

Export-led Growth

Central European Experiences -
Magic Formula for the Western Balkans?

Edited by Michael Ehrke



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Authors: Michael Ehrke, Andras Inotai, Bela Galgoczi, Martin Muransky, Andrej Kumar, Milica Uvalic, Ana S. Trbovich, Mihail Arandarenko, Milan Zivkovic, Marija Stambolieva, Jens Bastian

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MICHAEL EHRKE¹

INTRODUCTION: EXPORT-LED GROWTH IN CENTRAL EUROPE AND THE WESTERN BALKANS

In 2010, economists from Central Europe, Slovenia and Western Balkan countries participated in a conference titled *Export-led Growth* organized by the Friedrich-Ebert-Foundation in Belgrade, Serbia. The issue discussed at the conference was as to whether the growth pattern seen in Central Europe after 1989-90 could be implemented in the countries of the Western Balkans. Economic growth in these countries between 2000 and 2007 was overtly characterized by a lack of exports and continuously high current account deficits. Such deficits were consistent at the time with high growth rates due to foreign loans that were readily available to these countries at very low costs. The high growth rates in the Western Balkans were (as in the case in Greece) the other side of the enormous trade imbalances within Europe, which had split the continent into the surplus countries of the North (above all Germany, but also including Austria, Scandinavia and the Netherlands) and the deficit countries of the South. As a trade surplus automatically means a loan for the deficit country, the imbalances in foreign trade are clearly visible in the financial relationship between a creditor and a debtor country. Although belated, the global financial and economic crisis came to the Western Balkans in 2008 and brought an end to this “imbalanced growth”: the favourable foreign loans which had financed the current account deficits of the Balkan countries were suddenly no longer available. The growth pattern, based on private consumption with a high share of imports and financed by foreign loans, was no longer viable. Regardless of how growth will be managed after the global crisis, sustainable growth will not be possible without a substantial rise in exports.

At the conference, it was more than logical to discuss the chances of export-led growth based on Central European experiences; these experiences can be summarized as having a large part of former state owned productive assets sold to foreign investors, above all to transnational enterprises which were willing and able to integrate the local production activities into their own international value-chains. In addition to this, the privatizations opened the door for new Greenfield-investment, which utilized the cost advantages of the region (low wages, taxes, and duties, combined with the geographical proximity and the assumed qualifications of workers (see the articles by Bela Galgoczy and Martin Muransky in this volume). Consequently, there was a dramatic increase of the foreign trade ratio in these countries' economies. While a growing part of national production went into export (see the article by Andras Inotai), export-led growth was also import intensive due to the fact that foreign companies only obtained a small part of their intermediate inputs from the local market. Therein, Central European countries' current account deficits

¹ Michael Ehrke is the Director of the Friedrich Ebert Foundation, Office in Belgrade

did not disappear, although they did slowly decrease. Within a few years, it was possible to integrate Central European economies into the European markets at a technologically relatively high level, a rather unexpected developmental success in such a short period of time. Of course this manner of export oriented growth in Central Europe has had its downsides: the abovementioned high import intensity, its weak effect upon employment and the division of local economies into a foreign dominated modern export and a stagnating/lagging local sectors (indeed, responsible for most of the employment). Nevertheless, the Central European pattern of the economic integration can at least be presented in comparison to Western Balkan countries as a successful model to consider.

High Import Inclination: the Europeanization of Consumption Standards

In spite of the highly different economic developments in both regions, one joint characteristic still exists: a high import inclination, which pushes for the generation of high exports. The reason for Central Europe's import inclination partly lies in the mentioned practice of foreign companies importing most of the needed intermediate inputs, especially from those countries from which the companies originate, whose subsidiaries are mostly located at the Western borders of Central Europe, and which are connected to European traffic networks. However, private consumption is also responsible for the high import inclination: the dominant consumption pattern is strongly influenced by the pattern of Western Europe. As Janos Kornai once identified, a premature welfare state in communism, today former communist countries can be seen as a *premature consumer society*, one that is characterized by an imbalance between dominant consumer standards and economic capacities. During communism, isolation from Western Europe kept consumer standards and production capacities at a certain balance, albeit an unpopular one where consumers had to be satisfied with shabby versions of the Western consumer goods, i.e. Trabants instead of BMWs. With the fall of the border between the different systems, this imposed balance also disappeared. Those products which could not be produced in the former communist countries (at least not at an appropriate level of quality), had to and could be imported, which was frequently financed by loans in Euros or Swiss Francs. The premature consumer society in Central Europe was strengthened through membership in the EU, and as has been frequently pointed out, the EU is a community of values. Yet, its shared values are not only Western and progressive traditions; they are ever the more tangible in Sport Utility Vans and flat screen televisions. In other words, membership in the EU justifies the aspiration of the middle class towards a Western European consumer level, regardless of the economic capacities of their home country.

When it comes to the private consumer standards, the middle class in the Western Balkans, whose countries are not yet EU members, also consider themselves as

being part of the European aspiration community. First of all, they already have a perspective on membership. Secondly, the Western European world of consumption is just as present in the Balkans as it is in Central Europe: in commercials, in the media, and in the products of Western import companies, from Benetton to Audi. Contrary to Central Europe, the Europeanization of consumption does not correlate with the partial Europeanization of production, nor with inclusion in European value chains (which may be able to make appropriate internationalized consumer patterns financially feasible).

There are two additional factors in Western Balkan countries which affect its high import inclination. The first lies in the fact that a considerable part of the former Yugoslav populace is now living and working in Western Europe; in part this is already true for generations. These labour migrants, many of whom have acquired the citizenship of their host countries, have not abandoned their contact to their original home countries; on the contrary, they send a substantial part of their income to their countries of origin. The volume of these money transfers frequently exceeds all foreign direct investment and has significantly contributed to the financing of current account deficits in the Western Balkans. Yet, these former *Gastarbeiter* do not only bring money into their original home countries, they also “import” a consumer pattern corresponding to the standards of their guest countries, i.e. into their new home countries. They demonstrate to their families and communities that Western European consumer goods represent social status and demand to be emulated.²

The financial transfers of former *Gastarbeiter* not only intensify the demonstration effect which comes from the western consumer pattern, they also increase consumer inclination at the cost of production and exports. This transferred money represents a relevant economic quantity; however, it is divided into smaller sums and it is almost impossible to put them together into an overall, larger quantity necessary for investments in the area of internationally tradable goods. These money transfers are mostly directed to families and relatives, as they support private consumption. They do, however, partly finance the construction of residential buildings, such as the first or second residence after retirement; therein, they also finance the local construction industry (which does not produce internationally tradable goods). If these types of transfers finance investments at all, they are small investments in the service sector - into fast food restaurants, gas stations or repair shops - which also do not increase the export capacities of a country. Most damaging due to transfers such as these, economic status is associated with working abroad; as a result, qualified young adults are motivated to look for a job in Western Europe instead of working or doing business in their own home country, (as either investors or as employees).

² See Andras Inotai, *The European Union and Southeastern Europe. Troubled Waters Ahead?* Brussels 2007

The second factor which pushes import inclination in the Western Balkans even above the level of Central European countries is the structure of the economic elite. In the Western Balkans, so called Tycoons dominate this sector of society, i.e. entrepreneurs who have become rich in the first phases of privatization under the Milosevic or Tadjman regimes and were able to accumulate enormous wealth in comparison to the economic size of their countries. In return for their political support of the government, they received economic privileges such as monopoly rights and import licences. These tycoons profited greatly from the wars and embargos of the region, and they were isolated from any international competition. Hence, they are not interested in international competition, owing to the fact that their monopolistic positions in the small markets of their countries are safer and more lucrative than participation in the broader international market. Finally, after the fall of Milosevic and the death of Tadjman, these tycoons came to an agreement with their subsequent governments and developed economic structures, mostly wholesale and retail empires, which dutifully profit from the import of consumer goods. The most powerful economic interests of the Balkans are therefore connected to importing. For instance, these elites are interested in the highest possible value of their national currencies, at the expense of the competitiveness of their exports.

No Protagonists on the Export Side

The high import inclination of Western Balkan countries pushes for the build-up of similar export capacities, as their high current account deficits cannot be sustained for over a long period of time. Nevertheless, the question at hand is which group of economic protagonists and entrepreneurs should carry out such development. These countries' tycoons are no protagonists of an active export strategy *per definition*: their economic empires are concentrated on producing internationally (not tradable goods and services) - such as the wholesale and retail trade internationally unexposed segments of the financial system, construction, property and insurance. Of course, it is still quite possible that the accession of the countries of the Western Balkans into the EU shall change their competition environment to such an extent that these same tycoons shall change their strategy; when the potential market of a company in the Balkans does not merely include two to seven million but 450 million customers, there will perhaps be sufficient incentive to serve these larger markets. Additionally, more competition in the domestic market would break the monopoly positions held by tycoons of the region and would force them to become more competitive. This hope is, however, crushed by the fact that these tycoons lack any starting points for an appropriate export oriented strategy, which is a significant difference compared to Slovenian entrepreneurs who were already specialised for exports in the former Yugoslavia and who were able to react to the break-up of the Yugoslav market by quickly steering themselves toward western markets (see the article by Andrej Kumar).

A second possible group of protagonists are small and medium privatised companies that are connected to *clusters* and which would be able, in their intense interaction with each other and with their clients, suppliers and the institutional environment, to occupy certain niche markets on the international level – i.e. a modernisation according to the South German, Austrian or North Italian model. However, there are only few starting points for this model as well; namely, there are no craft-industry traditions which small entrepreneurship of this kind would be able follow. There is also the question as to whether globalization has gone so far that it no longer leaves space for entrepreneur strategies that had originated in the 19th century, in the transition from craftsmanship to modern the industry.

The export-led growth of Central Europe and the growth pattern which is currently being strived for in the Western Balkan countries is also different from the Asian “export-led growth”. This variety of growth had once been a hallmark at East and Southeast Asian economies where *export-led growth* was the product of a development strategy led by the state and aimed at avoiding international specialization in the production of raw materials and simple industrial goods, along with its trap of longstanding sinking *terms of trade*. In the framework of this strategy, profitable modern industries were identified and selected “national companies” were put into the position to operate on the global market through subsidies and other measures. This strategy was unorthodox, since state authorities pretended to do what should ultimately be the task of the market: the selection of products, industries and companies and their preferential treatment (about the industrial policy see the article by Milan Zivkovic). Still, it was successful. In the sixties, when the World Bank recommended to Japan that it should specialize in the production of textiles, Japanese industrial politicians and the large companies supported developed a domestic electronic industry. Unfortunately, this form of state-guided industrial policy is unrepeatable. In regard to Central Europe, there is no similar development strategy, let alone in the Western Balkans. The choice of those branches and companies privileged by the state does not only disturb the market and therefore seen as being inefficient - more importantly, it is *prohibited* in the regulatory framework of the EU.

The only imaginable carriers of export-led growth are neither small or large companies, nor the state, but transnational companies (see the article by Ana Trbovic), which integrate local production structures into their value chains and distribution systems, as has been the case in Central Europe. In that, the state possesses two other instruments by which it is able to implement export-led growth: first it must do everything in its power to offer the most favourable investment conditions possible (i.e. low wages, taxes and duties, developed infrastructure and legal security, an environment generally friendly for entrepreneurship and investments in the education of employees) to potential international investors. The state has to try to attract foreign investors, even though this means that it has no influence on what

is being produced, nor under which conditions, as well as not having any influence on any long-term economic consequences. Companies themselves need to decide whether they will produce for export or whether they will be satisfied with less risky activities in the smaller markets of their host countries. Therefore, the state has a second instrument at its disposal: the devaluation of its national currency. However, for a state to do so, it not only would have to go against the interests of its tycoons, but also against the import-inclination of its national economy supported by its middle class. Almost all of social powers would become enemies of the state: its economic elite, employees (as wages and social dues would have to be lower than in other countries) and its middle class, which would not be as able to import and travel as it had been before the introduction of export-led growth.

Reorganization of the Industrial Division of Labour within Europe - or *Business as Usual*?

Per capita, the amount of foreign direct investment in Western Balkan countries is not even one third of that in Central Europe. Most investments have financed the takeover of companies which had been in state or “social” ownership and were thusly made in connection to privatization. However, these privatizations did not open doors to Greenfield-investments, as had been the case in Central Europe. In regard to the Western Balkans, there were no new production capacities created, apart from certain exceptions; instead the privatizations caused a reduction in capacities and employment positions (see the article by Milica Uvalic). In many cases, the goal of privatization was not the maintenance or expansion of production capacities, rather an increase in state income. Most important of all, few cases of foreign investment supporting export projects exist, as most foreign investment has financed the production of non-tradable goods and services; such as investments in telecommunications, property markets, media or the financial system. Evidently, the potential international competitiveness of the economies of the Western Balkans has been estimated as being too low in order to justify the risk of export oriented investments.

This restraint is logical at first glance, as when the first large investment waves came to Central Europe in the nineties, war was taking place in the Balkans and conflict still persisted after its end. The internal order of countries in the Balkans does not yet seem to be strong: their (small) economies are highly politicised, their legal security is problematic, they have not overcome their corruption and organised crime and their infrastructure has not been sufficiently developed. Many of these factors had also been present in Central European countries during the nineties, but they did not prevent foreign investment. The difference between the two regions in transformation has not so much been caused by the internal shape of the host countries, rather by the dimension of the investment. For instance, foreign direct investments that went into Central Europe were much more extensive than would

have been expected, based on the local GDP per capita. Whereas China in the first years of the 21st century attracted less than half of foreign investment calculated on a per capita GDP basis, the amount in Central Europe was twice to three times that in comparison.³ This investment boom in Central Europe was outside of the range of “normal”. Export oriented direct investment was connected to a fundamental reorganisation of the industrial labour division within Europe wherein Central Europe very quickly became the “extended workbench” of the Western European - especially German - car and electronic industry. This process had several layers: the labour intensive, less knowledge/technology intense sectors distanced from the end customer segments of production were relocated at the periphery, whereas the knowledge intensive and close end customer segments remained located in Western Europe. However, in many cases, the capacity for final production (as in the car industry) was also created in Central Europe.

The problem of Balkan national economies lies in the fact that an export oriented growth strategy cannot rely on a continental industrial wave of the sort that Central Europe originally saw. On the contrary, the Europeanization of the production in the Balkans is proceeding only according to *business as usual*. If privatisation profits are possible, they are being accepted, the small domestic markets are served with limited capacity building. Indeed, even when there are export capacities being built in exceptional cases, such as in the cases of U.S. Steel and Fiat in Serbia, they are isolated examples; no true export-clusters have been created. The transformation of the Balkans is missing the historical dimension of the change that had happened in Central Europe where the management of large Western companies reacted with an also almost historical international reorganization of industrial production. Perhaps cultural preferences had been significant in practice as well: for the German managers of large companies, Central Europe was a region close to their own cultural space, although it had been occupied for 40 Years by a hostile power. The Balkans, on the other hand, was perceived as something “foreign” for Europe – a picture that seemed to be confirmed by the wars and conflicts of the nineties.

Additionally, the policies of the EU did influence the perceptions of potential investors. The treaties closed with countries in Central Europe in the early nineties consisted not only of a clear *road-map* for European integration, but also included a time schedule. Investors knew that the countries of Central Europe would become EU-members and that they would be subject to EU-regulations. In accordance with this perspective, long-term investment risks could be classified as relatively low, definitely lower than in East Asia. The mix of risk assessment on one hand and low costs (wages, taxes, duties...) on the other, combined with its geographical proximity, made long-term investments in Central Europe so attractive. Conversely, coun-

³ S. Robert A. Lipsey, Measuring the Impact of FDI in Central and Eastern Europe, NBER Working Paper 12808, Cambridge, MA, 2006

tries in the Western Balkans have maintained a “European perspective” since 2003, but there has never been a proper time schedule laid out. These countries were supposed to come closer to the EU according to the regatta principle, where their different results would be awarded with different accession dates. This integration without accession date and accession certainty further strengthens the uncertainty of potential investors.

Under current conditions, the countries of the Western Balkans (apart from Croatia) could offer themselves as production locations with the *advantages of still being an outsider*, i.e. the advantages of being non-EU members and not yet subject to certain regulations. Of course, this would especially apply to the lower ends the value-chain, where wages are extremely low, where there is damage to the environment and workers’ health, which hurts social standards, consumer protection is avoided and intellectual property rights are not seriously followed (services which are prohibited in the EU could also be added, such as human trafficking, human organs trafficking, drug trafficking, etc...). Large investments of this type, however, are extremely risky since the local advantages of the outsider would disappear with EU-accession.

Nevertheless, investment decisions which keep the future EU-membership of the Western Balkans in mind and anticipate European regulations are also risky, since accession into the EU might not take place in the end, as one of the (current) 27 EU-member countries could be against any further enlargement. Due to the uncertainty regarding the future economic order of the region, for now, the most rational decision of potential investors is to *wait*.

Perspectives

Is export-led growth in Western Balkan countries possible even though (unlike in Central Europe) there are no continental industrial reorganization processes and there is no clear political horizon (certain future EU-membership) to rely on?

Border-crossing industrial reorganization is not a one-time event that will be finished at a certain moment; rather it is one that is permanently taking place. In the nineties, foreign direct investment in Central Europe had just created an especially high wave in this process. As long as industries are under competitive pressure they will *have to* use international differences between wages, taxes and other costs and location advantages. An example of this fact can be seen in the decision of Fiat to develop its production capacities in Serbia (and to close down a factory in Italy). Serbian wages are still below those in Bulgaria and Romania, and this difference can be significant among the conditions of hard international competition. This applies even more so to some automotive suppliers, whose production is very labour-intensive and for whom the wage-cost-competition can be a deciding factor in their economic success. The relocation of industrial activities out of the European centre

to its semi-periphery and periphery shall surely take place in the future, even if it will not change the labour division within Europe as suddenly and as deeply as it had done during the investment boom in Central Europe of the nineties.

For export-led growth, one condition above all is missing in the Balkans: demand in the EU, the largest trade partner of the region. This demand had been present in Central Europe during the modernization of its production structures. Those same companies that had developed the production capacities of Hungary or Slovakia represented demand for their products, which they integrated into their international networks. Without this connection, the export chances of the Western Balkans depend on the general demand of its trade partners, above all of those countries which had already achieved a large export surplus in the years before the crisis. Since these surplus producing countries - Germany being the foremost of which - are all looking for a solution to the crisis in the same manner which pulled them into the crisis in the first place; namely, surplus export production there is almost no possibility that their dynamic of internal demand offers a chance of growth through exports to deficit-ridden countries. The Western Balkans is therefore a part of the imbalances within Europe, which are clearly obvious today in Greece. The economies of the Western Balkans (the periphery of the southern periphery of the EU) are of course small and their crises will therefore not gather international attention. They are neither EU nor Eurozone members so that any possible financial consequences will reflect in no influence upon richer EU-member countries. Without European economic development, which would take care of both sides of the imbalance of the (southern) deficit and the (northern) surplus production, there will be no miracle of self-healing through self-strangulation in Greece, as well as none in the countries of the Western Balkans.

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In a comparative perspective, the article by **Andras Inotai** analyses the basic pattern of transformation in Central Europe and the Western Balkans. Foreign trade and foreign direct investment are the focus of this analysis, where Central European countries have been transforming themselves into open national economies with a large share of foreign trade in their GDP. Due to modernisation of the economy through foreign direct investment, it has been possible for them to achieve export-led growth. Conversely, the countries of the Western Balkans have merely opened their economies to import, resulting in high trade and current account deficits. Since 2000, they have remained caught up in the “trap” of being fixated on their smaller internal markets. Inotai notes that the global crisis has been hard on Central European countries, precisely due to their export orientation. The opinion can be already heard that it is necessary to reduce their dependency on foreign companies and markets. The counter-argument is that exports also represent a mechanism which will help lead them out of the crisis. In contrast, since the start of the crisis,

the countries of the Western Balkans have been facing the problem that the largest financial source for their external deficits, namely foreign investments, could dry up.

