

How Macroeconomic Policies Erode Business Competitiveness: Serbia's Experience

Dragan Djurićin *

Iva Vuksanović *

Abstract: Current economic crisis in Serbia is not only a consequence of the last global economic crisis, but also a consequence of pre-crisis structural instabilities and uncompleted transition, both geopolitical and economic. Actually, ever since the transition in Serbia officially started in 1990, the country has never left the crisis. Namely, the output gap is still significant, both transitional (GDP in 2011 is around 30% lower than GDP in the last pre-transition 1989 year) and factual (Serbia lives far beyond its transitional peers and its potential). The fact that macroeconomic policies did not manage to fix these problems forces us to question whether the orthodox policy framework followed by Serbia's macroeconomists gave best possible results. This paper analyses the influence of macroeconomic policies on performance and competitiveness of Serbia's economy. The accent will be on monetary policy with respect to its role during transition and subsequent policies considering prime rate, FX rate and inflation, as well as other impediments and functional distortions faced and borne by the economy. The paper shows that continuing policy of gradual inflation and real FX rate appreciation constantly erodes competitiveness of Serbia's enterprises and their profitability. Additionally, it provides recommendations for overcoming current situation in the light of double-dip crisis in Europe.

Keywords: Serbia, competitiveness, real FX rate, industrial policies, energy sector

Keywords: L52, E52, E62, E40

Introduction

Before the 2008 global economic crisis, macroeconomic orthodoxy, as is the case of Serbia as well, assumed that there was no incompatibility between keeping inflation low and stable, and seeking for maximum growth (or minimal output gap). Sadly,

* Dragan Djurićin and Iva Vuksanović are at Faculty of Economics, University of Belgrade, Belgrade, Serbia.

the 2008 global economic crisis triggered the break down of many of the orthodox macroeconomic models because the modelers largely ignored their microeconomic implications, or how firms and banks would react to imposed policies and regulation that attempted to exploit past correlations in the data base in order to eliminate market failures. Consequently, the modeling that took fixing of such problems for granted resulted in breakdown of fixing.

From Serbia's perspective, the misconception of macroeconomic orthodoxy becomes obvious to anyone. Quite frequently in the last period Serbia had the highest inflation in Europe and in all years following 2000. The unemployment rate also ranks among the highest and thus far has widely surpassed the critical threshold of 20%. The fiscal situation is, also, discouraging, with shrinking fiscal revenues, rising budget deficit, and unpleasantly high public debt. Unfortunately, despite frenetic efforts to stabilize the currency, the dinar has almost constantly appreciated in real terms, hurting the most vital export sectors of the economy. Contrary to expectations, expansionary fiscal policy along with restrictive monetary policy does not seem to have produced desired and long sought results.

Today, besides domestic transitional recession, Serbia's economy is exposed to upcoming global double dip crisis. The consequence of such "combined crisis" is significant output gap, both transitional (the GDP in 2011 is around 30% lower than the GDP in the last pre-transition 1989 year) and factual (Serbia lives far beyond its transitional peers and its potential). Accordingly, policy makers in Serbia must to react to the main transitional contradiction - that price stability was not followed with sustainable employment and growth.

This paper analyses the influence of macroeconomic policies on performance and competitiveness of Serbia's economy. The accent will be on monetary policy with respect to its role during transition and subsequent policies considering prime rate, FX rate and inflation, as well as other impediments and functional distortions faced and borne by the economy. The paper shows that continuing policy of gradual inflation and real FX rate appreciation constantly erodes competitiveness of Serbia's enterprises and their profitability. The authors suggests that in a country with structural instabilities and in the absence of automatic stabilizers orthodox macroeconomic policies (monetary and fiscal, primarily) lose their purpose, especially in the case of transition in which radical reforms such as privatization and financial deregulation provoked output gap and raised unemployment.

The paper is structured in the following way: after introduction, the second part of the paper analyses characteristics of the macroeconomic policies conducted in the period since democratic changes in 2000. The following part presents the main policies' achievements in terms of contradictory impact on economic development with particular accent given to the devastating effect on export-oriented businesses' competitiveness. The fourth part provides some recommendations for overcoming current situation in the light of double-dip crisis in Europe and it identifies indus-

trial policies as a main tool for elimination of structural imbalances and competitiveness gap.

Macroeconomic policies framework in Serbia since 2000

During the last stage of transition Serbia's policy makers have experimented with several policy tools. Most of these tools, however, were ultimately discredited by inflationary pressures, output gap, and high unemployment. The present state of Serbia's economy can be understood as very complex and highly intertwined nexus of numerous factors, which are hard to enumerate and estimate their relative weight. Unfortunately, many of those factors, we believe, refer to erroneously led monetary and fiscal policy.

The central bank's healthy mandate was reduced exclusively on inflation control. In that regard National Bank of Serbia, or NBS, behaved myopic, indeed politically. Contrary to the fact that the output gap was significant, NBS suggested keeping interest rate high. Controversy of this policy is evident because it actually cuts stimuli for under-heated real economy. Moreover, inflationary expectations are constantly above official targets.

