TRANSITION, STABILISATION AND SUSTAINABLE DEVELOPMENT: SERBIA'S PERSPECTIVE

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Abstract:
The largest problem of Serbia's economy is inbalance between production and demand which represents structural cause of inflation. Low level of economic activities is a result of slow transition process, reflected through meager efficiency of privatized enterprises as well as slow rhythm of new investment. In such conditions, macro-economic stability can hardly be obtained, and, when obtained, it is sustained with high costs. The exit from the existing situation is new strategy based on the concept of sustainable development (not only transition completion but also resource allocation in respect economic, social, and environmental goals). The core idea of new development strategy is shift from resource-driven to investment-driven economy. The essence of proposal given in the paper is that income from privatization of commercial and financial sectors should be reinvest in state-owned companies from strategic sectors. Also, paper advocates initial public offering procedure in statet-owned companies from strategic sectors as well as state banks and insurance companies.

Keywords:
Transition, stabilization, sustainable development, growtht strategy, transitional stagflation, monetary policy, money sterilization spiral, transitional entrepreneurs, investment myopia, strategic sectors, capital market.

Problem postulate

During the Cold War period, Yugolavia represented a buffer zone in spreading communism throughout European continent. Geopolitical importance of the country was further enhanced when regional buffer zone model was globalized through formation of Non-Aligned Movement, in which Yugoslavia had leading role. At that time, Yugoslavia was at the peak of its power and its geopolitical importance has considerably outpassed its economic performances. Tremendous amount of soft credits and uncovered political support in international relations from the West colourfully explain who was nourishing the buffer zone project.

Transition has utterly devaluated geopolitical importance of Yugoslavia. With the fall of Berlin Wall, software became obsolete and hardware started to crumble. Communism ideology was major internal integrative factor of the country. The essence of communism ideology in Yugoslavia was connecting people of different confessions into single nation. The reach of that concept was meager, because inefficient economy, with huge regional gaps, was not capable of surpassing serious misunderstandings from the past, differences in value systems and culture, caprice and unpredictable reactions from relevant people. Despite attempts, Yugoslavia was not preserved.

It is apparent today that Serbia is former Yugoslav republic and former socialist economy. Yugoslavia's dissolution, which started in Slovenia in the year of 1990, actually represented gradual separation of former Yugoslav republics from Serbia and their catching up of transition. From the very beginning, separation was accompanied by confronting interests, which escalated through the series of wars with humanitarian and economic burdens. The dissolution ended peacefully and almost with no emotions by exit of Monetenegro from completely reduced Yugoslavia (Union of Serbia and Montenegro) in the year of 2006.

Dissolution of former Yugoslavia was kicked off independently of Serbia's will. However, this process has had strong influence on Serbia's transition. There are two opinions regarding the question: when the transition in Serbia has actually started? According to the first opinion, the transition has started in the year of 1989, at the same time as in other Eastern European socialist economies. The proponents of this approach relies on simple argument that there were two triggers for transition process: introduction of multi-party political democracy, and initialization of regulated privatization. During the first decade of transition, the privatization process failed to get the power of impact wave due to serial civil wars which brought Serbia in isolation and deap economic crisis. Besides, the attitude of political establishment towards transition, especially economic transition, was unfaithful. Consequently, regulated privatization was slow whereas unregulated one was rapid, almost instantaneous, and widespread. Regulated privatization was fulfilled through so-called insiders' paradigm, more precisely through the giveawy model or free distribution of social capital to employees. Such type of privatization was non-obligatory, without time limit and focused on commercial sectors only. Financial sector (banks and insurance companies) was overshadowed from regulated privatization. Privatization of state-owned companies had *ad hoc* and, sometimes, reversible character (e.g., going private of Telecom Serbia in 1998 and going public in 2003).

According to the second opinion, transition actually started in the year of 2000, when Milosevic's regime was overthroned. Transfer of power triggers paradigm change. More precisely, the giveaway model was replaced with sales model. Additionally, privatization has become obligatory, timeframed, and widespread. Crucial reforms started with liberalisation (trade and balance of payments) and contunued with acceleration of ongoing privatization as well as with initialization of privatization in financial sector.

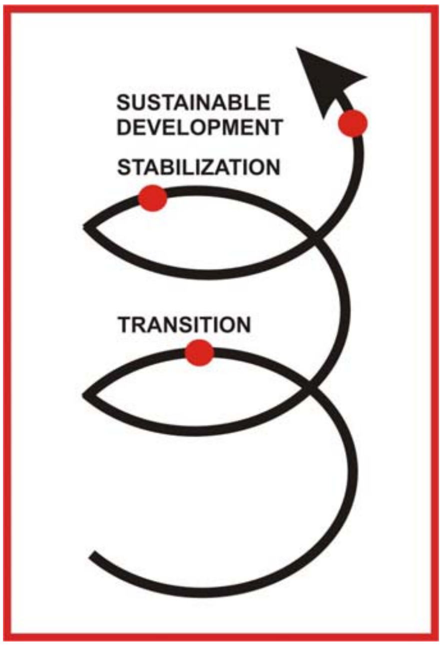
Overall effect of reforms was turnaround. Namely, longstanding decline were replaced with growth. In period 2000-2005 compound annual growth rate in Serbia was 4.7% where the year 2004 experienced the period maximum rate of 7.2%. Despite high growth rates, the level of production is still meager and consumption is higher than production.

The faith in rapid recovery after the year of 2000 was not realistic. It is the fact that privatization has not been completed yet, new sector is still insignificant, and macro-economic stability is hard to be obtained, and when obtained it is very fragile and related to high costs. In the year of 2005 or 17 years after the start of transition process, GDP level was 56% of that achieved in pretransitional year of 1989. The unemployment rate is 21%. The inflation rate is about 17%, which is the record in Europe. GDP p.c. of USD 3,265 is low and sets Serbia into group of resource-driven economies in sense of *M. Porter* [8] and [9]. External indebtedness in the year of 2005 of USD 15.5 billion approaches two thirds of GDP. The deficit of current account was 10% of GDP owing to excessive trade deficit of 22% of GDP. The position of economy is unenviable, which is obvious through the lense of competitiveness. For instance, the last report of World Economic Forum [12] shows that Serbia, according to Index of global competitiveness, holds 85-th place in competition of 117 countries. Social and political stability, as well as economic expectations, are predominantly influenced by transfers (remittances from abroad and income from privatization) instead of new value creation.

