more intensive attracting of foreign investments, and it is indispensable to establish as soon as possible the Development Strategy of Free Zone Development from 2010 to 2015, proposing the zone model which already exists in Turkey.*

more; it means that, for example, local economic development may double without any new investments.

**Figure 1.**




## CREATING OF INVESTMENT MOTIVATION

Creative access to the economic development[5] through free zone results in cumulative effects of the zone business activity and of economic companies concentrated in it, with activating local material and human resources. Because of slow including of these potentials, economies of the transition countries have experienced heavy destruction, a real collapse in employment sector. Unemployment is a source of poverty with more hundred thousands unemployed citizens capable for work. These are potentials non used and still live and they have to spend every day, regardless of the fact that they do not produce anything. Society has to make a development programme which will activate and absorb these potentials including official and unofficial programme for revitalization of economy through opening job positions with comparatively low investments and high effects. The problem can be overbridged by modelling of free zones, opening new jobs and production and service enterprises, by introducing new enterprises in the free zone in the cantons and on all suitable locations, where two parallel effects can be attained and these are: (1) training of people for new possibilities

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[5] *In more details on economic development: Ćulahović, Besim, Ekonomija svijeta - rast, razvoj i trendovi (World Economy – Growth, development and trends), School of Economics in Sarajevo, 2008.*

and (2) earning for life and for the future, still more intensive development. The top (final) effect is the effect on positive changes of economic state of a country and its including in international flows.

Performing business activities in the zone makes possible local economic and social development and appearance on the world market without great (considerable) charges. Results are incontestable and easily noticeable. Training of newly employed is raised to a higher level, and the labour becomes more productive. The enterprise in a zone lowers charges, its products become more competitive and in this way, it makes breakthrough to foreign markets, and the international exchange granting to the zone, becomes a significant factor of undertaking and regional development. Multi-development effects act as a feedback to creation of better products and services, widening of the market area, higher international competitiveness, growth of employment, increase of export, larger foreign exchange inflow, diminished drain of the most productive labour, etc.

All this has a beneficial effect on improvement structures of economic system and international position of the transition countries economy, owing to, in no small measure, stimulating incentives of the free zone. This still more affirms our belief that free zone is a big enterprise, a wide working facility in which economic companies motivated by investments and activated by business perform their tasks and attain their objectives.

## EXPANSION OF ENTREPRENEURIAL BUSINESS

Running of business activities in free zone is regulated by the local regulations and acts of incentive character. Based on such regulations, the free zone encourages expansion of business, supports employment programmes, formation of small enterprises resistant to failures because smaller enterprises are more capable by manoeuvring of easier adaptation to the competition and various blows from the environment.

By the end of the twentieth century began a more intensive formation of free zones by private capital[6]. The effects are multiple. Contrary to the state, private owners more rapidly acquire the skills for selection of activities and encouragement for business initiative. With this institution and their business reflexes they assure mechanisms unknown in the theory to rapidly and efficiently include new workers in the work process. The process of learning is done at work

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[6] *In the period from 1995/2001 there were founded 40 private zones on the Philippines. Employment tripled within seven years (from 203 to 708 thousand employees). In the same period export raised from 2,7 to 19,5 mld USD. See, WIR 2006, p. 214.*

and on the job achieving business and tertiary effects. This enables to avoid the learning costs, since knowledge is acquired in the process of work. So "schooled" employees usually open a new enterprise, independently beginning with new activities what is a good manner of widening of entrepreneurship with small or no investments. These enterprises employ young people with strong potentials for work, so that the employer realizes his business ideas with small risks and adequate earning within short time. Therefore it is logical to expect from such enterprises from free zone to be long time in business and become essential factor of the development process on larger scales.

These same enterprises quickly include in export, overcome the international contract procedures, as well as financial transportation, packing procedures and all manners of the international trade. They learn these lectures in practice (1) by participating in international fairs because the zone enables them lower hiring costs of the exhibition area, (2) by forming export groups for joint foreign market research, (3) by establishing zone funds founding for financing of trial quantities intended for export and so on.

Business consulting is the most precious service which can be obtained in the free zone, and which refers to business management and solving various entrepreneurial problems.

## EXPORT ORIENTATION

On their development way free zones evolved from customs zones to export zones capable of performing complex operations on global market in the free customs zone simplified operations are being performed as a rule, jobs of low complexity (storing, sorting, repacking, distributing), while the export oriented zone has improved business structure by production, finalizing, services and service information.

Countries - export zone founders oblige by their regulations the enterprises located in the zone to direct a specific percentage of the annual business activities to third markets. The condition is the same both for local and foreign residents. In return, enterprises performing business in export zones use programmed facilities and stimulations of the cost nature. Import of goods and components for the business activities in the zone is usually on LB regime (free import) which is comfortable due to the costs releases, i.e. it benefits of the Zero rate, for customs, taxes, fees and other duties to the state. Import of input is not exempt from fees for the purpose of customs evidence.

Depending on imagination and objectives of the national judicature, every country may create new strategic variants of enterprise attracting to move into the zone area encouraging expansion of the zones[7] and expansion of international trade. In the countries which had extended them hospitality, the zones have given a high contribution to the total development through dinamizing export, employment, and inclusion of the local economy in the world scale.

## BALANCING OF USEFUL AND HARMFUL EFFECTS

Free zones yield great benefits to the enterprises conducting their business within the zone. Stay in the zone strengthens market competitiveness through the facilities lowering the costs of running business. Here exemption from taxes, fees and customs is effected for import of components of input, as well as lower labour costs from the local sources. Leasing costs for the land and connections to the infrastructure are pretty lower, what has favourable repercussions to the lowering of business activity costs in the zone

**LIST OF USEFUL EFFECTS**

- **in free zones man power from local sources is employed,**
- **newly employed learng at work/training in the zone,**
- **foreign investors bring in new technology,**
- **local man power get in contact with up-to-date technology,**
- **by training, general level of knowledge and skills of the newly employed is raised,**
- **investors in the zone pay the costs for the location site, connections and services,**
- **free zone encourages development of the local market in the manner that the employees increase by their earnings buying funds and demand/consumption,**
- **through cooperation of the local enterprises in zone with foreign companies, using of the local installed capacities is increased.**

Useful effects observed in the process have impact on restructuring of business activity of the local enterprises, and in a near future, it promises better competitiveness of export of the host country.

[7] *By the mid of the twentitieth century the first export oriented free zones were founded in Ireland. In the next fifty years, more than thousand free zones were formed throughout the world.*

It should be emphasized that there are also different standpoints regarding the free zone usefulness. The opponents say by accepting a zone, the host country realizes larges damages than benefits. The truth may be on both sides. Dialectics, as the skill of finding out the truth suggests that every innovation my have also undesired connotations. It means that acting in the zone with evident benefits may result by harmful effects, as well. Therefore we shall deal with observation of counter-arguments.

***LIST OF HARMFUL EFFECTS***

- **enterprises in a zone have unlimited right to dispose of and transfer of net gain,**
- **right to transfer the profit is an open valve for drain of capital from the host country,**
- **unlimited transfer of earnings cancels the useful effects of forming free zones,**
- **foreign managers in the zone have high salaries which they spend in their country, and not in the country of earning money,**
- **foreign companies running business in the zone are strong competition to the local enterprises and they may suppress them,**
- **great danger from non-controlled import of dirty technology threatens,**
- **local employees obtain less paid repetitive jobs what makes effects of learning at work are negligible, and creativity is denied.**

There are also other unfavourable social repercussions. Practice has shown that in the zones exploitation of women and children is expressed through exceptionally low wages for these categories of man power. Just for these reasons in free zones locate work intensive activities which do not require high financial investment in a job position. For attracting foreign companies to the zone, «softened» labour judicature is frequently used to the harm of the host country workers.

Some analyses of the free zone critics say that in the total value of the free zone business activities, the local contents occupy only ¼ activities and effects. But there is also another side of the business effects: export from the zone constitutes 1/5 of the world export.

The export share from the zone in the total export of the host country[8], expressed in percentages stands at the high 82,2% u Dominican Republic and modest 13,4% in Bangladesh. In China it is 56,9%, in Mexico 45,2%, in the Philippines 40,9%, Morocco 34,7[9]....

Experiences and knowledge in structuring of free zones in other countries may be used in regulation of free zones in the transition countries. Regulation of the zone is based on the investment thinking, to locate in the zone profit attractive activities with high rate of employment, low capital investment, short period of capital activation and its return and so on. When doing this, production and service activities are preferred as a model of high employment and successful business activities. In this aim, the activities of finishing, improvement, assembly, repacking and others etc. are located in the free zones. Not so rare is included production of garments and shoes, food articles, then automobile, electronic, pharmaceutical and other industries.

## DEVELOPMENT INCENTIVES

There is no ideal concept of development. Behind every success there are difficulties requiring persistence and readiness for risk taking over. In the zone, companies work, as a rule, with risk less than that outside the zone, and these are the effects of specific infrastructure of the free zone offering facilities for tax, market, customs, financies, and others, all this in favour of lowering the costs and increasing competitive advantage.

The zone should be regulated legally and practically for stimulating business and control of the activities in the direction of the development effects. Enterprises which are located in the zone have available options of programmes to be chosen from several fields of the production and service activities which can be easily adapted to the own financial possibilities and available resources. The stay in the zone improves the entrepreneurial spirit, encourages creative thinking in the sense of continuous improvement of business effects, and this, by itself, already means development.

The free zone is a comfortable foundation for efficient manners of achieving development of business and of total economic prosperity. For this we have confirmation in economically developed countries, regarding the fact that business development and entrepreneurial infrastructure development is the tested way of overcoming non-development and poverty. Free zone is, as we have already pointed out, a special infrastructure with a series of facilities for

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[8] *WTO Annual Report, 2004., p.15.*

[9] *Kozomara, Jelena Spoljnotrgovinsko poslovanje,(Foreign Trade Business Operations, Beograd 2002*

development of entrepreneurship. From the other hand, entrepreneurship is the basic moving force for economic development and simultaneous entry in the market economy and the world economic competition.

The model of free zones may be applied in all countries under development, and it means also in Bosnia and Herzegovina, Serbia, Macedonia… Application of the model to the conditions of, for example, those of BiH economy imply the endeavours to attain that the height of capital investment is as low as possible with the development effects which should be as larger as possible, and especially in the employment sector. To such endeavours legal regulations for leading business in the free zone should be adjusted.

The basic starting point is to create by regulation of the zone the preconditions for development of entrepreneurship, viewing the zone as a large and composite corporation, from functions of which, there will be results in the economic development of the country. Economic policy should be built-into shaping of the zone with far-reaching look to the future. This policy includes entrepreneurial infrastructure, corresponding marketing[10] and financial policy.

## MESSAGES AND LECTURES

The message of this Paper is unambiguous: in the transition countries there are convincing conditions and reasons for establishing free zones which may contribute to the solution of economic, social, and thereby political problems, on the way of more successful economic development. At the same time, attractive motivation will be created for entry of great world investors in economic system of Bosnia and Herzegovina and other countries in transition, where the free zone is only a new form of development, infrastructure and human resources on the way of decreasing poverty. In such a case one of the strategic possibilities is running business activities in a zone not requiring great investments, but yielding the effects of economic development. In this way, zone assumes the role of a catalyst in mobilization of the available resources, and especially of the man power. Zone is a flexible development strategy with positive impact on disturbed economic and social situation of the national economy. Zones will, in our opinion, help stopping and turning the actual descending trend of development moving. As a source of the growth appear an additional energy originating from restructuring of business entities in the form of a free zone which, offering facilities, lowers the costs and accelerate revitalization of economy and total life in general.

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[10] *In more details: Hanić, Hasan, Upravljanje marketingom (Marketing Management), Beograd, BBA, 2008.*

Economic progress requires the state's thinking in terms of development too. The countries in transition such as Bosnia and Herzegovina, Serbia need policy and strategy which will encourage investing in development, what is attained in a part though free zones. Zone may contribute to overcoming various difficulties, taking for itself the role of improvement of free market economy. For this occasion, a clear and functional legal framework of free zone must be regulated, so that enterprises within the zone would be more competitive compared with those located outside the zone. Economic growth and development will become prominent within such basic and incentive frameworks.

Finally, development of zones and enterprises in free zones is the moving force of economic growth and strategic factor of development. Economic future of Bosnia and Herzegovina and other countries in transition is connected with profitability of economic companies, and the companies will be more dynamic if they act in a free zone. Zones may become main bearers of economic development and pulling out of economic system from the present stagnation. Acceleration of this process is urged by creating pre-conditions in the zone for free entrepreneurship. Legal support to shaping of free zones is a significant factor of development and harmonization of prices, employment and remedying of salary balance by means of the export strategy measures.

## SUMMARY

Actual economic situation inspires interest in using free zones in development of economy of Bosnia and Herzegovina, Serbia and other transition countries. Business activities in the free zone initiate multiple development programmes, encourage creative business operation and offer a wide space for flourishing of entrepreneurial initiatives. This is where development potentials are concentrated in the infrastructure adapted to the needs of business activity development on the principles of profit acting. The development strategy without abundant financial sources requires new ideas and inventiveness. The zone is stimulative, legally regulated environment that removes administrative barriers and other restrictions for investments, employment, and trading, whereby a comfortable environment is attained for mobilizing development potentials, and investments from internal and external sources.

In free zones business operations are led by the capital owners having stimulation for business development and profit rising and increase of property value through reinvestments. Such motivation may become a decisive factor of economy development on the principle of increasing and improvement of the effects. Here, the level of more rapid and efficient economy development of a country burdened with economic and social problems. In operative sense, free zones bring new elements in business activity with synergetic effects on the total development.

It is especially valuable fact that the zone may be structured from any area of production, service and trade. This makes easier determination and decision-taking for entering in business by free choice. The zone is a good ambient for local and foreign investments in development including also wide possibilities of employment, mitigating so the main development problem of Bosnia and Herzegovina. All business entities within the free zones make profit in better getting along on the local and foreign market, in selection of investments, in running operations, in improvement of the selected activity, in conceiving business policy, in building fair relationships with business partners what has to bear result in receiving better business effects. Free zones like a great incubator urge the development of entrepreneurship, as a main leverage of economic development. Bosnia and Herzegovina, as well as majority of the transitions countries in the environment disposes of power, raw material and human resources which can result by smart activating in larger financial capital, as a condition of the future economic development. With the benefits offered by free zone one can achieve the development objectives, stopping further growth of unemployment and poverty. It is in the free zone that you can achieve the union of science, profession and practice so improving modern business for achieving better effects with smaller risks.