Discussing Central Europe, **Bela Galgoczi** continues Inotai's analysis and further describes the financial and productive integration of the region into the European economy. He shows that the transformation driven by foreign direct investment has given rise to a new pattern of international division of labour, as national economies of Central Europe have been included in value chains dominated by western companies, visible through the high ratio of their inter-industrial and inter-company trade. Since these value chains are concentrated in two industrial sectors (the car industry and the production of electronic components) whose rates of growth are largely influenced by business cycles, Central European national economies are very susceptible to external shocks, such as the local effects of the global crisis have shown. Nevertheless, they have also been able to quickly come out of the crisis, most of all due to their "productivity reserves" (compared to their income *per capita*, productivity is extremely high in these economies), which have been able to maintain their competitiveness even as wages have risen. This is the difference between Central European and South European countries such as Greece and Portugal: both country groups have financial and budget problems, but Central Europe no longer has any trouble being competitive.

The main sector of industrial transformation is the car industry. **Martin Muransky** offers the example of Slovakia where the significance of foreign car manufacturing companies for the local economy can be seen. He also mentions the deficits of such a production pattern as an industrial monoculture. In his article, he does not find a direct connection between the extremely neoliberal economic policies between the years of 2002 - 2006 and the "economic miracle" induced by the car industry, which has made Slovakia the country with the highest car production *per capita* in Europe (noting, the expansion of the car industry is a regional, not Slovakian phenomenon.) In addition, such neoliberal economic policies have failed to transform the "once in a life-time investments" of three multinational companies into a foundation of long-term growth. Small and medium companies were not given the opportunity to connect with final assembly factories, which would have better strengthened the general economic effects of the foreign investment. An education and training policy was lacking as well, which could have been the basis for a higher participation of Slovakia in the areas of research and development.

As a former Yugoslav country, Slovenia has historically belonged to the Balkans, but has also been part of Central Europe according to its economic structure. As **Andrej Kumar** writes, it did not have an explicit export-oriented growth strategy, but its economic growth had been export-oriented while the country was still one of the republics of the former Yugoslavia. After its independence, companies simply continued following this pattern and were quite successful into the nineties. Though,

in the long run, the Slovenian economy has turned out to not be flexible enough in creating new products and accepting new challenges in markets outside of Europe. The global crisis has merely demonstrated the problems that had been accumulating in its economy the decade before, such as insufficient structural adaptability connected with non-effective regulation of privatization.

Five articles in this book deal with the national economies of individual Western Balkan countries: three of them deal with Serbia, one with Croatia and one with Macedonia. In regard to Serbia, *Milica Uvalic* inquires about the deficits of the transformation and the causes of Serbia's insufficient export ability; namely, whether these deficits are able to be found in the exchange-rate which puts export at a disadvantage or whether they can be found in structural factors, such as an unfavourable composition of exports. Both factors have played a role, Uvalic says. The root causes, however, can be found on the microeconomic level, in the inefficient organization of privatisation. Likewise, the volume of foreign investment has been small and has not been enough to reorganize large industry sectors. Uvalic thinks that one of the solutions for Serbia's weak export lies in industrial policy, which would not foster "national champions" but would be able to promote investment, innovation, product quality and high technological standards in accordance with EU principles. Additionally, she demands a new approach to employment policy regulations for labour taxation and for an extensive re-organization of Serbia's science and education system.

Also on the topic of Serbia, *Ana S. Trbovich* claims in her article that foreign investment is a necessary requirement for export-led growth in a developing country; therefore, she posits the question of how it would be possible to overcome the reluctance of potential foreign investors. The cause for this reluctance no longer lies in Serbia's political instability, rather in its excessive and inefficient regulations. Trbovic examines the position of Serbia in different international indices (World Economic Forum, World Bank, and EBRD) and analyses the activities of the Serbian National Competitiveness Council. This body, which is composed of state representatives, as well as representatives from the private sector and the academic sector, made 214 suggestions altogether for 2009-2010, of which only 32 were implemented. Understandably, without the appropriate "political will", even meaningful political instruments will remain fruitless.

Mihail Arandarenko deals with the political consequences of Serbia's "post-crisis" model of economic growth (developed by Serbian economists and officially recognized), which aims to create the stimulation of export-led growth. He analyses the effects of Serbia's proposed currency and exchange course policy, of its state expenditure policy and of its tax policy on income distribution. According to Arandarenko, Serbia's post-crisis model's tax policy would cause a hard regression of income distribution. The model suggests reducing contributions for social insur-

ance and increasing Serbia's national value added tax; a combination that should be neutral. However, since only 1.8 million Serbs out of a total of 7.4 million (below 25%) are actually formally employed and would be able to take advantage of reduced contributions for social insurance, the program is in fact directed against pensioners, the unemployed, dependent persons and those employed in the informal sector of the economy.

Switching to Croatia, *Milan Zivkovic* maintains the hypothesis that industrial policy must be once again included in the country's social-democratic political catalogue. In essence, the problem is who decides what is to be produced. Opposed to the neoliberal belief system that only the market and private companies can answer this question, he elaborates on the answer of western industrial countries to the global crisis; an answer which cannot and may not be given to a country like Croatia. Zivkovic also critically discusses the crisis in the former Yugoslavia, the stability policy of the IMF, and the economic and exchange rate policy of the Croatian government after the country gained independence.

Marija Stambolieva discusses the connection between insufficient economic development and the political system in Macedonia. Following Herbert Kitschelt's theory regarding communist regimes as bureaucratic-authoritarian, national-adjustable and patrimonial varieties, she classifies Macedonia as belonging to the patrimonial type, as it survived transformation and was reproduced in the form of a political machine in which formal democratised institutions became prey to the leading groups of political parties. Together with uncertainty which followed the break of Yugoslavia and sanctions against Macedonia, the continuation of patrimonial traditions ensured that the privatisation process was manipulated through corruption. Under these circumstances, the officially represented politics of liberalisation, deregulation and privatisation supported by international financial institutions are and will not be able to achieve their proclaimed economic development goals.

Jens Bastian analyses the still incomplete and fragile economic recovery of countries in the Balkans, which has yet to include their labour markets. According to Bastian, export-led growth requires an expansion of foreign trade. Institutional framework conditions for such expansion (the Stabilization and Association Agreement of the EU with individual countries, as well as the Central European free trade zone CEFTA) are there. However, the countries of the Western Balkans do not have a favourable starting position since their export to the EU is limited to a certain range of products which have to withstand pressures of price competition. In spite of many positive attempts of cooperation between these countries, which have seemed to confirm Tim Judah's hypotheses of a "Yugosphere" in the economic area, an export oriented growth strategy is still risky - not to mention the fact that Greece's economic crisis continues to threaten to contaminate the national economies of the Western Balkans.

ANDRAS INOTAI⁴

TWENTY YEARS OF ECONOMIC DEVELOPMENT. THE NEW MEMBER STATES OF THE EUROPEAN UNION AND WESTERN BALKAN COUNTRIES: A COMPARISON

Introduction

The topic indicated in the title is more than timely, for several reasons. Firstly, after twenty years of systemic transformation in the countries formerly under Soviet influence, in military (Warsaw Pact), economic (Comecon), ideological and geographic terms (less so in historical, cultural and social heritage), a comparative analysis focusing on two decades is quite overdue, though it is hardly an easy task and certainly possesses a number of inherent contradictions and persistent uncertainties. Secondly, following on almost a decade of decomposition of the former Yugoslav Federation, which was marked by several years of war, ethnic cleansing, widespread destabilization and socio-economic hardship, the last decade has been dominated by successful efforts to re-establish security and, not without deficiencies, political stability to the Western Balkan region. The basic preconditions for sustainable economic development may at least be created in most of the new (nation-) states that have come into existence as a consequence of the dissolution of former Yugoslavia. Thirdly, the European Union has become the key external anchor of security and socio-economic evolution in both Central and Eastern Europe (CEE) and the Western Balkan countries (WB). In this regard, both the decade-long pre-accession process and experience of full membership for CEE countries (as of May 2004 and January 2007 for Bulgaria and Romania) offer interesting foundations for comparison and for the formulation of some important lessons for the future of the WB countries with regard to membership prospects/promises. Finally, the impact of the global crisis needs to be considered, since it has produced and continues to generate a number of challenges to the quality and depth of transformation in individual countries of the region. Moreover, the crisis may also have shifted priorities within the EU, without “depriving” it of its leading role and key responsibility regarding stability and sustainable development in WB countries.

This paper sets a rather modest objective of offering an economic approach to selected issues, mainly within the context of a comparative study of trade and capital flows. A comparison of the initial conditions and the trajectory of transformation over the years for both groups will be presented first. Subsequently, the transformation process will be linked to the key external anchor, the European Union, including the overall adjustment to EU rules and institutions, both within and out-

⁴ Andras Inotai is the General Director of the Institute for World Economics of the Hungarian Academy of Sciences, a visiting professor to the College of Europe Bruges (Belgium) and Natolin (Poland), to the Zentrum für Europäische Integration (ZEI) in Bonn and to the European Online Academy, Berlin-Nice.

side the pre-accession (and full membership) stage. Finally, some impacts of the crisis will be addressed, with particular reference to the “development pattern” of new member states (NMS), lessons for the WB countries and, last but not least, the changing (or partially new) priorities of European integration.

The author is obliged to dampen any overly high expectations regarding his analytical assessment: on the one hand, a comprehensive evaluation, though more than needed, would require a high-level interdisciplinary team effort, engaging international experts mostly from the respective region(s), on the other hand, transformation, nation-building (in some countries), and post-crisis adjustment are ongoing processes within a dynamic setting and are influenced by several domestic, regional, European and global developments. Consequently, any attempt to offer a static (closed) picture ought to be avoided. Of course, this does not rule out that, based on two decades of development, some important policy lessons might be drawn.

Transformation in retrospect – with question marks for the future

In 1989-1990, all CEE countries experienced the effects of a common and unprecedented external implosion. Since the Soviet Union was no longer able (and indeed, luckily, no longer willing) to keep the “empire” together, decades-old institutions firmly rooted in the post-second-war European “peace structure” ceased to function within a very short period of time. While the end of the military pact opened up wide opportunities for political independence (without creating a security vacuum in Europe!), the dissolution of economic “integration” posed unique challenges to the largely Soviet-oriented economies in the fields of production, employment and exports. Among Western experts, it was widely thought that the collapse of the traditional “Eastern” markets would create decades-long barriers to economic development following a systemic transformation, as neither the previous geographic orientation nor the “uncompetitive production and export pattern” could be changed overnight. In addition, some domestic developments, such as aspirations of political independence, freedom of the press, multi-party systems or acceleration towards Western European standards of living, were, at least on the surface, similar, but hindered by considerable illusions, misunderstandings or even ignorance.

Nevertheless, the common umbrella (or challenge) could not conceal substantial differences, in both political and economic aspirations and in the socio-economic patterns of the individual countries. Without going into too much detail, a few examples can demonstrate these divergences. In political terms, a systemic transformation was best prepared in Poland and Hungary (a wide social basis in the former and the benefits of “enlightened self-interest” on the part of the governing party in the latter). The subsequent political domino-effect that occurred elsewhere was more a result of the spectacular events at the Berlin Wall than of any well thought out domestic preparations. In addition, the regained independence of the Baltic

states originated two years later, and was the product of the (self-imposed) dissolution of the Soviet Union in 1991.

The economic differences were even greater. Although all CEE countries depended on the Soviet market for the most part (but partly also on other smaller CMEA markets), their degree of dependence was different. Of equal importance was the fact that the microeconomic orientation (on the individual company level) ranged from totally state-directed companies in most countries and companies with 3.000 joint ventures with Western firms in Hungary. On the macroeconomic level, some CEE countries entered transformation with a huge external debt. Bulgaria had to announce default, Poland, credited mainly by Western European governments, could write-off half its debt in negotiations with the London and Paris Club, while Hungary, whose – ambiguous but still feasible – economic modernization projects were financed by the (private) international financial market, had no other option than to seek ways to “grow out” of its debt to create some manoeuvring room to finance the costs of transformation. Conservative or orthodox CEE countries did not face this challenge. East Germany has been continuously financed by West Germany and its debts have been taken over by the Bonn government. Romania, with disastrous consequences for its future, repaid most of its debt in the eighties by strangling any form of economic growth and increasing overall poverty. Finally, Czechoslovakia did not become indebted; however, the price was almost total isolation from Western Europe and modern technology and highly outdated industrial stock on the threshold of transformation.

Consequently, the economic policies opted for in the first years of transformation revealed substantial differences. Poland, within the framework of a unique stabilization (austerity) package, ended up with a decade-long shortage in a very brief period (the unavoidable price being high unemployment, higher consumer prices, social differentiation, etc.). Czechoslovakia was not under any external pressure to take a high-speed transformation path and wished to keep state-owned companies or privatize them under a voucher-type privatization. Hungary, to get rid at least of part of the external debt, was obliged to choose market-conform privatization, which unequivocally meant selling state-owned companies to foreign buyers. Bulgaria and Romania entered an almost decade-long phase of economic, financial (and partly political) turmoil. Meanwhile, to create a new economic structure for their regained political independence and to make this process unchangeable, the Baltic countries opted for different kinds of currency board arrangements, fixing their newly created currencies to the DM (Estonia), the US dollar (Latvia) and the SDR of the International Monetary Fund (Lithuania).

As a result, after the first years, transformation revealed rather different approaches to such crucial issues as the passage from state to private ownership, the role of international capital in the transformation process, the degree and speed of eco-

conomic liberalization (including trade and capital flows), the balance (or imbalance) between economic transformation and its social (and political) costs. Moreover, this period was characterized by a continuous “beauty contest” involving all CEE countries (and in particular the Visegrad 3 and subsequently 4), to show whose transformation performance was the best. To be sure, the process was “supported” by several international institutions, including the World Bank, the EBRD, and also the European Commission. Initially, Poland and Hungary were the frontrunners. It was no chance that these two countries were selected by Brussels for funding (the acronym PHARE starts with their initials). Then Czechoslovakia emerged by virtue of its lowest level of unemployment (indeed, no unemployment at all) and its stable (state-owned) industrial structure – eschewing the issue of whether the situation actually reflected a pre- or post-transformation stage. Then Hungary came to the fore with market-conform privatization, unprecedented growth of foreign investments, rapid structural changes and financial stabilization in 1995. A certain status quo was achieved in the competition before some new protagonists appeared on the scene (Slovenia, without raising too much dust, and the new Baltic states). This situation ended with a crisis that burst the “transformation bubble” in the Baltic (with the partial exception of Estonia), and mainly domestic-policy generated problems in Hungary (even prior to the crisis). A new light seemed to shine then from Poland, which was the only country with positive growth in the EU-27 during the crisis year of 2009. Nonetheless, this transformation saga is far from over.

Despite temporary (time-related) differences in their approach to socio-economic development, at the end of the day, all these countries are characterized by some basic similarities. This phenomenon can be explained by several factors. Firstly, whatever original idea was behind their foundation, all of these countries had to face the reality of their size, geographic location and close interrelation with international (economic) developments. Secondly, they were all incorporated into the EU’s accession strategy, and consequently had clear pre-accession conditions to comply to. Thirdly, international direct and financial capital treated all the countries as belonging to the same region (including Turkey!). Decisions on the location of future investments were taken in light of the regional context and not according to short-sighted “national priorities”.

To sum up some basic similarities:

- The liberalization of trade and capital flows, though somewhat delayed in some countries, but without creating longer-term handicaps for the latter (in case of rational economic policy-making);
- The openness of national economies that certainly includes both a high level of vulnerability but also potential for flexibility;
- A leading role played by foreign direct investments in the structural modernization and geographic reorientation of trade flows;

- Sustainable development based on export-driven growth;
- An evident catching-up process with the EU per capita average (and living standard), over at least one decade, despite some income polarization (both real and perceived in most countries);
- The crucial role played by the EU as the external anchor, offering a pre-accession agenda (sometimes not without uncertainties) and actual membership attained by 10 CEE countries between 2004 and 2007.

In contrast, how can developments in the WB region be characterized? First, a fact that remains to be recognized by many contemporary thinkers, the Yugoslav Federation was by far the most significant and immediate victim of the fall of the Berlin wall and the abrupt abolition of a divided Europe. Over decades, Yugoslavia had been a clear winner in a divided Europe, thanks to an intelligent balancing act between the two sides (although it was closer to the East because of its “communist” ideology). Second, although it came as a rather bad surprise for many politicians, the widespread disruption in Europe led to military interventions and civil wars in Yugoslavia. While the CEE countries, despite all the political, economic and social tensions, could remain stable and managed to avoid any major domestic atrocities, let alone regional wars or open conflicts, the WB were plunged into almost one decade of gross instability in military, political, social and ethnic terms. Third, as a result of the Yugoslav Federation’s disintegration several new states were born: though Slovenia escaped the decade-long turmoil, all the other republics of ex-Yugoslavia were deeply embroiled. Of course, new nation-states came into being in CEE as well, but without the need for any military action: not only the “Velvet Divorce” of Czechoslovakia (separated into the Czech and Slovak Republics), but also the independence of the three Baltic states proceeded along a peaceful path. Fourth, as a continuation of the “Yugoslav drama”, dissolution did not take place in one clean “cut”: for Serbia, the core of the Federation, it proved to be a protracted process in several painful stages (starting from the dissolution of the Federation, passing through the departure of Montenegro from the federation and ultimately the independence of Kosovo). Fifth, while the new nation-states in CEE have not left any doubt about their capacity to build, recreate and even strengthen their “independent statehood”, the new countries in the WB do not all seem to be up to this task: at least two failed states can be seen in the region at present: Bosnia and Herzegovina, established in the Dayton Agreement of 1995, and newly-born Kosovo, from the political point of view. Taking economic factors into consideration, the “failure rate” might be deemed even higher: rapid globalization has narrowed the room for manoeuvre of small national economies and makes them particularly vulnerable (whether or not they are open to and highly involved in the international economy or relatively closed – see the crisis-ridden Baltic countries).

The differences in economic development, though perhaps less spectacular, are not less enduring. First and foremost, it must be stressed that the difference between

economic development in the WB and in the CEE countries is not just time related. In other words, the logic that the development of CEE can simply be copied one decade later does not hold. For several reasons: the difference is qualitative and structural and the existing gap cannot be narrowed merely by imitating the “more advanced” CEE countries. To find a suitable “model”, all the WB countries (in particular Croatia and Serbia) should first forget their positive memories of the seventies and eighties. At that time, Yugoslavia was the envy of all CEE countries, because of its economic progress, relative liberal economic system, freedom of the press and the availability of hundreds of licensed products from the West produced in the country. Citizens of several CEE countries were not permitted to visit Yugoslavia because of its different system! The remnants of this semi-socialist, semi-capitalist, “socialist management-based” system are still one of the major barriers to economic modernization, as if the international and especially the European environment had not changed. Second, over the last 20 years transnational companies have involved the CEE region into their global or European production, service and retail network. This new structure, though constantly changing, has established a strong network covering almost all the markets of Europe (and even beyond). It is increasingly difficult for newcomers to access this network and, consequently, change the already established, stable links within the given system. A successful approach can no longer be based on “blindly” following a well-known pattern, involving the new, promising CEE region in the production and marketing network of European or global enterprises. Third, the conditions of global cooperation have been changing, particularly as the result of restructuring in global companies facing post-crisis challenges. Evidently, this can offer new opportunities as well, but the absence of “stages of genuine and bottom-up development” can hardly be overcome. Fourth, the anchor role played by the European Union has undergone significant shifts/modifications over the last years, particularly in the wake of the “Eastern enlargement” and the impact of the global financial, macroeconomic and increasingly social crisis.

Structural differences in growth, trade and foreign direct investments – the statistical evidence

Overall trade

Widespread international experience shows that foreign trade (and foreign direct investments), particularly for small countries, has become the most important factor of sustainable economic growth over the last decades. All CEE and WB countries, with the partial exception of Poland, belong to the category of “small economies”. In this context, the difference between the two groups is striking. Exports in the new EU member countries amount to 42.5% of GDP, surpassing 60% in Hungary and Slovakia and reaching almost 60% in the Czech Republic. In contrast, this indicator fluctuates between less than 10% for Albania and Montenegro and 29% for Macedonia (17% for EU candidate Croatia). Import figures are much more similar, indicating

a heavy dependence among the WB countries on external supply. This poor performance in exports is partly compensated by a specialization on services (mainly tourism) in Montenegro, Croatia and Albania. Still, the openness of the CEE and WB groups is strikingly different. As *Table 1* shows, the level of openness in the economy (the total export of goods and services plus the total import of goods and services expressed in percentages of the GDP) is less than 100% in each WB country (with 75% in Croatia), while it is clearly above this mark for all new EU member countries, Hungary leading with 148%, 140% for Slovakia and 133% for the Czech Republic.