In the last ten years, a rough consensus had emerged among Serbia's policy makers about the benefits of inflation targeting. In principle, the NBS was expanding money supply whenever inflation threatened to fall below the target and reducing money growth whenever inflation threatened to rise above it. In order to conduct the monetary policy, the NBS adopted not fully explicit model of inflation targeting. Over the last period, strategists of monetary policy focused more on the short-term interest rate than on money supply itself in order to achieve monetary tenet.

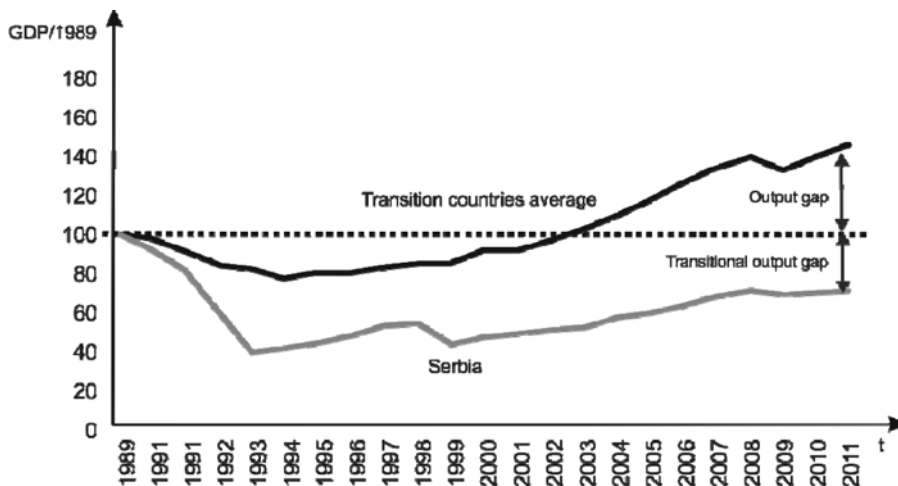
Output was off the radar of monetary policy and, as a consequence, this strategy allowed production collapse. Implicit costs of this strategy are, also, numerous and they refer to increase of financial costs of maintaining low and stable inflation, higher interest rates, appreciated FX rate, as well as greater indebtedness. Unfortunately, this strategy led to the main transitional contradiction, price stability advertised as macroeconomic stability was not followed with sustainable employment.

The level of output in Serbia has been primarily affected by unique adverse forces under which transition occurred. The beginning of the transition in Serbia coincided with the break-up of Yugoslavia and destructive conflicts that postponed economic reforms. These forces were additionally amplified by economic sanctions imposed in the early stage of transition (in 1992). Consequently, before political changes in 2000, the transition evolved in a vacuum, in the face of excommunication and no access to foreign capital. As a consequence, Serbia's economy experienced a dramatic drop of the output followed with hyperinflation. The biggest drop in output occurred in 1993,

when the GDP was at a staggering 40% of its pre-transitional 1989 level, followed by a massive hyperinflation (313×10^6 % annually, the second highest hyperinflation recorded in monetary history).

Economic performances during the 1990s were so deteriorated that the reforms after political changes in 2000 could not have satisfactory impact. Despite accelerated privatization, regulatory reforms, and frenetic reindustrialization efforts, Serbia has never reached its pre-transitional GDP level. This is in stark contradiction to the vast majority of transitional countries. Transitional countries have managed to reach pre-transitional GDP levels and close transitional output gap 8-13 years after the start of transition in 1990. The reason for this is transitional recession, which is the logical first stage when radical reforms take place. As a consequence, typical transitional output curve is a *J-shaped* curve (Djuričin, 2008, p. 44). But in case of Serbia, the transitional output curve is a *perverse triple J-shaped curve*,¹ which never reaches its pre-transitional level. At the end of 2011, Serbia's transitional output gap was around 30% (see Figure 1).

Figure 1: Serbia's triple J-curve



Partially modified according to EBRD: Transition Report, 2011

Today Serbia's economy is not only impotent, but also out of tune. As a consequence, in the entire period of 2002-2011 economy was constantly running current account deficit. Another consequence of structural instabilities is budget deficit. Due to visibly declining fiscal revenues, budget deficit is continually rising. Furthermore, failure to intervene more decisively on the expenditure side of the budget aggravates fiscal crisis and narrows the set of possibilities left in front of the policy makers. The continuing presence of *twinned deficits* implies that the country lives beyond its means.

Still, increasing of consumption up to an unsustainable level thanks to privatization proceeds and foreign borrowing is surely going to come to a dead end since previous sources are about to dry up.