The solution is turnaround. The role of the state is irreplaceable in this process. The state must be part of solution, not the part of the problem. Namely, state must find new balance between stability (political, institutional, and macro-economic) and development. Government of Serbia has adopted the document entitled *National Strategy for Economic Development of Serbia for the period 2006-2012* (NSEDS) [6], which represents an attempt to enlighten new solutions for turnaround.

The aim of this paper is to make link between transition, stability, and sustainable development (see illustration 1). The titles that follow causaly and chronolocicaly are dedicated to mentioned problems. The last title deals with the link between the analyzed phenomena from the NSEDS perspective. The paper is finished with concluding remarks and some recommendations to strategists.

Illustration 1: Transition, stabilisation, and sustainable development



Transition

By definition, economic transition represents radical reform of the economy through liberalisation of trade and balance of payments as well as privatization, in order to develop full-fledged market economy with the capital markets in its centre. This is long and deeply destructive process.

Destructive character of economic transition cold be summariyed through the transitional stagflation (decline in the level of production followed by constant inflation pressure). Transition must be quick in order to avoid negative consequences of this effect.

Unfortunately, transition process in Serbia is slow and with obvious delays in comparison to similar economies. In order to get insight into Serbia's position, the sample of neighbouring countries for comparison has been created. The sample is composed of two former Yugoslav republics (Slovenia and Croatia), Hungary as the leader of transition, and Romania as a late follower.

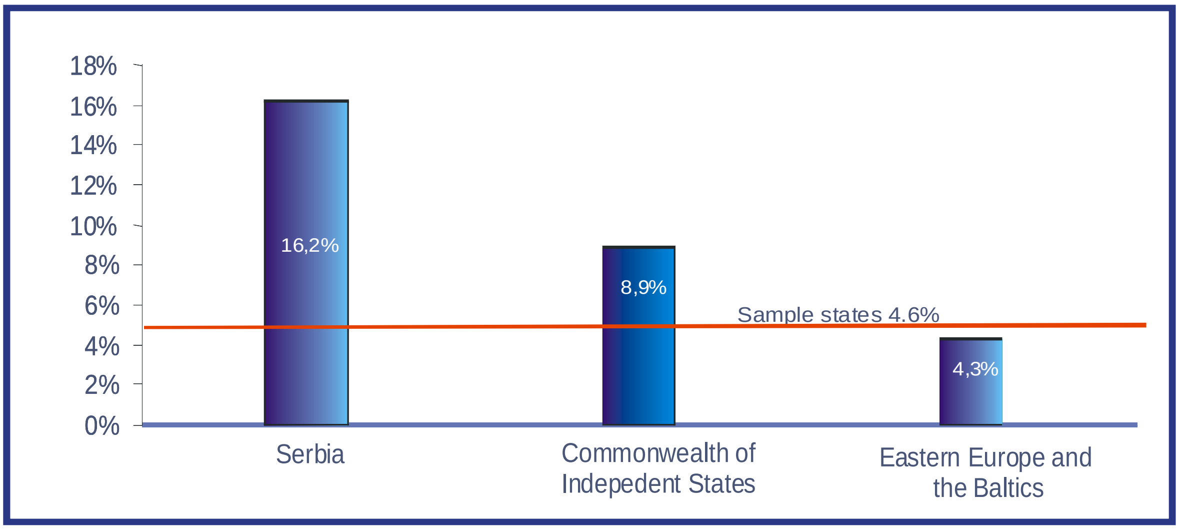
Illustration 2 exhibits the level of GDP for selected sample of states in year of 2005 in relation to pretransitional year of 1989. The illustration shows that in the year of 2005 Serbia (with Montenegro) has reached 56% of the level of GDP achieved in pre-transitional the year of 1989, that Croatia is very close to pretransitional level (97%), while other economies from the sample has surpassed their pretransitional levels (Slovenia 130%, Hungary 125%, and Romania 105%).

Illustration 2. The level of economic activities for the sample states

	GDP_{01}/GDP_{89}	GDP_{02}/GDP_{89}	GDP_{03}/GDP_{89}	GDP_{04}/GDP_{89}	GDP_{05}/GDP_{89}
Serbia and Montenegro	0,47	0,50	0,51	0,54	0,56
Hungary	1,09	1,12	1,15	1,20	1,25
Slovenia	1,14	1,19	1,20	1,25	1,30
Croatia	0,85	0,88	0,91	0,93	0,97
Romania	0,83	0,88	0,91	1,00	1,05

The level of inflation in Serbia in the year of 2005, measured by the consumer price index, was 16.2%, while annual growth in retail prices (period December 2004 - December 2005) was 17.7%. That is not only the highest inflation in Europe but also the inflation rate that is significantly higher than the average inflation rate for sample states (4.3%), economies in transition (4.7%) and the Commonwealth of Independent States (8.9%). Comparative analysis is given in Illustration 3.

Illustration 3. Comparative analysis of inflation rates for the year of 2005



By comparing the level of activities and inflation rates it is possible to determine the duration of transitional stagflation. Appropriate comparison is given in Illustration 4. Illustration shows that in Serbia (along with Montenegro) this effect is still on, which is not the case with other sample states.

Illustration 4. Duration of transitional stagflation

	Serbia and Montenegro		Hungary		Slovenia		Croatia		Romania	
	Inflation rate	Growth rate	Inflation rate	Growth rate	Inflation rate	Growth rate	Inflation rate	Growth rate	Inflation rate	Growth rate
'90	580,4	-6,6	28,9	-3,5	550,0	-4,7	136	-8,6	5,1	-5,6
'91	118,1	-8,2	35,0	-11,9	118,0	-8,1	149	-14,4	174,5	-12,9
'92	*mega*	-27,9	23,0	-3,0	201,0	-5,4	937	-9,0	211	-10,0
'93	*mega*	-30,8	22,5	-0,6	33,0	1,3	1550	-8,0	256	-1,5
'94	3,3	2,5	18,8	2,9	21,0	5,3	97,0	5,9	136	3,9
'95	78,6	6,1	28,2	1,5	13,5	4,1	2,0	6,8	32,3	7,1
'96	94,3	7,8	23,6	1,3	10,0	3,5	3,5	6,0	38,8	3,9
'97	21,3	10	18,3	4,6	8,4	4,6	3,6	6,5	155,0	-6,1
'98	29,5	1,9	14,3	4,9	8,0	3,8	5,7	2,5	59,1	-5,4
'99	37,1	-18	10,0	4,2	6,1	5,6	4,2	-0,9	45,8	-1,2
'00	60,4	5,0	9,8	5,2	8,9	4,1	6,2	2,9	45,7	1,8
'01	91,1	5,5	9,2	3,8	8,4	2,7	4,9	4,4	34,5	5,3
'02	21,2	3,8	4,8	3,5	7,5	3,5	2,2	5,2	22,5	4,9
'03	11,3	2,7	4,9	2,9	5,6	2,7	1,8	4,3	15,4	5,2
'04	9,5	7,2	6,8	4,2	3,6	4,2	2,1	3,8	11,9	8,3
'05	16,2	4,0	3,8	3,5	2,5	3,8	2,9	3,5	9,2	5,5