Table 1 - Trade openness of the Western Balkan countries (figures for 2009 in % of GDP)

| Country | Exports of goods | Imports of goods | Exports of services | Imports of services | Exports + imports of goods and services |
|------------------------|------------------|------------------|---------------------|---------------------|---|
| Croatia | 16.9 | 33.3 | 18.6 | 6.1 | 74.9 |
| Macedonia | 29.0 | 52.4 | 9.3 | 8.9 | 99.6 |
| Montenegro | 9.9 | 55.5 | 22.7 | 9.9 | 98.0 |
| Serbia | 19.0 | 34.2 | 7.9 | 7.9 | 69.0 |
| Bosnia and Herzegovina | 23.8 | 51.7 | 8.1 | 3.7 | 87.3 |
| Albania | 8.4 | 34.2 | 19.2 | 17.9 | 79.7 |
| <i>For comparison</i> | | | | | |
| Bulgaria | 34.8 | 46.9 | 14.4 | 9.8 | 105.9 |
| Czech Republic | 58.8 | 53.8 | 10.6 | 9.9 | 133.1 |
| Hungary | 63.2 | 58.8 | 14.0 | 12.4 | 148.4 |
| Slovakia | 62.7 | 60.8 | 7.1 | 9.1 | 139.7 |
| Slovenia | 46.4 | 48.2 | 12.4 | 9.5 | 116.5 |
| NMS-10 | 42.5 | 43.1 | 9.2 | 8.0 | 102.8 |

Source: *wiiv, Current analyses and forecasts, July 2010*

Two important conclusions can be drawn from the figures above. Firstly, trade (particularly export) is a key factor in explaining sustainable and export-led growth in the CEE group. In contrast, the WB countries have not been able to follow along this path to date. Their economic growth still depends predominantly on domestic consumption and the import of consumer goods, indispensable raw materials and energy. Secondly, the high degree of openness both in export and import reveals deep integration in the international production (and services) networks. The high volume and rapid growth of exports is, to a large extent, based on the import of inputs necessary for mainly export-oriented production. This connection is absent

in the WB countries, where high dependence on import (figures for Montenegro, Macedonia and Bosnia and Herzegovina are similar to the Czech Republic and higher than for Slovenia or Bulgaria) does not generate growth in export, but is mainly geared towards satisfying domestic consumption.

This structural difference becomes even more obvious when the low volume of exports (and also of imports to a certain extent) is taken into account. Between 2005 and 2009 the cumulated exports to the rest of the world of all WB countries were a fraction of Hungary's total exports, and even less when compared to the Czech Republic. In 2008 (the last year before the global crisis), Czech exports were ten times the total exports of the WB countries, while Hungarian export were almost 8 times and even Slovenian exports were almost double. It is more than significant that only two WB countries are among the EU's 50 leading suppliers: Croatia at 39th and Serbia 45th. The situation is only marginally better in EU exports: Croatia is 24th, Serbia is 31st and Bosnia and Herzegovina is 49th among the EU's extra-EU markets (see *Table 2*).

Table 2 - Western Balkan countries among the 50 leading trade partners of the EU (extra-EU trade) (2009)

| Indicators | EU - exports Croatia | EU - exports Serbia | EU - exports Bosnia & Herzegovina | EU - imports Croatia | EU - imports Serbia |
|------------|----------------------|---------------------|-----------------------------------|----------------------|---------------------|
| Euro mn | 10.736 | 6.587 | 2.939 | 4.384 | 3.212 |
| Share * | 1.0 | 0.6 | 0.3 | 0.4 | 0.3 |
| Ranking | 24 | 31 | 49 | 39 | 45 |

Source: Eurostat (Comext, Statistical Regime 4) and own calculations

* Exports of the EU to the three WB countries among the first 50 non-EU markets (Euro 20.3 bn) equalled to exports to South Korea (Euro 21.6 bn), Singapore (Euro 20.4 bn) or Hongkong (Euro 19.7 bn). Similarly, imports from the two WB countries among the first 50 non-EU markets (Euro 7.6 bn) were on the level of imports from Vietnam (Euro 7.8 bn), Chile (Euro 7.5 bn) or Azerbaijan (Euro 7.3 bn).

Detailed figures comparing trade between the EU and the WB and the EU and CEE can be found in *Tables 3 and 4*.

Table 3 - Trade of the Western Balkan countries with the European Union (in euro mn)

| Imports of the European Union | | | | | |
|-------------------------------|-------|-------|-------|-------|-------|
| Country | 2006 | 2007 | 2008 | 2009 | 2010* |
| Croatia | 4.891 | 4.979 | 5.169 | 4.384 | 4.466 |
| Macedonia | 1.304 | 1.858 | 1.765 | 1.195 | 1.500 |
| Serbia | 2.835 | 3.656 | 4.013 | 3.212 | 3.690 |
| Montenegro | 293 | 341 | 271 | 130 | 161 |
| Kosovo | 28 | 47 | 86 | 79 | 133 |
| Bosnia and Herzegovina | 1.725 | 1.832 | 1.937 | 1.527 | 1.847 |

| | | | | | |
|---------------------------------------|---------------|---------------|---------------|---------------|---------------|
| Total | 11.076 | 12.713 | 13.241 | 10.527 | 11.797 |
| Share of Croatia (%) | 44.2 | 39.2 | 39.0 | 41.6 | 37.9 |
| Share of WB in extra - EU imports (%) | 0.82 | 0.89 | 0.85 | 0.88 | 0.87 |
| <i>For comparison**</i> | | | | | |
| Hungary | | | | 46.847 | 51.110 |
| Luxembourg | | | | 13.250 | 11.160 |
| Romania | | | | 21.589 | 24.720 |
| Slovenia | | | | 12.998 | 14.560 |
| Greece | | | | 9.010 | 9.120 |
| Bulgaria | | | | 7.595 | 8.670 |

Source: Eurostat. External and intra-European Union trade. Monthly statistics – Issue number 02/2011.

* January-November; ** Intra-EU exports

Table 4 - Trade of the Western Balkan countries with the European Union (in euro mn)

| Exports of the European Union | | | | | |
|--------------------------------------|---------------|---------------|---------------|---------------|---------------|
| Country | 2006 | 2007 | 2008 | 2009 | 2010* |
| Croatia | 12.361 | 13.258 | 14.311 | 10.736 | 9.504 |
| Macedonia | 1.832 | 2.080 | 2.532 | 2.073 | 2.114 |
| Serbia | 5.793 | 8.012 | 9.044 | 6.587 | 6.771 |
| Montenegro | 517 | 673 | 871 | 530 | 488 |
| Kosovo | 277 | 424 | 533 | 624 | 569 |
| Bosnia and Herzegovina | 2.883 | 3.123 | 3.736 | 2.939 | 2.867 |
| Total | 23.663 | 27.570 | 31.027 | 23.489 | 22.313 |
| Share of Croatia (%) | 52.2 | 48.1 | 46.1 | 45.7 | 42.6 |
| Share of WB in extra-EU exports (%) | 2.04 | 2.22 | 2.37 | 2.14 | 1.82 |
| <i>For comparison**</i> | | | | | |
| Hungary | | | | 38.264 | 41.380 |
| Greece | | | | 27.580 | 22.260 |
| Romania | | | | 28.456 | 31.060 |
| Bulgaria | | | | 10.118 | 10.150 |
| Slovenia | | | | 13.476 | 14.010 |
| Bulgaria | | | | 7.595 | 8.670 |

Source: Eurostat. External and intra-European Union trade. Monthly statistics. Issue number 02/2011

* January-November; ** intra-EU imports

EU import statistics confirm a very low and stagnating export capacity in WB countries. Their share in total EU imports does not reach even 1%. In comparison, their total export to the EU amounted to €10.5 bn in 2009 and slightly exceeded that of Greece (a completely uncompetitive economy despite three decades of EU membership), but were 25% lower than that of Luxembourg! Hungary's exports alone were 4 to 5 times higher than the total exports to the EU from the WB countries. In EU exports, due to the abovementioned, distorted domestic consumption-oriented "development pattern", the share of the WB countries is about 2%, which is lower than that of Greece (another distorted pattern) and about 60% of the EU-related imports of Hungary.

A lack of export competitiveness combined with domestic consumption-driven imports necessarily results in very high levels of trade deficit. Between 2005 and 2009 no change occurred in this general picture, since not even half the imports could be covered by exports (*Table 5*).

Table 5 - Trade of Western Balkan countries* with the world

| Year | Exports (Euro bn) | Imports (Euro bn) | Trade balance (Euro bn) | Coverage ratio (X/M, %) |
|--------|-------------------|-------------------|-------------------------|-------------------------|
| 2005 | 12.3 | 28.3 | -16.0 | 43.5 |
| 2006 | 12.4 | 26.8 | -14.4 | 46.4 |
| 2007 | 14.0 | 30.0 | -16.0 | 46.5 |
| 2008 | 14.1 | 33.8 | -19.6 | 41.9 |
| 2009 | 11.0 | 25.9 | -14.9 | 42.5 |
| 2010** | 6.4 | 12.4 | -6.0 | 51.5 |

Source: Eurostat. *Intra-European and External Trade of the European Union, Monthly Bulletin, No. 2. 2011*, and own calculations
 * ex-Yugoslavia minus Slovenia plus Albania; ** January-June

A similar situation exists with the WB countries' largest trading partner: the EU. While Hungary and the Czech Republic respectively, regularly register a high surplus in trade with the EU (as a result of export-led and mainly foreign direct investment-driven development patterns), and in 2009, after two decades of huge deficits, even Poland reached balanced trade with the EU, total exports of the WB countries have managed to cover between 43 to 47% of their imports between 2005 and 2009. Macedonia's initially "better" coverage fell dramatically, while that of Croatia's and Serbia's remained practically unchanged. Kosovo is a singularly negative example, since exports (which are minimal in any case) cover only between 10 and 13% of imports from the EU (*Table 6*).

Table 6 - Coverage of trade between the Western Balkan countries and the European Union (exports in percent of imports)

| Country | 2006 | 2007 | 2008 | 2009 | 2010* |
|-------------------------|-------------|-------------|-------------|-------------|-------------|
| Croatia | 39.6 | 37.6 | 36.1 | 40.9 | 47.0 |
| Macedonia | 71.2 | 89.3 | 69.7 | 57.3 | 71.0 |
| Serbia | 48.9 | 45.6 | 44.4 | 48.8 | 54.5 |
| Montenegro | 56.7 | 50.7 | 31.1 | 24.4 | 33.0 |
| Kosovo | 10.1 | 11.1 | 16.1 | 12.9 | 23.4 |
| Bosnia and Herzegovina | 59.8 | 58.7 | 51.8 | 51.9 | 64.4 |
| Total | 46.8 | 46.1 | 42.7 | 44.8 | 52.9 |
| <i>For comparison**</i> | | | | | |
| Hungary | | | | 122.4 | 123.5 |
| Czech Rep. | | | | 116.8 | 118.4 |
| Poland | | | | 100.2 | 100.7 |
| Slovenia | | | | 96.5 | 103.9 |
| Romania | | | | 75.9 | 79.6 |
| Bulgaria | | | | 75.1 | 85.4 |
| Portugal | | | | 59.6 | 65.0 |
| Malta | | | | 34.3 | 39.7 |
| Greece | | | | 32.3 | 41.0 |
| Cyprus | | | | 14.8 | 16.5 |

Source: Eurostat. External and intra-European Union trade. Monthly statistics – Issue number 02/2011

* January-November; ** figures for intra-EU trade

This dramatic imbalance, and the equally important inability to improve the situation over years, can be seen in *Table 7* which illustrates developments in trade balance between 2006 and 2010.

Table 7 - Cumulative trade balance of the Western Balkan countries with the European Union (between 2006 and January-July 2010)

| Country | Exports in euro mn | Imports in euro mn | Balance in euro mn | Coverage (X/M, %) |
|------------|--------------------|--------------------|--------------------|-------------------|
| Croatia | 22.147 | 56.611 | -34.464 | 39.1 |
| Macedonia | 6.979 | 9.771 | -2.792 | 71.4 |
| Serbia | 15.973 | 33.572 | -17.599 | 47.6 |
| Montenegro | 1.124 | 2.898 | -1.774 | 38.8 |

| | | | | |
|------------------------|----------------|----------------|----------------|-------------|
| Kosovo | 338 | 2.207 | -1.869 | 15.3 |
| Bosnia and Herzegovina | 8.142 | 14.436 | -6.294 | 56.4 |
| Total | 54.713* | 119.495 | -64.782 | 45.8 |

For comparison: intra-EU exports in the crisis year of 2009 alone: Czech Republic 68.640, Sweden 55.040, Ireland 50.850, Hungary 46.850

Source: Eurostat. *External and intra-European Union trade. Monthly statistics – Issue number 11/2010 and own calculations*

Over this period, the WB countries have accumulated a trade deficit of almost €65 bn that ought to have been covered by other revenues, four of which require serious consideration: income from services (an important factor for Croatia and Montenegro), inflow of foreign capital (see below), remittances from migrant workers (not relevant to this paper) and international aid (mainly from EU sources).

Consequently, current account deficits have been lower than those generated in trade, but the abovementioned inflows have still been unable to cover the gap completely. Indeed, all the WB countries are struggling with huge current account deficits as compared to most new EU member countries (except Bulgaria and to a certain extent Romania) (See Table 8).

Table 8 - Current account of Western Balkan and selected new EU member countries

| Country | 2009, in percent of GDP |
|------------------------|-------------------------|
| Croatia | -5.4 |
| Macedonia | -7.3 |
| Albania | -15.1 |
| Bosnia and Herzegovina | -7.5 |
| Montenegro | -29.8 |
| Serbia | -5.5 |
| <i>For comparison</i> | |
| Bulgaria | -9.4 |
| Czech Republic | -1.1 |
| Hungary | +0.2 |
| Romania | -4.5 |
| Slovakia | -3.2 |
| Slovenia | -1.0 |
| NMS-10 total | -1.6 |

Source: *wiiw, Current analyses and forecasts, July 2010*

At the end of the day, these deficits lead to higher external debt, and in the medium term (if not in the short term) this poses questions regarding the sustainability of the current “development pattern”.

Structural weakness is clearly illustrated by the commodity composition of exports to the EU from the WB countries. In 2009, 15% of exports consisted in agricultural products (to a highly protectionist market), 14% was in energy and mineral products, while 22% were semi-manufactured goods (steel, basic chemicals and others). Machinery and electronic goods made up only 15%, and likewise textiles and clothing. Twenty years ago, this same type of commodity structure characterized the export from CEE countries to the EU. Today, more than 60% of exports consist of medium- and high-technology machinery and electronics, while semi-manufactured goods and (mainly unskilled) labour-intensive products are rapidly declining. Unfortunately, none of the WB countries (Croatia included) are aiming at a similar structure; indeed, such a “catching up process” has yet to initiate in any WB country. *Table 9* shows that WB exports to the EU amount to 0.9% of the EU’s total extra-EU imports. Nevertheless, an above average share is seen in iron and steel (4%), personal and household goods (3.4%), clothing (2.1%), other semi-manufactured products (2%) and agricultural commodities (1.7%). However, due to the very low level of exports, even this “specialization” cannot generate sustainable export-led growth.

Table 9 - Commodity structure of WCB exports to the EU, 2009 (based on EU import statistics)

| Main commodities | EU imports from WBC in Euro mn | Commodity share of imports, in % | Share of the given commodity in total extra-EU imports of EU, in % |
|------------------------------|--------------------------------|----------------------------------|--|
| Total | 11.180 | 100.0 | 0.9 |
| agricultural products | 1.624 | 14.5 | 1.7 |
| fuels and mining products | 1.575 | 14.1 | 0.5 |
| iron and steel | 712 | 6.4 | 4.0 |
| chemicals | 615 | 5.5 | 0.6 |
| other semi-manufactures | 1.142 | 10.2 | 2.0 |
| office and telecom equipment | 279 | 2.5 | 0.2 |
| transport equipment | 666 | 6.0 | 0.8 |
| other machinery | 1.428 | 12.8 | 1.2 |
| textiles | 122 | 1.1 | 0.8 |
| clothing | 1.270 | 11.4 | 2.1 |
| personal and household goods | 982 | 8.8 | 3.4 |

Source: Eurostat (Comext, Statistical Regime 4)

Intra-regional trade potential and bottlenecks

Can intensified regional cooperation, concentrated on intra-WB trade flows, offer a way out of this structural dead end? As a starting point, we have to consider that by far the region's most important trading partner is the EU (both as a market and a supplier). In 2009, the EU absorbed 69% of total exports from the WB and covered 65% of total imports (*Table 10*).

Table 10 - Trade orientation of the WB countries (2009, in % of total trade)

| Target countries | Exports of WBCs | Imports of WBCs |
|------------------------|-----------------|-----------------|
| EU-27 | 69.1 | 64.9 |
| Russia | 1.3 | 7.4 |
| China | 0.7 | 5.5 |
| Turkey | 1.5 | 3.1 |
| USA | 1.9 | 2.0 |
| Switzerland | 1.3 | 1.9 |
| Croatia | 4.4 | 4.5 |
| Serbia | 5.8 | 1.9 |
| Bosnia and Herzegovina | 9.4 | 1.7 |
| Macedonia | 1.2 | 1.0 |
| Montenegro | 1.3 | 0.2 |
| Albania | 0.9 | 0.1 |
| Kosovo | 2.0 | 0.0 |
| Total WBC | 25.0 | 9.5 |

Source: Eurostat (Comext, Statistical Regime 4)

Interestingly, from a geographical view on trade, the WB countries are very similar to the CEE group, since for both groups the EU is the unquestionable "trade anchor". Although the EU trade figures for Poland, the Czech Republic, Hungary and Slovakia are between 75 and 85% (while Slovenia is within the same margin as the WB countries), differences arising from the geographic patterns of trade are much less relevant than in other areas examined. WTO data on individual countries provide a somewhat different picture, but even here, an EU orientation is obvious (80% of Albanian exports, and from 54 to 65% for other WB countries' exports go to the EU (*See Table 11*).

Table 11 - Main trade destinations of selected WB countries, 2008
(export and import shares in per cent of total exports and imports)

| Country | Main export directions | % of total exports | Main import directions | % of total imports |
|------------------------|------------------------|--------------------|------------------------|--------------------|
| Albania | EU | 80 | EU | 61 |
| | Serbia | 8 | China | 7 |
| | Macedonia | 3 | Turkey | 6 |
| Bosnia and Herzegovina | EU | 55 | EU | 48 |
| | Croatia | 17 | Croatia | 17 |
| | Serbia | 15 | Serbia | 11 |
| Croatia | EU | 61 | EU | 64 |
| | BiH | 15 | Russia | 10 |
| | Serbia | 6 | China | 6 |
| Macedonia | EU | 65 | EU | 50 |
| | Serbia | 19 | Russia | 12 |
| | Croatia | 5 | Serbia | 9 |
| Serbia | EU | 54 | EU | 53 |
| | BiH | 12 | Russia | 15 |
| | Montenegro | 12 | China | 8 |

Source: WTO Trade Profiles, 2009, www.wto.org

Indeed, the regional market plays an important role in the total exports of the WB countries, for about one-fourth of exports find markets within the region. At the same time, in total imports of the region intra-regional trade plays only a minor role, slightly below 10%. The difference can be attributed to several factors. First, even if intra-regional trade, on the whole, needs to be balanced (exports have to correspond to imports, with only slight statistical discrepancies), global trade imbalances (much higher imports than exports) explain the difference. Second, the entire region depends heavily on energy imported mainly from Russia and on imports of consumption goods from China and to a lesser extent from Turkey. Third, for many companies it is easier to export to neighbouring countries, both due to the geographic distance and, probably more importantly, because of remaining or recovered networks originally created in Yugoslavia. Following international experience, while many products from the region can enjoy a competitive advantage within the region itself, they cannot successfully face global or European competition beyond the WB countries. Within such a context, it is an open question whether and to what

extent intra-regional trade might be an efficient training ground for broader competitiveness, particularly with regard to the EU markets.