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# CHAPTER 30. DEVELOPMENT OF THE BANKING SECTOR AND THE ECONOMIC DEVELOPMENT OF THE COUNTRY

**Milan VUJOVIĆ**, Credy bank, Serbia

***Abstract***

*The paper analyzes the basic directions of transformation of the banking sector in conditions of transition of the economy of our country. The emphasis is put on the rehabilitation of banks and reform processes in the banking sector from the point of view of development of legal, economic and monetary system in the country, as well as building institutions of the legal state, privatization of banks, change of ownership, organizational and management structure of banks, inflow of foreign investments in the banking sectors and their role in the economic development of the country. It was evaluated that the banking sector development in the next period must be based on a national strategy of the economic development, strengthening the bank capital, more efficient and more profitable loan politics, thus forming development banks which will provide all means needed from numerous funds on Republic level and provide more stable sources of means for more favourable and long-term financing of strategic development priorities in the infrastructure, energy sector, agriculture, regional development and so on. Fast economic improvement of our country can only be realized in conditions of more efficient over-coming of the economic and financial crisis, both in the country, as well as in the world. For the realization of these directions of development, it would be necessary to provide consensus of all social factors in the country, first of all, the parliamentary political parties, the Government and the economists.*

***Key words**: banks, banking sector, foreign banks, economic crisis, privatization, transitions, development bank, profit, economic development of share-holding*

The social changes in our country which have been realized in the past twenty years have changed the constitutional system, started the democratic processes in the society, strengthened the international position and reputation of the country in the world, thus intensying the transitional, ownership, management and organizational processes in the economy. It contributed to creating a more favourable social-economic climate, changes in the legal and economic system, construction of institutions of legal state and macro-economic stability in the country. On the basis of that numerous system laws, directions, regulations, decisions and other bylaws which more closely manage certain questions from the areas of the political, legal and economic system of the country were brought, thus developing market capital and stock market activity. However, those processes did not have a constant upward movement, and there were deadlocks and inefficiency in the realization of the economic and development politics, fast incorporation in the international economic integrations, tardiness in the privatization of state and public companies and realization of tax, monetary and credit politics. Also, after many years of sustainability of stability of the banking sector, its contribution to the economic development of the country is supposed to be bigger.


*Source: RSZ*

Having in mind that there is the global economic and financial crisis for two years, which appeared in out country as well, the following development period of the society will be aimed at bringing measures of economic and development politics which will provide the society to get over the crisis, where the banking sector should make its contribution. In this regard, the results of the economic activity in the first quarter of this year in the country show the first signs of recovery of the economy, expressed through a slight growth of GDP of 0.6 % [15,], increase of industrial production of 4.8 % and export of 18.1 %, as well as reduction of the deficit of foreign exchange of 22.3%, along with high growth of unemployment from 7.2 %, stagnation and reduction of direct foreign investments. [16, p. 3].

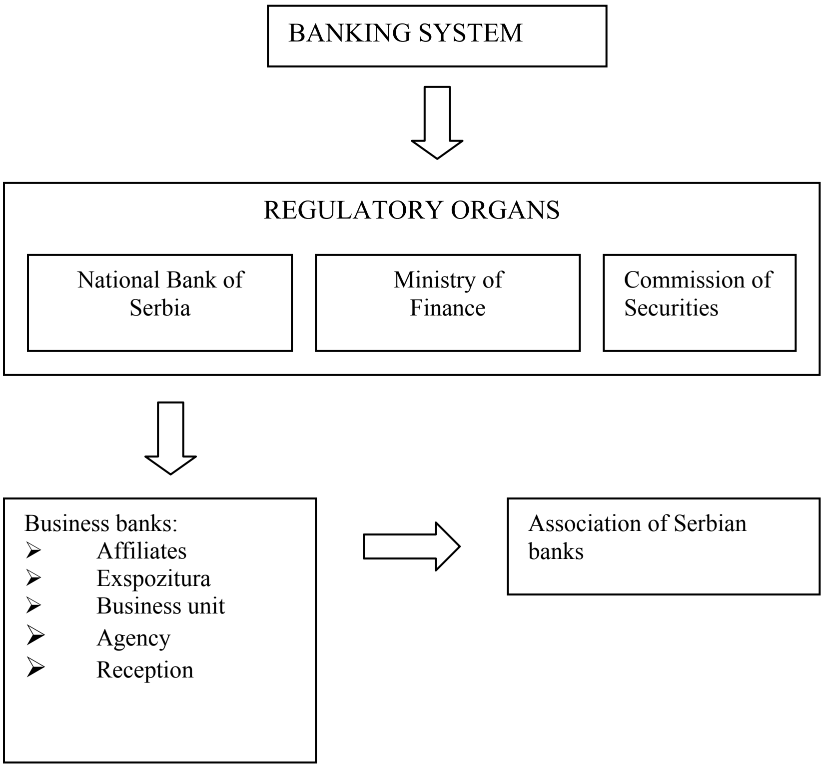

*Source: RSZ*

**REFORM PROCESSES IN THE BANKING SECTOR**

The system-reform processes which started in the ex-Yugoslav society in the 80's and 90's of the previous century, beside the changes in the social-economic system, entered the banking system, as well. The change of ownership structure of the companies and banks with development of stock-holding and the movements on the market of securities encouraged the creation of more favourable market atmosphere in the country, where knowledge, creativity, innovativity, enterpreneurship and market philosophy became incentive powers of progress and prosperity in the society.

Until the global economic and financial crisis started in the second half of 2008, all the measures contributed to high growth of GDP, better macro-economic stability, more stable movement of the currency rate with continual development of foreign exchange reserves in the amount of 10,5 billion euro [7, p. 28]. That set the foundations for faster development of society reforms, which created room for improvement of the business environment and creation of more favourable social atmosphere for the construction of more efficient and more competitive social and economic structure.

The transformation of the banking sector was based on the fact that the banks, in conditions of change of ownership structure of capital, market activity, economic regularities and competition would develop into joint stock companies with modern business and developed information systems, marketing and management. By bringing the law of banks and other financial organizations [10, p. 90], banks become legal persons, individual financial subjects which manage their own capital in order to gain profit. That made the banks, for the first time after the Second World War, to become organized as joint stock profitable companies. The liberalization of the foreign trade, development of economic relations abroad, more efficient monetary politics, improvement of the management of public finances and tax politics, development of the market capital and stock exchange business, as well as the construction of institutions of the legal state, all contributed to it greatly.




However, in the second half of the 90's of the previous century there was a deadlock in the reforms of the economic system of the country, as well as the banking sector, mostly because of the economic sanctions by the International community towards our country, high inflation rate, war activity in the region, as well as the NATO bombing in 1999. Beside that, the banking sector was faced with big problems in terms of lack of capital, liquidity of the economy, payments in the country and abroad.

More important changes in the banking system were started in 2000, during the renewal of the economic cooperation with the International community. On the basis of the estimation of the conditions in 2001 in the National Bank of Yugoslavia, it was evaluated that there are significant problems in the banking sector. [1, p. 28]:

- High rate of contaminated payments which cannot be charged and low level of real interest assets, which directly influences high profitability
- Low degree of real formed reserves for the cover of potential losses
- Real subcapitalisation and inability of the capital and reserves to absorb the undertaken risks
- Lack of solvency of the biggest banks
- High insolvency
- Lack or inadequacy of the system of internal control and internal audit, inadequate system of risk management and
- Low degree of professionalism of external audits

Expertise by international audit companies *Ernest&Young* and *KPMG/Barents* confirmed the evaluation of the National Bank of Yugoslavia that the condition in the banking sector was very unfavourable. Out of 83 banks, 74 were analyzes, grouped in four categories (the other 9 banks with put in a separate category)

A- Healthy banks - 9 banks,
B- Solvent banks with insufficient capital -36 banks,
C- Insolvent banks - 6 banks, and
D- Insolvent banks without importance for the system -23 banks.

In March 2001, The World Bank, on the basis of bank reconstructions in Central and Eastern Europe, estimated that in order to solve problems in the banking sector in Yugoslavia, it was necessary to provide 21.1 billion DEM, accordingly: 6.4 billion DEM for net re-financing of obligations – loans in the London and Paris club, World Bank and the International Bank for Renewal and Development with a discount of 67 % by Naples conditions; 7.5 billion DEM for frozen foreign savings and 7.3 billion DEM for expenses of complete rehabilitation of the banking system.

According to that, the analysis showed that the condition in the banking sector was very unfavourable, which demanded that the state authorities, first of all the National Bank of Serbia, should undertake radical measures for its rehabilitation and enabling to perform significant financial functions in the economic development of the country.

## REHABILITATION OF THE BANKING SECTOR

The basis for problem-solving in the banking sector was the Strategy for Restructuring the Banking System of the National Bank of Yugoslavia [3, p. 26], which was created with the following objectives:

- Return of trust in the banking system
- Creation of permanently profitable banks for successful business
- Fast and efficient bank restructuring

- Provide a source of financial means according to market standard for the economy
- Significant engaging of foreign institutions in the process of restructuring
- Implementation of the reconstruction in «one move»
- Privatization of banks as end goals, and
- Establishing the real balance sheet and incoming flows of the balance structure of banks

Change of ownership, organizational and management structure of the banking sector were conducted in the following four basic forms:

- Bankruptcy or liquiditation
- Recapitalization/choice of strategic partner
- Tender sale of the state package of shares to foreign investors
- Merging and integration of banks

The restructuring plan of the banking sector foresaw four stages:

Stage A – period of preparation for intervention (from December 2000 to June 2001)

Stage B – Intervention of the National Bank of Yugoslavia (June – September 2001)

Stage C – Beginning of the Intervention by an Agency for Rehabilitation of Banks (July 2001 – March 2002)

Stage D – privatization of banks (period around 2002)

According to the plan about the restructuring of the banking sector in 2001, 23 banks lost the business approval, 4 banks got a deadline for recapitalization, the process of rehabilitation was started in 5 banks, administration was introduced in one bank, 5 banks were put in the group of problematic banks, measures for harmonizing indicators of businesses were introduced in 17 banks, whereas 18 banks were merged with other banks.

Having in mind that some banks were faced with huge difficulties, the estimation of the justification of their rehabilitation or liquidation was planned for stages B and C. Besides that, the forecasts foresaw that the financing of the rehabilitation expenses of banks would come from domestic and foreign sources. However, in the realization of the programme of bank restructuring, the third stage C – bankruptcy or liquidation of the banks, the Agency for Bank Rehabilitation estimated that there were no conditions nor possibilities for the rehabilitation of the four biggest banks: Beobank, Belgrade Bank, Jugobank and Investbank. These banks comprised 66 % of the balance amount of the total banking sector in the country. On the basis of that estimate, the National Bank of Yugoslavia revoked the business licences of these banks and started the bankruptcy procedure, which lasts for almost ten years.

Due to the complexity and gravity of the problems in the banking sector of the country after many banks had been closed, especially regarding the amount of capital and balance amount, it could be stated that the remaining banks were left almost without capital and realistic possibilities, small and undeveloped network of organizational parts to satisfy the demands of the economic sector, as well as the population, for banking and other financial services. Such state of the banking system mostly affected the current economic business, and mostly investments and development of the country.

Besides that, the economy, banks and the state in whole, were not able to service their financial and other obligations to foreign creditors timely. So, the Federal Republic of Yugoslavia concluded a contract with the Paris and London club, as well as the countries and commercial banks as creditors in 2002, about the possibilities and methods of solving the foreign debt. [13,]. By that, the state undertook all the obligations from the banks from foreign creditors for which it was a warranty and, through more affordable arrangements with foreign creditors, returned the trust and increased the rating of the economy and the banks worldwide and created more favourable conditions for new business and credit arrangements, i.e. more efficient business of the banks and the economy, both on the domestic, and the foreign market. With the collapse of the Federal Republic of Yugoslavia in 1993, Republic of Serbia undertook all the obligations towards foreign creditors.

## DEVELOPMENT OF THE SHARE-HOLDERS CAPITAL IN THE BANKS

After the period of hyper-inflation, which, during the 90's in the previous century, almost completely devastated the share-holding capital of the banks, new capital was formed in very different ways [17, p. 141]. On the basis of approval from the Committee of Securities, banks were obliged to, mostly for known buyers, realize part of their shares on the market through the stock exchange. Other than that, the share capital in the banks was increased through real credit arrangements with the economy and the population, as well as by selling currency to the economy, payment of interest rates, fees, commission and other obligations with the obligation to buy shares in the value of 5 to 40 % from the value of the arrangements. Besides that, the employees of certain banks had to invest a significant part of their salary in buying shares of the bank. Although the share capital in banks was made in different ways, which often are not in accordance with the laws of market economy, thus formed capital cannot be considered to be unreal. On the contrary, in conditions of undeveloped capital market, inadequate legal regulations and lack of other sources for capital gain, it was one of the ways how banks came to bigger capital, and the economy and population to means for work.

Banks came to increase of share capital on the basis of a specific law [13] through which the state converted the undertaking of debt of the banks to the Paris and London Club into shares, as well. The state, on the basis of that, became the majority owner of 14 banks, and it was the carrier of the decision-making process. That was how – legally – the state Serbia made a somewhat state-ownership of those banks [9, p. 108]. That made the participation of other share-holders, especially the minor ones, marginalized, which is contrary to the core and management relations and respect of interests of all capital owners, including the minor ones. In this regard, the information from the newest report of the World Economic Forum about the competitiveness of the economies of 133 countries, puts Serbia on 128th place by the protection of rights of minor share-holders in 2009 [4, p. 48]. The condition is not much better when other indicators of competitiveness are analyzed, such as innovativity, efficiency, export, regional sale, technological sophistication, foreign investments, research and development, relations between the economy and universities, immigration of highly educated people etc. Bearing all that in mind, in order to increase the competitiveness of our country, solutions must be found in increase of knowledge, development of infrastructure, high technology and innovations, bigger foreign investments, reduction of immigration of highly educated people etc.