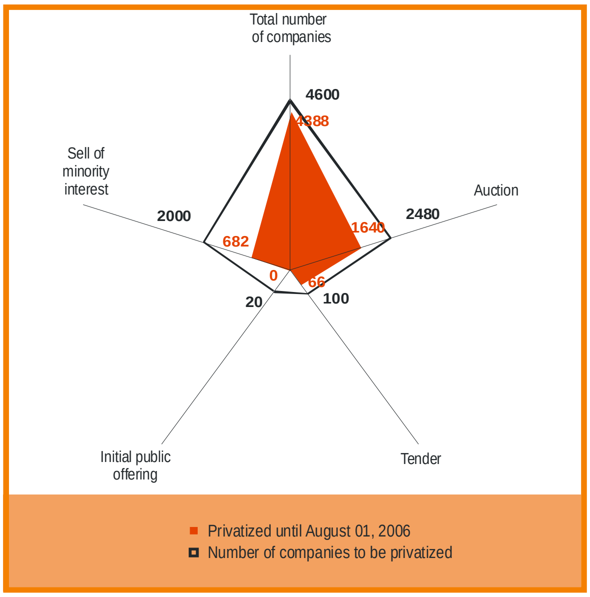
Production is not capable of absorbing aggregate demand, despite high growth rates in the last two years that were higher than medium-term trends. This is structural cause of strong inflation pressure. Besides, there are two other triggers of new inflation pressure: fiscal populism and monetary expansion. The major reasons for fiscal expansion are delays in restructuring of business-controversial and state-owned companies. However, opportunities for wider use of restrictive fiscal policy are meager due to excessive social risks that put off the issue of restructuring of state-owned companies and liquidation of unprofitable companies. Monetary expansion is a consequence of increased inflow of foreign capital *via* privatization, and intensive crediting from abroad. Money sterilization using by central bank through increasing obligatory reserves and launching repo papers, provokes so-called "sterilization spiral". Namely, due to inflexible demand for credits in corporate and retail sector, restrictive monetary policy provokes financing cost growth form one side and growing banks activism in repo operations (as a very lucrative business).

Another effect inherent for economies in transition that could be identified in Serbia's case is *Balassa-Samuelson* effect [10]. Inflation in economies in transition is usually followed by national currency appreciation which leads to decline in competitiveness and growth slump. Using restrictive monetary policy as anti-inflation tool has limited capacity and currency appreciates even in the regime of free flow. The logic of this effect is as follows. Privatization on the company level initiates radical restructuring in terms of rightsizing (assets, capital and number of employees) and technology revamp. Previous activities lead to productivity growth and competitiveness improvement, which in turn increase export. Unfortunately, productivity growth in sectors with tradable goods opens space for salary growth. The problem is that salary growth is not localized on sectors with tradable goods, but leads to so-called "demonstration effect", i.e. to salary growth in sectors with non-tradable goods (even in state-owned sector). Therefore, salary expansion pushes inflation in two directions. Salaries are incorporated in price of products (cost inflation) and increase aggregate demand (demand inflation). Moreover, relatively higher domestic inflation than foreign inflation has not complete influence on nominal currency rate because its formation is far more influenced by prices of tradable goods which grow slower than prices of non-tradable goods. Currency rate is formed on a basis of tradable goods, which means that it does not truly reflect the total price level. In other words, sector of non-tradable goods with faster price growth does not influence currency rate, which means that currency rate grows slower than inflation. Currency appreciation is indispensable.

Such a setting may cause boomerang effect, which means that sector of tradable goods, instead of influencing sector of non-tradable goods and state-owned sector, is influenced itself by them. The effect is accelerated by the measures of monetary policy especially when inflation flame, caused by excessive inflow of foreign capital, is watered by intensive money sterilisation. Money sterilisation increases interest rates, enforces the activism of foreign banks toward credit expansion, and boosts demand for domestic currency. Higher interest rates push financing costs up thus slowing down the process of economic revival. In new setting, restructured companies from the sector of tradable goods may increase their product prices, as the major way to sustain profitability in ambience of overall increase of financial costs, which further feeds inflation and reduce competitiveness.

Another important question is: what is going on with privatization? Illustration 5 gives insight into the level of privatization through five privatization tracks. Precisely, on August 1, 2006, 4,338 companies, out of total number of 4,600, entered privatization process. Out of that number, sales of stock is occurring in 682 out of 2,000 previously privatized enterprises, auction sales in 1,640 cases out of 2,480, tender sales in 66 out of 100 cases and initial public offering in none of 20 projected cases. Shaded radar diagram in Illustration 5 represents the approximation of already privatized companies, while unshaded radar diagram refers to unprivatized companies. Insight into proper gaps in privatization tells that privatization process is close to end.

Illustration 5: Level of privatization in real sector



Despite the fact that privatization process is approaching the end, the effects of efficiency growth, on a basis of privatization, are not sufficient for radical lifting of the overall activity level. Profit making companies, taken over by strategic partners, do not have vast space for efficiency growth. Besides, for new owners, dominantly inspired by return on investments, capital expenditures (CAPEX) are not priority. Also, shift in performances for business-controversial companies (loss making companies with profit potentials) needs time for consolidation and restructuring programme. Finally, enterprises in crises, which were cheaply acquired by transitional entrepreneurs, stagnate due to dominance of brokerage instead of industrial mentality of new owners.

The major problem of Serbia's economy is investment myopia. The level of investments is low both in existing sector and new one. Ratio CAPEX/GDP for the period 2001-2005 is around 15%, which is far less than in successful transitional economies (25-30%). In order to shorten transition, it is necessary to develop new sector. New sector is the second leg in the transition walk. At the beginning of transition, World Bank has projected that it is necessary to increase contribution of new sector, through foreign direct investments, to at least 40% of GDP in order to outweigh transtitional deficit which is a consequence of stagflation. It was shown that this estimate was appropriate.