From the very outset of the stabilization and association process, one of the conditions set by the EU was free trade among the WB countries. It should also be remembered that similar attempts were undertaken by Brussels in the nineties concerning free trade among the Visegrad countries. There were, however, two important differences: first, it was not a strict condition but a “strong recommendation” and second, although the Visegrad countries agreed to create a free-trade zone well before EU membership, it was less institutionalized than it has been the case in the WB region. Among the WB countries, 28 bilateral free trade agreements have been signed and in 2008, they were all included in a multilateral regional framework. This, of course, does not automatically create additional trade, but it provided some clear mutual commitments and excluded protectionist measures. The Visegrad Group never reached this level prior to EU membership. Indeed each country took care to avoid this trap. In actual fact, several bilateral protectionist measures remained in force and were applied several times in intra-regional trade up until accession on May 1st, 2004. Interestingly, well before official membership, free trade with EU-15 had already been fully established by the beginning of 2002 (except with regard to some agricultural products). In contrast, national “trade practices” remained in force among Visegrad countries despite the fact that the EU accounted for at least two-thirds of total trade, while intra-Visegrad trade was considerably below 10% (except for Czech-Slovak trade which became “external” after the separation of Czechoslovakia). The genuine breakthrough came at the moment of accession, when all national trade competences had to be transferred to Brussels. As a result, trade among the new member countries suddenly became the most dynamic part of their total trade and, despite its relatively low weight, the most dynamic element of overall intra-EU trade as well. For instance, the participation of the new member countries in Hungary’s total exports sky-rocketed from 7.5% in 2003 to 20% in 2008-2010. Beyond doubt, the most important drivers of this development were transnational companies already located in the region which had clear strategies on how to take full advantage of complete liberalization within the enlarging EU market.

Concerning the share of intra-regional trade in total trade, there is no great difference between the new EU member countries and the WB countries. Indeed it is quite the opposite, intra-regional exports are sometimes actually higher (between 25 and 30% and even more for Bosnia and Herzegovina, Croatia, Macedonia and Serbia). In contrast, only Bosnia and Herzegovina seems to rely in a significant manner on regional imports. The largest contribution to intra-regional exports is from Bosnia and Herzegovina, followed by Serbia and Croatia. In intra-regional imports, Croatia absorbs almost half of the total, followed by Serbia, Bosnia and Herzegovina and Macedonia, all ranging between 10 and 20%. Albania, Montenegro and Kosovo are all much less involved in this respect, because of their very modest economic

performance (see Tables 10, 11 and 12). However, this does not automatically imply that intra-regional trade is not a significant factor in their total trade.

Table 12 - Share of individual WB countries in total intra-WB-trade (in %)

| Country | Intra-WB exports | Intra-WB imports | Intra-WB trade turnover |
|------------------------|------------------|------------------|-------------------------|
| Albania | 3.5 | 0.9 | 2.3 |
| Bosnia and Herzegovina | 37.5 | 18.3 | 28.5 |
| Croatia | 17.5 | 48.1 | 31.9 |
| Kosovo | 8.2 | 0.3 | 4.5 |
| Macedonia | 4.8 | 10.7 | 7.6 |
| Montenegro | 5.1 | 1.8 | 3.5 |
| Serbia | 23.4 | 19.9 | 21.7 |

Source: Eurostat, Comext, Statistical Regime 4, and own calculations

Beyond the statistical framework, six points must be underlined:

First, the volume of intra-regional trade is very low when compared to that of the new member countries. This is consequential, as their total trade is only a fraction of new members' total trade. The WB countries' intra-trade in 2009 reached between €2.5 and €2.6 bn in both directions (the turnover was slightly higher than €5 bn). In contrast, Hungary's exports alone to the new member countries amounted to more than €15 bn (and the total turnover was more than €25 bn), in other words, five to six times higher than trade among the WB countries.

Second, despite free trade on paper, the practical implementation of the agreements has run into several difficulties. On the one hand, most WB countries produce the same goods, there is therefore either no additional demand or else domestic producers are in (or will be put into) a privileged position. On the other hand, deficient infrastructure does not allow for the development of intra-trade to its full potential. Furthermore, persisting administrative barriers at border check-points, including the well-known visa issue for traffic between Kosovo and Serbia, are further hindrances.

Third, the Visegrad countries teach the lesson that sequencing of trade liberalization and the subsequent generation of additional trade flows do not come from regional markets with very modest and highly competitive export potential, as they are burdened with additional measures, but from the leading EU market and its positive impacts on intra-trade, once an institutional framework has been provided (in this case EU membership with its clear rules). Of course, obligatory intra-regional free trade may abolish some administrative barriers and create better market access, but shortcomings in supply, very limited demand and several other barriers

(e.g. infrastructure bottlenecks) may hinder the full use of the existing or the development of new potential.

Fourth, as already mentioned, the basic drivers of intra-regional trade among the new member countries were transnational companies with large-scale production localized in several countries of the region. For several reasons, this type of structure has not developed to date in the WB region; hence, the main drivers of enhanced intra-regional (and EU-oriented) trade are missing. This role cannot be assumed by small, under-capitalized and non-competitive regional firms, even if they do have the advantage of geographic proximity and established contact networks dating from a time when the entire region was one domestic market. In such a context, rapidly increasing imports from the EU (and some other countries) cannot improve the export perspectives of businesses.

Fifth, according to some experts, relevant support to overall export performance and intra-regional trade could be provided by the recognition of the regional cumulation rule by the EU. The WB countries have free or preferential market access to the EU with products that have a certain level of “domestic origin”. While this includes domestic inputs and imported inputs from the EU, it does not include imports from other WB countries. If imports from other WB countries were included in the share of the “domestic origin” of given products, much more commodities could enjoy this free or preferential access. Simultaneously, regional cumulation could give rise to intra-regional trade and, not less importantly, a regional specialization with enhanced regional and European competitiveness, at least in the medium-term. Foreign capital, moreover, would be more likely to view the region as a potential location for future investments. However, repeated attempts (strongly supported by Slovenia, for understandable reasons), have failed in Brussels, because of the resistance from France.

Sixth, intra-regional trade has an impact on the trade (and current account) balance of the respective countries. Since all WB countries have a formidable trade deficit, intra-regional trade might offer a source of surplus which would, at least to some degree, finance the huge deficit in other geographic relations. Indeed, the substantial trade deficit of new EU member countries, such as the Czech Republic or Hungary, with Russia in energy trade and China (or the Far East) in imports of industrial inputs, and to a lesser extent of consumer goods, can be easily financed by surplus achieved in trade with the EU in general, and in particular with the new member states. Moreover, Slovenia’s relatively balanced trade is closely linked to the huge surplus registered in its trade with the WB countries. Considering the overall, high deficits of each WB country in global trade, a regional trade surplus might only provide a partial remedy, but it would be a very important one. In contrast, deficits in intra-WB country trade could further aggravate the trade-financing gap in other countries of the region. As *Table 13* shows Bosnia and Herzegovina is the main sur-

plus producing country, while Croatia has by far the highest deficit. To what extent these imbalances remain sustainable is debatable (or requires closer examination), even if we are aware of the fact that imbalances in intra-regional trade are just a fraction of the total trade deficit.

Table 13 - Western Balkan intra-regional trade (2009, Euro mn)

| Country | Exports | Imports | Balance |
|--------------------------|--------------|--------------|---------|
| Bosnia and Herzegovina | 1,031 | 448 | +583 |
| Serbia | 642 | 486 | +156 |
| Croatia | 481 | 1,177 | -696 |
| Kosovo | 225 | 7 | +218 |
| Montenegro | 141 | 43 | +98 |
| Macedonia | 133 | 262 | -129 |
| Albania | 95 | 23 | +72 |
| Total intra-trade | 2.748 | 2.446 | |

Source: Eurostat (Comext, Statistical Regime 4) and own calculations

Foreign direct investment (FDI)

Over the last decade, alongside political stabilization and economic recovery, the WB countries have begun to attract foreign capital. With a decade of delay, they followed the general trend already ongoing in Central and part of Eastern Europe which had began shortly after the political transformation. Mainly as result of this delay, the growth of FDI was much higher than in the CEE region, where this process had started earlier with a certain level of “maturity” or “saturation” already visible over recent years. In 2004 – 2005, the inflow of FDI to the WB countries amounted to € 6.8 bn or just 10% of the inflow to the new member countries. Due to a rapid increase of inflow, this grew to 20% in 2006 – 2007 and to 23% in 2008 – 2009. In other words, the annual inflow more than doubled between 2004 and 2009. Still, the total inflow of foreign capital to the entire region in 2006 – 2007 was only slightly higher than the sum absorbed by Bulgaria or Romania and just 60% of that registered by Poland.

Nevertheless, as a result of the quantity invested and the relatively small population, the per capita figures reached those of some CEE countries in Croatia (€ 5.729) and Montenegro (€ 5.233), which was comparable to Slovenia (€ 5.400), higher than Bulgaria, and twice as high as either Romania or Lithuania. When compared to Croatia and Montenegro, only Estonia, the Czech Republic, Hungary and Slovakia recorded a higher FDI stock per capita in 2009. However, at the same time, other WB countries were lagging behind, with FDI stock per capita ranging between € 800 (in Albania) and € 2.000 in Serbia (see Table 14).

Table 14 - Inflow of Foreign Direct Investment to Central and Eastern Europe, Western Balkans and CIS-4 (in Euro mn)

| Country | 2004-05 | 2006-07 | 2008-09 | 2010* | Stock/head (Euro) |
|------------------------|---------|---------|---------|--------|-------------------|
| Region | 105,789 | 193,850 | 170,076 | 66,600 | 2,200 |
| EU-10 | 67,957 | 98,861 | 62,368 | 23,300 | 4,300 |
| Bulgaria | 5,888 | 15,274 | 9,910 | 1,500 | 4,670 |
| Czech Republic | 13,381 | 11,989 | 6,380 | 3,000 | 8,049 |
| Estonia | 3,078 | 3,430 | 2,521 | 1,300 | 8,407 |
| Hungary | 9,805 | 9,565 | 5,773 | 1,500 | 6,410 |
| Latvia | 1,081 | 3,024 | 915 | 100 | 3,628 |
| Lithuania | 1,449 | 2,921 | 1,413 | 400 | 2,895 |
| Poland | 17,349 | 28,613 | 17,852 | 11,000 | 3,323 |
| Romania | 10,396 | 16,311 | 14,052 | 3,500 | 2,408 |
| Slovakia | 4,393 | 6,115 | 2,287 | 1,000 | 6,300 |
| Slovenia | 538 | 1,619 | 1,265 | 0 | 5,400 |
| SEE | 6,783 | 17,224 | 14,105 | 3,400 | 2,500 |
| Albania | 491 | 740 | 1,373 | 400 | 800 |
| Bosnia and Herzegovina | 1,060 | 2,128 | 1,087 | 300 | 1,500 |
| Croatia | 2,418 | 6,435 | 6,067 | 1,000 | 5,729 |
| Macedonia | 338 | 851 | 581 | 200 | 1,500 |
| Montenegro | 437 | 1,166 | 1,569 | 500 | 5,233 |
| Serbia | 2,040 | 5,905 | 3,428 | 1,000 | 2,000 |
| CIS-4 | 31,049 | 77,765 | 93,603 | 39,900 | 1,100 |
| Belarus | 377 | 1,586 | 2,808 | 800 | 620 |
| Moldova | 271 | 580 | 543 | 100 | 510 |
| Russia | 22,758 | 63,912 | 79,342 | 35,000 | 1,200 |
| Ukraine | 7,643 | 11,687 | 10,910 | 4,090 | 789 |

Source: WIIW, as quoted by Vilagagdasag, June 09, 2010. * forecast

Some conclusions can be drawn both from the attached data, and even more, on the actual structure of FDI in question.

First, despite the rapid growth of FDI in the WB countries, a substantial gap still exists between the two groups compared in this paper. This can be accounted for by the quantity of FDI in GDP as well as the highly different per capita indicators used (except for Croatia and Montenegro).

Second, and more importantly, there is a qualitative difference in the priority areas of investment. FDI in the WB countries (in some ways similar to Bulgaria, Romania and the Baltic states) was fundamentally directed towards the demand for foreign and domestic market services (tourism, telecommunications, energy, retail trade, real estate). Very few projects were focused on manufacturing or, more generally, on export-oriented activities. As a result, no meaningful investment was made in industry or, broadly speaking, in increasing the competitiveness of the respective country. In contrast, particularly between 1995 and 2005, substantial foreign capital supported, or was even the motor of structural modernization and international competitiveness in CEE economies. Consequently, while CEE countries took the path of export-driven development, the WB countries, despite the substantial inflow of FDI, remained locked in a (very small) domestic market-oriented “trap”.

Third, the differences between the basic features of FDI in CEE and the WB countries can be explained by two factors. On the one hand, the gap of one decade has to be understood as being of crucial importance, particularly so when one considers that the initial conditions in ex-Yugoslavia were far more favourable for FDI than in any other transitional country. However, this opportunity has already been lost. On the other hand, still today, outdated legislation can be considered as an obstacle to FDI and with it the attitude of a society in general. Moreover, the approach of many politicians and experts needs to be mentioned, who continue to “distrust” foreign ownership of domestic assets and insist on antiquated and increasingly illusionary visions of “national independence” in the storm of globalization.

Fourth, due to a domestic market-orientation (to date), the positive impacts of FDI on growth, employment, technological transfer, new managerial methods, exports, and, first and foremost, growing integration into the international network of production, services, distribution, technology transfer, etc. were unable to develop in the WB region. Moreover, the global crisis may indeed have strengthened the convictions of those who were for the protection of “national strategic sectors and interests” and against opening “too much”.

Some remarks on the role of the European Union

Looking back over the last two decades, the European Union’s reaction to the systemic changes and, more importantly, to the end of the division of Europe, has been both ambiguous and late. Moreover, most decisions were taken in hindsight, as a reaction to (unforeseen?) developments. Therefore, instead of a proactive policy, a reactive “strategy” took place. Fortunately, the driving role was taken over by the transitional countries (“supported” by the collapse of the Soviet Union) and the international business community who were able to evaluate the unique opportunities offered, and assess the security risks much better than political bodies. It should be added, however, that strategic thinking has started to gain ground in

the EU (certainly in the Commission, less so in some member states) over the last decade, also in light of the sad lessons learned from the Western Balkan tragedy.

In pure numerical terms, the accession process of the CEE and the WB countries reveals some similarities. Three and a half years after the fall of the Berlin Wall, the EU presented the Copenhagen criteria, which allowed for broad interpretation and defined the criteria under which candidate countries could be deemed ready and willing to join. During the same period, between 1999 and 2003, the WB countries secured a promise of membership in Thessaloniki. The negotiations on accession for potential new members from CEE started in 1998 (Luxembourg group), in 2000 (Helsinki group) while still others began five years later. Croatia's accession negotiations were launched just two and a half years after the Thessaloniki declaration, while negotiations took four years for some CEE countries and, for several reasons, more in some cases. Considering this scheme, the WB countries, except Croatia, will be able to join the EU by 2020. However, the dynamism of international, European and regional processes may easily reschedule this date and shape a scenario somewhere between early accession and no accession at all.

There is no question that the EU played an "anchor role" in the transformation, adjustment and accession process of the CEE countries, all of which were, though with some national and time-related difference, ready and able to follow the route mapped out and, as a result, became full-fledged members of the EU. However, this process cannot be automatically applied to the WB countries. There are a number of reasons or concerns for this:

- The WB countries are in many respects different from CEE, starting with issues of stability and state-building through economic development to the prospective economic contribution they can provide to Europe's global power and competitiveness;
- The last decade has fundamentally altered the global positioning and some basic priorities of European integration;
- Further enlargement, although still on the agenda, has to be considered within the framework of the new challenges presented by global macroeconomics and the financial crisis, and in particular its impact on the Eurozone;
- The EU's approach to the WB accession process has been focused more on institution-building rather than on fostering the driving forces of economic development (export-oriented growth, reduction of unemployment, cross-regional infrastructure projects, clear positive signs to transnational companies, etc.);
- However, the WB countries are also to be blamed for the current situation, because, based on the ex-Yugoslav heritage, they – politicians, experts and a considerable majority of society - were not prepared to meet the challenge of globalization and the changing conditions in Europe;

- Public opinion in favour of further enlargement is difficult to mobilize, not because of some unfounded though much publicized “enlargement fatigue”, but because of other factors (not least the inability and unwillingness of several EU member states to undertake long-term and somewhat painful domestic reforms);
- There is no imminent security threat to the EU that would change the rational sequencing of long-term adjustment to accession in favour of a potential “emergency enlargement”;
- The WB countries do not have a convincing agenda to show the EU that their membership is not only inevitable in long run but also imperative in the shorter term;
- Finally, while the earlier “Eastern enlargement” was driven by security, political, economic and, in part, also by social and cultural considerations, no such issues seem to be vital to the current EU strategy in encouraging rapid (urgent or inevitable) enlargement.

Certainly, the EU has to remain the key anchor of stability and (hopefully) development for the WB region. However, the arguments connecting EU priorities (though changing and not always clearly defined) with high-flying expectations and partial adjustments made by various countries in the region are unlikely to create a strong foundation for any powerful arguments in favour of a quick-track accession agenda.

Lessons from the crisis and impacts on future development

The global crisis of 2008 – 2009 was the first crisis to interrupt the long-term positive correlation between growth and trade. Over several decades, export-oriented economies had higher growth rates than those focused on domestic markets or unable to switch to exports. In 2009, the GDP growth rate of the developed world shrunk by 2% and that of the EU by more than 4%. Recession was accompanied by a dramatic decline of international trade, about 12% in global terms and almost 20% in the EU. Countries that depended heavily on external trade were particularly hit, including all CEE countries. The WB countries, though much less open (or “vulnerable”) to external shocks, did not behave differently. Despite their lower degree of openness, their total exports fell by more than 20%.

This unexpected and very harsh impact on global trade immediately gave rise to nationalistic, protectionist and in some cases isolationist measures and voices. Some experts in the WB countries claimed that concepts and policies to lower the degree of openness, limiting the role of foreign companies and strengthening the protection of (mainly uncompetitive) national strongholds and interest groups were justified by the crisis. Similar reasoning also emerged in several CEE countries due to their excessive degrees of openness and consequent vulnerability, structur-

al development and dualistic production structures, exports, and in more general terms, economic performance and competitiveness.

However, without any better idea about how things could or should be done, “recommendations” were issued aimed at reducing the degree of openness in the economy, changing the well-developed and technology-intensive structures of some Central European countries and ending the “dominance” of international capital, while, at the same time providing strong support for largely uncompetitive and tax-evading domestic small- and medium-sized enterprises. Such opinions were voiced even stronger in several WB countries, for some experts felt that the global crisis supported their cautious (protectionist?) attitude against opening to the world and were in favour of guarding the “family fortune” (often an unsealable (mis)fortune in any case). The sooner and more unexpectedly the collapse came, the sooner and more unexpectedly it would be overcome. While a return to the pre-crisis GDP level may take another two years in most developed countries, international trade can be expected to reach pre-crisis level already by 2010. Consequently, the export-led development pattern has not been questioned, quite the opposite, it has once again turned out to be the main element of economic recovery. The right answer to “excessive” openness is not closing in (which would be impossible within the EU in any case), but renewed efforts to identify and conquer new (mainly extra-EU) markets. Structural vulnerability (mainly in the high-tech sectors of some CEE countries) needs to be alleviated by improved domestic value added and upgraded position in the international production (value) chain, and not by downgrading the structure to low- and medium-level technology and unskilled to semi-skilled labour-intensive and raw material-intensive production (with an inevitable drop in wages and living standards). Additionally, foreign companies should not be expelled; instead, they should be incorporated deeper into the domestic economy, alongside increased cooperation between large foreign and smaller domestic firms. Finally, the ephemeral illusion of the WB countries of being less vulnerable to international trade and capital flows, quickly evaporated in light of the rapid post-crisis recovery.