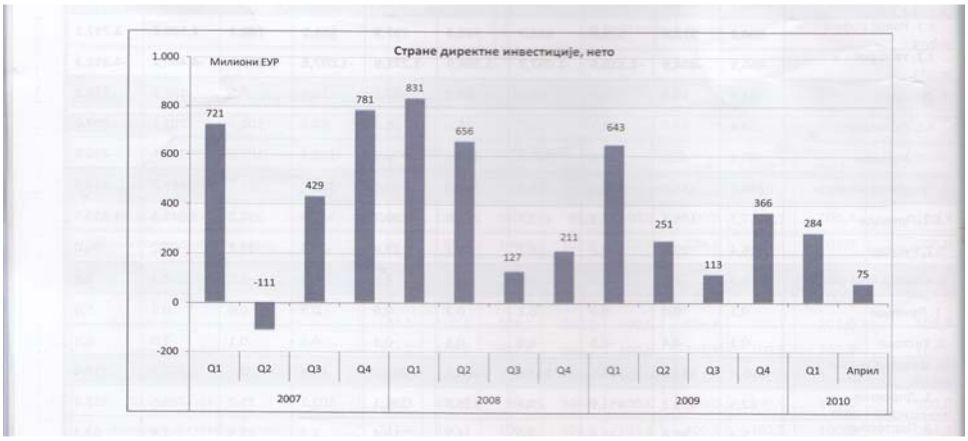
By selling shares in newly-state owned banks through open calls, strategic partners with respectable credibility, the state made income in the amount of 805 million euro, thus providing means for settling the obligations towards the Paris and London clubs of creditors and the obligations towards the old foreign savings. By so doing, not only *Alpha Bank*, but other banks appeared on the financial market, as well – *Erste Bank*, *Nova Ljubljanska banka*, *OTP Bank*, *National Bank of* Greece and *Sanpaolo IMI*. At the same time, by buying out private banks, the following banks came to our market *Credit Agricole*, *Banca Intesa*, *Piraeus Bank*, *EFG Eurobank*, Marfin banks, *KBC*, *Fidomestic Bank* and *ATE Bank*. Five banks got *greenfield licences – Raiffeisen bank, UniCredit Bank, Procredit Bank, Opportunity bank* and *Moscow bank*. In March this year, by recapitalization of Credy bank ltd. the New credit bank Maribor came to our market.

## OWNERSHIP STRUCTURE OF THE BANKING SECTOR

According to the information from the National Bank of Serbia at the end of the first quarter of 2010, there are 34 banks with 2600 organizational parts and 31026 employees in the Serbian banking sector. Out of the total number of banks, 21 bank is in the ownership of foreign owners, 13 banks are owned by domestic people – out of which 8 banks are owned by the state as a majority, or biggest, single share-holder and 5 banks are owned by private people.

The domestic banks owned by the state or private people make up 47 % of the profit of the sector, 26 % of the total assets and 28 % of the total capital, as well as number of employees, while the banks with majority foreign capital participate with 53 % in the profit, 74 % in assets and 72 % in capital, as well as total number of employees. [18, ].

The most important banks with foreign capital, by the participation in the total assets in the sector come from Austria and Italy with 21 % participation each, followed by Greece with 16 %, France with 7 % and the rest of the countries with a total of 10 %. When we discuss the participation in total capital, the biggest participation is from banks from Greece with 20 %, Austria with 14 %, Italy with 13 % and France with 8 %, whereas the rest of the countries participate with 17 %. From the point of view by countries, the foreign banks come from banking groups from eleven different countries.




*Source: Newsletter of Public Finances – MF*

With the arrival of foreign banks on the domestic market, additional capital was brought, new banking products were introduced and wider possibilities for bigger credit arrangements and investment activities were opened [5, p. 12]. The business network of the banking sector was broadened, especially in the domain of working with population. All of that contributed to enrichment of the range and increase of quality of the bank products and services, application of modern knowledge, improvement of organization and technology of work and management, as well as increase of the total number of employees. Besides that, the growing competition on the market of bank products and services forced the banks, other than the interest politics, to use other methods of keeping the existing clients, and gaining new ones.

The banking sector is Serbia is very fragmented, with regard that there is small participation of a large number of banks in assets, loans, deposits and income of banks. Thus, the market participation of 17 banks on the total market makes up for a total of 2 %, which Intesa Bank alone has participation higher than 10 %, which amount to 14.25 %. Thus, an indicator of the level of concentration in banking, which is shown through HHI index of concentration shows lack of concentration of the banking sector in a small number of banks [18, p. 4.].

When the future destiny of banks with majority state capital is discussed, the Government of Republic of Serbia brought the Strategy for Management of Share in Banks owned by Republic of Serbia for the period 2009-2012 last year (in 2009). The strategy foresees that four banks with majority state capital should be transformed so that two banks – Srpska Bank ltd and Economic Bank ltd Pancevo, are merged with the bank Postanska Stedionica in one bank, and the process is still going on, whereas in the case of *Credy* bank, recapitalization to be made, or a strategic partner be chosen or be merged with Postanska stedionica. After the second audit of the Stand-by arrangement with the International Monetary Fund, the Government of Republic of Serbia agreed to realize those obligations.

By bringing the Law about changes and addendum of the Law of taking over share-holding companies in urgent manner, recapitalization of *Credy* bank ltd by the New credit bank Maribor was done. Since the state as majority owner of the bank expressed no interest in recapitalization, nor did some domestic investors, the entry of foreign capital proved to be the right solution. By the change of ownership, organizations and management structure in the banks, the credit and business activity will be more intensified, first of all through the increase of the capital, more efficient approach to foreign sources of means in more favourable conditions by creating new products, strengthening the marketing and market competitiveness, and more profitable business.

However, although around three quarters of the assets and capital in our banking are owned by foreign banks, out banking is strongly globalized and exposed to changes which happen on the world market. Other than that, from the point of view of participation of foreign banks in the ownership of banks in the country of the region, which goes over 80 %, our banking is the least internationalized.

## MOTIVES OF FOREIGN BANKS FOR INVESTMENTS

The investments of foreign investors in the banking sector motivated by interests for engaging capital on new markets with a perspective of long and long-term sustainable growth and possibilities for spreading the networks of organizational parts in the form of branch offices, branches, agencies, business units in order to generate demand and market spread for their bank products, and bigger placement of capital in more profitable development projects.

The models of capital investment include greenfield investments, brownfield investments and portfolio investments. The effects of investment of the foreign capital can be seen in the creation of new, more progressive market and business philosophy, increase of profitablity of the business of banks, bringing several years of experience and development of share-holding culture, application of new technologies, introduction of financial innovations, better offer and a wider range of bank products/services, promotion of competition climate, development of principle of business ethics in business etc.

Managing the share-holders capital in the banks is characterized by the dominant role of the owner of capital in management, strengthening banks on the basis of more profitable business and increased responsibility of the management for realization of the strategic business objectives. During the last three years, there was an integration of certain banks in the country, first of all, banks with majority foreign capital. That, first of all, is related to the merging of *Intesa* and *Sanpaolo banks* in one bank, than the joining of Niska, Kulska and Cepter Bank in OTP Bank and the merging of Kontinenal Bank with NLB Bank. Other than that, for the first time after 2001, the National Bank of Serbia gave permission for the establishment of Moscow Bank from Russia. Bearing the global financial crisis in mind, as well as the condition of the banking sector in Europe and the problems with which banks today are faced, it would be realistic to expect that, due to increase of efficiency and professionalism in the work, as well as more rational and more functional organization, some new banking integrations and groups to be formed. Those processes could be expected in our banking sector as well, by the fact that the biggest part of our banking sector is international and actively participates in the world flow of capital.

A reform of the banking sector in Serbia, followed by a change in the ownership structure, international share-holding and introduction of corporate management in the banks, is characterized by a significant decrease of the domestic in favour of the foreign capital increase, i.e. increase of private with regard to social and state capital. Changes in the ownership, organizational, financial and management structure of the capital in the banking sector, are conditioned by the need for more effective and profitable business, faster incorporation of banks in modern capital flow by creating new bank products and providing more quality services to clients, above all the economy and population. The privatization of banks with majority state ownership, where only banks with foreign capital participated, is mostly followed by a big increase of demand in the economy and population for credits and increase of all forms of deposits.

## DIRECTION OF THE DEVELOPMENT OF THE BANKING SECTOR

In the case of Serbia, the capital of the banking sector, in the period of 2006 till 2008 doubled, while in the last few years the international rate of capital growth was in the range of 45 to 60 %. The capital growth has continued in the first quarter in 2010 in comparison with December last year for 3.6 %. The recapitalization of four banks in the amount of over 160 million euro by Komercijalna Bank, Unikredit Bank, Credy Bank and Marfin Bank especially contributed to it. With regard that the level of adequacy of capital of banks is high, and that during the last year it did not go below 20 %, it could be stated that the banking sector in Serbia is satisfyingly recapitalized and resistant to macro-economic shocks, and that, with the existing capital and reserves, it can absorb all the foreseen losses and yet remain over the regulatory minimum, which is 12 % in Serbia. Besides that, stress tests, which were made by the National Bank of Serbia in the score of the Financial Sector Support Programme last year, on a sample of 16 banks which make over 80% balance amount of the banking sector, showed that the banks in Serbia, in case of realization of the pessimistic macroeconomic scenario for 2009 and 2010, did not need emergency recapitalization. However, with no regard to the high level of caution of the banking sector towards highest credit activity, the information show that there is a growing number of clients with difficulties in paying back the credits, both in the economy, and the population. That increases the credit risk, banks refrain from bigger placements, and the economy lacks turn-over and investment capital more and more. In such business atmosphere with clients, banks must seek solutions, first of all through relaxation of their obligations by long-term payment and to direct the means, in profitable economy projects instead of in the state operation.

The newest experiences in solving the world economic and financial crises show that almost all countries, first of all the developed ones, focused to solve their own problems individually. There are huge financial means which are first of all aimed at rehabilitation of certain banks, insurances and companies are dedicated. Efforts which are undertaken by the most developed countries with creation of certain alliances, groups and integrations and similar, for now, remain declarative, without concrete measures and actions. The newest G20 summit in Toronto at the end of June this year, in the adopted declaration planned to reduce the budget deficit by half, as well as to stabilize or reduce the relations of the public debt and gross domestic product by 2016. It was emphasized that by the following G20 summit in November this year, the new financial regulative should be completed [19, ]. In such conditions of development of the world market, Serbia, no matter how dependent it could be by others, must put all the efforts to increase its economy. [14, p. 13].

**Table 1. Indicators of Financial Stability in the Banking Sector**

| | **Participation of credits in GDP in (%)** | | **Participation of Credits in Balance Amount of Banks in %** | | **Participation in indexed Credits %** | | **Participation of Nn-chargeable Credits in total** | | **Credit Growth Rate** | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **2007.** | **II 2008.** | **2007.** | **II 2008.** | **2007.** | **II 2008.** | **2007.** | **II 2008.** | **2007.** | **II 2008.** |
| Serbia | 34,2 | 35,8 | 48,4 | 52,5 | 69.0 | 66,9 | 3,8 | 4,8 | 39,2 | 31,7 |
| Bulgaria | 66,8 | 73,8 | 91.0 | 102,4 | 56,9 | 58,5 | 2,1 | 2,1 | 62,7 | 52,3 |
| Hungary | 51,9 | 52.0 | 46,8 | 46,3 | 53,1 | 53,1 | 2,4 | - | 17,3 | 16,6 |
| Romania | 36,6 | 40,1 | 56,9 | 60.0 | 54,2 | 55,1 | 9,7 | 9,7 | 60,4 | 63,4 |
| Croatia | 75,5 | 75,7 | 61,6 | 64,3 | 62.0 | - | 4,8 | 4,8 | 14,6 | 10,5 |

*Sourcer: web sites of Central Banks*

Having all that in mind, the role of the IMF, the World Bank, EU, commercial banks and other international financial institutions and organizations, first of all, from the point of view of solving the problems of the foreign debt, opening new credit lines for financing the foreign-trade deficit, realization of development projects of national significance, as well as undertaking other activities which enable faster incorporation of our economy in international capital flows. In relation to that, the support of the IMF for the reform changes which need to be realized in Serbia was granted.

In the projecy of privatization of the banking sector, it would be necessary to respect the real interests of the social community, first of all, from the point of view of realization of its national priorities in the development of the country, such as traffic and community infrastructure, energy, agriculture, modern technology, increase of export and employment, faster and balances regional development and similar. The state should create a national strategy of development for those priorities [20], those measures of the development and economic politics which will provide conditions for the creation of stable and strong financial institutions. There must be a state consensus about all the relevant factors in the country, first of all the parliamentary parties, the Government, as well as the employers. Because of that, in conditions of sharper market competition, the social community should have a majority package of shares in at least one bank. The state should consistently realize those determinations. [6, p. 84].

Due to more efficient management with public income, from the Budget of the Government of Republic of Serbia and numerous funds such as the Development Fund, National Investment Plan, Agency for Insurance of Deposits, Agency for Promotion and Encouragement of Export –APEE, Agency for Balanced regional

Development and etc, the state should opt to create a development bank, which should provide realistic possibilities for provision of long-term sources of means which will be more favourable than the market, i.e. standard conditions of commercial banks. It should be pointed out that for the National Investment Plan alone an amount of one billion euro from the budget of the state is allocated, which is 3.5 % of the GDP. Thus, it would be very important and economically justified to unite all those means, to be concentrated and invested in a new financial institution – a development bank, founded by the state.

Seen as a whole, along with all the measures undertaken by the Government and other state organs for economic recovery and achievement of sustainable development long-term, the focus of the activities should be directed at solving the current problems of liquidity of the real sector through revitalization and restructuring of the economic sector. The banking sector should actively participate, along with the state, as a warrant and co-financier of the interest and part of the principal, in bringing up a programme for each economic subject with realistic possibilities to exit the insolvency and realization of the perspective programme of development. It would also mean that banks should direct significant means, instead of the state sector, in real sector, which could increase production and export, and greatly influence the increase of budget income, or demand. In that way, the banks would significantly solve the problem of high credit risk. At the same time, it would assume that through the increased production, the financing of export and new investment activity would be encouraged, which could open realistic possibilities for new employment.