Macro-economic stability in Serbia is still a problem due to imbalance between production and aggregate demand. Domestic entrepreneurial capacity is insufficient. Initial capital is aglomerated by transitional entrepreneurs as a consequence of unequitable trade in the period of hyperinflation (space-rocket selling prices and knock-down buying prices for privately-owned vis-à-vis socially-owned companies). It was actually the transfer of social capital (zero-sum game) instead of entrepreneurship as a means for opening perspectives not only for yourself but also for others (win-win). The greatest problem of most of transitional entrepreneurs is limited capacity for turnaround of acquired companies and, consequently, high investment myopia. This kind of entering in business without clear vision and expertise as well as capacity to attract adequate management team, leads to the fact that survival of acquiring companies is primarily based on non-economic, mainly political instruments. Consequently, such model of privatization influenced excessive corruption and negligible level of economic freedom, the factors that inhibitate authentic entrepreneurship as well as foreign direct investment.

Privatization process has not brought sustainable development of typical institutions (stock exchange at the first place) and mechanisms (equity financing) of full-fledged market economy. Consequently, capital market is shallow and in retreat, and stock exchange has not become the infrastructure for capital raising but infrastructure for privatization ending. As a result, financial intermediaries (investment funds, pension funds, for example) have not been developed yet. Finally, stocks acquired in privatization process have become neither material basis of middle class and guarantee for political stability nor the lever of efficient corporate governance. The reason lies in the fact that the privatization model has changed from one extreme (dispersed ownership by employees as a consequence of giveaway model used in the 1990s) to another extreme (model of concentrated ownership based on sales model after the year of 2000).

Macro-economic stability

Period of overall instability caused by political isolation and economic sanctions is finished in the year of 2000. The exit from previous situation indicates the beginning of recovery. Liberalization of trade and balance of payments has enabled the integration of Serbia into international trade and capital flows. In the year of 2005, foreign capital inflow accounted for 18% of GDP and surpassed needs for debt servicing caused by the deficit in the account of current transactions (10% of GDP). In the year of 2006, the mentioned trend is continued, mostly based on privatization inflows, which are planned to be at the level of around EUR 3.0 billion. However, liberalization has its price. Price of liberalization is increase in trade deficit and foreign debt. Liberalization is an opportunity as well as a threat to macro-economic stability.

Transition, similar as sustainable development, is more efficient if applied in conditions of macro-economic stability. In that sense, price and currency stability as the main objectives of macro-economic stabilization policies still remain the same in transition period. These objectives are also interrelated.

Exchange rate is nominal anchor of macro-economic stabilization policy. That situation, in the setting of larger inflow of foreign capital, results in strong inflation pressure. Inflation imperils the apex of monetary policy, which is low (one digit) and stable inflation. National Bank of Serbia has lately increased the level of money sterilization in order to prevent money volume to jump over tolerable frontier. Two measures are used: increase in obligatory reserves through larger rate and expanded base for calculation, and using open market operations (repo operations). For example, in the middle of the year of 2006, the rate on obligatory reserves for credits with two year maturity was 60%. At the same time, interest rates on two-week and two-month repo papers were 21% and 24%, respectively.

Price of money sterilization is paid by debt holders through increase of interest rates. Increase in costs of financing has reduced profitability and competitiveness. The overall result is growth slow down. Money sterilization is not only unefficient but also counterproductive measure. Namely, interest rates on securities issued by central bank stimulate commercial banks to participate in that game in spite of the fact that they are actually the target, whose credit expansion is aimed to be reduced. It is paradoxical that commercial banks are motivated to get loans abroad, because they have lucrative opportunity for capital placement in purchasing central bank sterilization securities.

Demand for loans in corporate and retail is greater than credit potential of banks. Banks are looking for additional money sources abroad. The motives for getting loans abroad lie in significant differences in interest rates. Described state represents huge problem for monetary policy, because heavy credit expansion backed by foreign curencies brings growing demand for domestic currency, and consequently, real danger for its appreciation.

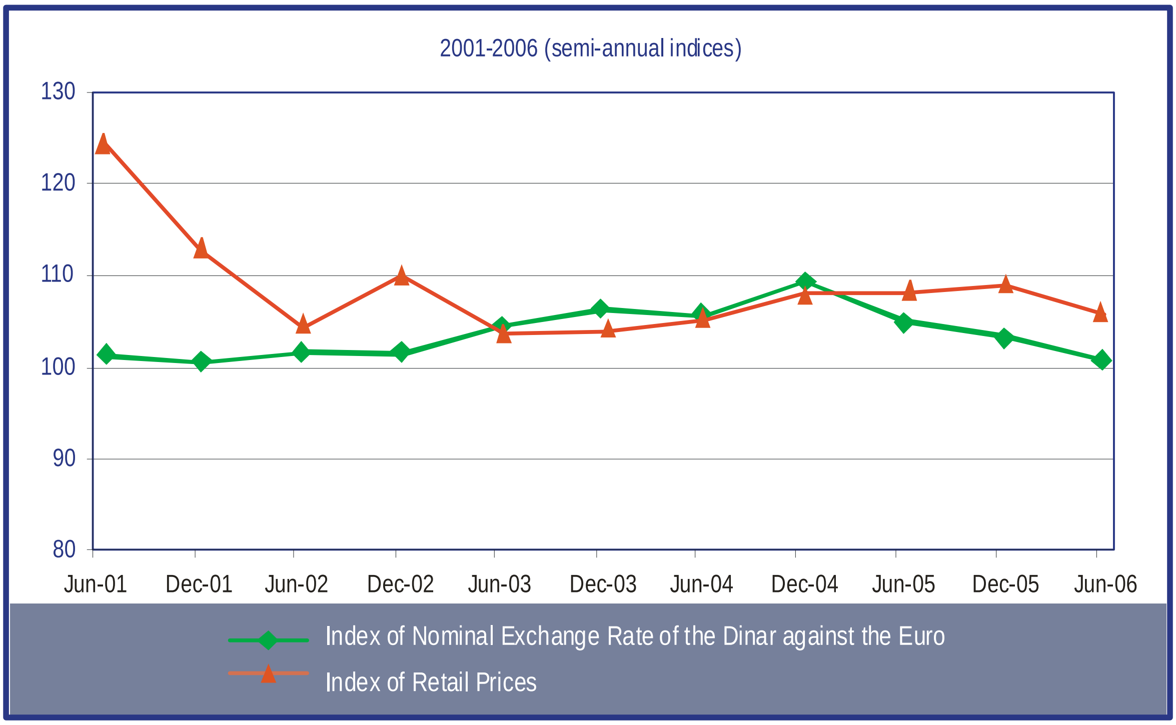
Obviously, the policy of money sterilization through increase in obligatory reserves does not give expected results but brings larger financing costs to debt holders. Therefore, sterilization does not prevent credit expansion but leads to another pressure on prices through financing costs growth due to higher interest rates.