However, the crisis has not overcome another, fundamentally important element of sustainable development in the WB region. As already stated, huge trade (and current account) deficits in all the countries of the region desperately require sustainable sources of external financing. At least two sources are now undergoing rapid and unpleasant changes. FDI, a basic source of financing deficits over the last years, faced with the challenges of crisis and post-crisis developments, has been shifted towards clear restructuring efforts in more competitive global locations. Therefore, the WB countries can hardly count with this kind of capital inflow. It should also be pointed out that high expectations in Bulgaria and Romania that international capital in Central Europe would change location almost automatically as a result of their latter EU membership and rising wages in Central European countries have

failed to materialize. Similarly, wages in some parts of the WB region that are higher than Bulgarian or Romanian wages, are another point against shifting production from competitive locations in Central Europe towards less competitive South-Eastern European countries. It is, however, even more significant that domestic market-oriented FDI will soon have reached its limits of expansion; all the advantages offered by privatization will have been consumed and, therefore, will be depleted. Further expansion may only be possible towards foreign/international markets. However, without competitive products (and services) this is highly uncertain. An unlikely regionalization of what have been until now domestic market-oriented activities (such as telecommunication, energy, retail trade) would be of little help either, because of the limited purchasing power of the regional market, strong external competition (including from the new member states of the EU), intra-regional legal, institutional and technical barriers, as well as the well-established regional strategy of international firms. As a result, the inflow of foreign capital is likely to be less than in previous years, while the need to finance trade imbalance remains high. Further investments financed by domestic profits, a major FDI component in some CEE economies (e.g. in recent years, about two-third of the FDI inflow to Hungary came from this source), can also be questioned, after achieving dominance in lucrative segments of the domestic market, no more foreign capital would be needed (privatization can only be done once).

Another source that is expected to create (external) financial equilibrium is the inflow of money from migrant workers abroad. Indeed, several WB countries have benefited considerably from such transfers. These are generally based on networks of WB citizens working in different countries of Western Europe (chiefly in Germany, France, Austria and Switzerland) and on first-generation migrants (in countries such as Greece, Ireland, Italy, Spain and the United Kingdom). In some years, such remittances represented 10% or even more of the GDP and were a key contributor to the financing of trade and current account imbalances. The crisis has had a clear negative impacts on the size (and sustainability) of such remittances. On the one hand, migrant workers were among the first to be affected by the recession and subsequent unemployment. As a consequence, they had to choose between returning to their native country or staying abroad and waiting for conditions to improve. On the other hand, opting for the second alternative, their capacity to send money back to their home country was seriously compromised, both because of reduced income (at best an unemployment benefit instead of a salary) and of the need to finance their period of unemployment. In addition, the EU's visa policy hindered the "opportunity for (illegal) migrants" from the WB countries, since the citizens of most countries could not enter the EU without a visa. (This situation has now changed; however, visa liberalization did not lead to a massive inflow of new young migrant groups onto the EU market, which is already struggling with high level of (post-crisis) unemployment.)

Finally, the traditional approach to sustainable security will most likely require re-thinking, both in the WB countries and the EU. More emphasis needs to be placed on establishing the conditions for sustainable economic development by:

- Identifying and supporting potential export-oriented sectors;
- Attracting FDI into export-orientation manufacturing;
- Minimizing the economic, technical and, not least, cultural, -barriers to intra-regional trade;
- Speeding up real (and not only institutional) convergence towards the EU;
- Providing access to and implementing instruments aimed at increasing competitiveness as part of the EU's financial transfer to the region;
- And, finally, establishing a clear timetable for the accession process, including a set of "firm" conditions and potential "rewards" – as long as most political circles and a share of the population (though already declining) are in favour of EU membership, instead of generating a new "hot spot" in the Western Balkans, with very high financial and other costs for the EU – provided the situation can still be kept under control.

BELA GALGOCZI⁵

POST CRISIS LESSONS: IS EXPORT-LED GROWTH STILL THE WAY FORWARD FOR CENTRAL EASTERN EUROPE?

Introduction

What kind of economy will emerge from the crisis and what foundations will future growth in Central Eastern Europe have? With the gradual easing of the dramatic and extraordinary pressures of the 2008-2009 economic crisis long-term structural processes are gaining more and more attention in temporary crisis management measures.

What we see on the European level is that short-term, mid-term and long-term objectives are coming into conflict with each other. Apart from acute crisis management and longer term perspectives – where resource efficiency and the low-carbon economy will play a crucial role – we will focus here on the mid-term perspective. This mid-term challenge for Europe and for the CEE region is, above all, to revise the growth model, by drawing lessons from the crisis, and restore economic equilibrium. The roots of the crisis lay in the accumulation of imbalances in national and international terms (excessive debt financing, growing inequality, international imbalances).

In this article, we will first give a brief review of how the crisis has hit Central-Eastern Europe, focusing on its vulnerability. Then, we will look at the foreign direct investment (FDI) driven and export based economic development model that has been viewed as a vulnerability during the crisis. When drawing lessons from the crisis, we make an attempt at identifying the major components of growth that proved to be unsustainable in CEE, linking them also to the current Eurozone crisis.

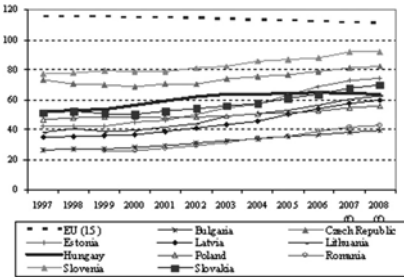
High growth and convergence before the crisis

For the eight Central Eastern European countries (The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), the fifth anniversary of EU accession was marked by the devastating effect of the worldwide financial and economic crisis that swept through the region in 2009. Bulgaria and Romania, which joined the EU in January 2007, were equally affected.

During the past decade a convergence process had taken place in Central Eastern European (*figure 1*), transforming economies in terms of GDP/capita at PPP towards the standards and realities of developed Western Europe. Their average growth rates over the last decade were characteristically between 4 and 5%, with Slovakia and the Baltic states reaching growth of up to 10% in certain years. Productivity was soaring and national currencies (those not pegged to the Euro) were undergoing a real effective appreciation.

⁵ Bela Galgoczi is a senior researcher at the European Trade Union Institute, Brussels, Belgium.

Figure 1 - Convergence of GDP/capita levels of CEE countries towards EU27 average at PPPs



Source: European Commission, Ameco database

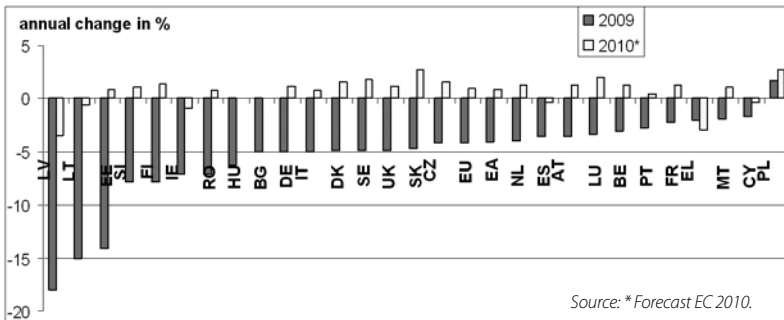
The impact of the crisis on CEE

The growth of CEE economies was largely based on external financing of different kinds, from bank loans and trade-related lending to foreign direct investment (FDI) and portfolio investment. They were hit hard within a short period due to a series of factors that highlighted how the previous high growth had become unsustainable once the external environment took a turn for the worse.

Economic growth and employment

The dramatic effects of the crisis on the CEE region called into question the sustainability of the economic and social convergence process that had characterized for the region in the previous decade. *Figure 2* provides an overview of GDP growth in 2009 and estimates for 2010. Some new member states in CEE were particularly hard-hit. In 2009, GDP declined dramatically in the Baltic countries, i.e. by 18% in Latvia and by 14-15% in Lithuania and Estonia. Falls in GDP clearly below the EU-27 average of -4.1% were recorded in Slovenia (-8.6%), Romania (-7.1%) and Hungary (-6.3%). The Czech Republic and Slovakia with a 4-5% decrease of GDP were also hard hit. Only in Poland did GDP growth remain positive (+1.7%).

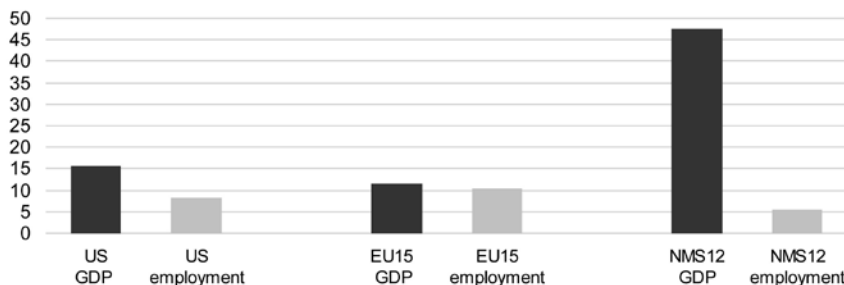
Figure 2 - Real annual changes in GDP, 2009 and 2010*



Source: * Forecast EC 2010.

Employment growth had been very weak in Central Eastern Europe even in the boom years, as illustrated by *Figure 3*. Both the US and the EU15 experienced higher increases in employment though with a fraction of the growth found in the new member states.

Figure 3 - GDP and employment growth in the US, EU15 and NMS12, cumulative percent change 1999-2008



Source: European Commission (2008).

During the crisis jobs were disappearing on a massive scale. Unemployment in the Baltic states increased sharply from the low levels of May 2008 to around 15% by May 2009, the increase was most dramatic in Estonia from 3.9% to 15.6% (Eurostat 2009). The unemployment rate also increased substantially in Hungary and Slovakia, reaching double digit levels by May 2009 (10.2% and 11.1% respectively).

Vulnerability factors of CEE economies

The underlying reasons for these severe effects were rooted in these economies' vulnerability, the most important factors of which will be addressed in the next sections.

Macroeconomic imbalances at times of financial turbulence

With the continuing paucity of domestic capital, the 'catching-up economies' have been notoriously reliant on external capital throughout the whole transformation process. This has included foreign direct investments (FDI), financial investments (in state bonds and diverse corporate assets), foreign bank and government loans and EU transfers. This high external financing need made these countries dependent on the available abundance of investment capital and a high risk-taking attitude on the part of investors.

In the association between international capital movements, economic wealth and economic growth – according to the neoclassical theory – capital should flow from the capital-abundant rich countries to the poorer, capital-scarce re-

recipient countries, both in terms of flow (through the widening of current account deficits) and a stock perspective (through deteriorating net foreign asset positions) and result in higher growth rates in the recipient countries (see Herrmann, S. Winkler, A: 2009).

The dramatic increase of financial and trade integration between the EU15 and the CEE transition economies during the late 1990s and early 2000s, with widening current account deficits and deteriorating net foreign asset positions in the latter, generated considerable interest for external sustainability analysis. While conventional wisdom suggested that current account deficits exceeding 5% of GDP are a potential danger to macroeconomic and financial stability, the payment balances on current accounts in most European transition economies were well above 10% of GDP. Given their impressive rates of economic growth during the 2000s, the theoretical and empirical opinion that the inevitable adjustment (so-called current account reversals) could have devastating macroeconomic implications no longer seemed important. The most striking example was Latvia, which was running current account deficits of 22.5% of GDP and a real GDP growth of 10% in 2007 (Source: IMF, 2009), exactly the country that was most severely hit by the global economic crisis with a projected negative real GDP growth of 18% in 2009.

In a number of countries consumption and private sector investments were largely financed by credits, in particular, countries with a pegged currency witnessed high price and wage inflation together with rising asset prices (especially homes).

Lane and Milesi-Ferretti (2006) argue that the benefits of international financial integration are tied with the gross holdings of foreign assets and liabilities, rather than to capital flows. In essence, the stock adjustment approach to external disequilibrium analysis presumes that it is not the current account, but the net foreign asset position per se that matters. Net foreign assets are defined as the difference between the stock of foreign assets held by domestic residents and the stock of domestic liabilities held by foreign residents. The changes in net foreign asset positions reflect not only the current account balance, but also the changes in valuation in terms of asset prices and relative exchange rates.

Although government debt (which used to be the focus of attention) in most CEE countries is (with the exception of Hungary) substantially lower than is usually the case for developed economies, their total external debt, including enterprise and household debt, has reached high levels in the most recent period. *Table 1* shows current account balances for 2008 and 2009 and also indicates levels of total external financing need (see more on current account deficits in the region in Shelburne, 2008).

After the shockwaves of the credit crunch and bankruptcies in the US and the Western European financial system, investors' confidence and appetite for risk suddenly evaporated. With growing risk aversion, foreign investors turned their backs on

emerging market assets (including government securities) and retreated to their domestic markets. According to the IMF, the retreat from cross-border exposures was faster than the overall deleveraging process (Financial Times 2009b). The needs of the stimulus packages for G7 economies may also have added to the diversion of money flows from CEE financial markets, as the amount of state bond issues in the G7 economies was estimated to grow from 1,000 bn USD in 2008 to 3,000 bn USD in 2009.

As a result, financial markets in the emerging Europe came under huge pressure and daily debt financing has suddenly become difficult. National currencies were shaken with devaluations of up to 30%. The credit ratings of state bonds were downgraded and country risk indicators deteriorated sharply, resulting in high interest rate margins, making debt financing difficult and in certain cases impossible. These developments triggered further devaluations of regional currencies (not only those of the countries affected) having launched a vicious circle and spreading contagion across the region.

Table 1 - Financial indicators for selected CEE countries

| Country | GDP/capita 2008, USD PPS | Financing need, % GDP* | Current account balance, % GDP** 2008-09 | Export share in GDP (2008) |
|----------------|-----------------------------|---------------------------|--|-------------------------------|
| Bulgaria | 12,372 | 29.4 | -24 -12.9 | 61.0 |
| Czech Republic | 25,757 | 9.4 | -3.5 -2.8 | 80.1 |
| Estonia | 20,754 | 20.0 | -10 -6.3 | 72.0 |
| Hungary | 19,830 | 29.9 | -6.5 -3.9 | 80.2 |
| Latvia | 17,801 | 24.3 | -14 -6.7 | 46.6 |
| Lithuania | 18,855 | 27.1 | -12 -4.8 | 59.0 |
| Poland | 17,560 | 13.2 | -5 -4.9 | 42.3 |
| Romania | 12,698 | 20.2 | -12 -7.5 | 34.4 |
| Slovakia | 22,242 | 12.5 | -6 | 90.5 |
| Slovenia | 28,894 | - | -6 | 70.5 |

Source: *The Economist*, February 28th, 2009 based on IMF, Moody's and the Financial Times, 27th February 2009 based on Thomson Data stream

* Total financing requirement, current account balance, principal due on public and private debts plus IMF debts, 2008 estimate

** IMF prognosis

The role of western banks in the region

Over 80% of the banks of Central and Eastern European countries are affiliates of Western banks. These banks were eager to grant credit on a mass scale, often denominated in foreign currency (especially in countries where interest rates in local currency were substantially higher), to the population and enterprises in all the

countries of the region. According to a study by the Centre for European Policy Studies (Gros 2009), the residential mortgage debt in the so-called Visegrad Four (V4) countries – the Czech Republic, Hungary, Poland and Slovakia – ranges between 11.7% of GDP in Poland and 15.3% in the Czech Republic, while levels in the Baltic states are over 30% (Latvia – 33.7%, Estonia – 36.3%).

Western banks made extraordinary profits in the region with levels over twice that attained in their home countries. Continued expansion was expected in the region, even when the financial crisis was just around the corner (Mühlberger 2007).

During the crisis, as a result of falling GDP, rising unemployment and weaker national currencies, the share of non-performing loans rose quickly and credit placements to CEE became 'toxic assets' for Western banks. Austrian banks have outstanding credits at their branch offices in Eastern Europe equalling up to 80% of the Austrian GDP. Eastern European borrowers had to repay \$400 billion in debt to Western banks during 2009. Western headquarters (themselves in trouble) were reluctant to bail out their eastern affiliates or even to continue credit provision.

Emerging Europe has thus been hit hard by global deleveraging and frozen cross-border bank lending. The impact has flowed through the same financial linkages with mature markets that previously allowed the region to build up a high degree of leverage through rapid foreign-financed credit growth. Cross-border bank funding was disrupted as the banking crisis in Western Europe intensified. Growth in credit to the private sector fell rapidly, intensifying the vicious circle between output declines and deteriorating asset quality (IMF 2009).

Although no western bank withdrew from the operations of its troubled CEE affiliates, the dramatic reduction in cross-border credit flows has had a huge impact on them. Through the activity of Western banks in the region, a large number of CEE enterprises and a substantial share of the population have become de facto integrated into the Eurozone without the safeguarding mechanisms applied to financial institutions in the Eurozone. This one-sided and unbalanced financial integration has greatly contributed not only to irresponsible lending practices by western banks prior to the crisis, but also to the lack of guarantees and supervision and ultimately to the absence of a lender of last resort during the crisis. It has contributed considerably to the confidence crisis and the financial turbulences that swept the region and concluded with IMF intervention in a number of countries of the region.

With household debt in several new member states (such as Hungary and Romania, for example) largely denominated in foreign exchange, as a consequence of currency devaluations of 20-25%, families face debt services that are up to 25% higher than originally planned. This has ceased to be just a problem of financial stability, indeed it has become a burning social issue.

Deep economic and trade integration with the West

In most of the region growth and modernisation were largely driven by foreign direct investment. Levels of FDI stock reached nearly 100% of GDP in certain CEE countries (e.g. Estonia, Hungary and the Czech Republic), while almost all have their FDI stock over 50% of GDP.

Though FDI was, on the one hand, an indispensable modernisation lever, it resulted in a dependent economic position with strategic decisions made at Western company headquarters and profit repatriation practices have had a negative impact on current account balances. This factor added to their vulnerability under stormy conditions. Moreover, the economies of the new member states have been integrated with the European and world economy to a greater extent than most EU-15 economies and are consequently highly dependent on external demand. The particular pattern of their economic and trade integration with Western Europe with its sectoral concentration on the automobile industry has become a risk factor. High dependence on the export of intermediary manufacturing products to Western Europe and other developed economies is, in particular, the major factor currently depressing growth prospects (export shares of CEE countries are shown in *Table 1*). The new member states from Central Eastern Europe, and specifically the so-called Visegrad Four countries, have been particularly exposed to the breakdown of demand from the West, particularly from Germany.

The large automobile production capacities established in the Visegrad Four countries are highly dependent on the economic cycle, but also on their parent companies in Western Europe (and in a few cases Japan, Korea and the US). The electronic components industry (an important part of manufacturing not only in V4 countries and Romania, but also in the Baltic states), and especially contract manufacturers, are even more exposed to economic cycles. As these industries constitute a large part of the reshaped industrial landscape in the new member states, they are vulnerable to external shocks. Developments in Germany are crucially important for the new CEE member states as most industrial investments and their industrial exports involve Germany.

High dependence on external financing and the resulting financial imbalances were the major factors behind the high exposure of CEE countries to the external shock derived from the crisis. Having reviewed the role played by different factors of vulnerability one by one, we can draw the conclusion that apart from individual weaknesses and vulnerabilities in certain countries (credit financed asset bubbles in the Baltic states, credit based consumption and high debt levels in Hungary and Romania) the specific production model was the common regional factor behind high exposure to the crisis.

Besides irresponsible fiscal policy, or asset bubbles in individual cases, the fundamental vulnerability of the region can thus be found in the one-sided and unbalanced nature of its economic and financial integration with the EU15. Apart from excesses in individual countries, is the sustainability of the whole export and FDI based growth model also at stake? It is worth looking at the foundations of this model, also in light of the Eurozone crisis, where the problem of the weaker members is exactly the opposite.

The main characteristics of the FDI-driven industrial base in CEE

In the next section we show the main characteristics of the FDI-based production model, where CEE production locations have, since the mid 90s, become integrated into the value chains of Western European manufacturing enterprises. FDI played a key role in the modernization and structural renewal of these economies and has brought about a new division of labour in Europe. The example of the automobile industry demonstrates a model case of the new division of labour within the integrated Europe.