Another question for country with deficit is whether it is using the produced output well. In Serbia twin output gaps and related twin deficits are not the consequence of overinvestment but the matter of overconsumption of the current output. Thus, by borrowing capital from abroad Serbia's economy has bridged the gap between over-consuming and an under-stimulating domestic economy. But this situation is not sustainable. By doing so, current generation constantly transfers the debt burden to the future generations.

Crucial problem for Serbia's economy is its impotency. At least two facts support previous point. First, there is a difference between gross domestic product, or GDP and gross national product, or GNP. Even though it is not controversial, however, the problem exists if the net effect of conflicting trends considering inflows and outflows is negative (namely $GDP > GNP$). This could be a new stressor for the economy having in mind that the level of remittances from abroad is quite high but unsure (EUR 3-5 billion per year). The main components of outflow are interest rates, profit repatriation, capital hedge, and nonresident labor remittances. Second, analysis of NDP (=GDP-Depreciation) indicates that the potentials for output increase are small because investments have been less than a half of the depreciation during the entire decade (Madžar, 2012, p.3). It means that consumption and government expenditure strongly dominate in formation of GDP because Serbia's economy has not received sizable investments.

A large and constant foreign borrowing indicates that domestic expenditures exceed domestic output. Also, when government saving is negative and net import is positive foreign borrowing is almost exclusive source of financing new investments.

The usage of proceeds from privatization and associated money expansion were the central misconceptions in monetary policy. Privatization is a form of divestment, not an export. If proceeds from privatization are qualified as cash inflows they trigger increase in monetary base and they spawn even larger increase in M1 (currency + currency deposits) aggregate. As a consequence, in the whole period the money multiplier was too high. The augmented monetary mass is supposed to provoke currency depreciation. However, since the government used acquired proceeds in a socially desirable manner, to boost consumption, it provoked further inflation increase. The mix of previous factors led to FX rate real appreciation, which is especially visible in the periods of massive privatization. This could be qualified as a form of outrageous behavior against real economy because it demonstrates policy failure that distorts competitiveness.

Given the aforementioned, it can be concluded that the policy makers (undoubtedly connected to the sources of political power) have been selling social capital and channeled it into consumption. This unfortunate combining of stocks and flows

created irrevocable mistakes in the functioning of the economy. Consuming capital means eating into the economic substance of the society.

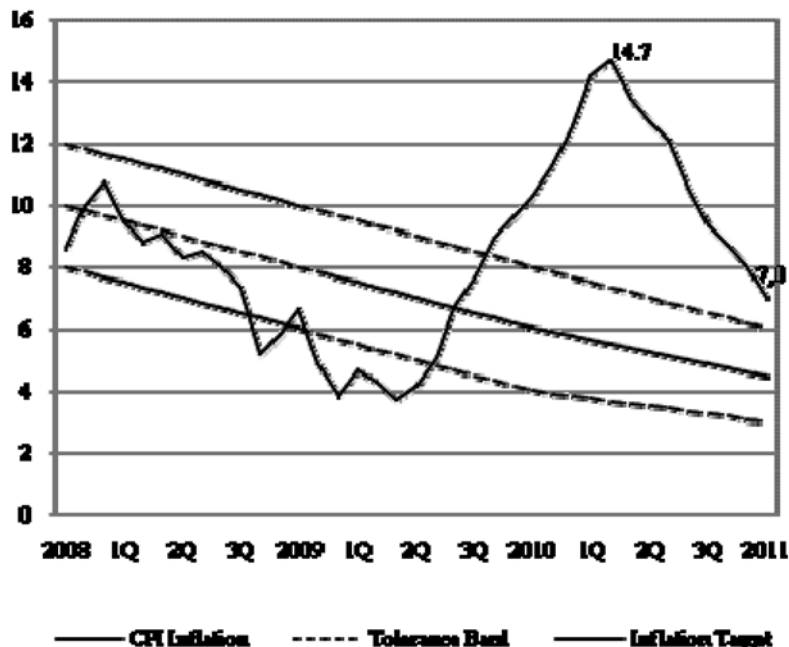
Financial system created after 2000 in Serbia has been bank-centric. Credit conditions are very restrictive. Due to high systemic risk, foreign banks try to improve the security of their claims by shortening maturity of their credits and by requiring payment in foreign currency (EURO and SCH). As a consequence, banks released credits primarily in brokerage businesses (investment banking, real estate, shopping malls, etc.) and, eventually, in businesses supporting previous ones (construction of commercial real estate, for example). On the one side, investment banking winners from the period of intensive privatization and construction of commercial real estate were coming from the segment of “hot money” investors. On the other side, borrowing from abroad with implicit government guarantees was essentially the way for brokerage part of private sector to socialize the risk of system wide default. Because excessive investments were financed with short-term debt (including additional currency risk in case of foreign currency mismatch), the system risk was born by the state and, hence, by domestic taxpayers (current and future). Last but not least, credits are extremely expensive. During the year 2011 total average interest rate is slightly falling from 10.77 to 9.86 %.