Average interest rates in Serbia are significantly higher than in EU countries as well as in neighbouring countries (Slovenia, Croatia, Hungary, and Romania, for example). In the year of 2005, the lowest rates (5-6% with foreign currency clause) are on the long-term loans given to large enterprises with solid financial health and good credit rating, while the highest rates (up to 35%) are on short-term loans for small and medium size enterprises. In the case of retail loan, average annual interest rate is 16%, while short-term loans carry sky-high interest rates.

Financial system is extremely bank-centered. At the same time, capital market is discharging according to requests of privatization completion. In conditions when the largest funds come from banks and when shallow financial market offers limited opportunities for sterilization through state securities, new capital inflows triggers higher monetization. If funds from alternative sources (stocks and bonds issuing, for example) existed, part of capital inflow would not enter multiplication channels and thus it would not increase monetary aggregates in domestic currency zone.

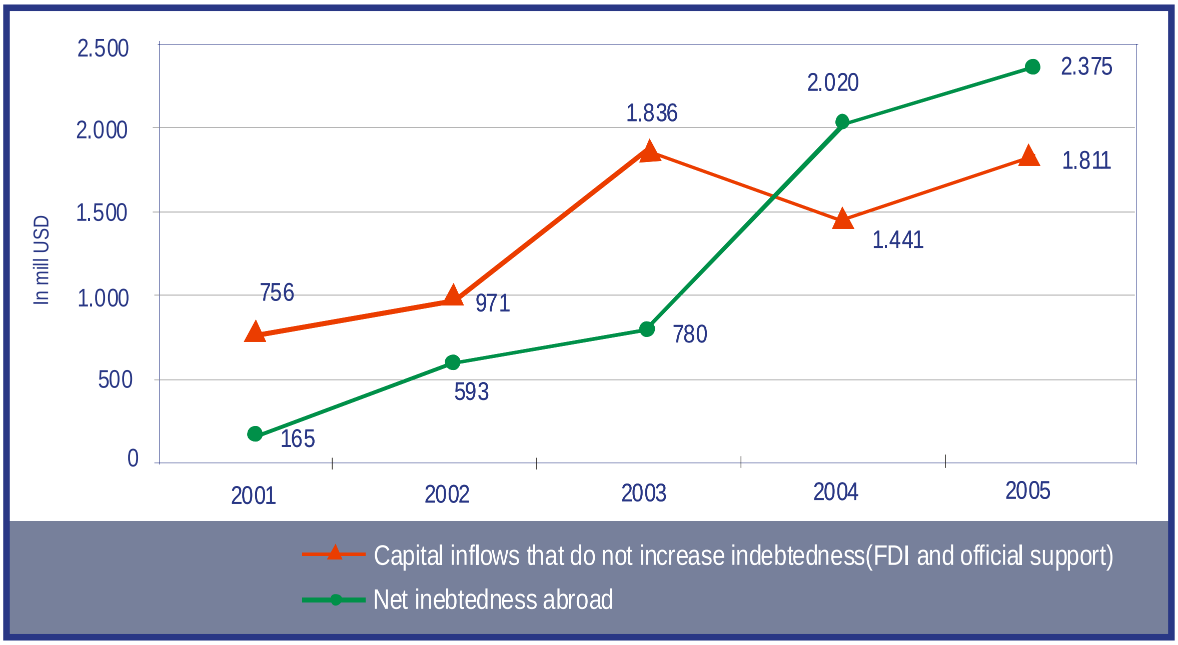
In reality domestic currency is in the zone of real appreciation. It is the phenomenon which might have fatal consequences on the general level of economic activities and competitiveness. The illustration 6 shows the movements in production and competitiveness. Illustration displays trends in currency exchange rate and inflation rate in period January 2001 – June 2006. The duration of appreciation is easy to notice.

Illustration 6. Movements in currency exchange rate and inflation



Appreciated domestic currency has small impact on inflation reduction. However, crucial question is related to the quality of foreign currency reserves which is the basis for exchange rate determination. Significant part of foreign currency reserves is actually sterilized capital from commercial banks. Question is: how will central bank fulfill its function if, for example, foreign commercial banks give up from operations in Serbia? The quality of foreign currency reserves is influenced by balance of payments and their components, current account and capital account. As the current account is negative due to trade deficit, the quality of reserves is primarily determined by foreign direct investments. Those are capital inflows, which, in comparison to bank credits, do not increase the level of country indebtedness. Therefore, for evaluation of quality of monetary reserves, it is important to compare them with the level of FDIs. Illustration 7 shows that in the last two years, FDIs has been growing slower than indebtedness. Taking this fact into account, it is probably better to weigh in different way growth in reserves in central bank or change the monetary model (targeted inflation, for example).

Illustration 7: FDIs and net indebtedness abroad according to (5, page 58)



The level of production and competitiveness of the economy is on a such level that we may expect the existence of trade deficit for some time in the future. That means that for maintaining macro-economic stability it is necessary to provide permanent capital inflow. In order to stabilize foreign currency reserves, surplus on the capital account should be approximately the same as deficit on the current account. However, insufficient capital inflow through investments in real sector due to low potency of the economy, on one hand, and speculative balloons on capital market, on the other hand, may represent clear indicators regarding poor perspectives of capital expenditures. Such situation, in ambience of growing indebtedness, may lead both to decreasing capital inflow and growing probability of capital retreat, mostly from banks. Capital retreat could be a trigger of chain reaction: monetary crisis, devaluation, and cost inflation. Each of mentioned elements, from its side, exerts influence on macro-economic stability. For example, devaluation leads to crises in real sector and crises of banking system due to inability of debt holders to pay their obligation regularly in condition when all credits are indexed (foreign currency clause). Therefore, the supreme issue for Serbia is related to new investments.

Sustainable development

Nature of macro-economic instability in Serbia is structural. Namely, it is combination of transferred defects from the past and new defects due to slow rhytm of transition. Structural defects cannot be removed with monetary tricks (sterilization of money volume, for example). Exchange rate should not be exclusively used as the instrument of stabilization policy nor as the instrument of development policy.