The new manufacturing base in CEE

Thanks to liberalised trade and investment flows from the early 90s, the economic integration of Central Eastern Europe into the European economy had largely taken place before the political and institutional enactment of their accession to the EU in May 2004. These regions have very different features, whether in terms of labour and capital, or of commodity price ratios and cost structures.

The combination of large-scale global capital and additional labour supply from emerging countries has effected a fundamental shift in comparative advantages worldwide. The arrival of multinational firms helped to open up the emerging countries to foreign products. It also accelerated the vertical division of labour allowing emerging countries to specialise in assembly and other labour-intensive activities, alongside traditional sectors, such as textiles/apparel. This explains the growth in industrial-product trade between advanced countries and emerging countries at different stages of the value chain (Feenstra 1998; Sturgeon 2002). The integration of low-wage countries in CEE into the European economy was deepening year by year and the pattern of economic activity changed conspicuously, driven by extensive and fundamental changes in technology, production, investment and trade flows.

Several studies have shown an increase on the global level in the share of vertical FDI, lured by low production costs. New member states have experienced a rapid shift in international specialization, thanks to the establishment of facilities by multinational firms, particularly in the automotive and electronic components industries (Kaminski and Smarzynska 2001; Sachwald 2005c). The European integration process thus brought about a new division of labour within Europe and a newly

emerging industrial landscape in the new CEE member states in the late nineties and early 2000s. Manufacturing played a larger role in the investment flows towards Central Eastern Europe than it did on the global level. While the share of manufacturing in total employment has tended to shrink in developed economies (e.g. in the UK it shrank from 32% in 1970 to 13% by 2003), in CEE a different pattern prevailed. In the initial phase of transformation in the early 1990s their former manufacturing base practically collapsed, but from the mid-1990s, primarily due to foreign direct investments, manufacturing output, especially exports, soared and the share of manufacturing in GDP and employment was increasing continuously. By the mid 2000s they had a higher share of total employment in manufacturing than most European economies: Hungary at 23%, Slovakia 25% and the Czech Republic 31% (OECD 2006).

High levels of manufacturing trade within the same industry (intra-industry trade or intra-firm trade) are signs of the cross-border integration of manufacturing activities throughout the value chain. Countries where intra-industry trade is above 70% of the total manufacturing trade can be seen as highly integrated into international value chains. In this case, intra-industry trade intensity is a sign that a large part of production is being carried out in these countries and the intermediate products are being re-exported to the home country, thereby substituting home labour, clearly the case in the Czech Republic, Hungary and Slovakia. The share of intra-industry trade in total manufacturing trade was 81% for the Czech Republic, 79% for Hungary and 75% for Slovakia (average values for the period 1996-2005), with an increasing trend (OECD 2006) in line with significant FDI flows into manufacturing.

Strong export expansion was also characteristic of these countries. In the period 1996-2005 the OECD countries that most increased their manufacturing export market shares on OECD markets were Hungary (116.2%), Slovakia (86.8%) and Poland (78.1%). The share of exports in GDP is particularly high in the smaller central-European countries, particularly in the Czech Republic, Hungary and Slovakia (between 80 and 90%, as *table 1* shows). As a result, the large initial trade surpluses that EU-15 had with the CEE countries have shrunk and from the early 2000s they transformed into deficits in the core countries (Broadman 2005). The fact that the Czech Republic, Hungary and Slovakia have maintained a trade surplus with the 'export champion' Germany is most significant.

Since the late 1990s, investment patterns have shifted from pure investments that simply exploited the market towards more complex forms, most notably production sharing networks. Thanks to this, both the benefits and the challenges have become more complex. Producer-driven supply networks are based on more complex forms of international division of labour. Such networks are mostly present in capital-intensive and more skilled labour-intensive industries such as the automobile industry and information-telecommunications.

Foreign trade data from the region clearly demonstrate a shift in quality. By 2003 the share of clothing in manufacturing exports had fallen dramatically compared to the peak in most of the CEE region. In the case of Hungary, clothing exports in 2003 was 80% lower than in the peak year of 1992; in the Czech Republic the decrease was 75% and in Poland 73% (Broadman 2005). Evidence from this period also shows a strong correlation between FDI and the level of involvement in global IT and automobile production networks. In 2003, the share of network exports in total manufacturing exports reached 53.8% in Hungary, 40.5% in Slovakia and 34.4% in the Czech Republic. These figures clearly illustrate that producer-driven-network FDI had fundamentally transformed the economic and export structure of these countries and moved their activities up the value chain.

To a large extent, therefore, export capacities in CEE locations were built up through FDI and relocation and have been subjected to subsequent upgrading. As a result, a shift from labour-intensive production towards technology and capital-intensive forms of activity took place (OECD 2006).

Manufacturing FDI in CEE is mainly efficiency seeking and export expanding; it is concentrated in the production of transport equipment and the electrical components industries. While it had partially replaced production in the EU-15, corresponding capacities were not downscaled there in parallel, an EU-wide pool of surplus capacities arose, especially in the automobile sector. The global car components industry is concentrated particularly in the CEE region, especially in Poland, the Czech Republic, Slovakia and Hungary.

Consequently it is worth examining the specific forms of labour division that exist between EU15 and CEE locations in the automobile industry. The special dynamic of the automobile sector is the result of four key processes that were undertaken at the same time: internal company reorganisation, the redefinition of business strategies, the outsourcing of non-core activities and the restructuring of supply chains. A common denominator of these change processes is an increase of cross-border activities taking the form of various outsourcing and off-shoring strategies.

It has often been argued that the initial reason why Western car manufacturers invested directly in CEE locations was to gain access to new markets; however, with the establishment of new capacities there, export platforms were created that could undermine the share of value added in the home countries and even threaten industrial manufacturing in high-wage countries (Sinn 2004; Dudenhöffer 2006).

The labour division patterns among original equipment manufacturers (OEMs) and first-tier suppliers, with particular attention to the role of CEE locations, cannot be characterised as exclusively market- or cost-driven and, in contrast to other industries, automobile production is not characterised by a clear East–West division of

labour. CEE countries, therefore, cannot be said to have a clear specialisation in the value chain; for example, as regards labour-intensive or low-skill activities. Apart from design and core R&D work, almost all tasks are carried out at CEE locations. A clear division between winners and losers cannot be identified either. With the establishment of new plants in Central and Eastern Europe the existing sites in Western Europe faced actual or potential competition. To a limited extent, this has led to the closure of production facilities, yet a more widespread effect seems to have been stagnation and loss of growth opportunities in the West. Other company functions, such as R&D, and other industries, such as machinery production in the West, have profited from these developments. The loss of value added due to imported intermediate inputs has been more than compensated by the export of cars assembled from intermediate products, as prices on the world market have remained competitive and strong exports have created new jobs.

In the CEE countries the new automobile industry has created around half a million jobs and offers opportunities for the further upgrading of capacities established there.

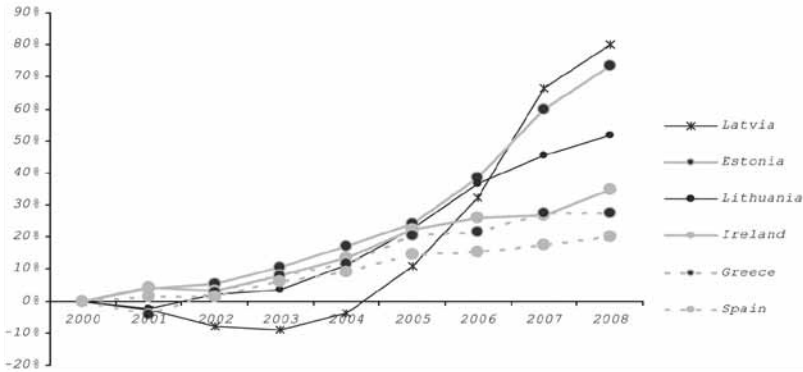
High intra-industrial trade (the share of which, within total manufacturing trade, grew within a short period from zero to the level of the EU15), a high share of FDI inflow into manufacturing (strengthening the manufacturing base in the new CEE member states, while it shrank in the EU15) and soaring manufacturing exports were the main features that demonstrated the qualitative shift that took place in European industry and led to a new division of labour between the West and the East. Even with this qualitative shift in trade and investment patterns EU15 countries continued to benefit from market expansion in the CEE region during the economic upswing until 2008. Within this framework, Western multinationals benefited from cheap sourcing from Central Eastern European locations and used this to strengthen their market positions and competitiveness on a global level. The sustainability of this form of labour division and the consequent production model in CEE had not been questioned until the huge impact of the crisis on CEE became evident. The mono-industrial nature of the new manufacture landscape in CEE, focused on highly cyclical branches, such as automobile assembly and electronic components production, has proven to be a risk factor in a time of heavy downturn. High dependence on an export demand that is concentrated on cyclical industries became a factor of vulnerability and added to the intensity of the downturn in CEE.

Lessons from the Eurozone crisis for CEE

While export dependence as a risk factor during the 2009 crisis in CEE raised doubts about the sustainability of export based and FDI driven growth, the case of the South-European countries in the 2010 Eurozone crisis led to an opposing set of arguments. Apart from the fiscal aspect of their difficulties, Greece and Portugal have

suffered from a long-term lack of export competitiveness, which has led to accumulating imbalances within the Eurozone. They were losing competitiveness vis-à-vis Germany as their unit labour costs rose substantially over German levels (wages increased faster than productivity). Figure 4 illustrates this divergence, also showing that the new CEE member states have seen even greater increases in their relative unit labour costs compared to Germany (this is true also for CEE countries not included on the graph).

Figure 4 - Change of nominal unit labour cost relative to Germany



Source: European Commission, Ameco databasis

The paradox is that while the South-European states in crisis have a long-term competitiveness problem, this is not the case for the core CEE countries. Table 2 shows some key competitiveness indicators based on the Annual Growth Survey report of the European Commission (European Commission, 2011). The real effective exchange rate – a key indicator of competitiveness for the Commission – shows the combined effect of exchange rate, inflation, nominal wage and developments in productivity (the higher the figure the greater loss in competitiveness). What we see is that Slovakia seems to be losing competitiveness on the greatest rate, followed by the Czech Republic and Hungary. Greece and Portugal are also losing competitiveness but to a lesser extent.

Table 2 - Key indicators for selected CEE and south European countries (Germany being the reference)

| Country | GDP/capita, % EU27=100, 2009, exchange rate parity | Labour productivity level, EU27=100 | Real effective exchange rate (REER), % difference from long term average |
|----------------|--|--|---|
| Slovakia | 30 | 78.7 | 54.2 |
| Czech Republic | 38 | 71.8 | 41.5 |
| Hungary | 30 | 70.2 | 13.0 |
| Greece | 78 | 98 | 12.8 |
| Portugal | 61 | 74.1 | 8.7 |
| Germany | 129 | 104.7 | -5.8 |

Source: European Commission, 2011

The data also reveal that CEE economies have a substantially higher level of productivity than their income levels (measured at GDP/capita) would reflect. Even if these countries are losing cost competitiveness, their low income (and wage) levels still make them competitive. Slovakia, while losing competitiveness at record level in the EU in the last years, still maintains a trade surplus and has no fundamental problem in its economic balances.

Moreover, it is true for the other CEE countries, with an FDI-driven export-based economy, that productivity and thus unit labour costs in their export sectors (mostly manufacturing sector) are significantly higher than their national average values. This dual aspect of their economies (elsewhere a source of tension) allows them to maintain export competitiveness even if unit labour costs (or REER) are increasing.

This is a major difference compared to the South-European countries that are in crisis now. The lesson is that Greece and Portugal lack precisely that FDI-based manufacturing export basis that Slovakia and the Czech Republic have. On the other hand, this also shows how important the competitive export sector is for these CEE countries, even if this has exposed them to a cyclical downturn during the 2009 crisis.

Even if individual countries have different vulnerabilities, a parallel between the two countries most exposed to the crisis delivers some lessons. While both Hungary and Greece had serious fiscal problems due to overspending in their government sector, Greece also has a competitiveness problem.

Table 3 - Key indicators for Hungary and Greece

| | Current account balance | | | Government deficit | | |
|---------|-------------------------|-------|------|--------------------|------|-------|
| | 2004 | 2007 | 2010 | 2004 | 2006 | 2010 |
| Greece | -10.2 | -14.5 | -8 | -7.8 | -3 | -12.5 |
| Hungary | -9 | -6.5 | -2 | -6.2 | -9.2 | -3.8 |

Source: Darvas, 2009

Conclusions

We have shown some characteristics of the FDI-based production model in CEE that marked a new division of labour in Europe in the period preceding the crisis. This was seen as the foundation of economic renewal in post-communist countries leading to economic and social convergence to Western European standards.

Then we identified a number of factors that expose the new CEE members in particular to the current economic crisis. One central factor, common to all countries in the region is a high reliance on external financing and a high level of economic and trade and financial integration with the West. This meant the global shock was rapidly transmitted to the national economies of CEE.

The 2009 crisis highlighted the fragility in the integration model that, during the previous period, helped CEE countries to achieve a considerable degree of convergence towards Western Europe.

While FDI-driven export-based growth concentrated in cyclical industries did indeed prove to be a risk factor during the downturn, the quick rebound of exports after the crisis has also shown the strength of this economic structure. The Euro-zone crisis in 2010 also showed that without a competitive export sector the South-European crisis countries are in a more difficult situation. Export competitiveness and high FDI involvement have ultimately proven to be a factor of strength for CEE economies, even if their concentration in a few cyclical industries makes them vulnerable to external shocks.

The case of the South-European crisis countries and the emergence of CEE economies from the downturn have also provided a lesson for South-Eastern Europe. Though having competitive, export oriented industry based on productive FDI is perhaps not an ideal solution, but for small "catching up" countries with scarce domestic capital there does not seem to be a viable alternative.

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THE AUTOMOTIVE INDUSTRY AS THE CORE OF EXPORT-LED GROWTH IN SLOVAKIA

Transformation and its specifics in Slovakia

The success story of the automotive industry in Slovakia can only be grasped within the context of the transformation processes in Slovakia during the nineties. The point of departure for the transformation of the economy, ownership, institutions and life in Slovakia was the loss of the armament industry's markets, which had made up for a considerable part of Slovak exports by 1989. Despite this loss, there still was an engineering tradition, however, without investment resources and modern technological know-how it remained rather useless. Nevertheless, both of these prerequisites could be acquired through foreign investment. The flow of foreign investment became quite complicated between the years 1993-1998, when the partition of Czechoslovakia led to the establishment of Vladimir Meciar's authoritarian regime. During this period Slovakia faced a political blockade of its EU-integration, pre-accession talks were stopped for the period of two years. At the same time, the country lacked strategies for the effective acquisition of foreign investment.

Only after 1998, a strategy for "catching up at any cost" was developed in order to politically and economically revitalise Slovakia within the shortest possible time. Mikulas Dzurinda's administration (1998-2006) expected this fast track modernisation to operate on the basis of radical neoliberal reforms, such as the introduction of a flat income tax and other race-to-the-bottom policies. Significant decisions regarding laws on foreign investments as well as the founding of industrial parks were also adopted by the government within the framework of neoliberal reforms.

Direct foreign investments in the automotive industry – A Central European phenomenon

One of the common arguments regarding the reforms that took place between the years 1997-2002 is that they were highly successful since they initiated an „economic miracle“ in Slovakia, due to them the country is known as the "Slovak tiger". However, opinions regarding the factors that can best explain the rapid growth of the Slovak economy prior to the economic crisis will always differ. According to the former Minister for Finance Brigita Schmögnerova, we can certainly assume that without the economic boom in Western Europe, the economic growth in Slovakia would have been lower. Regarding the establishment of the automotive industry in Slovakia, we must also bear in mind that aside from the government reforms car-

⁶ Martin Muransky is a project manager in the Friedrich Ebert Foundation Office in Bratislava.

ried out between 1998 and 2002, the industry developed in the entire Central European region, not only in Slovakia. Between 2005 and 2007 around 2 million cars were produced per year within a perimeter of 500 kilometres around Bratislava, with a potential to increase production to 4 million per annum. Slovakia's portion of this production capacity was 500 000 cars per year. According to data published by Brigita Schmögnerova, in 2006 the foreign investments attracted by the countries of Central and Eastern Europe were a third higher than those in the record-breaking year 2005, when, according to the Vienna Institute for International Economic Studies (WIIW), direct foreign investment in Central Europe was worth of € 77 bn. It certainly is of some interest that this 33% increase in 2006 was seemingly part of an even wider global trend, when in the same year worldwide direct investments raised by nearly a third – to € 100 bn per year – as was pointed out at the time in the Financial Times Deutschland.

That is why a question raised by Lobo Uhlar, President of the Slovak industry, can be seen as relevant: Why were these investments attracted to the Central European region? The main positive factors he cites are the political stability of the Central European region (connected with EU membership) and the convenient geographical position (in terms of the EU market size and the proximity of the Russian market). A third positive reason was the health of the inhabitants and the level of elementary and secondary school education. The basic downsides of the Central European region for foreign investment were, according to Uhlar, the non-transparent operation of public institutions, bad infrastructure and the low level of innovation.

The basic facts about the automotive industry in Slovakia

Nowadays, three global car producers operate in Slovakia – Volkswagen, Peugeot and KIA (VW, PSA, KIA). The arrival of the last two in 2006 meant a 169% increase of investment in the automotive industry. In 2006-2008, prior to the crisis, about 500,000 vehicles were produced in these plants, and it should be borne in mind that the target manufacturing capacity of KIA production in Slovakia is one million vehicles per year. At present the automotive industry makes up 36% of the total export industry in Slovakia.

However, the automotive industry in Slovakia is not only represented by direct car manufacture. Suppliers present a second significant economic sector, mainly among small and medium-sized businesses. Around 240 car component and part producers participate in the car production in Slovakia. Thus, the Slovak automotive industry employs 68,000 workers and further 28,000 workers are engaged in the automotive distribution network. The automotive industry is the most significant source of economic growth and industrial production in Slovakia. It became the main form of “westernization” of the industry in Slovakia and is compatible with the industry in Western European countries. The import of know-how as well as of new forms of la-

bour management and new labour culture are also associated with the emergence of this sector. At the same time, the complexity and multi-sector focus of car production has given rise to new supplier branches. From the long-term perspective, the automotive industry could imply some risk for the economic life of the country; the main risk is the dependence of GDP growth on a mono-industrial structure.

A deepening in regional diversities is another specific problem in Slovakia. The two major plants, Volkswagen and Peugeot, are situated close to Bratislava, while the third big player KIA is located in the northern part of Slovakia. Taking infrastructure accessibility and highway connections into account, it is not surprising that a considerable number of suppliers are also located close to the highways. This shows how manufacture in the automotive industry is centred in the western part of Slovakia. The traditionally less developed eastern and southern parts of Slovakia – which lack a continuous highway link – are dragging behind. This indirectly confirms the theses on the regional presence of the automotive industry in all Central and Eastern European countries, which cannot be rebuilt merely by considerations focused on options for the national state. Applied research development and innovation are also a specific problem to be tackled. The central factor of car production in Slovakia is “manufacturing”.

The global financial and economic crisis and its impact on car production

Two distinct factors marked the course of the global financial and economic crisis in Slovakia when compared to neighbouring countries: firstly, the impact the crisis had on the automotive industry was intensified by the cut-off and considerable reduction of gas supplies from Ukraine which lasted from 8 – 17 January 2009. The Gas crisis became a threat to the economic efficiency of businesses and led to a temporary stoppage of the production at KIA and Peugeot. The second factor influencing the course of crisis in the country was a healthy bank sector, which as a result of bank reform in 2000 was not particularly affected by the impact of the financial crisis. This bank reform had set strict criteria for investment control, based on lessons learned during the times of “wild” privatisation in the Nineties. Considering Slovakia’s relatively low level of indebtedness before the crisis (c. 35% of GDP, € 3,540 pro capita), it is no surprise that a “car-scraping benefit” (€ 2,000 per old vehicle) was successfully introduced in the country. Despite both of the abovementioned peculiarities of the crisis in Slovakia, it should be said that the main influence of the crisis in the Slovak car industry was due to the fact that its target market are mainly the old EU member states and partly China and Russia. Car production fell by almost 35%, which had a bad influence on the consumers’ market and purchase power and consequently the efficiency of business. When compared to the present situation, a total of 10,015 cars registered in January and February of this year, 21.7% up on the same time period last year. At the same time it is 29.66% less than in the first two months in 2008, when 14,237 new vehicles were registered.