Macroeconomic policies achievements

Contrary to expectations, the combination of an expansionary fiscal and a restrictive monetary policy does not seem to have produced the desired and long sought results. The main tenet of Serbia’s macroeconomic policies over the last decade resulted to be inflation, not output. Flexible inflation targeting or returning inflation to stable target over some corridor was the main policy choice in monetary part of macroeconomic policies. In spite of exclusive focus on inflation control, there is a gap between achievements and expectations. Cumulative inflation rate (CPI base) for the period December 2001-November 2011 is 174 %. In the period 2002-2011 economy was five times burdened with double digit rate of inflation (14.8% in 2002, 13.7% in 2004, 17.7% in 2005, 11% in 2007, and 10.3% in 2010). Moreover, in the whole period inflation was much greater than 2%, which is the theoretical reference point for inflation targeting.

Due to severe structural imbalances and their influence on macroeconomic stability, the architects of monetary policy were forced to make two adjustments in setting the inflation targets. The first adjustment refers to high level of targeted inflation (>2%), and the second refers to inflation tolerance band ($\pm 2\%$). However, inflation targeting as a monetary tool for inflation control is not constantly efficient in the case of Serbia as we can see in Figure 2. Inflation was below the targeted level in the period 3Q 2009-3Q 2010, but in the period 3Q 2010-4Q 2011 it was significantly above the target.

Figure 2: Inflation level, targets and tolerance bands per year (period: 2008-11)



Source: National Bank of Serbia

Did the NBS make some mistakes? The answer is yes, not only because this policy was ineffective in terms of main policy tenet (low and stable inflation) but also because it was counter-productive in terms of provoking volatile and high output gap. Namely, growing money supply fueled by privatization proceeds influenced a pressure on prices. In order to stabilize aggregate price level the NBS usually contracted money supply by using conventional monetary tools. However, the gap between NBS intents and outcomes was very wide indeed, especially where actions were mediated through simultaneous increase of reserve requirements and growth of interest rates. Higher reserve requirements diminished money multiplier, and thus supply of money, and high level of interest rates led further to investment contraction. Consequently, anemic output growth was followed by inflation (still notable) and unemployment.

Related issue is a potential conundrum emerged as a consequence of double-digit interest rates effect on the output gap. Again, in the absence of other instruments for cooling the economy, the NBS would have to face a controversial choice, having to accept higher output gap in exchange for relatively low inflation.

Even better question is whether the NBS fully controlled the core policy variables. In the segment of interest rates, the monetary policy was hostage of portfolio investors and their expectations. In Serbia's case, open market operations represent prevailing method for setting the prime rate. Namely, the NBS was constantly sell-

ing financial assets (repo papers) and by doing so, it was withdrawing liquidity from the economy. Even once, yearly repo rate was 24%. At the end of the day, hot money investors left the country with extraordinary capital gain, which pushed other investors yield curve up.

It is legitimate that when central bank expects the budget deficit to be inflationary, it may try to counteract it by tightening monetary policy (Tobin, 1998, p.46). Such reaction of central bank would reduce the expected effect of deficit spending. But implementation of such policy in Serbia ignores significant structural imbalances (twin output gaps and twin deficits). So by keeping the interest rates high the NBS actually generates high unemployment. Moreover, by doing this the NBS continually misses the opportunity to use the interest rates cutting to energize activity in sectors that are interest sensitive. The drama of the previous conclusion stems from the fact that these sectors are actually the ones in which Serbia has comparative advantage and huge potential for output expansion (energy, agriculture, food processing, infrastructure, etc.).

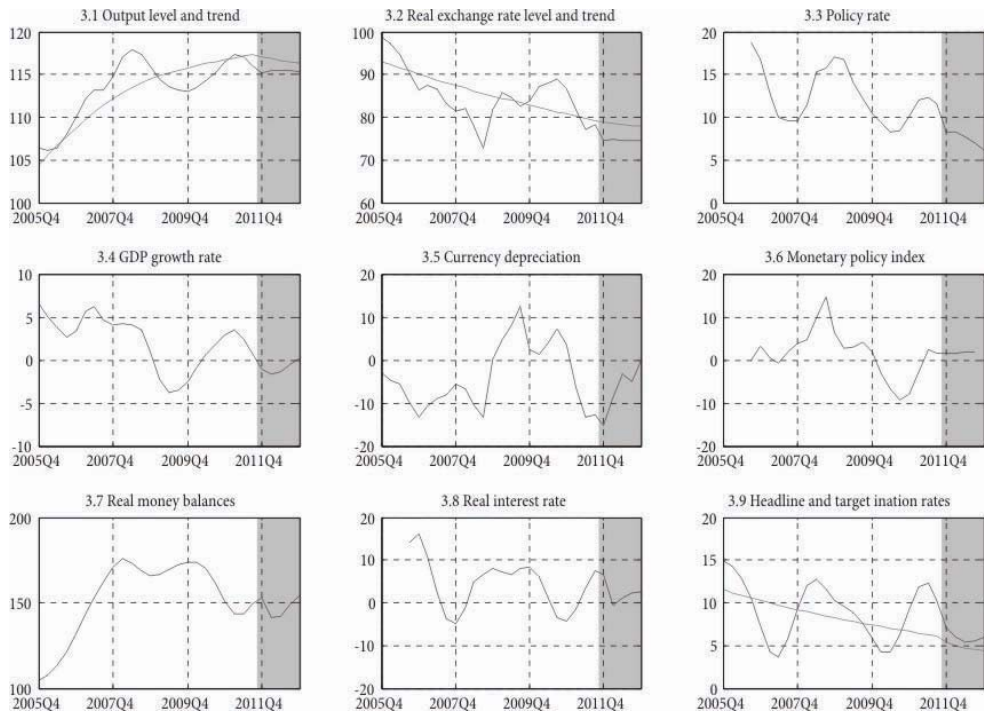
Inefficient monetary policy has deepened long standing structural fractures. As a result of this policy, the gap between intents and outcomes remains large. Continuous inflation tends to depreciate local currency. But in reality, real FX rate is constantly appreciated because inflation differential exceeds the nominal rate of depreciation of the FX rate. The previous point could be depicted by the influence of privatization of *BK Telekom* by *Telenor* on M1 and FX rate. Concretely, in 2006 when privatization occurred, M1 aggregate rose for 38%, while FX appreciated substantially.