What Serbia really needs is stability and growth which respects triple-bottom line criteria (or sustainable development). In order to achieve sustainable development, focus should be changed from macro-economic policy measures to privatization completion (along with restructuring) in order to move economic performances closer to those economies from which the capital is imported. Capital investments are the trigger for equity investments and, *inter alia*, capital market development. It is prerequisite for sinergy in capital market because efficient stock exchange is not only complement but also supplement to banking industry.

When it is finally accepted that macro-economic policy measures cannot solve issue of inefficient economy, new strategy of economic development should position itself toward three important issues:

1. strategic sectors
2. infrastructure
3. educational system

1. *Strategic sectors.* Strategic sectors should represent the most important anchors of new development strategy of Serbia. There are several logical explanations which support this stance. First, today it is obvious that the interests of foreign capital for investments in Serbia is insufficient to provide the level of activities needed for sustaining social balance and that domestic entrepreneurs do not have appropriate entrepreneurial capacity to take the key role from foreign investors. There comes the question: who should compensate for transitional deficit? One of possible answers is that it should be the state sector. The state has not only legitimate right but also obligation to deal actively in economy because, at least, it possesses potent assets in important sectors (network technologies, infrastructure, industries with high external effects). Second, privatization is not the process without residual. Namely, privatization should provide the dominance of private ownership in GDP creation but not ownership uniformity. Third, there are industries in so-called public sector, whose efficiency has less dependence on ownership. Typical industries of this type are energy business and agriculture (including food processing industry). These industries may be profitable and make positive effects on balance of payments regardless that they are still state-owned. Fourth, strategic sectors should be the springboard for technological development which essentially influences the competitiveness of national economy. In the long run, Serbia must rely on its own resources in development of core technologies taking into account its current industrial infrastructure. Fifth, production from these sectors, due to volume and character, leads to multiplication effect, which increases standard of living and stimulate development of other sectors, including service sector.

Major strategic industries in Serbia are energy and agriculture. Energy sector was always strategic one in Serbia, not only because of its character, but also because of the value of capacities. At this moment, the discounted cash flow of National Electricity Utility is couple of times larger than the total effect of privatization of commercial and financial sector completed up to date. Also, Serbia, after removing disparity in electricity prices, has significant opportunity to increase energy production from renewables and to increase energy self-sustainability [7]. The level of attractiveness of renewables is increased with the fact that those are, in ecological sense, very acceptable energy sources which obey strict rules of international agreements (Kyoto protocol, foremost) and is compatible with EU regulation.

Serbia has natural prerequisites for agriculture production expansion. Agriculture is strategic branch because it secures food procurement to population and market surpluses. This is crucial in conditions of excessive indebtedness. Serbia has immense potential for organic food production as well as high value-added products. Last but not least, agriculture is a substitute for fosil fuels.

2. *Infrastructure.* Infrastructure is essential prerequisite for pushing investments up in commercial sectors. Infrastructure means conceptual and physical ones. EU framework (legislation and regulatory bodies) is standard for institutional infrastructure development. Unfortunately, there are huge gaps in this field. Particular problem is judicial system.

Inadequate physical infrastructure refers to inappropriate road networks, irrigation channels, train tracks, ports, and airports. BOT projects (build-operate-transfer) represents good model for capital investments where an investor design, finances, and exploits particular capacity in defined period and then transfers it to the state. High level of indebtedness of the state gives rise to this type of projects.

PPP projects (private-public partnerships) are another way to build infrastructure by combining private and public ownership. PPP have immense opportunities of application in municipal utilities, waste management, etc.

3. *Educational system*. In new development strategy the important place is reserved for educational system including lifelong education. People, as protagonists of intangibles, represent key potential of Serbia.

How to finance expansion of strategic sectors? The logical answer is: mostly from privatization revenues. In general, the use of privatization revenues should increase credibility of the system. The state should not use privatization revenues for consumption. Demand is already overheated. Also, the state should avoid trap to invest money from privatization into other group companies with intention to turn them into companies with tradable goods for export. However, privatization revenues may and should be used for investments in strategic sectors. Also, money could be used for development of some infrastructure functions, such as establishment of the Guarantee Fund, which function is to guarantee for par value of stocks issued from companies from strategic sectors (energy, renewables, and agriculture). Investing in strategic sectors is better alternative than other options, such as foreign debt payment or foreign currency reserves' increase.

Investments' growth in strategic sectors may be followed by their corporatization and opening to the influence of financial market. On one hand, the usage of privatization revenues for investments in energy sector does not heat demand significantly. On the other hand, capital market development, through securities' issuing from strategic sector, is important for demand cooling. In that sense, the state may find itself in another important role. Development of capital market may be stimulated, at the first place, with securities (stocks and convertible bonds) of state-owned enterprises from priority sector and financial institutions (banks and insurance companies). In the shortest term, the procedure of initial public offering should be launched.

National Strategy for Economic Development of Serbia 2006-2012

In NSEDS it was clearly stated that the general level of economic activities in Serbia, despite high growth rates in recent period, is not enough for maintaining social balance and external liquidity. On the other hand, it is obvious that projection period 2006-2012 represents only a phase on the long path of recovery. Serbia does not have strategic technologies nor ultimate natural resources to be able to rely on explosive growth rates based on foreign direct investment, in middle term, could compensate for all what was missed in the last 17 years.

GDP projection is based on the state in the year of 2005 which shows that the contribution of non-financial sector is 58% and contribution of financial and state sector (along with households and not-for-profit sector) is 42%. NSEDS gives two scenarios: World Bank scenario (coservative scenario) and optimistic scenario. According to World Bank scenario, average real growth rate of GDP in the observed period (2006-2012) is projected on 5%. According to optimistic scenario, proper rate is 7%. It is interesting that differences in efforts between 'scenario 5%' and 'scenario 7%' are less than benefits.

Core of new strategy are investments. Architects of new strategy have projected that the level of total investments during the planning period will be around USD 60 billion out of which 1/3 will be invested in infrastructure. Investments in infrastructure are important because infrastructure serves as a springboard for investments in other sectors. Other investments must have, at the first place, anti-import, and, desirably, export goals.

Investment growth should provide growth in employment, productivity and export. Productivity has larger contribution to GDP growth than employment. It is assumed that contribution of foreign direct investments to productivity growth is around ¼ and contribution of domestic savings around ¾. In scenario 5% contribution of non-financial sector to GDP growth is far less than contribution of financial and public sector in all projected years. According to scenario 7%, the contribution of real sector in the last two years of projection period is greater than contribution of financial and public sector. In scenario 5% it is estimated export growth of 2.7 times in the year of 2012 in comparison to the year of 2005 for import growth of 2.1 times. In scenario 7%, import would be increased by 3.1 times and import by 2.4 times. Also, it is estimated that some changes in export structure will occur because export of goods should go up much faster than export of services.