Let us take a look at the impact of the crisis in numbers: In the oldest (1991) and the largest car production plant, Volkswagen Slovakia (with earnings at a record high: € 5,7 bn. in 2007), the consequences of the financial crisis were very diverse: car production stopped between February 16th and 24th 2009 – which meant a cut in production of estimated € 100 - 200 bn. On the one hand, this resulted in redundancy (from 8,500 employees in 2007 to 7,500 today). On the other hand, the factory management devised various measures to sustain labour, such as a prolonged general factory holiday, the introduction of the flexible working hours account (Flexikonto), as well as generous severance pay for those who accepted voluntary redundancy.

PSA is the second oldest car production plant in Slovakia. It was established in 2003 in Trnava – a convenient location that enjoys a developed infrastructure. Due to this investment the direct export of Slovakia increased by 100 bn krona annually. The consequences of the financial crisis in PSA were the loss of 190 jobs by the end of the year; a reduction in the production of Peugeot 207, which was balanced out by the production of Citroën C3 Picasso; and by the offer of the option to terminate employment with 4 or 5 month's severance pay.

The youngest car production plant is KIA Motors Slovakia. Construction of the plant began in 2005 and – already in 2007 – a 173% increase in sales was recorded compared to 2006.

The Consequences of the financial crisis were the introduction of a 6-hour shift; from February 16 to the end of February only one shift operated; employees staying at home got 60% of their salaries.

Paradoxically, by overcoming the economic crisis substantial structural deficiencies were uncovered, which stand in the way of a long-term development of the automotive industry in Slovakia. First of all, it faces a shortage of trained labour force, a persistent problem despite a 14% unemployment rate in Slovakia. As Jozef Uhrík, President of the Slovakia Industry Board and a co-founder of Volkswagen Bratislava points out, sustaining a satisfactorily qualified labour force is limited by an insufficient education network and a prevailing interest in University education, with very little interest in technical specialization. Neither the geographically convenient location nor low salary costs can secure the sustainable competitiveness of the Slovak industry, not to mention the increasing shortage of a qualified labour force. Sustainability requires a necessary shift from the current line of manufacturing organisation to one focused on research and development. At this point there is still a lack of infrastructure for research and development, as well as support for innovative companies. Secondly, according to Uhrík, it is essential to aim at the completion of an adequate infrastructure, which is a must for the competitiveness of the supply industry.

Our Opportunities

Stefan Chudoba, a Managing Director of the automobile cluster in Trnava and a former manager of Volkswagen Bratislava, suggests that supporting the development of the supply industry presents the main opportunity for sustainable development of the automotive industry in Slovakia. According to Chudoba, it is necessary to make use of the potential of small and medium-sized businesses in the industry and to find the appropriate stimulus to increase their portion in industrial production, thus decreasing the vulnerability of an economy dependant solely on large foreign investors. In particular, the issue of appropriate stimulus for small and medium-sized businesses in Western Europe must be carefully considered.

By aiming at the supply sector, the flexible sector of production of small and medium-sized businesses is being supported as well as highly sophisticated and innovative production. More than 30% of supplies for the car industry consist of metal sheet press and welding products and about 30% are plastic components. Within 500 km of Bratislava there are not so many body-work assembly facilities. The life time of every car model is about 5 years and every year approximately 3 models are renewed. This requires a system of welding, approximately 80 technological automatic lines with control system and other logistic devices, which opens considerable space for innovation within the field of products and technologies. As Chudoba points out, it is due to the regional development of innovation centres that we can aim at the production of technologies for welding, assembly and logistic facilities, in cooperation with small innovative businesses that are able to generate such technologies in cooperation with universities, and at the same time able to preserve the maintenance of technology.

What we lack

From the perspective of the development of the automotive industry, the main deficiency seems to be a lack of qualified labour force with technical education. A common opinion within the economic circles regarding this issue is that the main source of such a qualified labour force was the “blue collar” generation, educated at technical schools during the era of socialism. Today, we can speak about a generation gap, which has been created over the past 15 years of the country’s development, where now up to 50% the school-leaving population aims at university (for the 5 million inhabitants of Slovakia, there are 24 universities specializing mainly in humanities). This unbalanced structure in the education system is closely linked to a missing relation between applied research and development at universities and production plants. Stefan Uhrík claims that the poor utilization of European funds for research and development also presents a specific problem. By the end of 2009 only 8 projects were contracted, which make only 0,24% of the allocation for the years 2007-2013. Under the heading of competitiveness and economic growth in

2007/2008, only 0,06% of European funds had been drawn and by the end of 2008 only 4 projects were contracted, this makes only 0,14% of the allocation for 2007-2013 – the utilization of funds in 2007/2008 was thus only 0,05%.

This is associated with more issues than the utilization of funds itself. Innovative enterprises gain little support and trust in our own skills is very often lacking.

What we need

Suppliers should take more responsibility for research and development activities and aim at promoting more research and development. Tax reduction could be one way of supporting technological development. From the perspective of state economic policy, an equal approach towards domestic and foreign investors is certainly lacking. Innovative companies would get considerably greater support in Slovakia, if we succeeded in creating the same level of field conditions for investors. Support for automobile clusters, based on networking and the coordination of cross-regional projects, local authorities as well as universities and companies, should become a new challenge for education focusing on the practical applications and the needs of economic development. Supporting an efficient education system is associated with creating the conditions for the foundation of technological centres and research camps linked to universities and aimed at achieving innovations in the business base.

To conclude, European funds could play a key role in supporting all of the above-mentioned innovations for increased competitiveness in the Slovak industry. The utilization of these funds should be focused on research – reflecting the needs of industrial development. The concept of an efficient and optimum use of this source of financing still needs to be developed when dealing with the strategic role of development in the automotive industry in Slovakia.

From manufacturing cars to a value added economy

The development of the automotive industry after 2001 has become a “once in a lifetime investment”, which – to the same extent and with the same significance – will most likely not occur in the forthcoming years. Nowadays, for logical reason, the time has come for innovation: investments of such significance are usually not made within a perspective of 5 or 10 years, but certainly longer, as this long-term vision depends on global as well as on local factors. Certainly, one cannot rely on high investment costs from foreign capital. The main path for the sustainable development of the automotive industry is to be foreseen in the creation of a stable and developed network of suppliers – together with an efficient highway infrastructure – which is a condition that needs to be fulfilled if supply businesses are to enter the market. In fact, this simple interpretation marks a shift from the short-term perspective in favour of the long-term perspective.

A short-term perspective prevailed in the past: the reform policies of the nineties, a “flat tax solves every problem” attitude, the result of which was actually a race to the bottom, based on cutting off costs and tax dumping. This type of macroeconomic policy-making was oriented solely at the big players and lacked any business concept for small and medium-sized businesses: suppliers. Such neoliberal politics lacked any properly worked out educational concept and, unfortunately, this is still missing today. In future, a long-term perspective based on the idea of centres for applied research and a long-term concept for the regional development of small and medium-sized businesses could prevail, focused on creating a strong network of companies and universities and developing technological cooperation within a 500 km range of Bratislava.

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EXPORT-LED GROWTH IN SLOVENIA - PAST AND PRESENT

At the time of writing this article Slovenia's results in economic development, related to the post economic crisis period, were not yet as distinctly negative as became evident at the beginning of 2011. But it was already evident that the Slovenian economy was facing serious structural difficulties. Generally, the production sector was not adjusting adequately to the new competitive challenges of EU membership and integration. Additionally, the economy and its structures were resistant to the challenges stemming from the global environment, such as rapid global technological advancement and general progress in knowledge and industrial innovation.

The global financial and economic crises that occurred from 2008 onwards were more of a trigger than the major reason behind the economic problems facing Slovenia today. The major obstacles in issues of economic performance in Slovenia are related to two basic issues: the first is rigidity and slow adjustment in the industrial structure, where products with higher added value were not being developed with the required intensity; the second issue is closely related to the first: there was no effective national legislation regulating the responsibilities of managers in business development in relation to effective owners' rights. These gaps in the legal system were particularly visible when the State (the government) was or is among the owners of enterprises, banks or public utility and transport systems.

The historical background of the transition process in Slovenia

Twenty years after independence, the growth and development problems in the Slovenian economy are far beyond the impacts which could be attributed solely to the global financial and economic crises. In the last five years, more or less, due to the structural and legal problems inherited, combined with the global economic crises, Slovenia has turned its previously successful transitional process and economic progress into an uncertain and potentially long-lasting struggle with serious problems in industrial restructuring in combination with, the need for the rapid implementation of a more efficient legal and judiciary system. Indeed, today's structural problems had been gradually mounting from the recognition of the country's independence. The reasons behind this were varied, but the most significant included:

- After independence, a major national and political objective was the fast achievement of EU membership, coupled with no reasonable doubts regarding the eventual negative impact of the process;

⁷ Andrej Kumar is a full professor at Faculty of Economics, Ljubljana (Slovenia), Faculty of Economics Rijeka (CRO) and occasionally at Drury University, Springfield MO (USA).

- In practice, economic growth and sustainability and the national economic development policy were subordinated to the objective of EU membership;
- The objective of EU membership led to a legal and economic restructuring and a transition which were not always consistent with actual implementation or were not really efficient in the longer term;
- The privatization process, which was based on public vouchers, led to a slow, non-transparent and inefficient market-based restructuring of the economy. Privatization was effected in two waves and was extended over a number of years reaching some form of finalization in the years before or at the outset of the global financial and economic crisis.

The structural and developmental problems of the Slovenian economy had already been observed during the nineties, a period when the results of transition were still positive. With regard to some of Slovenia's developmental problems, Andras Inotai and Peter Stanovnik (2004) pointed out the following: "Repeated delays in privatization, the slow and selective inflow of foreign capital, the weaknesses in the banking sector, and the country's high production costs, compared to the Czech Republic, Hungary, Poland and Slovakia, noticeably narrowed Slovenia's competitive advantages in the second half of the 1990s." All the problems mentioned above have persisted in Slovenian economic development to recent time.

On the other side, Slovenia was relatively successful in achieving economic growth for a number of years following 1991. Positive growth results were mostly based on the export oriented production structure inherited from the previous economic system. Successful growth was supported for more than a decade by more effective and more market-orientated management and employment structures which were inherited from the earlier socio-economic system. Market orientation and the experience of managers and employees in Slovenia were founded on historical differences in the previous socio-economic system, which was much stronger and more efficient than in other transitional countries.

Slovenia's successful development and transitional achievements were based on these human resources and were, to a great degree, results of export-led growth development. Export-led, growth oriented development was not a orientation of national development policy or a strategic orientation of major businesses. Export-led growth in Slovenia was actually the result of different political, economic and formal relations which had been developed in former Yugoslavia, including its relations with the European Community and other countries.

Becoming independent, Slovenia started out with an economic structure which was more advanced and richer (in GDP per capita) than all other parts of former Yugoslavia. Prior to 1991, the Slovenian economy and Slovenian businesses had developed a strong orientation towards increased exports and trade with "west-

ern" economies. In the Yugoslav period, this export orientation was mostly led by the need to acquire sufficient hard currency for imports whether on the national or on the business level. On the other hand, such an orientation in economy and business helped Slovenia to adjust after the breakdown of the larger Yugoslav domestic market. In the last years of the former state, the export orientation of the Slovenian economy was additionally accelerated by a gradual slow down in the domestic market outside of Slovenia. Pressure to survive economically pushed the economy and businesses to aim at new foreign markets. Searching for new foreign market partners was combined with efforts to increase export and trade with existing partners from Western Europe and from other regions.

Slovenia's export and trade-oriented efforts were more successful because after the declaration of independence, the sui generis co-operation agreement, between ex-Yugoslavia and the EC (dated 1980), was (silently) extended. It allowed Slovenia to continue to enjoy privileges, including preferential access to EC markets. On the bases of the old agreement, a cooperation agreement was successfully concluded in April 1993 between Slovenia and the EU. The successful reorientation of a large portion of trade from the previous domestic market to European and other markets was additionally supported by adopting a political and economic program called "Europe 1992", which already dated from 1989. The acceptance of such a program had evidently been reached already some time before the breakup of socialist Yugoslavia. It was "buying" Slovenia additional time in preparing for transition to a market economy. The program supported activities regarding how to prepare for new economic and political relations with Europe and how to adjust the economy to actual market conditions. It is worth adding that all this background helped Slovenia to be successful in its economic development in the first years of transition.

Economic growth in Slovenia after independence and some theory

In theory (a set of assumptions), we believe that the social welfare of a nation improves when a particular change in the economy leaves at least one individual better off and no one worse off. In practical terms, we have better welfare in a country if at least one person can consume more, while the rest do not decrease their consumption. This would suggest that increased national consumption creates improved social welfare. An increase in a nation's consumption depends on the growth of national income, which is in turn based on GDP growth. Theoretically, we expect that at certain level of GDP national income can be enhanced by the successful development of external trade. GDP growth could be trade or non-trade oriented. If GDP growth is trade oriented, the economy will have a positive and accelerated growth in national income, thus creating a higher level of national consumption.

How important the relationship between GDP growth rate and trade is, with its accelerating impact on national income, might be illustrated by putting one cent

on the first square of a chess board, two cents on the second, four on the third, etc. (The case is further explained in Romer, 2007, p.1.). Putting the cents only on all the white squares, the initial cent will multiply in value thirty-one times, leaving € 21.5 million on the last square. By using both black and white squares, the cent will grow to € 92,000,000 bn. To obtain higher national income growth, the message is clear. For a nation, the choices that determine a doubling in income with every generation or instead with every second generation, make all other economic policy concerns rather irrelevant. One can figure out how long it takes for something to double by dividing the growth rate into the number 72: in the 25 years between 1950 and 1975, income per capita in India grew at a rate of 1.8% per year (at that rate, income doubles every 40 years because 72 divided by 1.8 equals 40); in the 25 years, between 1975 and 2000, income per capita in China grew at almost 6% per year (income doubles every 12 years).

From 1993 to 2003, Slovenia had an average real growth rate of 3.8%, thus taking 19 years to double its GDP. Between 2004 and 2009, Slovenia had average real growth rate of 2.9% (see BS Report October 2010), or 25 years to double its GDP. The basic reason behind this longer period for GDP doubling was a sharp decrease in growth in 2009 (-8.1%), as a consequence of the global economic crises and specific structural and developmental features of the Slovenian economy, partially explained above as *managers buyouts* (the second privatization wave) approximately over the last five years. Additionally, the growth engine of Slovenia's external trade is slowing down due to structural production problems (too low value added) and a *suboptimal regional product structure* of external trade. Most trade is concentrated in the EU, almost all the rest is in the Western Balkan region (See table). Trade with the EU (either 25 or 27) is not actual foreign trade, as it has not the same multiplication effects as external trade with countries outside of the EU. To have a better acceleration of income growth, Slovenia has to increase its trade with countries outside the EU.

Table 1 - Slovenia - Exports and imports of goods by groups of countries 2005-2008 in %

| | Exports | | | | Imports | | | |
|--------------------------|---------|------|------|------|---------|------|------|------|
| | 2005 | 2006 | 2007 | 2008 | 2005 | 2006 | 2007 | 2008 |
| TOTAL | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| EU-25 | 67.9 | 68.4 | | | 80.9 | 80.2 | | |
| EU-27 | - | - | 70.6 | 69.0 | - | - | 78.9 | 77.9 |
| Other European countries | 25.0 | 24.3 | 22.5 | 23.9 | 11.4 | 12.0 | 11.0 | 9.6 |
| Non-European countries | 7.2 | 7.2 | 6.8 | 7.0 | 7.7 | 7.8 | 10.0 | 11.2 |
| Other n.e.c. | 0.0 | 0.1 | 0.04 | 0.04 | 0.0 | 0.0 | 0.1 | 1.2 |

Source: http://www.stat.si/eng/novica_prikazi.aspx?id=3776

The macroeconomic indicators for 2007 to 2010 show that Slovenia suffered a massive decline in growth rate in 2009 and that improvements in 2010 were not really substantial (see the table below).

Table 2 - Slovenia macroeconomic indicators 2007-2010

| | 2007 | 2008 | 2009 | 2010 | | | |
|-----------------------------------|--------|--------|--------|------|------|------|------|
| | | | | Q1 | Q2 | Q3 | Q4 |
| Nominal BDP (Billions €) | 36.4 | 37.1 | 35.7 | | | | |
| Real BDP growth (%) | 6.8 | 3.5 | -7.8 | -1.2 | 2.2 | 1.7 | 2.1 |
| BDP/capita (€) | 17,123 | 18,367 | 17,657 | | | | |
| Inflation (yearly average in %) | 3.6 | 5.7 | 1.0 | 1.7 | 1.9 | 1.9 | 1.9 |
| Unemployment rate (%) | 7.7 | 6.7 | 9.1 | 10.6 | 10.6 | 10.7 | 11.1 |
| Manufacturing product. growth (%) | 5.7 | 1.8 | -13.8 | -0.4 | 4.4 | 6 | 5.1 |

Source: Hypo Group, Daily Report

The problem was aggravated in 2010 and at the beginning of 2011 with a number of bankruptcies among the largest construction companies in Slovenia and with a sale of shares of the major nationally-owned retail trading company Mercator on the financial market. The seller of the Mercator shares was a company in liquidity difficulties because of management buyout activities from the past.

Can an “export-led growth” orientation create higher economic growth?

Conventional wisdom suggests that the openness of an economy promotes economic growth. Theory, from A. Smith, D. Ricardo to P. Romer (1989), suggests and even proves that greater trade creates higher economic growth. A significant positive relationship between growing openness and higher GDP growth is shown in 94 countries out of 124 (Sinha, Tapen, Dipendra, 1999) in the post WWII period. Openness in a national economy must be combined with an “export-led growth” strategy to secure “sufficient” external trade and a positive impact on economic growth. Neoclassical theory suggests that economic growth could be neutral or trade and anti-trade based. For that reason, a nation needs an export-led growth strategy which must preserve a continuation of trade-based economic growth. In the case of Slovenia, trade based economic growth occurred because of specific circumstances, after 1991 and well on towards EU membership. Surprisingly, such growth in Slovenia was not actually supported by a national export-led growth strategy. How can such a paradox be explained? Already before 1991 Slovenia had a substantial developmental impetus, from its well developed external trade growth. Apparent “export led growth” was not based on any officially implemented

national development strategy, whether Slovenian or Yugoslav. It was more a reaction of the economy – of companies – seeing increased exports as a good business opportunity, based on:

- Generating extra income from selling retained hard currency at above the official exchange rate;
- Exploiting enhanced import opportunities for raw materials, investment goods and merchandise within the import restricted ex-Yugoslav trading system.

The creation of economic and political barriers to trade with other former Yugoslav republics shortly before 1991, found Slovenian companies able – based on their knowledge and experience and using their preferential access to EU market – to redirect part of their domestic trade into external trade proper, mostly with EU partners. Such trade growth and its reorientation continued during the entire EU accession period. Trade expansion in the years before EU membership was more a question of inertia rather than the actual implementation of a national “export led growth” strategy – which formally has never been accepted or systematically implemented.

Specifics of Slovenian trade growth

As stated above, an export and trade building strategy or export-led development strategy was never formally implemented in Slovenia. Although export growth and its importance for Slovenia after independence does indirectly suggest that there ought to have been a consistent national strategy underlying trade developments. In actual fact, following the loss of the greater part of the former Yugoslav market, the business sector and the entire economy behaved as if such a strategy were implemented. The absence of a policy supporting export-led growth, negative privatization processes and a trade concentration on the internal EU market, have gradually reduced the share of external trade in Slovenia’s total trade balance. Over recent years, around 70% of trade has been limited to trade with the EU internal markets. The impact for Slovenia of trade openness in the EU market (based on the cooperation agreement and later on the European accession agreement) made growth in sales relatively easily, although these cannot be properly defined as exports. These positive developments created a general belief on the corporate and state level that Slovenian products were generally competitive and successful on external markets. Other studies (EF2001, and others) began to show that the growing problems of export structure were based on the growth of sales on the EU internal market. Trade with third markets was mostly based on products derived mostly from raw materials and simple labor. The table below indicates this inefficient trade structure based on the intra-industry trade index for Slovenia from 1996 to 2005.