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# CHAPTER 31. SMES IN LARGE COMPANIES' SUPPLY CHAIN IN HUNGARY[1]

**Andrea GUBIK SAFRANY**, University of Miskolc, Hungary

***Abstract***

*The importance of supplying increased during the last few decades. Companies keep on concentrating on their key competences due to social and economic changes and substitute suppliers for part of their own production. Technical literature pays special attention to the analysis of supplier relationships concerning small- and medium sized enterprises. The reasons for this are twofold. First, the major precondition for the success of large- and expatriate multinational companies is the access to a well-functioning supplier network. Second, supplying enhances the transformation of small- and medium sized enterprises sector to networks.*

*The aim of the paper is to contribute to the evaluation of supplier activities of small- and medium sized enterprises via empirical analyses. The first step is to analyse the relationship between the objective characteristics of the enterprises, for example size, fields of activities, performance, etc. and their involvement in supplying. The second step is to check how companies involved in supplying evaluate their own positions and whether suppliers can be distributed to different types. The third and last step will be to analyse the advantages and disadvantages of supplying as sensed by the involved companies.*

## INTRODUCTION

Cooperation among companies is related to the ever-wider spread of information technologies, and their effects on economical and management processes. Still, this can not be the sufficient reason for the spread of cooperation among enterprises we meet today in itself (Kocsis, 2000). A very often mentioned argument backing cooperation is its favourable effect on company-competitiveness (Observatory of European SMEs 2003/5). Cooperation can be inspired by the broadening of the scale of products, or the achievement of

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[1] The author publish this paper with the contribution of OTKA K 76870 (2009-2012) „Globalisation, institutional changes, Hungary's adjustment strategies" Research Project

economies of scale, either on the sale or the purchase side, or on the field of infrastructural investments, or negotiating with the public institutions.

The firm's partnerships can secure competitive advantage for the company as cooperation can bring them to a more favourable position compared to their counterparts in the market. Despite being not forced to integrate either horizontally, or vertically, it still can be able to decrease its cost or improve the quality of its products.

Another positive argument can be the possibility of gaining more information concerning the market, or the technology. Besides, strength and weaknesses of counterparts can be gain knowledge on (Hamel, Prahalad, 1990), or new competences can be gained. Cooperation among companies creates a wider space for learning (Dussauge, Garrette, Mitchell, 2000), which a precondition for enhancing efficiency and contributes to the increase of economic performance (Fischer, 2003). Company cooperation plays an important role not only in passing knowledge but also in stimulating innovation. According to Fritsch (Fritsch, 2001) innovation and cooperation are processes which strengthen each-other.

Cooperation can not be thought of as a remedy for all problems of the company; what is more, it is not a path for all firms. A company can faced with lack of interest of the potential partners, lack of financial resources or time, lack of recognition for benefits of cooperation and legal barriers. A possible pitfall for cooperation can be the geographical isolation of the company. A reason for the company to avoid committing itself in a relationship can be the fear of loosing its competitive position, unwillingness to share its ideas (Schermerhorn, 1980).

Several points of views must be taken into account when evaluating cooperation among companies. The question of *costs* arises in decision making. Costs are necessarily related to any form of cooperation the company commits itself to (expenses evolving from communication, legal and other costs). According to another approach, the number one shaping power of relationships among companies is the profitability of investments. No matter what kind of activity we talk about, investment are needed on the field of resources in order to accomplish it. The next important question is *time*. It can happen that a company simply decides to get involved in using external resources to obtain products or services it needs faster.

The company can improve its efficiency by specialization thank to the involvement in cooperation, but it looses important competences at the same time, as already existing capacities and competences can be lost.

The nature of cooperation is double, it brings out advantages and risks at the same time (Dussauge, Garrette, Mitchell, 2000). Cooperation necessarily brings the partners to a more or less interdependent position. It can happen that the relationship becomes asymmetric, and all the benefits of cooperation go to one of the partners.

## TYPOLOGY OF THE FORMS OF COOPERATION

We can witness the formation of networks on each fields of life, in personal relationships and among companies as well. Networks can transform in several ways, can serve different aims (for example cost saving, searching for security etc.) and must not be geographically concentrated.

It is probably impossible to create a perfect typology introducing cooperation forms among companies; the variety is enhanced by the industry-specific characteristics, the combinations of formal and informal elements, different goals and motivations.

Professional literature usually analyses relationships among companies by applying four dimensions to them. These are (1) The permanency of the relationship among companies; (2) Complexity of the relationship; (3) Symmetric or asymmetric nature of the relationship; and finally (4) The indirect nature of the relationship.

The relationship among the members of the network can either be formal or informal. In practice, not one of the two forms exists but a certain mixture of these (Dyker et al., 2002). *Informal networks* seem to be more significant for small- medium sized enterprises, friendship and family-ties can be decisive in cooperation.

Fischer (2003) differentiated five types of networks, according to his opinion any possible forms of cooperation can match one of these. (1) *Supplier networks* include any agreements between the company and its suppliers, among others on component-production and sub-contractor treaties. (2) *Purchaser networks* include the relationships of producers to distributors, marketing channels, wholesalers and final consumers. (3) *Networks on technological cooperation* aim to acquire key technologies and to participate in knowledge transfer. (4) *Networks on research and development* which also include relationships between companies and industry, which is oriented at gaining access to scientific and technological knowledge and exploiting the advantages of scale of common research and development. (5) *Producer networks* include all types of cooperation which aims to merge competing producers' capacities, financial and human resources in order to broaden their product-variety and/or geographical scope.

Networks can also be differentiated based on the relationships among the companies participating in them. So, we can differentiate vertical, hierarchical, and horizontal networks. The first two types of Fisher taxonomy (supplier and purchaser networks) belong to vertical cooperation while the others can be regarded horizontal.

*Vertical cooperation* between companies is a relationship between a large and a small- and medium-sized enterprise. Several small- and medium sized partners surround one or more large companies usually.

The other type of networks relating companies is *horizontal*, in which partners are in the same positions. The objective of such cooperation is to exploit common competitive advantage, for example economies of scale, greater purchasing power, bargaining power, etc.

Networks of small- and medium sized enterprises differ from hierarchical networks. Relationships among them are founded by informal, prior knowledge of the partners more often (for example common school, friends and relatives), they are based on a mutual faith arising from familiarity, and promises are strengthened by the expectations of the local community as well. Regarding the fact that the major share of small- and medium sized enterprises are managed by one person only, relationships can be personal, and are usually attached to the acquaintances of that person. Executive officers standing in the centres of junctions have personal relationship not only with other company managers/owners but employees of public bodies as well.

In reality it is difficult to draw a border between forms of actual cooperation precisely. Solely vertical or clearly horizontal cooperation are rare to be identified. So, further typology of networks connection small- and medium sized enterprises is necessary. One of these is *extended enterprise*, in case of which companies step over traditional organisational borders in order to increase the efficiency of business processes. The application of information- and communication technologies, intensive communication and long-term cooperation are the major characteristics of this form.

Another form of cooperation among companies is a dynamic network the members of which are changed over time. This type of cooperation is called *„virtual” enterprise* in the literature, which can be regarded as an occasional network as well. Companies react to certain, actual market situations by forming these networks. Any new situation can result a new network which is characterised by a certain project-based structure.

Evans and Wurster (1997) emphasized the complexity of cooperation among companies in their *hyperarchy model* as well. While in case of hierarchy several smaller enterprises surround a large one, and in case of a non-hierarchical organisation members being of the same status form a network, an extraordinarily complex, difficult relationship with several directions exists in hyperarchy networks.

## SUPPLIER NETWORK

The most typical form of vertical networks is supplier network. Any activity which aims to contribute to the production of a final product, for example the production of components, spare parts or any related services can be regarded as supply. In a narrower sense all the activities which will not be built in the final product, but serves other purposes of the producer of the final product, can be excluded from the category of supply, for example cleaning or accounting. In a broader sense any companies which gain their revenues from large companies or small- and medium sized companies supplying large companies can be regarded as suppliers. In this case there is not any sectorial restriction.

Supplier relationship can only be an opportunity for a small fragment of companies, for several objective and subjective reasons. The scope of activities pursued by the company, its size, competences of its owners and the willingness to take risk determine whether a company can become supplier or not.

Supplying is a relationship in which two elements, replacement and subservience are present at the same time. Replacement means that the supplier takes on a certain technological and financial risk for the partner, while subservience means that it has to follow the order of the partner. Supply, according to this is a vertical, hierarchical relationship. While previously supply was a national, regional level activity, due to technological progress and the global activity of transnational companies, it is in the process of internationalisation (Christensen, 1999). All these processes require further competences from the suppliers, for example enhanced flexibility, language knowledge, etc.

Considering the fact that being involved in a supplier-purchaser relationship also means dependence for the purchasers, mainly due to technological reasons, these cooperation are usually characterised by a large extent of stability. The need for technological progress even in case of companies located at the lowest levels of the supply chain. Besides, suppliers can also learn from their purchasers.

As any forms of relationships among companies, supply can also be organised in several fashions. Some activities do not require narrow cooperation with the partners while others can't be completed without that. Supplier partnerships can differ in terms of the complexity of their goals as well, some activities can be simple, or even standardized, while other can only be accomplished by complex coordination. Small- and medium sized enterprises can play very different roles in vertical cooperation.

Christensen (1999) differentiated possible roles in the vertical supply chain according to the scale of necessary coordination and the complexity of the interactions' objectives. Based on these he divided companies to three sorts, s*tandard, traditional and strategic suppliers.*

Jones (1995) differentiated between two forms of relationships between companies, namely (1) progressive cooperation and (2) traditional supplier relationship. He saw the main advantage of the first one in forming cooperation between the companies involved, which can be exploited by efficient coordination, generating new ideas, development of products and processes, and the transfer/flow of information, knowledge and technology among companies involved.

According to Sako (1992) two ideal types of buyer-supplier relationships exist. On the one extreme company which „maintains three steps difference" can be found. Sako calls these *arm's-length contractual relation*. The other type of relationship is called *obligational contractual relation*. Trust between partners plays an important role in case of the latter; transactions can be completed without prior settling of the conditions. Tari (1998) called this type of relationship *consensus based vertical partnership.*

## METHODOLOGY OF THE EMPIRICAL RESEARCH

In the course of empirical analysis we used a questionnaire, what was made as part of the FKFP 0015/2002. educational and research platform. The aim of the questionnaire was to survey the small and medium sized enterprises' operational environment, trans-border economic function and the nature of association among enterprises.  We surveyed whether the county's frontier position reflects on the companies' more intensive international presence or not.

As the aim of the original research was monitoring of the trans-border function of the county's enterprises together with the companies' system of relations, which function's feasibility is rising together with the growing size of the company on account of the necessity of some additional expenses and competences, we tried to achieve the representativity of the model without the micro-enterprises. Thus the model's 217 Borsod-Abaúj-Zemplén (BAZ) County's enterprises represent the county's joint businesses which employ 10-249 employees according to scope and size of activities. Besides we analysed the data of 16 micro enterprises, but only in questions where the subjective opinion of the entrepreneurs is measured to show the tendencies according to the size of enterprises. The results for the calculation of which these data have been used have to be dealt with precaution.

The consistence of the county's enterprises in terms of size does not differ significantly either from national or European statistics. By analysing only enterprises which consist of more than 10 persons, we get the result that the small and medium sized enterprises' distribution is nearly 80-20 per cent. While 59 per cent of the model is functioned industrially, 27 per cent deals with trade and 14 per cent deals with provision. The survey covered 217 enterprises, which is 14.1 per cent of all registered small and medium sized enterprises in the county.

## THE SITUATION OF BORSOD-ABAÚJ ZEMPLÉN COUNTY

In this paper we would like to demonstrate the county's situation only by laying some data, given the limited framework of this paper. The per capita GDP is 1563 thousands HUF, which is 66 percent of the national average (KSH 2008a). The same fallback is perceptible in investments, where the county's per capita performance is 64.5 percent of the national average (215.5 thousands HUF) (KSH 2009). The county shows underdevelopment in terms of the economic organisation's statistics as well. Low enterprising willingness implies unfavourable economic situation too. 4.59 per cent of the country's registered enterprises can be found in the county, about 71.5 thousands. This statistic proves that enterprising here is far below the national average. The number of enterprises vested for a thousand inhabitants is 102 while the national average is 156. (KSH 2009) It partly contradicts the GEM's subsequent survey, as according to it the Northern-Hungarian region is the 4-5th in the region's hierarchy in terms of enterprising activity. According to the authors the better data can be the sign of convergence, in which motorway-building can act as a catalyser. (Szerb, L., Varga, A. 2004) In terms of research-expansion, performance is below the national average again. (KSH 2008b)

## CHARACTERISTICS OF THE BUYER-SUPPLIER PARTNERSHIPS AMONG SMALL- AND MEDIUM SIZED AND LARGE COMPANIES

Small- and medium sized enterprises can be involved in both vertical- and horizontal types of cooperation. The former one is cooperation among small- and medium sized enterprises and one or more large companies, while the latter is partnership of small- and medium sized enterprises. Supplying (subcontracting) is a special type of vertical relation between companies, in which small- and medium sized enterprises are related to large companies, and their products or services will be built in other companies products, increasing its value.

Any activity which aims to contribute to the production of a final product, for example the production of components, spare parts or any related services can be regarded as supply. All the activities which will not be built in the final product can be excluded from the category of supply.

The majority of small- and medium sized enterprises pursues its activities in the service sector which does not fit in the narrow interpretation of supplying. The above mentioned factors determine what share of companies can possibly be involved in supplying and what the market supply will look like.

Besides the field of activity other reasons can also explain why small- and medium sized enterprises do not participate in supplier relationships, like the insufficient nature of the system of relationships among small- and medium sized enterprises. Cooperation among companies is less costly for SMEs due to trust and knowledge of the partners. Widespread family- and social ties, the so called informal networks are useful for the cooperation, but these are not the proper channels when a small- and medium sized enterprise would like to get connected to a large enterprise.

It is well known that vertical and horizontal cooperation differs in the aspect of the strength of parties taking part in them, and the reciprocity of these relationships. Vertical partnerships usually incorporate hierarchical elements as well, causing a higher level of dependence for small- and medium sized companies. This type of dependence can also be present in case of horizontal relationships; furthermore, it can be regarded as necessary because of the common objectives. The symmetric or asymmetric nature of relationships differs in case of vertical and horizontal relationships. Generally, the larger a company is, the smaller its dependence on its environment can be, letting it obtain more and more control over its relationships.