The structure of sectors' contribution 58:42 in favour of non-financial sector in GDP growth is polemic. It should be better that projection are made on the basis of modified proportion in which non-financial sector would reach even higher share. That is, by the way, typical for entrance in the phase of investment-driven economy which is characterized by faster growth of real sector in relation to service sector.

Also, it is important to note that, within the structure of FDIs, the dominant share must be hold by greenfield investments and CAPEX in the existing enterprises from real sector over equity investments and investments in trading chains. Larger inflow of greenfields and additional capitalization may be expected only with the reduction in corruption level and enhancement in economic freedom. In solving this problem, the first step in right direction will be resolution of issues of purchasing city land and operationalization of one-stop-shop concept when handing out proper permits. Also, it is necessary to continue with stimulating measures for investors, such as low tax rates and exemptions in the case of reinvestment.

Investments in infrastructure, due to high volume and slower return, should be financed with the least increase in indebtedness. In that sense, useful instruments are BOT arrangements and PPP projects. In financing investments in tradable goods sector, the important channel are foreign direct investments, because they do not cause increase of debt and provide growth in external liquidity. In order to keep debt covering below critical ceiling of 25% in relation to goods and services export and to maintain foreign currency reserves at the level of 6-month import of goods and services, it is necessary to have foreign direct investments in the whole projected period at the level of USD 1.5 billion per year. However, under these assumptions, there is financial gap of USD 6.3 billion. Aware of this problem, strategists recommend that financial gap should be covered by foreign direct investments growth to the level of USD 2.0 billion per year and with reduction of foreign reserves to 3-month level of import of goods and services. Those are hardly feasible assumptions. Precisely, foreign direct investments growth is crucial, especially now when privatization process is almost finished and when this source of new capital is getting scarce. In the year of 2005, it is achieved the largest level of foreign direct investments which is matched with the level of projected average but with the dominant share of investments in privatization of enterprises. Also, pulling down the level of reserves to 3-month import level increases default risk and imperils country's credit rating.

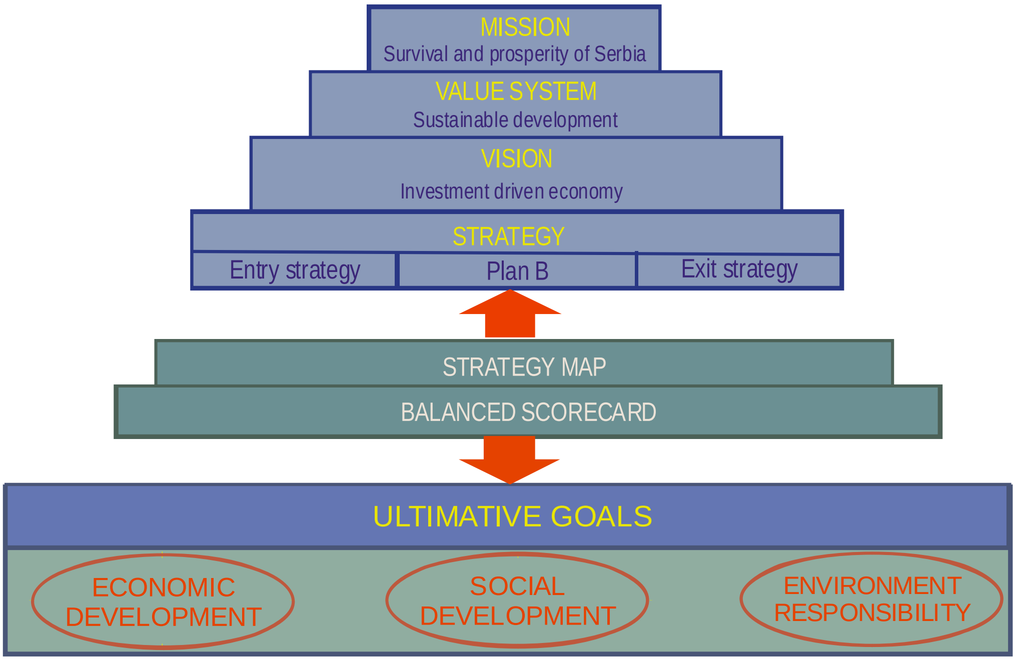
Where to find the solutiont? Relaxing still existing large risks may be accomplished if the significant part of investments is financed from domestic sources. It is supposed that larger part of private savings is out of banks (the level of private deposits in the banks is about EUR 2.5 billion). The rest of around EUR 3.0 billion should be accepted by capital market and banks. Capital market development is priority. Therefore, the proposal to strategists is to dedicate particular attention to corporatization of large state-owned companies, banks and insurances and opening them up to capital markets through initial public offering.

Financial part of NSEDS is featured by constructive skepticism. Even if the maximum projected growth rate was achieved, the level of GDP of Serbia would have the largest gap in relation to EU countries as well as other countries in transition. This is vivid through two facts. First, if the average growth rate for projection period is 7%, Serbia will, in the year of 2012, double GDP p.c. In absolute number, it will be USD 6,500 only. Second, beside significant export growth, the share of deficit in current accountas proportion of the GDP remains still at the high level of 17%. In short, despite

NSEDS, the economy will still be greatly impotent and citizens will spend more than they earn.

Illustration 8 exhibits logical structure of strategic approach applied in NSEDS. It is obvious that ultimate goals fulfill triple bottom line principle (economic, social, and environmental). In order to achieve ultimate goals, it is essential to formulate mission, value system, vision, and strategy. Also, it is important to pay attention to their implementation through operating decision-making system. NSEDS mission is survival and creation of prerequisites for Serbia's prosperity. Value system is based on principles of sustainable development. Vision is given based on transfer of Serbia's economy from resource-driven to investment-driven stage of development. Strategy has three basic elements: entrance strategy, plan B, and exit strategy. Entrance strategy in precise manner defines feasible goals, initiatives for their completion, key information on implementation results, general data on movements of relevant stakeholders and timing in decisions' implementation.