Figure 3 shows that nominal depreciation was followed by real appreciation. Moreover, the figure indicates that in the whole period of analysis, with exception of 2009, real FX rate was appreciated. Positive impact of FX rate depreciation in 2009 was reflected on current account deficit. Namely, it decreased from 21.6% in 2008 to 5.5% of GDP in 2009, and than slightly rose to 7.2% at the end of the year. Obviously, this episode explained the old policy rule, when FX rate is competitive it is barrier to import. The rest of the graphs in the Figure 3 depict some results of macroeconomic policies in the period 2005-2011.

Previous analysis raises the fundamental question. Is inflation targeting with partially fluctuated FX rate the right policy in situation when structural imbalances are continually increasing the inflationary pressures? Dramatic character of the answer is amplified by the fact that this kind of monetary policy is extremely costly way for inflation control. Thanks to this policy, economy has spent the entire privatization proceeds and remittances from abroad. In spite of massive privatization and significant remittances, the gross currency reserves dropped to slightly over one-third of GDP.

Fiscal policy played secondary role in the whole period with political constraints sharply limiting its usefulness. Architects of Serbia's fiscal policies ignored that counter-cyclical fiscal stance was extremely desirable for economies with limited number of fiscal stabilizers. As a consequence, the mission of fiscal policy didn't get much further than imposing fiscal rules to achieve debt sustainability.

Figure 3: The main policy results (period 2005-11)



Calculations based on data of the National Bank of Serbia

Many developed countries learned from the debt crises that it was very risky to expand domestic spending rapidly through foreign debt financing, especially when expansion was through consumption. The situation in Serbia could not be qualified as alarming, but increased vulnerability of the economy calls for additional caution. The figures tell that, currently, the situation seems to be held under control with all the debt categories kept close to, but not above limits. Concretely, in 2011, external debt relative to GDP decreased to 73.6% (with 80% as a limit for high indebtedness), where external public debt accounts for around 27% of GDP, and the rest represent private debt. The total public debt at the end of 2011 was near the limit, slightly above 46%.

Deficit spending drives up interest rates and undercuts private investments and consumption.² More precisely, when government runs deficit, it obtains the difference by borrowing on the open market, competing with borrowers from real economy and therefore, drives up cost of capital.

When privatization proceeds and debt-fuelled growth predominate in economy, the recovery is increasingly jobless. Output growth was slowly restored, but the jobs did not. In the period 2002-2011 output almost doubled (from 16 to 31 billion of

EUR), but the economy lost almost 15 % of jobs.³ Moreover, in 2011 unemployment rate reached critical level of 22.3%.

Constant inflationary pressures due to structural instabilities along with relatively high level of indebtedness provoke constant aggravation of systemic risk of the country. It refers to increased fragility of the system due to interconnectedness of its elements, without capacity to amortize eventual collapse of the system caused by failure of certain important players or a sector. Consequently, illusionary macroeconomic stability is kept artificially as a life of patient in coma.

Serbia is highly exposed to the stressors that captured developed economies in 2008. Financial deregulation and securitization, which marked the period before the crisis allowed risk not to be taken, but continually transferred. Portfolio investments that entered Serbia in the period before the crisis spilled out of country after the 2008 global economic crisis, worsening capital and financial structure and widening the output gap.

Macroeconomic policies are aimed at reducing systemic risk or fragility of the economy. On the other side, in Serbia their outrageous influence on the real economy can be observed through high cost of capital and appreciated FX rate. As a consequence, tradeable sectors are dwindling to extremely low shares, with nontradeable sectors determining the crawling growth thrust.