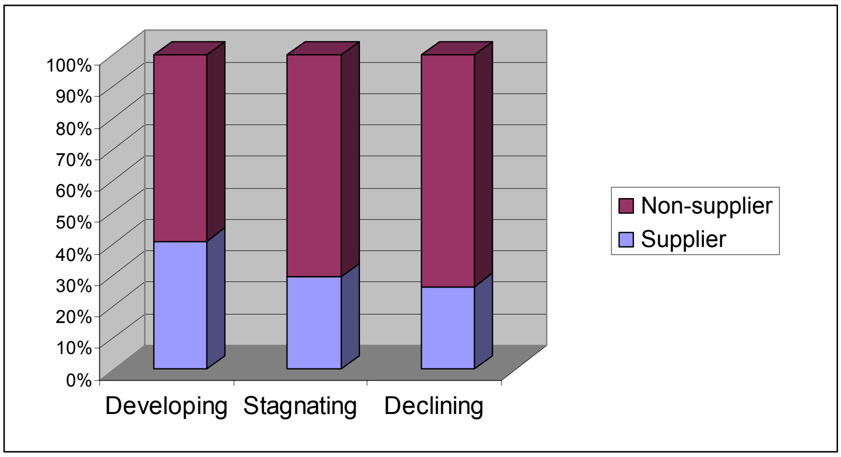
An integrating institution, for example a cluster, network or a medium sized enterprise with stabile market positions (integrator) can contribute to the success of cooperation. The strength of the integrator force can be decreasing with the increase of the company size.

About 35 percent (81 companies, 4 micro) of the asked companies declared to have supplier partnership(s).

Our empirical analysis showed that involvement in supplier relationship was not influenced by the size of enterprises. We were also unable to identify significant relationships with the objective performance of enterprises (revenues, per employee research and development costs and investment).

No significant relationship can be identified between the judgement of economic situation and involvement in supplier relationships either, but we discovered a tendency according to which those enterprises which evaluate their own economic situation more optimistically tend to be involved in supplier relationships to a higher extent. The relationship is shown on the next figure.

**Figure 1. Enterprises involved in supplier relationships, according to their judgment on their economic situation**




*Source: own elaboration*

Weak, but significant relationship can be identified between involvement in supplier relationships and in international activities (Cramer's V= 0,283, p= 0,000). A higher share of enterprises being present on international markets in any forms reported involvement in supplier relationships.

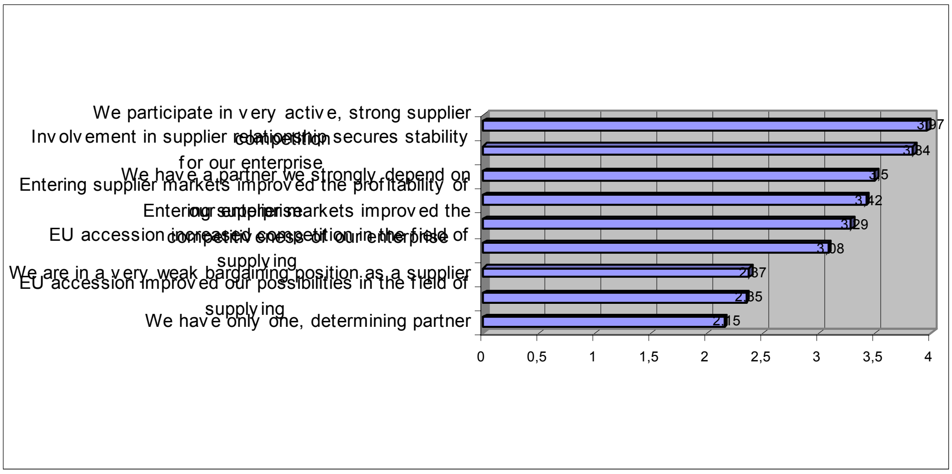
We were not able to identify significant relationship between the types of company owners (foreign or domestic) and involvement in supplier relationships, so ownership structure does not have a significant influence on supplier relationships.

### Evaluation of supplier position

Opposite to the general way of thinking (the belief that supplier position is generally advantageous for small- and medium sized enterprises) our *hypothesis* is that supplying is beneficial only for a limited group of small- and medium sized enterprises

To test this hypothesis we asked the companies about the consequents of EU accession, about their bargaining power, competitiveness and performance in connection with their supplier position. They could range the distinct statements for on a Likert scale ranging from 1 to 5 (1: not at all characteristic, 5: highly characteristic)

**Figure 2. Evaluation of supplier position**




*1: not at all characteristic, 5: highly characteristic*
*Source: own elaboration*

Table 1 groups the evaluation of supplier position according to the scale of the company.

**Table 1. Evaluation of supplier position according to the size of the company**

| | 10-19 | 20-49 | 50-249 |
|---|---|---|---|
| We participate in very active, strong supplier competition | 4,28 | 3,55 | 4,40 |
| We have a partner we strongly depend on | 3,74 | 3,56 | 2,93 |
| We are in a very weak bargaining position as a supplier | 2,29 | 2,55 | 2,29 |
| We have only one, determining partner | 1,84 | 2,47 | 1,93 |
| Involvement in supplier relationship secures stability for our enterprise | 3,96 | 3,88 | 3,73 |
| Entering supplier markets improved the competitiveness of our enterprise | 3,67 | 2,91 | 3,40 |
| Entering supplier markets improved the profitability of our enterprise | 3,77 | 3,06 | 3,53 |
| EU accession improved our possibilities in the field of supplying | 1,77 | 2,41 | 3,07 |
| EU accession increased competition in the field of supplying | 3,04 | 2,81 | 3,80 |

*1: not at all characteristic, 5: highly characteristic*
*Source: own elaboration*

Competition was judged to be strong independent of the size of the companies, Medium sized enterprises evaluated this factor as most critical. EU accession influenced the competitiveness of medium sized enterprises unfavourably. According to the opinions of companies – irrespective of their sizes – supplier position brings over stability and is favourable for both competitiveness and profitability.

To characterise the actual situation in the County, we performed factor analysis, which helped us form three groups of companies.[2]

Variables of the three factors are the following:

| Factor 1: *Performance* |
|---|
| Involvement in supplier relationship secures stability for our enterprise |
| Entering supplier markets improved the competitiveness of our enterprise |
| Entering supplier markets improved the profitability of our enterprise |
| We participate in very active, strong supplier competition |
| Factor 2: *EU accession* |
| EU accession improved our possibilities in the field of supplying |
| EU accession increased competition in the field of supplying |
| Factor 3: *Bargaining power* |
| We have a partner we strongly depend on |
| We are in very weak bargaining position as a supplier |
| We have only one, determining partner |

Following this analysis, applying these factors we performed a cluster analysis[3], differentiating among three clusters.

- *Existentially dependents*. The first cluster includes those enterprises which judge their positions as highly dependent on their partners, and are in weak bargain positions. They evaluate their performance and profitability is independent of their supplier positions. (N=33)
- *Potential suppliers*. Companies of the second cluster do not sense significant improvement in their competitiveness and profitability due to their supplier positions, but feel the ever stronger competition in supplying. They are not strongly dependent on their partners. Even though the companies of this cluster maintained their independence, they were not successful in exploiting the potential advantages of it. (N=26)

[2] We identified three factors, applying Maximum Likelihood method. The three factors maintain 56,4% of the aggregate information content of the original variables, which can be regarded acceptable (Székelyi, Barna 2002). Fitting of the model is also proper (Chi-Square=17.239, p=0.141[2]).

[3] We performed hierarchical cluster analysis with Ward method.

- *Winners*. Companies of the third cluster sense significant improvement in their competitiveness and profitability due to their supplier positions. EU accession did not influence their supplier positions, their relationship with their partners are symmetric. These companies can be regarded as the winners of supplier relationships, who are capable of exploiting the advantages of cooperation and maintain their bargaining positions at the same time (N=11).

We can declare that only 15 percent of the surveyed companies judged their subcontractor position to be advantageous. Companies belonging to this cluster are those who spend the largest sums on development and investment, are more motivated than the average, and feel smaller obstacles to cooperation on general. Another cluster of about 47 percent of the surveyed companies can not realize profits even on the cost of approving a high level of dependence in their partnerships, while 37 percent maintained their independence, but did not manage to harvest the opportunities of subcontracting either.

On the one hand, there is no general correlation between the supplier position and the advantages that can be gained from cooperation. On the other hand, supplier position is only beneficial for a small fragment of companies which has an over-average performance and can maintain its relative independence.

## Motivations and barriers of subcontracting

We analysed both the motivations and barriers to small- and medium sized enterprises' cooperation.

### *Motivations*

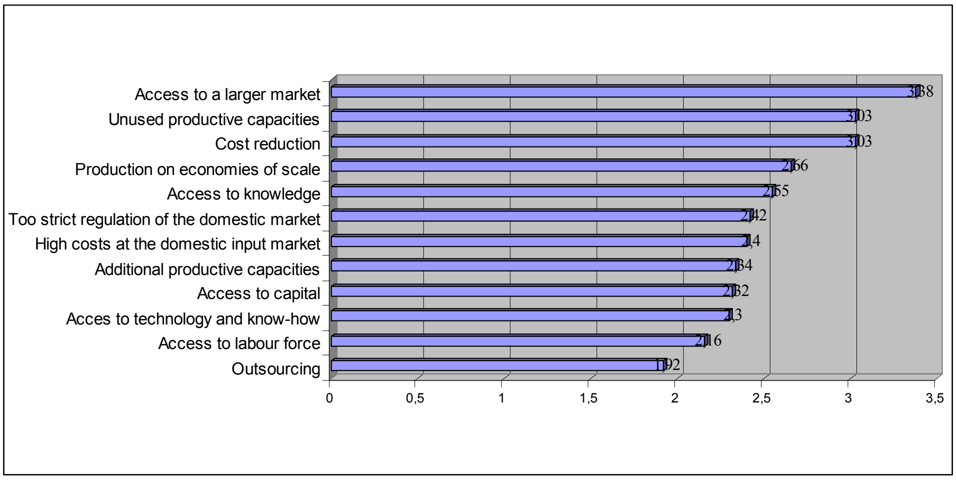
We measured distinct motivations for on a Likert scale ranging from 1 to 5, then we ranked the results we obtained, and analysed them according to different points of view.

Average points given by the companies included in the sample are rather low, none of the factors were evaluated as being of high importance.

The most often mentioned argument for supplying is that even though it is difficult to get in the circle of suppliers, if a company can meet the requirements it should, it is relatively easy (in questions of price, quality etc.) to maintain its stable business position.

According to the opinions of the surveyed companies supplying as a possible mean of increasing efficiency is mainly motivated by the opportunity to obtain market share and use of their capacities and cost reduction. Figure 3 shows the average points were given by the companies.

**Figure 3. Motivations for supplying**




*1: not at all inspired, 5: highly inspired*
*Source: own elaboration*

When analysing the motivations we found major differences according to the scale of companies. As the size of companies increases, competitive and efficiency points of view are appreciated. Smaller companies aim to obtain additional knowledge, but as the scale increases, the above mentioned efficiency gains, making use of excess capacities, harvesting economies of scale and getting access of markets becomes ever important Table 2 shows the most important motivations companies of our sample mentioned according to the size of the company.

**Table 2. Motivations thought to be of the most important, according to the size of the company**

| | 0-9 | 10-19 | 11-49 | 50-249 |
|---|---|---|---|---|
| 1. | Cost reduction | Access to a larger market | Cost reduction | Access to a larger market |
| 2. | Access to know-how and technology | Cost reduction | Access to a larger market | Unused productive capacities |
| 3. | Access to labour force | Access to knowledge | Unused productive capacities | Economies of scale |
| 4. | Access to knowledge | Unused productive capacities | Access to knowledge | Cost reduction |

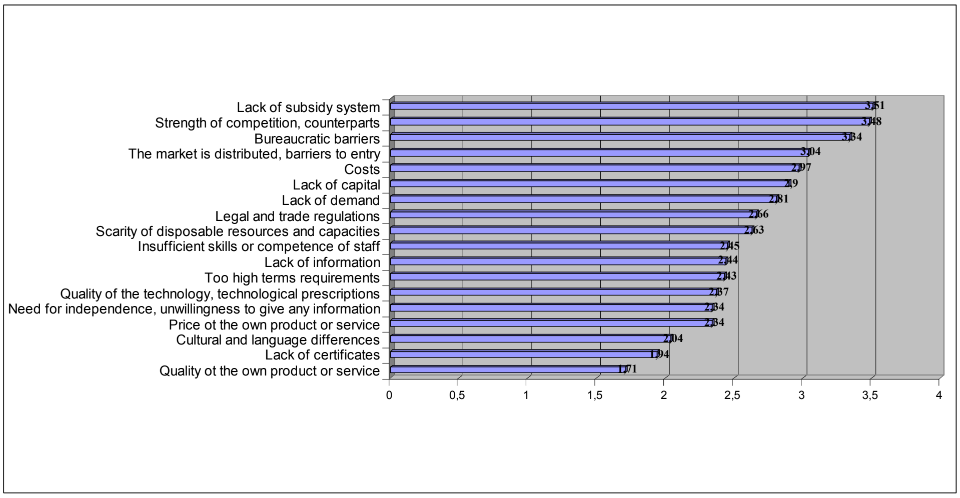
*Source: own elaboration*

According to the field of activity we can not find a significant difference.

*Barriers*

Companies are usually satisfied with their own performance (efficiency, quality, range of products, etc.) and see the reason of a less successful operation in external factors. External barriers to supplying were given high points by the surveyed companies. The obstacles regarded to be most important were connected to the problems of the subsidising system, to bureaucracy, and to strong competition. Rank of the sample's companies can be seen in figure 4.

**Figure 4. Possible barriers to supplying**




*1: not at all inspired, 5: highly inspired*

*Source: own elaboration*

In connection with the obstacles to supplying we were not able to find any significant differences according to the scale of companies and field of activities.

## SUMMARY

In this paper we analysed the supplier activity of SMEs. We found that this vertical type of cooperation can be a realistic option for a small fragment of the sector because of such characteristics of small- and medium sized enterprises like their scale or field of activity.

The results of the supplier relationships' analysis let us think that only a limited fragment of these companies can make use of this kind of relationships. The increasing complexity of the system of requirement and the internationalisation of activities also takes us to this direction.

Considering the relations small- and medium sized enterprises usually form with their close environment we can conclude that forming a cluster could be an optimal solution to their relations to large companies.