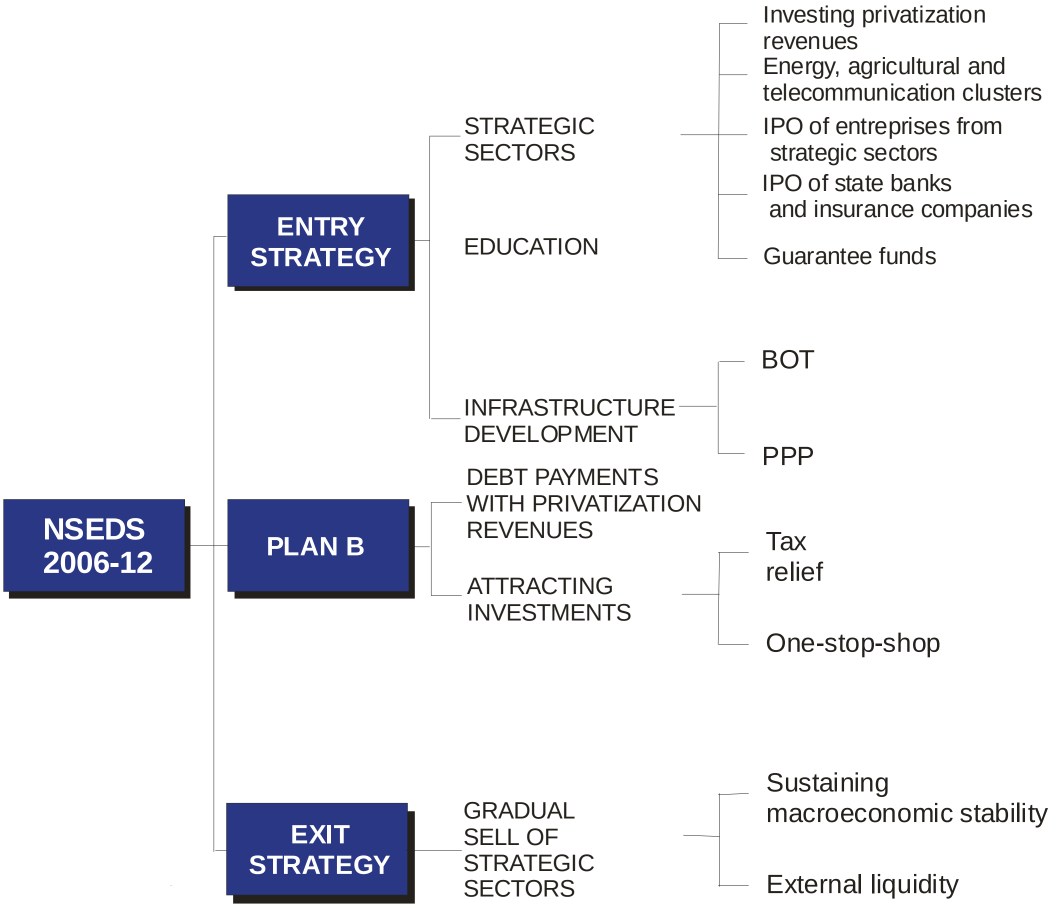
Illustration 8. Strategic approach



Formulation and implementation of strategy on a basis of holistic approach is based on methodology of Strategy Maps and Balanced Scorecards. This methodology was initially developed by Harvard professors R. Kaplan and D. Norton [2], [3] and [4]. Strategy Map depicts causal and chronological relations between basic goals from different perspectives while Balanced Scorecard contains scheme of key performance indicators, tasks and initiatives for their accomplishment.

Naturally, central decision of strategic approach is strategy. Illustration 9 shows basic elements of NSEDS, which are elaborated in detail and partly modified.

Illustration 9. NSEDS 2006-12



The application of Strategy Maps/Balanced Scorecard for NSEDS formulation and implementation enables engagement of all relevant stakeholders from Government and Ministries over enterprises, banks, scientific and research institutions to NGOs and prominent individuals.

Conclusion and recommendations

Until now privatization in Serbia has not brought expected results. Also, new sector is too small to compensate transitional deficits. Namely, after 17 years, net effect of privatization is transitional deficit of GDP of over 40%.

Level of privatization and completion of restructuring across sectors are different. Unregulated privatization, in the shade of business transactions, was significant, which enabled the appearance of transitional capitalists who legalized acquired capital through regulated privatization. Privatization of small enterprises is done through sales. Privatization of medium enterprises is completed through combination of giveaway model and sales model. Business-controversial enterprises, mostly from social and political reasons, are in the stage of permanent restructuring. Large privatization of state-owned companies has not started yet (with exeption of Telecom). Banking sector is restructured through liquidation of big state-owned banks and through greenfields from foreign banks.

How to fill transitional deficit? It is hard taking into account that transitional capitalist have limited capacity for business revival of acquired enterprises. Additionally, foreign investors are focused on good enterprises which mostly continue with the same energy, raw materials and labor intensive production, to penetrate the local market niches, often with high level of ecological risks.

Spontaneous activism of market forces cannot, in reasonable term, correct transitional pathologies. Market activism must be combined with normative approach i.e. by formulating and implementing new strategy for economic development. The state is the main constituency in that process.

Insight into NSEDS clearly indicates that the strategy for economic development for period 2006-2012 is just one of the steps on the path of long-term recovery. Unfortunately, according to this strategy, in the last year of projected period, Serbia will spend more than it will earn. That means that maintenance of macro-economic stability and external liquidity requires permanent foreign capital inflow. Privatization of non-financial sector is almost completed thus this source of capital inflow is almost depleted. Frontal privatization of strategic sectors could be harmful. The exit lies in greenfield investments, investments in infrastructure, joint ventures and additional capitalization within existing enterprises. However, foreign investors are not ready to invest in Serbia. Risk aversion should be diminished through publicizing good examples. The state may give good example if privatization revenues are invested in strategic sectors (energy sector and agriculture, foremost). Alternatively, plan B for utilization of privatization revenues could be premature payments of outstanding foreign debt.

The state should not sell state-owned companies from strategic sectors but should invest in them. Responsible state increases this way the level of activities and employment, achieves the demand multiplicative effect, increases export and enables technological development on its own industrial platform. Selective sales of state-owned companies could be the exit strategy. This strategy should be implemented only after all other instruments, for providing macro-economic stability and external liquidity, are exhausted. The development of capital market as a complement and supplement of banking sector should provide decline in costs of capital and productive utilization of savings. Only with the developed capital market it is possible to remove two large gaps in the system: gap between inflation and currency rate and gap between profitability of non-financial and financial sector.

Bottom line is competitiveness, more precisely its growth. Sufficient condition for competitiveness' growth is stability (political, institutional, and macto-economic). Additionally, in implementing macro-stabilization policy monetary determinism should be replaced by versatile reformistic (instead populist) approach which relies on restricted fiscal policy. Also, it is the right time to think about the replacement of the existing model of monetary policy with the model of inflation targeting.

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