Table 1 captures and summarizes majority of previously mentioned problems. It shows the prevailing trends in key macroeconomic performance indicators for the last ten years in Serbia. Figures are fully indicative and they portray the effectiveness of policy rules during the analyzed period.

Table 1: Key macroeconomic performance indicators (period: 2002-11)

Indicators	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP growth rate	4,3	2,5	9,3	5,4	3,6	5,4	3,8	-3,5	1,0	0,8*
Consumer prices inflation, in%	14,8	7,8	13,7	17,7	6,6	11,0	8,6	6,6	10,3	7,0
Exports (in EUR million)	3.125	3.847	4.475	5.330	6.949	8.686	10.157	8.478	10.070	11.463
- growth rate	16,0	23,1	16,3	19,1	30,4	25,0	16,9	-16,5	18,8	13,8
Imports (in EUR million)	-6.387	-7.206	-9.543	-9.613	-11.971	-16.016	-18.843	-13.577	-14.838	-16.815
- growth rate	27,2	12,8	32,4	0,7	24,5	33,8	17,7	-28,0	9,3	13,3
Current account balance (in EUR million)	-671	-1.347	-2.620	-1.778	-2.356	-5.053	-7.054	-2.084	-2.082	-899
- in % of GDP	-4,2	-7,8	-13,8	-8,8	-10,1	-17,7	-21,6	-7,2	-7,2	-10,1
Unemployment rate	13,3	14,6	18,5	20,8	20,9	18,1	13,6	16,1	19,2	23,7
Budget deficit/surplus, in %	-4,3	-2,6	-0,3	0,3	-1,9	-1,7	-1,7	-3,3	-3,6	n.a
Public debt, in %	71,9	63,7	50,9	50,6	40,1	31,8	26,9	34,1	41,9	44,6
External debt, in %	58,7	55,9	49,8	60,1	60,9	60,2	64,6	77,9	82,1	74,5
RSD/EUR FX rate (period average)	60,66	65,13	72,70	83,00	84,10	79,96	81,44	93,95	103,04	102,09

* NBS estimate

Source: National Bank of Serbia

Recommendations: The role of industrial policies in the new policy framework

While double-dip recession is clearly appearing on the horizon, nobody in the EU has single silver bullet to prevent its negative consequences. Still, every country is in search for its own ways to prepare for it. A shift in perspective is particularly important for Serbia, which entered the 2008 global economic crisis with impotent economy, low competitiveness, and unfinished geopolitical repositioning.

Sustainability of current policy framework has been definitely brought into question. If monetary targeting continues to be implemented two lingering questions stay without answers. First question is related to costs of this policy in case when inflation is combined with stagnating output. The previous question brings us to new dilemma: if inflationary pressures continually rise due to significant output gap, would central bankers be willing to induce high unemployment in order to keep high interest rate? Second question is related to central bank's reaction in case of major economic shocks, like the 2008 global bank and government "run". The question is whether the monetary policy in the period of recession and major economic shocks has to hold the orthodox anti-inflation line or to falter to the heterodox line.

In combined crisis the economic policies framework must be changed. Radical reforms in an impotent economy with nominally depreciated, but really appreciated currency, high interest rates, unfunded internal government liabilities, and high external debt cannot be framed on orthodox platform. Continuity of liberalization with budget cuts and flexible labor market lead to further increase of output gap with serious difficulties to reach inflationary targets.

Economic policies could be roughly divided into macroeconomic or broad policies (monetary and fiscal), industrial policies, and supporting policies (population policy, regional policy, competition policy, etc). Approach toward economic policies is different in developed and developing world. In developed economies there was great ignorance toward industrial policies. Inversely, in developing economies macroeconomic policies are not concerned as wheels of prosperity but as the "oil" which lubricates the acceleration of the growth of output and renders the motion of tradable sectors, as principal wheels of prosperity, more smoothly and easily. In these economies government and regulatory bodies through industrial policies intervened extensively to create tradable sectors. The export led managed growth strategy enabled extraordinary growth in some developing economies and fast reach of the ranks of the developed ones (Rajan, 2009, pp: 47-8).

Besides inflation (low and stable) as an ultimate tenet of broad macroeconomic policies, policy makers, faced with combined economic crisis, will have to consider additional tenets including output gap (stable and low), composition of output (dominance of real economy over services), behavior of asset prices (including the currency), and leverage of different economic agents (equitable position of real economy and financial sector) (Blanchard et al., 2010, p.7). Accordingly, combination of indus-

trial policies and new automatic stabilizers in monetary and fiscal policy are promising routes for improvements (Djuričin, Vuksanović, 2011, p.329).