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# CHAPTER 32. SOCIAL RESPONSIBILITY AND BUSINESS ETHICS

**Azra HANIĆ, Živka PRŽULJ, Dragan MILINKOVIĆ**,
Belgrade Banking Academy, Serbia

***Abstract***

*Social responsibility and business ethics are very hot topics nowadays. They appear as a response to many scandals which do damage to individuals and the society where companies do business. Business ethics is a response to freedom of entrepreneurship and market economy. Social responsibility goes beyond business ethics and emphasizes the need for companies to be included in solving problems and development of the community where they do business. While business ethics relates to the obligation of the company not to do damage to interest groups (stakeholders) in the business, as well as the community, social responsibility emphasizes the need for assistance and uses companies in the development of the community. This paper has an objective to point out the importance of these issues in business and areas which are especially ethically sensitive.*

***Key words:*** *society, responsibility, ethics, business, company*

## THE CONCEPT OF SOCIAL RESPONSIBILITY

Corporative social responsibility is a very hot issue nowadays. This concept broadens the responsibility of the corporation outside the internal focus of products and profit. In that way a corporation is seen in a broader concept of the community and their interests.

The social responsibility of entrepreneurs entails all what entrepreneurs voluntarily do, showing that they care for their employees, youth, environment and everything surrounding them.

Social responsibility entails the application of ethnic principles in all segments of the community where we live. To be socially responsible means to work within the ethical principles, with awareness that our actions are a part of a wider, interactive picture of the working environment and wider community. At the same time, it entails us working by ethical principles in contacts with colleagues, buyers, suppliers, competitors and the community where we live.

Each company has an obligation to make a choice and makes responsible decisions about issues such as environment pollution, discrimination, safety and health of employees, possible contributions to the community and similar. The fact that more importance has been given to such commitments in the past few decades, encouraged many companies (enterprises) to become socially responsible.

The key questions which are asked when defining the social responsibility of companies are: What are the relations on the work place? Is there an ethical codex? Have we included the environment protection component? What is the community participation? Does what we do influence health and security? Do we respect differences, as well as the right to being different? Do we contribute to the development of the local economy?

The concept of social responsibility evolved with times on the basis of a change of attitude about who the company needs to be responsible for.[1] In this regard, there are three different attitudes towards understanding social responsibility: traditional social responsibility, responsibility towards stakeholders and affirmative social responsibility.[2]

**Traditional (or classic) social responsibility** means that *the company has responsibility solely to itself and an obligation to make profit.* According to this belief, the state and the public are responsible for solving social problems, not the company. Each company decision which does not go in favour of the stakeholders is considered irresponsible. Such belief is mainly based on the materialistic ideals which appeared during the industrial revolution during the 80’s of the XIX century, when there were the first big corporations. Such approach to social responsibility is applied worldwide today, and there is criticism that it is selfish.

**Social responsibility towards stakeholders** means, as the title shows, that the companies are responsible for the stakeholders, i.e each group with which the company comes into contact during business. According to this belief, the company is not only responsible to make profit, but has the responsibility towards buyers, competition, suppliers, state agencies, NGO’s, consumer associations etc. This belief appeared during the 30’s of the **XX** century, during the big world economic crisis, when there was a significant progress in the approach towards the rights of the employees and human rights. This perspective is not only aimed at what is good for the company, but obliges the company to accept ethical responsibility.

[1] Debeljak, J. (2007), p. 204
[2] Lamberton, H. L. and L. Minor-Evans (2007), p. 522

**Affirmative (or public) social responsibility** is the widest of the three perspectives. According to this belief, the responsibility of the company is not only connected to their profit rate and stakeholders, but companies are also responsible for the public and the society as a whole. Companies are expected not to create social problems, such as environment pollution and poverty, and to work towards improvement of the conditions for the entire society. This belief appeared in the 60's of the XX century, when the judgment of business practice got wider publicity. This was based on ethnic principles, especially the moral rights principle, justice principle and categorical (Kant) imperative.[3]

As that are plenty ethical dilemmas, there are many difficult questions connected to social responsibility. For instance, what happens if the company is not in a position to support humanitarian institutions any more? When the company decided to give up giving charity to maintain its financial stability, outside observers might find it as a selfish move of the company. Or, how should the company choose organization to donate financial aid?

One of the problems of ethical nature which is connected to social (ir)responsibility of companies is related to the issue how the employees (including managers) should react, or what they are supposed to do when they find out that their companies act against ethnical principles? Namely, as De George points out (*Richard T. De George*), corporations have a moral obligation not to do evil. This obligation falls on the corporation as such, internally it falls on those who manage the corporation. However, the other members of the corporation – for instance, engineers and workers have no moral justification to participate in any immoral activity. Thus, from the moral point of view, those who cannot participate in any kind of activity for which they know that will do damage, including, for example, the production or sale of products for which they are aware that will do damage. Do they still have a moral obligation to prevent damage, if they can do so? [4]

According to general rules, as De George points out, people have a moral obligation to prevent doing serious damage to others, if they are in position and can do it with a small price for themselves. What does the employee have to do to prevent the company to do damage to others? This question has become known as "whistling" or "whistle blowing" in business ethics.

People usually do not report irregularities, dangerous, unfair and unethical practice in companies where they work for different reasons, such as fear of revenge or conviction that there is nothing they could do to prevent such behaviour. Even many moral people, who respect ethnical principle, have fear to report irregularities.

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[3] *Ibid,* p.. 523

[4] De George, R. (2003), *Business Ethics*, p. 248

In the USA there has been protection for those who report dangerous, unfair and unethical practice in companies where they work since 1978. The law of protection of “whistle blowers” was brought in 1989, and broadened in 1994. Even than, due to the already given reasons, employees fear to report irregularities.[5]

Business ethics literature mentions alternative strategies which could be used by someone who is faced with the moral choice connected to reporting irregularities, which include:

- anonymous threats to the offenders that they would be reported if they did not stop or improve their unethical behaviour,
- anonymous report to someone in the company,
- anonymous threat to the manager in charge that the offence would be reported to the authorities out of the company unless the dubious behaviour changes
- finding ways to sabotage the results of unethical behaviour, public report of the offence in the company,
- silent resistance and refusal to implement the plan which is not in line with ethical principles,
- anonymous or public report directed to the authorities outside the company[6]

For the complex nature of this issue speaks the attitude of De George who says: in some cases whistle blowing can be morally prohibited, in some case it can be morally allowed, in some morally obligating.[7]

## ETHICALLY SENSITIVE AREAS OF BUSINESS

The community has plenty of benefits from the business of companies. Companies produce goods and provide services needed. They provide employment for individuals, and so on. Companies – manufacturers are morally obliged to produce products which are safe reasonably and according to the standards that consumers and the wider public expect with right, bearing in mind the degree of technical knowledge. Producers are morally obliged not to bring consumers of their products in danger consciously. Producers are also morally obliged to warn consumers about possible damage from the use of the product (for instance, tobacco products). Cases of conscious production of dangerous products, wrong representation of a product and similar examples are similar examples of unethical business of the company.

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[5] *Ibid*, p. 523

[6] Lamberton, H. L. and L. Minor-Evans (2007), p. 523

[7] In more detail: De George, R. (2003), p. 253-264

As the level of safety expected by the society can vary, so the level of safety expected in the production process can vary, as well. The danger is put to the safety of the workers, not the buyers or consumers. As is the case with the safety of products, here as well there is the minimum, and the risk of the job position which goes below that minimum is not ethically acceptable.[8]

From the ethical point of view, especially sensitive are company decisions, or decisions of the top management which relate to marketing (especially advertising, as the most expressed form of marketing), environment, restructuring and sale of the company (bearing in mind the implications of such decisions on laying off employees), as well as certain decisions from the domain of human resources management (employment, rewarding, promotion, laying off employees and similar). Maybe one of the most sensitive questions today is how ethical behaviour on the internet should look like. We will briefly discuss the issue of ethics in marketing and towards the environment, which belong to ethically specially sensitive issues of business.

## ETHICS AND MARKETING

Decision-making in marketing comprises a whole set of decisions, starting from the choice of the target market, marketing strategy, marketing mix (product, price, product placement and promotion), to decisions about implementing the chosen marketing programme. In the everyday business, marketing managers come across situations where they question what the right thing (ethically) to do is, even when doing a certain activity does not clash with the law or the company rules. Those morally problematic business situations are considered to be ethical dilemmas where questions if the done deed is going to be fair and equally good for all interested parties. People generally feel the difference between right and wrong behaviour, no matter if what they decide about it is regulated by law or not. Legal rules cannot always predict all the business situations which might occur. In most cases, laws, as we have already mentioned, come out as a reaction to existing unethical behaviour. By setting boundaries which should not be passed and nurturing ethical rules which tell us to behave in a manner which we expect from others. The utilitarian principle should be added which states that the results of our behaviour should bring the best to the majority of subjects.

Although all this seems rather simple, we are very often witnesses to undesirable, problematic situations and events from the business practice which destroy the reputation of the companies which apply them, the reputation of marketing experts, and in this instance, the reputation of the entire marketing. It is often heard that experts or managers on one hand have “domestic moral” which does

[8] De George, R. (2003), p. 235

not allow them what is allowed by the “business moral” on the other hand. Marketing which is constantly criticized about the fact that certain marketing situations do damage to their consumers, even the society as a whole, defends itself by the statement that experts who do that, do not follow the real marketing concept. Problems of ethics in marketing relate to areas of the products or services themselves, price putting, sales, distribution, promotion, market research and similar.[9]

For instance, there can be a case when the buyer asks for a product which is not in stock at the moment, and that the seller happens to know that the competition has.It is a regular, loyal buyer which the seller does not want to lose. Should he inform the buyer about it or let him go without the desired product and the valuable information? If the pillar of each modern business is put on the first place – development of long-term relationship with clients, buyers (unlike the short-term aspect of that relation – transaction marketing), in this particular case it would mean that the buyer, valuing the right information about the current offer of the competition and the action which shows that the seller does not have just temporary profit in mind, but a long-term relationship, would return to the company in the first possible occasion – when the desired product arrives, or some other situation.

**The area of marketing communication** creates many possibilities for ethical problems which could arise in different shapes. One of them is honesty in advertising, which is important in the product labelling. Often it is the case that producers emphasize that their product is something, which can later be discovered to be untrue or exaggerated. Each exaggeration in promotional messages, conviction in untruth or any deceit of consumers is a serious violation of the basic principles of ethics. Wrong or confusing promotional message, problematic publicity strategies or promotion of sales and similar shapes of using marketing tools are unethical and do damage to the company and the product. In the advertising itself, companies sometime bring out false facts, or what is more common, exaggerate, suppress important facts, there are ambiguous and not clear statements.

The wide public often discusses questions and examples of sexist advertising which make use of the female body in an ethically wrong and completely immoral manner. Marketing advocates of such commercials emphasize that the goal justifies the means. Although there is the opinion that sex is a very interesting appeal in advertising messages, which can attract not only the target group, but the attention of wider public as well, the questions is what and in what manner should be advertised. There is a wide range of products and services which can be damaged or their image can be disturbed. There are many messages which

9 Hanic, H. (2006), p. 162-183

explicitly present the bare sexual act, so the public sometimes wonders where the end to it is! Thus, at the beginning of March 2001 *Volkswagen Golf* in cooperation with *Volks Bank* published an advertising for car loans in the Croatian press. The ad presented two elderly women in the background and two young women in front. The text was: “Old for new”. There was no car in the message at all. This ad was evaluated as distasteful and an insult to male, especially female, intelligence. At the same time, it shows lack of creativity and poor taste. Many organizations reacted to it, which brought to a sharp end of the campaign. The creators of the promotional message even publicly apologized.[10]

Having in mind that children, due to their innocence and ignorance, since they have not been fully formed their personalities, belong to a specially vulnerable group, the question of ethics in cases of advertising aimed at children is asked, i.e. when children are the target group of consumers. Small children can hardly make a difference between a promotional message and regular TV programme, and it is even more difficult for them to evaluate the value of what is offered and the credibility of the message itself. From the ethical point of view, it is problematic that children are used for promotions of products which are not directed to them, but to parents, and the advertisers appeal for love and care for the little ones.

The pressure that advertising of certain products and services puts on parents whose children want the thing that had seen in adds or messages should be mentioned. Their parents, at the same time find their price too high, that they do not have any educational value, that they could badly influence children and similar. Some countries made advertising for children strictly supervised and regulated. For example, there is the association Children Advertising Review Unit in USA which offers help and advice for children, so they evaluate adds directed to children under the age of twelve. As for children and youth, there is a mention of advertising of fizzy drinks, chocolate and high calories food from fast food restaurants, because they are the most common target group. Coca – Coca, Pepsi and the other manufacturers of fizzy drinks agreed to end the campaigns directed at small children in 2006. It was considered as a very serious move in the industry which opted for *socially more responsible sales and marketing practice*, and could be considered as an up-coming pattern of a higher care of producers and sellers with regard to children’s health.

Especially problematic is the so-called deceiving advertising from ethical point of view, i.e. advertising which deceives or will likely deceive the people to whom it is directed, thus influencing the behaviour of people it is directed to. Although deceiving advertising on the market is legally prohibited, much of the advertising “walks on the thin wire” between what could be considered deceiving advertising.

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[10] *Business Journal*, Zagreb, 6/4, (2004), p. 7

## ETHICS AND ENVIRONMENT PROTECTION

Along with the development of science and technology, there was – which is a paradox in a way – the danger of threatening the environment, human survival and existence. In other words, there was an ecological crisis which took global character. Along with the ecological crisis, there is an awareness-raising that there is an evident danger for the survival of the human kind. There has been special attention put to environment protection all over the world in the past few years, on all levels, especially corporations.

The problems of ecological damage and environment pollution represent a special kind of ethical problems. Factories pollute the environment, they throw out toxic material in rivers and streams, they bury harmful material in the ground, greedy entrepreneurs cut forests, remove the ground by surface mines and unadvisedly destroy a bigger and bigger number of species. Business has a serious and often harmful influence on the environment.[11] Because of the imbalance between the natural systems for life protection and industrial, technological and demographic needs of the society, there is the ecological crisis, or the crisis of the environment.

The violation of the eco balance in nature is a consequence of the modern civilisation. The draining of natural resources came to a critical point, so the question of the possibility of their use in the future is asked. The main focus would be on renewable natural resources where fossil fuel reserves and limited reserves of metals belong. It should not be mentioned that the climate change on the planet has been caused by human behaviour. There was the overheating of the planet, thus many scientists believe that it represents a danger for the human life.

The violation of ecological balance in a scale which puts a question mark of the survival of life on the planet, started with the industrialization. Namely, production based on developed natural powers, did not take care of the natural laws. In other words, it did not pay attention that the eco-sphere as a unity of the bio-sphere and eco-system is irreplaceable, which means that if it was destroyed, it could not be replaced neither by natural processes, not by human activity.

The ecological crisis was conditioned by the globalization of the economic production activity which is profit-driven, as well. So, the humanity today is faced with the problem of drained and limited natural resources, and the modern man has to answer problems related to energy crisis, environment pollution, demographic explosion and many other questions about the harmonizing natural development and ecological rules.

[11] De George (2003), p. 236

The discussion about the ethical dimension of environment protection has often been contradictory. There was a search for ways to respect legal regulation and business ethics, and to satisfy individual interests. With that respect, some claimed that management processes have no obligation in environment protection, bigger that the one required by law, while others opposed that request.

In reality, ethics of environment protection means protection of the entire surrounding as a frame of human life. Therefore, the ethics of environment protection is based on moral responsibility of a man not to endanger the surrounding where they live, because only by doing so they create condition for a higher quality of life. The concept of "*sustainable development for sustainable future*" entails a balance between resources consumption and ability of natural system to satisfy the needs of future generations

## CONCLUSION

The issue of business ethics and social responsibility has not become hot only because it is a pattern in modern business, but primarily because it became a condition for survival both of business and society where the business operates. It was shown the business ethics is possible and necessary and can positively influence business results. Doing business in a socially responsible way is important for all companies, who have trust as one of their key components. The majority of potential partners would, at the beginning, do business with a company which has a reputation of active implementation of social responsibility. By responsible activity of the company towards the surrounding and the environment, towards the employees and the market, the company transfers positive impact from the cause related marketing. It is one of the safest ways of creating positive image, and good image often presents the boundary between successful and unsuccessful spread on desired markets in the modern business world.

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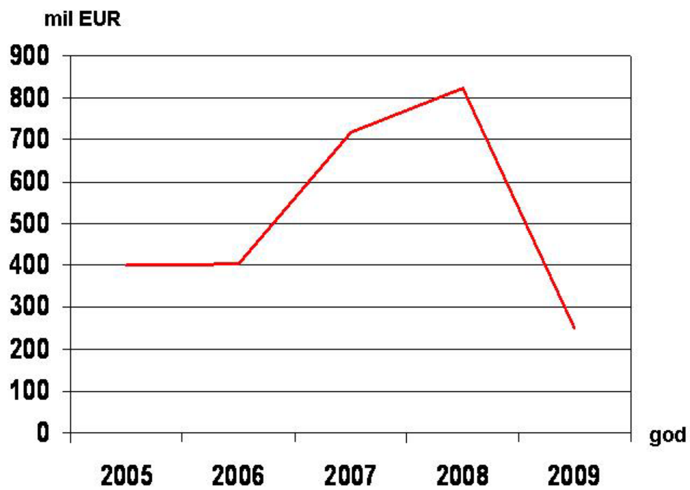
# CHAPTER 33. LIMITING FACTORS IN THE DEVELOPMENT OF LEASING INDUSTRY AND INFLUENCE OF LEASING AS A GENERATOR OF ECONOMY DEVELOPMENT

**Vojo MILADIĆ, Ljiljana JABLONJSKEJ, Ružica RISTIĆ PRISTOVŠEK**,
Porsche Leasing SCG doo and Porsche Mobility doo, Serbia

## LEASING AS A GENERATOR OF ECONOMY DEVELOPMENT

With the beginning of 2010, leasing industry in Serbia has entered the 8th year of its existence. After a modest growth of 7 percent during 2006, restructured market was marked with extremely high growth rate in 2007 and 2008- of 70% and 16%. Average growth rate, of 36.5% in last 4 years, is one of the highest comparative growth rates of leasing market in the region and volume of 'new business' has almost reached the amount of a billion euros in 2008. In 2009 leasing industry in Serbia has faced numerous business challenges in drastically changed circumstances causing a drop of demand leading to lower placement for 66.49% in comparison with 2008.

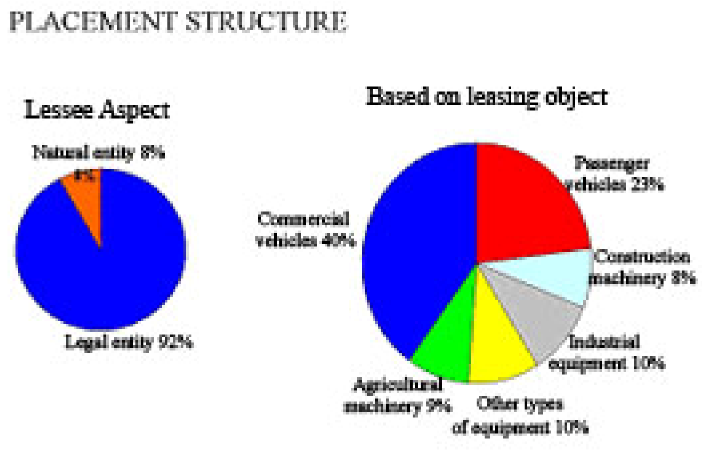
Cumulative amount of placement through leasing into economy of Republic of Serbia exceeded 3.5 billion euros.



The parameters relating to the amounts of the assets means of leasing companies and the business success indicators of these companies as well as indicators of growth in total assets of banks and providers of the lease show intensive development of leasing segments within financial sector which has become one of the most desirable financial factors in relatively short period of time.

The transition of the financial economy, together with intensive restructuring of financial sector and high level of needs to replace obsolete and outdated technology and vehicle fleet proved as a very fertile ground for development of various forms of leasing business. Average age of the cars at the beginning of 2000-s was more than 15 years, while the average age of agricultural machinery was more than 20 and even 25. Need for high level of capital investments in the real sector, lack of quality medium and long-term financial options and a fact that only a small number of small and medium-sized enterprises have satisfactory credit worthiness and quality financial indicators have shown once again on the market of Republic of Serbia why leasing is the most efficient especially in countries whose economies are in transition.

Beside that, initial legislation (La on financial leasing), high level of transparency of credit debt of potential clients through Credit Bureau database, quality database of Financial Leasing Register as well as prompt and effective performing process were enabling high level protection of creditors. It has, together with low barriers to enter the market, within a short period of time attracted great number of international leasing companies which have influenced on intensive development of this sector by their knowledge and technology. There are 16 leasing companies actively working in Serbia today, mostly affiliations of foreign renowned financial institutions and domestic banks with foreign capital.



Placement structure in terms of the lessee clearly shows that dominant share of leasing belongs to corporative sector with relative share which is more than 90%. In terms of leasing subject the greatest share goes on financing commercial vehicles (40%), passenger vehicles (23%), industrial equipment (10%), agricultural machinery (9%), construction machinery (8%) and other types of equipment (10%).

Although leasing gained its popularity through financing passenger cars for natural entity, this segment represent only the 10$^{th}$ part of the market and it is constantly decreasing in favour of economy financing. Soundness of leasing placement and the most distinctive need to replace dilapidated vehicle fleet in the industry as well as of the individuals influenced that leasing industry makes the most intensive growth in segment of financing passenger and commercial vehicles. This has directly influenced on diverse offer in car segment and also on intensive growth of supporting industries, such as insurance, where Kasko insurance records high growth rate of nearly 40 percent a year.

Leasing as flexible and secure financial option, depending on its form, thanks to various influences on client balances, is fully prepared to meet various needs of their users, so it is found widely used in developing the economy of the Republic of Serbia. Its multiplying effects on economy development are obvious, to begin with the establishment of healthy competition in financial services market, through employment increase, developing small and medium-sized companies and growth of tax base, up to growth of capital investments and GDP growth.

## INFLUENCE OF GLOBAL FINANCIAL CRISIS ON LEASING INDUSTRY

Leasing sector in Serbia is experiencing, as all of others in Europe, decrease in business volume which is additionally threatened by the volume growth of financing in delinquency which is the consequence of weakening economy, productivity drop, employment drop, inflation, all caused by financial economic crisis in Serbia and global financial economic crisis in Europe and the World.

According to ALCS leasing sector has financed 110.04 mio euros, mostly in the private service sector in the first half of 2009.

In the first quarter of 2010 finance amount is 36.25 mio euros. The lack of economy development and global world crisis have influenced on the decrease of the financing amount which is clearly shown by the data (bearing in mind and acknowledging differences of the observed periods, as well as season character of leasing sector financing intensity, when the second quarter significantly increases financing intensity in leasing sector).

**In mio EUR**

| | **FBL-financial leasing without services included** | | |
|---|---|---|---|
| **A2 Structure in relation to the lessee** | **Prime cost** | **Financed value** | **Number of contracts** |
| KGR-agriculture, forestry and fish farming | 6.02 euros | 5.15e | 165 |
| IPG-industrial production | 32.24 e | 26.42e | 735 |
| JSS- public utility service | 6.73 e | 5.66e | 213 |
| ZSS- private utility service | 39.27 e | 32.37e | 1388 |
| POT- consumers (private individuals) | 14.30e | 10.62e | 1091 |
| OSTO- others | 34.86e | 29.86e | 1663 |
| TOTAL | 133.43e | 110.84e | 5205 |

**In mio EUR**

| | **TOTAL** | | |
|---|---|---|---|
| **A2 Structure in relation to the lessee** | **Prime cost** | **Funded value** | **Contract No** |
| KGR-agriculture, forestry and fish farming | 0.73e | 0.60e | 24 |
| IPG-industrial production | 9.65e | 7.79e | 331 |
| JSS- public utility service | 3.75e | 3.21e | 105 |
| ZSS- private utility service | 13.06e | 10.73e | 673 |
| POT- consumers (private individuals) | 5.56e | 4.14e | 444 |
| OSTO- others | 11.40e | 9.78e | 592 |
| **TOTAL** | 44.15e | 36.25e | 2169 |

Data on delinquent debt in leasing sector according to the Credit Bureau Data

**Statement of debt according to bank loans and liabilities on 31/05/2010**

Amounts in dinars

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Natural entity** | | | | | | | |
| | Number of Loans | Number of users | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| | 40512 | 11775 | 96979.63 | 15628 | 4534 | 50091.30 | 4921.93 |
| **Entrepreneurs** | | | | | | | |
| | Number of Loans | Number of users | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| | 5878 | 4431 | 5527.77 | 1741 | 1322 | 2020.82 | 211.40 |
| **Legal entity** | | | | | | | |
| | Number of Loans | Number of users | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| | 16.654 | 15993 | 8397.87 | 1978 | 1749 | 1100.49 | 446.44 |
| ∑ | **63044** | **32199** | **110905.27** | **19347** | **7605** | **53212.62** | **5579.77** |

*Notion:* Delinquency with legal entities and entrepreneurs represent liabilities with lateness of more that 15 days and with natural entities more than 60 days

Although the number of signed leasing contracts with private individuals is increasing in 2010, approximately about 3000 contracts in comparison with 2009, at the same time the drop of financing volume through leasing is recorded, for about 12.369 mio dinars, simultaneously followed by its negative accelerator, growth of the amount of leasing delinquent debts, particularly of legal entities for 2.230 mio dinars in 2010 in comparison with 2009, which additionally confirms the fact of insolvency that is economy insolvency.

**Statement of debt according to leading contracts and liabilities on 31/05/2010**

Amounts in dinars

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Natural entity** | | | | | | | |
| | Number of Loans | Number of users | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| | 43208 | 12524 | 86169.30 | 17357 | 5374 | 47671.74 | 7151.88 |
| **Entrepreneurs** | | | | | | | |
| | Number of Loans | Number of users | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| | 6.204 | 4601 | 4880.73 | 2002 | 1523 | 1874.77 | 298.08 |
| **Legal entity** | | | | | | | |
| | Number of Loans | Number of users | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| | 13521 | 12746 | 7126.27 | 1740 | 1558 | 1099.33 | 455.83 |
| ∑ | **62663** | **29871** | **98266.30** | **21117** | **8455** | **50645.84** | **7905.79** |

*Notion:* Delinquency with legal entities and entrepreneurs represent liabilities with lateness of more that 15 days and with natural entities more than 60 days

Entrepreneurs and private individuals indicate mild changes in the growth of financing amount as well as in the growth of the amount of leasing delinquent debts for the observed period.

Data on delinquent loan

Data from the given charts show growth of the signed loan contracts for private individuals of 18563 contracts, short-term and framework contracts which indicates restrictive sales policy of banks, growth of financing amount of 181.000 mio dinars and simultaneous growth of delinquent debt amount based on the loan given to legal entities of 64.218 mio dinars in 2010 compared to 2009.

Crediting entrepreneurs and private individuals indicate growth of financing amount of 44.000 mio dinars, as well as the growth of delinquent debt amount for 9.000 mio dinars for the observed period.