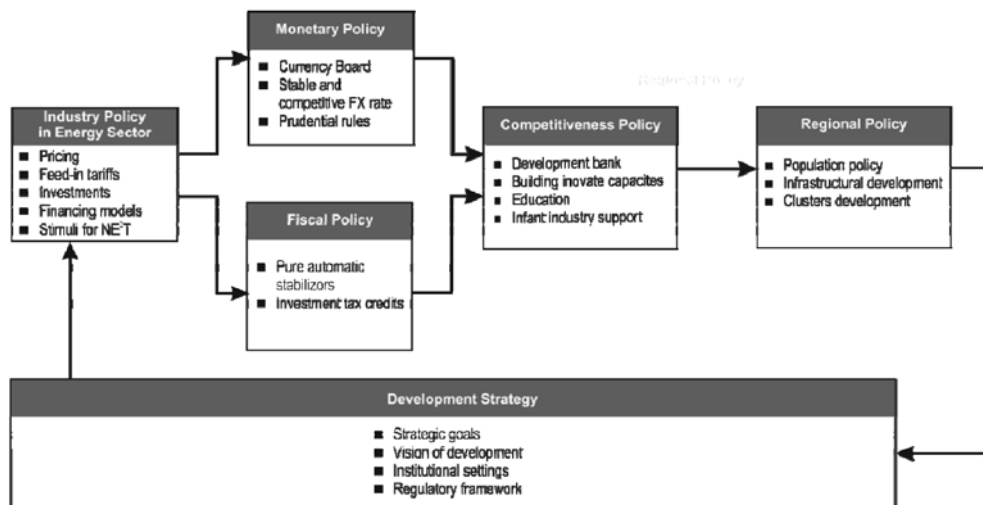
Which model of industrial policies is feasible for Serbia? Fast growing developing world promoted the model of *managed capitalism* (Rajan, pp: 53-67). Positive experiences undoubtedly shape the typical path followed in the quest for growth. What is clear is that the best practice characterizes intensive government support in the first stage of development of infant industries, and steady and continuous focus on export. Since private sectors in these countries were relatively uncompetitive, few choices remained. They could choose active government role through founding of state-owned enterprises, or they could choose the role of enabler to build and expand hard and soft infrastructure and regulatory environment. Also, governments had to play the role of protector *via* different protectionism measures from foreign competitors allowing domestic businesses to prosper (Rodrik, 2008, p.5).

Still many of the countries practicing mentioned policy, impatient for growth, fell into the trap of vicious circle that caused their economic strength to vastly downgrade. Namely, even after they managed to increase output and export of higher value-added products, they were still technologically inferior and dependent on import of technology and know-how. By exporting competitive (thus cheaper) commodities and goods and importing expensive technology, the rising gap in current account had to be bridged by foreign borrowings. This model proved unsustainable because it generates deficits in both part of BOP. The solution to the previous trap was to decrease borrowing and return back to roots-sources of comparative advantage.

The successful strategy for advancement assumes moving from the least sophisticated technology (easy-to-make, labor intensive goods) to the frontiers of technology, slowly and gradually, using low labor cost to stay competitive until technology and human capital improve (Chang, 2002, p.137).

Given the aforementioned, the new comprehensive economic policies framework in Serbia has to be based on three pillars. The primary pillar refers to industrial policies. Focus must be shifted from services toward real economy, both in private and state sector. Industrial policies are sector based (energy, telecommunication, agriculture, food processing, infrastructure, logistics, tourism, etc). The second pillar represents broad policies (monetary and fiscal). Competitiveness and regional policy as supporting policies follow as a third pillar. Development strategy acts as conceptual base for all previously mentioned policies. Figure 4 depicts the idea of new policy framework with industrial policy in energy sector as an example.

Figure 4: New policy framework



Industrial policies are directed towards expansion of output in tradable sectors by promoting import substitution and/or supporting export. For example, in energy sector, the most important measures refer to pricing, feed-in tariffs, and investment and financing. Global demand for energy is rising every year, so the expansion in the energy sector could play both export and anti import role. In the previous period there have been some built in de-stabilizers like government administrated pricing in energy sector (dramatically below the market level). With EUR 57 per MWh compared to the average EUR 190 per MWh in EU27, investing in energy in Serbia is not attractive.⁴ Competitive pricing would attract investments in the existing capacities based on fossil fuels, as well as in the renewable energy. Effort must be made to introduce new counter-cyclical stimuli like investments in new energy and efficiency technologies, or NE²T. The potential magnitude of these investments as well as their multiplier is extremely high.⁵

Competitive energy sector requires dynamic financial system constantly promoting discipline but without excessive risk and outrageous behavior against real economy, and explicit and efficient fiscal system. That might be hard to achieve, but it would be worthwhile.