Bank Association of Serbia
- Credit Bureau-

**Statement of debt according to leading loans and liabilities on 31/05/2010**

| **Natural entit** | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Number of Loans | Number of users | Loan type | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| | 31141 | 18605 | Long-term | 449891.28 | 7928 | 5519 | 119993.39 | 47213.44 |
| | 48317 | 22194 | Short term | 451527.93 | 10018 | 6382 | 90813.73 | 53543.87 |
| | 23215 | 12821 | Framework | 116218.14 | 1759 | 1366 | 17121.26 | 26242.60 |
| ∑ | 102673 | 34927 | | 1017637.35 | 19705 | 10690 | 227928.73 | 126999.92 |
| **Entrepreneurs** | | | | | | | | |
| | Number of Loans | Number of users | Loan type | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| | 40523 | 31191 | Long-term | 31977.44 | 8461 | 6982 | 7504.27 | 2410.25 |
| | 26008 | 19065 | Short term | 15787.77 | 4562 | 3961 | 2549.43 | 1368.40 |
| | 16469 | 10859 | Framework | 2309.50 | 741 | 691 | 433.96 | 4114.25 |
| ∑ | 83000 | 48358 | | 47074.72 | 13764 | 10455 | 10487.67 | 4114.25 |
| **Legal entity** | | | | | | | | |
| | Number of Loans | Number of users | Purpose of the loan | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| | 568100 | 527010 | Cash Loan | 101615.66 | 65184 | 62060 | 13864 | 6505.76 |
| | 277406 | 259210 | Consumer's | 32099.83 | 27818 | 26992 | 2197.81 | 1157.39 |
| | 19137 | 18378 | Adaptation | 10557.87 | 806 | 789 | 392.23 | 109.33 |
| | 68665 | 64598 | Residential | 231098.81 | 2976 | 2897 | 12408.99 | 2128.39 |
| | 137896 | 130319 | Other | 39851.92 | 8560 | 8303 | 3738.06 | 2238.32 |
| | 66766 | 51406 | Agricultural | 23734.57 | 19970 | 17665 | 4911.66 | 2953.26 |
| ∑ | 1137970 | 977367 | | 438958.65 | 125314 | 114802 | 37513.48 | 15092.44 |
| ∑ | **1323643** | **1060652** | | **1503670.72** | **158783** | **135947** | **275929.88** | **146206.61** |

*Notion:* Delinquency with legal entities and entrepreneurs represent liabilities with lateness of more that 15 days and with natural entities more than 60 days

**Statement of debt according to bank loans and liabilities on 31/05/2010**

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Natural entit** | | | | | | | | |
| | Number of Loans | Number of users | Loan type | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| | 32398 | 18808 | Long-term | 355350.59 | 2981 | 2174 | 65391.67 | 18036.78 |
| | 35602 | 18808 | Short term | 383350.59 | 4271 | 2836 | 49355.50 | 41667.40 |
| | 16110 | 18649 | Framework | 97371.08 | 564 | 485 | 4733.97 | 3078.07 |
| ∑ | 84110 | 32478 | | 836631.48 | 7816 | 4610 | 119481.14 | 62782.24 |
| **Entrepreneurs** | | | | | | | | |
| | Number of Loans | Number of users | Loan type | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| | 43430 | 33160 | Long-term | 33169.72 | 2158 | 1860 | 2356.36 | 713.68 |
| | 23709 | 18589 | Short term | 10416.27 | 1782 | 1607 | 1069.34 | 628.90 |
| | 9783 | 8191 | Framework | 2549.99 | 260 | 248 | 140.68 | 119.95 |
| ∑ | 76922 | 47790 | | 46135.98 | 4200 | 3401 | 3566.38 | 1462.52 |
| **Legal entity** | | | | | | | | |
| | Number of Loans | Number of users | Purpose of the loan | Amount of remained debt | Number of delinquent loans | Number of delinquent lessees | Amount of remained delinquent debt | Delinquent amount |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| | 661455 | 608010 | Cash Loan | 117961.00 | 48547 | 46036 | 11341.49 | 4845.28 |
| | 279986 | 260238 | Consumer's | 22303.27 | 24246 | 23656 | 1546.09 | 770.42 |
| | 15270 | 14672 | Adaptation | 6119.40 | 270 | 269 | 92.39 | 35.44 |
| | 66305 | 60463 | Residential | 204182.37 | 1671 | 1630 | 5498.26 | 977.51 |
| | 778576 | 73953 | Other | 19938.68 | 6719 | 6534 | 2036.33 | 1317.86 |
| | 89856 | 66919 | Agricultural | 24147.58 | 8775 | 7907 | 2593.09 | 1291.65 |
| ∑ | 1190729 | 1001570 | | 394652.29 | 90228 | 83683 | 23107.64 | 9238.16 |
| **∑** | **1351761** | **1081838** | | **1277419.74** | **102244** | **91694** | **146155.16** | **7348292** |

*Notion:* Delinquency with legal entities and entrepreneurs represent liabilities with lateness of more that 15 days and with natural entities more than 60 days

## COMPARATIVE ANALYSIS OF LEASING AND LOAN PRODUCTS BY THE AMOUNT OF FINANCING AND AMOUNT OF DELINQUENT LIABILITIES

Data from the above given charts point to the same growth tendencies of delinquent receivables amount by loans in relation to leasing sector. Growth of delinquent receivables in leasing sector is 1.42 in 2010 compared to 2009, and with loans 1.99 for the same period.

Conclusion derived from statistic data analysis points to necessary measure of the state which will initiate macro economic development and thus give the base for more expansive business policies of leasing companies as well as of banks, which will activate accelerator of further industry development and more stable macro economic development of Serbian economy.

## STATE REGULATIVE OF SERBIAN ECONOMY DEVELOPMENT AND LEASING DEVELOPMENT

Leasing sector could be one of economy development drivers, only if the state perceives:

**1) history and current state of economy and industry in Serbia**

Causes of economic crisis in ex-Yugoslavia are transferred, together with negative consequences of civil war into Serbian economy and with inefficient economic and politic moves in the last decade in terms of industry consolidation absence, parallel with global financial economic crisis, have brought Serbian economy into a state of latent total insolvency.

Basic generator of all economics is production, which is in constant decrease for 30 years, especially in industrial sector, currently consisting only of US Steel and Fiat. On the one hand, saved from the first impact of world crisis, due to existence of industrial sector with a minor share in the overall economy, with the transfer of financial crisis into economy sector, minor share of industry in overall economy structure of Serbia is becoming basic problem to get out of crisis. Current share of industry in GDP is really low compared to some competitive countries and countries which have achieved a lot of significant development and export results like Slovakia, Hungary, Poland, Slovenia… In addition, devastating is the fact that such small industrial production is experiencing continuous decrease. In November 2009, industrial production was 4.2% lower than in the same month of the previous year, and 2.8% lower compared with the mean value in 2008.

**2) current directed structure of Europe and World Economy**

Countries as participants in European and world economy have precisely divided assignments (or have no assignments at all) and are further inhibited by the impossibility to chose their own development direction. For majority of countries it means absence of their own capital and as well as lack of market for product placement of such willingly chosen development direction on international market. With such inherited and deepened problems in economy, Serbia is generally forced to increase industrial production with foreign capital investments, which were also present before the global crisis, due to internal and foreign political interests and demands, rather slow.

**3) contradictory crisis causes**

Apart from industrial production, unemployment and inflation are the consequences of economy catharsis of Serbia, and also the causes of contradictory measures of fiscal policy and anti-inflation policy. In the other hand, they could be, with their quality and carefully selected combination of measures, the main sub-engine for economy development and coming out of the crisis.

Employment problems must not be resolved independently from market-monetary stability and vice versa. In terms of inflation acceleration, anti-inflation policy must take care of its effects on employment. State must not sacrifice one goal in order to achieve another. Instead, it is necessary to decrease conflicts of goals to the minimum by implementing adequate economic policy measures.

Fiscal policy includes government expenditure and tax policy. Anti-recession policy means increase of government expenditure and tax decrease, and anti-inflation policy means the opposite, decrease of government expenditure and tax increase. In terms of parallel existence of inflation and unemployment, problem in finding optimal combination of stabilization policy measures complicates (knowing state of Germany in third decade of the century). In this case stabilization economic policy must be selective and differentiated.

Every tax increase citizens are obliged to pay to the state means decrease of available income of the citizens. This leads toward decrease of consumption. Every decrease of consumption, when investments have not changed, leads toward decrease of national income and employment. Decrease of citizens' tax liability leads toward increase of available income. Increase of available income influences consumption increase depending on, naturally, inclination of the citizens toward consumption. Consumption increase lead to multiplied increase of national income. Increase of national income is followed by increase of employment. When unemployment and depression are prevailing, i.e. deflation "gap", decreasing tax should lead toward decrease of unemployment and depression. Every decrease of tax expenses leads toward increase of available income. This causes new initial consumption which moves the whole chain of secondary consumption.

Leasing sector is unfairly burdened by Value Added Tax on interest. This diminishes its competitiveness with other forms of financing (for example loans), and in the other hand it disables leasing sector to be economy development engine. Government has a huge role in correcting this irregularity.

One of two main forms of fiscal policy against economy stagnation, unemployment and inflation is appropriate budget policy (policy of general investment and budget consumption), that is public government expenditure (public works). Budget policy includes:

1. general investment consumption
2. public financing of budget, government and public expenditures
3. Public Government Investment (public works, construction of roads, schools etc). In many of these areas, Government appears as direct investor and organizer of production activity. Leasing sector with its capital can help the Government which performs its direct production function, which has exceptional significance. In many of these areas the Government as a big buyer and consumer.

Monetary-loan policy should be selectively expansive, tax policy selectively mild and policy of general and joint standing should be selectively expansive, and all of them should be directed toward those sectors and branches which represent production bottlenecks and enhance inflationary tendencies. Also it is necessary to lead anti-monopoly policy in order to eliminate monopoly terms of operating and to establish liberal competitive market model, selective development policy for deficient branches and branches with comparative advantages and beneficial economic policy toward foreign countries in order to eliminate structural disproportions and import dependence of the economy.

Leasing sector in all of its above mentioned varieties is compatibly adjusting and merging with all flows of economy movements which will be created by government in particular circumstances. If a combination of fiscal, monetary and economic policy measure in Europe, as well as in our country leads toward positive moving, capital inflow and export activities will make a ground for active leasing participation in economy development and its own positive development which had rising trend up to 2008.

## GROWTH CHALLENGES

Nowadays, when it is, due to expected effects of financial crisis influence on our market, very uncertain to estimate future growth with certainty, leasing industry in Serbia, as well as whole financial sector is facing great challenges.

2009 was marked by postponement tendency of investment decisions or financing investments by its own funds. As its result demand for leasing was lower than demand for products supported by leasing, which points to the fact that companies and individuals have financed equipment and vehicle procurement because they did not want to get further onto debt in state of uncertainty and maybe at the same time endanger their solvency for medium and long-term period. Thus in these circumstances of negative growth recorded in 2009, and thanks to the faster portfolio return through leasing installments, as opposite of the whole market, leasing companies are faced with solvency surplus which they cannot place adequately. This leads to premature repayment of the loan to the foreign creditors and thus leaves the market without additional necessary solvency assets.

Demand drop and deteriorated solvency of potential clients are only some of the problems leasing companies are facing. In the other hand, independence and lack of quality initial parameters for assessing creditworthiness of clients are only some of the challenges risk department and are directly connected to placement security.

## LIMITING FACTORS IN LEASING INDUSTRY DEVELOPMENT

Considering which factors influence development of leasing industry development, necessary reform of executive proceeding is mentioned as first. In circumstances of endangered solvency, and without it, inefficiency of court rulings executing system represents one of the core problems. In fact, although Law on Financial Leasing strictly prescribes summary enforcement proceeding (3+3 days), this legal regulation is not applied in practice. Long delay of executive proceeding reform was, unfortunately, stimulating for negligent debtors and increased risks and placement costs of leasing companies. In this way, it seems that creditors, as far as leasing is in concern, are completely unprotected and that leasing loses its purpose as flexible model of financing, which, as a rule, does not rely on other forms of credit security/collateral. Sheer fact that lessor is at the same time legal owner of it, represents basic purpose of leasing itself. If there is no mechanism which would imply respecting contract clauses of leasing, leasing as institute/department loses one of its main supports. Unfortunately, inefficient or slow executive preceding that is sanctions prescribed by law or its postponing practically stimulates non-fulfillment of obligations assumed by contract, which creates bed perception of investment security in our country for current and new investors as well.

Next segment where it is possible to make a significant regulatory improvement is the Law on Financial Leasing whose changes have been reconsidering for 2 years now. As an important flaw of Law on Financial Leasing in Serbia we se limitation from the point of business aspect and from aspect of choosing potential leasing object. Law practically excludes the possibility of performing operative leasing activities fro the present leasing companies, which certainly increases operational costs and limits their activity exclusively to financing of movable properties. In terms of decreased offer relating to financing construction and purchase of real estate, for business and residential purposes, introducing possibilities of financing real estates by leasing, new development possibilities would arise. These development possibilities would show their secondary effects as well through the development of construction and related industries.

Analyzing financial indicators of companies in the domain of financial leasing, deteriorating of almost all business indicators in last two years is clearly perceived (operational results of the companies which deal with financial and operational leasing were cumulatively monitored). Profitability drop is also notices, as well as drop of other indicators such as Return on Average Assets (ROAA or ROA) or Return on Average Equity (ROAE or RAE), which brings leasing companies into potentially unenviable situation in circumstances when due to insufficient demand comes to constant and abrupt drop of portfolio. Particularly since their business is currently based on a single product, with limitations of more restrictive character compared to other surrounding countries and with impossibility to compensate eventual negative tendencies through diversification of services as in case of banking sector.

## NEW TENDENCIES IN DEVELOPMENT OF LEASING INDUSTRY AND THEIR INFLUENCE ON ECONOMY GROWTH

Leasing as typically investment form of financing is leaned on economy and its primary role above all is development, for small and medium-sized companies and as well for medium-sized and large corporation.

Leasing represent an alternative in financing fixed assets procuring, needed for efficient development of real sector. The appearance of leasing lead toward adding quality to financial services field and this has, by product diversification, influenced on development opportunities of the economy.

On increase of interest for leasing (placement growth) in the following period will influence stabilization of economic system, growth of investments and new projects or in the other hand increase of placement based on increase of risk that is decisions on loans.

Market orientation of leasing companies and treating all limiting factors of growth and leasing industry development as “risk and opportunity” will lead toward leadership positioning of the companies which have adjusted its business, organization and rationalization to new business terms. And which have diversified scope of products and clients, invest in development and improvement of business and which are able to adapt fast to changes that have occurred.

In a time when payment ability of population and economy is endangered, leasing companies pay great attention to quality of their placement, risk decrease and investing assets in secure business. Increasing quality of service represents a new opportunity for leasing companies to establish competitive advantage. Similarly, greater dedication to specific clients' needs, consistency of the offer and continuity in service delivery represent additional elements in establishing competitiveness of leasing companies.

**BELGRADE BANKING ACADEMY**
**FACULTY FOR BANKING, INSURANCE AND FINANCE**
Zmaj Jovina 12, 11000 Belgrade, Republic of Serbia
Tel. +381 11 2621-730; fax: +381 11 2631-926

**INSTITUTE OF ECONOMIC SCIENCES**
Zmaj Jovina 12, 11000 Belgrade, Republic of Serbia
Tel: (011) 2622-357, 2623-055; faks: (011) 2181-471

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