New monetary model is in the center of broad policies. It could be the model of currency board. Currency board with automatic adjustments ensures stable and competitive FX rate. Stable and competitive FX rate plays the role of automatic stabilizer. It encourages export and discourages import. This model has capacity to solve deadly relationship between large cost of capital and raising inflationary pressure on real economy. Implementation of currency board means not only the choice of FX rate that is stable and competitive, but also a balanced budget and managing the FX

rate determinants. Competitive FX rate is a barrier to entry and stimulus for export. It is opposite to current monetary model of inflation targeting where really appreciated currency is a stimulus for import and barrier for export. Also, stable FX rate is a prerequisite for investments. It means that stable and competitive FX rate is a prerequisite for keeping the output gap low and stable. Last but not least, if Serbia chooses the monetary policy of a currency board system, it will adopt the monetary policy of the euro zone.

When thinking about additional (external) sources of financing, it is important to make distinction between support to counter-cyclical macroeconomic policies and long-term development financing, though increases in the later can have counter-cyclical effects. In case of Serbia, the WB and the EBRD could play the crucial role in development lending while the IMF has already played a more important role in macro management. New channel could be funds provided by newcomers from the reserve-rich countries (China, Russia, Norway, etc.) in the areas in which Serbia has unambiguous comparative advantages. Concretely, the feasible arrangements are joint ventures (let's say up to one half of the equity of state-owned enterprise) for efficiency improvement and capacity expansion in energy sector, private-public partnerships in renewable energy, agriculture, food processing etc., and building-operating-transferring arrangements in infrastructure, transportation, logistics and tourism. These channels of funding are extremely important in order to relax potential built-up of unsustainable debt, or debt that would crowd out developmental efforts towards output expansion.

Conclusion

At the beginning of 2012, Serbia's economy was affected by falling export demand and/or prices accompanied by reversals of capital flows, both in financial and real sector. The initial impact of the 2008 crisis has been felt in real economy but now it is returning back to the financial sector.

The previous analysis confirms that there are some fault lines. First of all, Serbia's crisis, similarly to almost all economic crises, had political roots. Dissolution of Yugoslavia and confused strategy of geopolitical repositioning were the main causes of political predisposition toward stimulating consumption (or "soft budget" constraints both on macro and micro level). The second set of fault lines emanates from impotency of the economy, as a consequence of inertia of deep structural instabilities. The final set of fault lines develops as the consequence of wrong economic policies during transition focused exclusively on inflation control and use of privatization proceeds and remittances for that purpose.

System risk is considerably high due to uncompleted economic transition. In addition, a "stuck in the middle" position *vis-à-vis* key geopolitical players erodes confidence in business community and causes capital outflows. When capital is scarce

resource it is possible that the risk-adjusted interest rate might be even negative since the nominal interest rate is high. This discrepancy between nominal and real in Serbia's economy colorfully explains lose-lose game between major economic agents. The above-mentioned as well as additional discrepancies between nominal and real (FX rate, for example) indicate that the economy is not only impotent but, also, out of tune.

During transition the output (and the real economy) was off the radar of economic policies. Moreover, there are many manifestations of outrageous behavior against real economy. Appreciated real FX rate and high interest rates constantly provoke crowd-out effect. Despite sacrificing output gap (low and stable), inflation (low and stable) was not achievable. Inflation targeting is not in capacity to keep the economy perpetually at its potential growth rate. Also, relatively high inflation indicates that the economy is prematurely exceeding the speed limit. The artificial overheating and expensive cooling are not favorable for investment. Without crowding in economic policies require revision.

The new policy framework has to be conceptually wider taking care not only of inflation but, moreover, of output. The high priority tenet of new economic policies must be to keep the output gap stable and low through industrial policies. As soon as the equilibrium between supply and demand is achieved, new broad policies come into the play.

In structuring reforms, especially, given the existence of enormous structural imbalances, strategy which settles for *status quo* brings the greatest risk for all. Cost of doing nothing is far greater than the situation we have recently experienced because existing fractures will only deepen. The new model of economic policies requires new set of priorities: real economy (instead of services), investments (instead of consumption), export (instead of import), and savings (instead of credits). Investment driven mindset is at the core of change. Prosperous economies continually matched investments in tradable sectors with comparative and/or competitive advantages through industrial policies.

To conclude, industrial policies are the road for solving the main transitional contradiction - that inflation control is not enough for sustainable employment. In order to eliminate reversibility, new economic policies framework requires the shift in focus from inflation towards output. This is the latest time to move from price stability toward dynamic management, both in public and private sector.

NOTES

¹ The third successive drop caused by global economic crisis in 2008 started when it reached just 73% of the pre-transitional GDP

² Deficit spending may drive up interest rates and undercut private investment as well as consumption, a phenomenon known as *crowding out*

³ Statistical office of the Republic of Serbia, available at www.stat.gov.rs/WebSite/PageView.aspx?pKey=2

⁴ European Commission Eurostat, available at http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Energy_price_statistics

⁵ According to EBRD, the potential of wind is at the level that provides catering full yearly needs of 400 thousands households. The yearly solar irradiation in Serbia is 40% higher than the European average, although costs of installing capacities for solar energy are substantial. Hydro potential has also not been fully used yet. Available at <http://www.ebrdrenewables.com/sites/renew/default.aspx>

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