The absence of a national strategy supporting export-led growth combined with the negative impacts of the privatization process, together created a prevailing at-

mosphere where only rarely did companies base their business development and growth of trade on innovation and the introduction of new higher added value products. The data below show how Slovenia's intra-industry trade index (IIT indexes) decreased in high and medium-low technology products.

Table 3 - Slovenian merchandise trade with EU15

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|-----------------|------|------|------|------|------|------|------|------|------|------|
| High technology | 80.0 | 81.4 | 65.2 | 64.0 | 59.4 | 60.2 | 55.3 | 62.8 | 56.2 | 61.6 |
| Medium-high | 81.8 | 85.5 | 84.4 | 86.1 | 84.0 | 90.4 | 89.3 | 90.5 | 90.5 | 94.3 |
| Medium-low | 98.5 | 98.5 | 98.4 | 90.4 | 83.0 | 81.2 | 83.4 | 81.4 | 85.9 | 84.7 |
| Low technology | 80.4 | 83.9 | 92.5 | 96.0 | 98.4 | 98.3 | 95.7 | 98.5 | 99.8 | 96.7 |

There is no doubt that these products are highly important in increasing trade value following a national improvement in competitiveness. For Slovenia, indeed, a growth in the IIT index was achieved in low-technology products. After EU membership, the IIT index tendencies remained similar to those presented in the above table. According to the data, Slovenia had not improved its trade competitiveness through the introduction of new products or products based on high or medium level technologies. Slovenia's trade structure predominantly followed the production structure inherited from Yugoslavia, using experience and knowledge accumulated in the pre-independence period. Such a concept has been losing its trade and economic growth efficiency over last few years, already before the global financial and economic crises began.

Current accounts, trade data for recent years and their projections (see the table below) show poor export-led growth in the economy for the near future.

Table 4 - Current account

| | 2005 | 2006 | 2007 | 2008 | 2009 | Projections | | | | | |
|------------------------------------|------|------|------|------|-------|-------------|------|------|-----|------|-----|
| | | | | | | 2010 | | 2011 | | 2012 | |
| | | | | | | Apr | ▲ | Apr | ▲ | Apr | ▲ |
| Export of merchandise and services | 10.6 | 12.5 | 13.7 | 2.9 | -15.6 | 5.1 | 3.1 | 6.0 | 2.0 | 6.7 | ... |
| Import of merchandise and services | 6.6 | 12.2 | 16.3 | 2.9 | -17.9 | 3.0 | -0.3 | 5.3 | 1.2 | 6.5 | ... |

Table 5 - ITT for Slovenia based on Gruber-Lloyd indexes (3 level SITC)

| | Grubel-Lloyd IIT index based on 3 level SITC | | | | |
|--|--|---------------|---------------|---------------|---------------|
| | 1996 | 1999 | 2003 | 2004 | 2005 |
| Foodlive animals | 42.931 | 42.107 | 38.749 | 39.030 | 46.303 |
| Beverages and tobacco | 75.213 | 63.896 | 45.470 | 58.458 | 60.109 |
| Raw materials excluding fuels | 39.135 | 43.960 | 44.009 | 47.251 | 53.425 |
| Minerak fuels | 14.631 | 12.506 | 10.849 | 24.391 | 20.526 |
| Animals and vegetable oils, fats and waxes | 39.269 | 40.892 | 37.594 | 30.122 | 33.381 |
| Chemical products | 56.577 | 56.547 | 58.008 | 58.352 | 60.072 |
| Other semi-manufactures by material | 67.714 | 70.073 | 69.932 | 69.272 | 70.626 |
| Machinery and transport equipment | 65.465 | 65.026 | 64.50 | 68.580 | 64.655 |
| Finished manufactured products | 70.640 | 68.302 | 68.499 | 65.722 | 66.427 |
| Other products | 18.348 | 9.791 | 87.724 | 59.638 | 39.791 |
| TOTAL | 61.895 | 62.479 | 61.486 | 62.821 | 62.258 |

Source: Calculated on the bases on Trade Statistics

Conclusions

Export-led growth strategy is based on theoretical and practical evidence, positively related to GDP growth and national income increases. Though a developing strategy was lacking in Slovenia, export-led growth helped the economy to sustain the economic changes after 1991 and to achieve a relative high level of GDP growth for a number of years. Unfortunately, due to the specifics of the privatization process and some other reasons (regulatory and otherwise), the potential of self-induced export, which had led to developmental growth, started to lose momentum around the time when the country attained EU membership. The principal reasons for this loss of potential in export-led development lay in the fact that trade was concentrated and remained concentrated for the most part in the internal EU market. An additional problem has been created by an increase in exports of products based on low level technology. Unfortunately, Slovenian regional policy and the product structure of trade were not strategically based on the implementation of export-led growth policy measures.

The expected recovery of the economy could be faster and more sustainable with the development and implementation of an active national export-led development policy. The projections of current accounts and trade suggest that self-induce growth in trade and the economy will be low and slow. Should a national development strategy be designed, improved incorporation and use of EU common trade policy measures ought to be among the options considered, especially in cases where Slovenia intends to penetrate new foreign markets. EU trade measures, such

as free trade agreements or economic support measures to some countries could be used as a vehicle to drive Slovenian export-led growth in the future.

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MILICA UVALIC⁸

SERBIA'S TRANSITION FLAWS:

WHY HAS EXPORT-LED GROWTH NOT BEEN ACHIEVED?⁹

Introduction

Although export-led growth has been a frequent topic in discussions among academics and policy-makers in Serbia in recent years, it has re-emerged as one of the central issues in the current debate on the future growth model that began some time after the outburst of the global financial and economic crisis in late 2008. Unsatisfactory export performance after 2001 led to an increasing trade deficit, the main cause of the rapidly increasing current account deficit, which by late 2008 was one of the highest in the region. The global financial and economic crisis, which hit the Serbian economy severely from late 2008 onwards, brought up the question as to whether the economic model pursued in Serbia after the political changes of October 2000 has been the best choice among feasible policy options. One of the key issues raised within this general debate is why the new course of transition adopted in Serbia in late 2000 has not ensured better export performance and faster economic recovery.

This paper attempts to contribute to the debate by discussing some of the most important reasons why export-led growth has not been achieved in Serbia. We will start by recalling the main features of the economic policies and macroeconomic performance of the Serbian economy after 2001 (part 2). The paper proceeds to discuss the main reasons of the relatively poor export performance of the Serbian economy (part 3). The central part of the paper deals with some of the main flaws of the post-2000 transition strategy in Serbia, providing further explanation for the disappointing foreign trade performance (section 4). In the concluding section, a few proposals are advanced regarding future policies (section 5).

Post-2000 macroeconomic policies in Serbia:

Achievements and failures

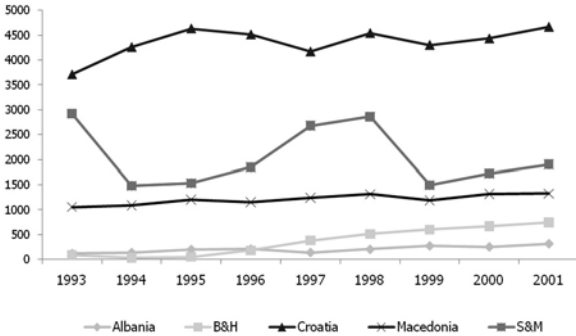
The new course in economic transition adopted immediately after the political changes in FR Yugoslavia in October 2000 brought a number of important achievements. Macroeconomic stabilization was gradually achieved by means of prudent macroeconomic policies, which brought average inflation down from over 90% in 2001 to less than 11% in 2008. The stabilization of prices was a particularly important objective for a country that had experienced several episodes of hyperinflation

⁸ Milica Uvalic is a professor in the Department of Economics, Finance and Statistics at the Faculty of Political Science, University of Perugia

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since the late 1980s. In addition, a relatively strong annual average GDP growth of 5.4% was achieved in 2001-08 (although this was growth, or rather recovery, from a very low base). The improved economic prospects and the normalization of the country's political relations with the outside world also permitted the gradual revival of foreign trade, which had fallen sharply after the break-up of Yugoslavia and the introduction of UN sanctions, and again in 1999 under the impact of the NATO bombing (see Figure 1).

Figure 1- Western Balkan countries, value of exports (million US\$), 1993-2001

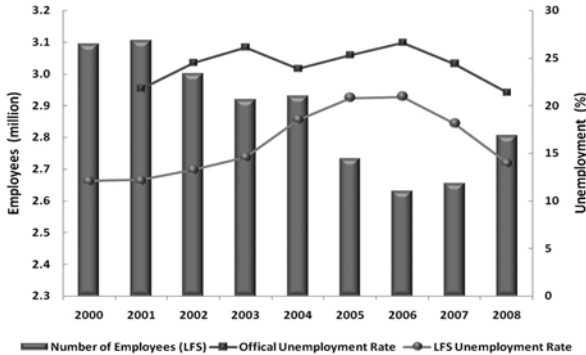


Source: Uvalic (2010), p. 224.

After the 1990s, when Serbia practically had no inflows of Foreign Direct Investment (FDI), it finally attracted quite substantial FDI, especially after 2003; by 2008, the inward FDI stock amounted to over US\$ 19 bn (Kekic, 2010, p. 49). In the meantime, there had also been a notable acceleration of institutional reforms, enabling the convergence of Serbia with other transition economies and its progress towards a functioning market economy. The transition indicators of the European Bank for Reconstruction and Development (EBRD) for Serbia in 2009 suggest a low (2 or 2+) score in only four areas - enterprise governance and restructuring, competition policy, securities markets, and infrastructure - while in all the other areas Serbia has reached or even surpassed the average of all 29 EBRD client countries (see EBRD, 2010).

However, there have also been policy failures. Three longer-term problems deserve particular attention. The first is the highly unsatisfactory situation on the labour market in Serbia, since 2006 all the main indicators have deteriorated. During 2001-06, there was a decline in official employment and high and increasing unemployment, as measured by both the official and the labour force survey rates, while a slight improvement took place only in 2007 (Arandarenko, 2009). The 2008-10 economic crisis led to a further deterioration of most labour market indicators. With such trends on the labour market, Serbian output has clearly been below its potential.

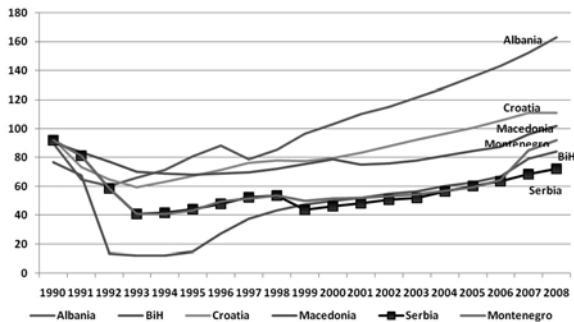
Figure 2 - Labour market indicators in Serbia, 2000 - 2008



Source: Uvalic (2010), p. 152, based on national statistics.

The second failure regards the process of recovery from the 1990s recessions. Despite relatively high growth rates after 2001, according to the EBRD, Serbia's real GDP by 2008 had reached only 72% of its 1989 level.¹⁰ This is the most unfavourable position among all SEE countries (see Figure 3); even a country like Bosnia and Herzegovina, which had war on its territory for almost four years, is in a better position, reaching 84% of its 1989 GDP. More recent data suggest a further setback in Serbia's recovery process. By 2010, after the negative GDP growth rate in 2009 of 3.1% and only mild recovery in 2010, Serbia's real GDP was down to 70% of its 1989 level (EBRD, 2010).

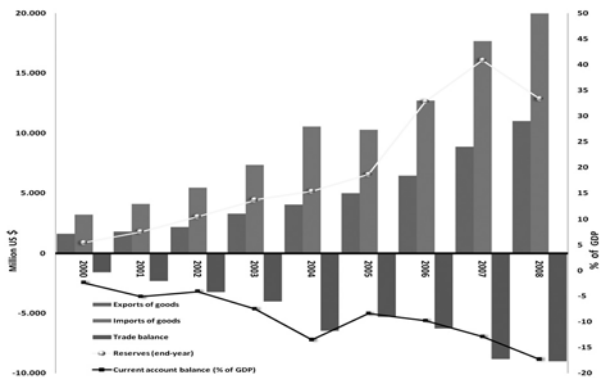
Figure 3 - Real GDP growth in Serbia and SEE countries, 1990-2008 (1989=100)



Source: Uvalic (2010), p. 258, based on statistics of the EBRD.

The third major failure regards the increasing external imbalances of the Serbian economy. Despite a strong recovery of exports from 2001 onwards, Serbia registers a continuous increase in the trade deficit, which in 2008 amounted to 22.6% of GDP. Due to very low coverage of imports by exports, during the whole 2001-08 period the value of imports has regularly been close to twice the value of exports. The trade deficit has crucially contributed to a rising current account deficit, which by late 2008 was one of the highest in the region, close to 18% of Serbia's GDP (see Figure 4).

Figure 4 - Serbia's external sector indicators, 2001-08



Source: Uvalic (2010), p. 156, based on national statistics.

¹⁰ This result must be taken with caution, as it probably reflects some exaggerations of the extent of officially recorded output decline in the 1990s.

After the outbreak of the global economic crisis that impacted Serbia severely in late 2008, declining foreign capital inflows and reduced export demand forced a sharp reduction in Serbia's current account deficit, down to 7% of its GDP in 2009, but the trade deficit remains very high. After the sharp drop in both exports and imports registered in 2009, during the first ten months of 2010 exports grew by 21% while imports by only 8%, to a great extent due to the strong real depreciation of the dinar from late 2008 onwards. The real exchange rate of the dinar with respect to the Euro has depreciated by some 18% from September 2008 to August 2010 (see FREN, 2010b, p. 30). Despite such adjustments, Serbia's very high trade deficit - 16.9% of its GDP in 2009 - remains problematic. The recent strong export growth and more balanced trade account has been taken as a first sign of "export-led growth" in Serbia, but it is yet to be seen whether this trend can continue.

Unsatisfactory export performance

Serbian economists are divided regarding the principal causes of Serbia's unsatisfactory foreign trade performance. One group primarily blames monetary and exchange rate policy, while the other group considers the main problem to be in the real sector, namely supply-side factors and the inadequate structure of Serbian exports. This dichotomy has frequently provoked heated debates among Serbian economists (see Madzar, 2006 or Marinkovic, 2006), although it is a somewhat artificial issue since both are important factors in understanding Serbia's relatively poor export performance during the past decade.

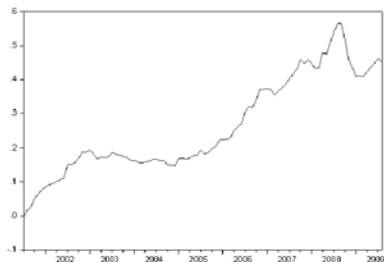
The exchange rate policy applied in Serbia has been subjected to different and contradictory assessments (see Marinkovic, 2006). After the political changes in late 2000, the question of the most appropriate exchange rate regime for Serbia was

an important issue discussed by government officials, and national and international experts. Although the post-2000 regime that was adopted was officially a managed float, initially it was referred to as a “near-pegged exchange rate” (EBRD, 2002, p. 146), since during the first two years the NBS intervened continuously to keep the nominal exchange rate stable vis-à-vis the Euro (Daviddi and Uvalic, 2006). Such an exchange rate policy was criticized as being too rigid, also because it had features typical of a currency board (Marinkovic, 2006). After 2003, the NBS implemented a more flexible exchange rate policy, allowing greater fluctuations of the national currency. In August 2006, the NBS introduced inflation rate targeting aimed at maintaining inflation within a defined target range through the use of the key policy interest rate as the main instrument for reaching the targeted inflation. Although the exchange rate regime remained a managed float, allowing the NBS to intervene in order to limit excessive daily exchange rate oscillations, to contain threats to financial and price stability, and to safeguard an adequate level of foreign exchange reserves (see www.nbs.org), after 2006 the NBS effectively allowed an almost free float of the national currency (Mladenovic and Petrovic, 2009, p. 14).

To what extent has the NBS’s exchange rate policy been responsible for the Serbian economy’s loss of competitiveness? There are a number of theoretical and practical problems involved in attempting to identify exchange-rate misalignments, since various methods provide different results (see Kekic, 2005; Owen, 2010; FREN, 2010a). It is difficult, therefore, to establish precisely how much the exchange rate of the dinar may have been overvalued during this period. Laza Kekic (2005) employs different methods as well as a cross-section model to estimate price competitiveness in 71 economies, including Serbia. These estimates suggest that the Serbian dinar in 2004 was significantly overvalued, by some 30% (see Kekic, 2005).

The movements in the dinar/Euro real exchange rate for the entire period 2001–09 are presented in *Figure 2*, based on estimates by Mladenovic and Petrovic (2009). After the strong initial devaluation at the end of 2000 and the switch to a more flexible exchange rate regime, still in conditions of very high inflation, the dinar displayed a tendency towards strong real appreciation. A large real appreciation was again experienced, particularly after August 2006, when the NBS changed its monetary and exchange rate policy. There was even some nominal appreciation of the currency, the first in a long time, due to large inflows of foreign capital and the almost free float of the currency from mid-2006 onwards (Mladenovic and Petrovic, 2009, pp. 13-14).

Figure 5 - Real exchange rate in Serbia, July 2001 – August 2009



Source: Mladenovic and Petrovic (2009), as reported in Uvalic (2010), p. 146.

Note: The figure depicts the real exchange rate: $(p-epe)$, where p is log of retail price index and $epe = e + pe$, i.e. log of dinar/euro exchange rate (e) plus the log of foreign (EU) price level (pe). Thus an increase denotes real appreciation.

Following the strong depreciation of the dinar that took place after October 2008 under the impact of the global economic crisis, its value against the Euro by August 2010 was considered to have “probably reached a level providing sufficient price competitiveness for the domestic economy” (FREN, 2010a, p. 60). According to recent calculations, although the August 2010 value of the dinar/Euro had approached its real 2005 level, the dinar is still around 10% stronger than it was in 2005 (FREN, 2010a, p. 61). In any case, these adjustments of the exchange rate since late 2008 have clearly helped exports (as reported earlier) and significantly reduced the costs of the 2008-09 economic crisis, when compared to countries with more rigid exchange rate regimes.

Although IMF recommendations to Serbia on exchange rate policy have oscillated between emphasis on controlling inflation and sustaining competitiveness, the IMF has tended to give priority to combating inflation; thus in July 2005, the IMF argued that only non-price competitiveness was the issue for Serbia, although earlier findings reported by Kekic (2005) and others had clearly indicated otherwise.

Therefore, an overvalued exchange rate appears to have been a significant problem in Serbia, influencing export performance negatively, particularly during 2001-02 and again from mid-2005 until October 2008. This was the price paid for some of the benefits of a stronger currency - in combating inflation, increasing purchasing power over imports, and providing a faster catching up process. Other things being equal, currency real revaluation contributes to the catching-up process, as the purchasing power of the domestic currency in terms of imports rises. However, real revaluation has an adverse effect on net exports and therefore on employment and on output growth. On balance, in the experience of post-socialist economies, real revaluation has contributed to the catching up process.

The other interpretation of the causes of increasing external imbalances in Serbia insists that this stems from supply side (“structural”) problems in the economy. According to this view, the structure of Serbia’s supply of goods and services is such that the exchange rate is unlikely to have a significant effect on exports; this implies that a different exchange rate policy would have only endangered price stability,

without beneficial effects that could compensate for this cost (Stamenkovic and Savin, 2002, as reported in Madzar, 2006, p. 110). Other Serbian scholars have sustained that long-term competitiveness of the Serbian economy on world markets cannot be secured with the current economic structure of its exports, without carrying out deeper restructuring in its economy (Petrovic, 2005, p. 110).

There is ample evidence to suggest that the structure of Serbian exports has changed only marginally since 2001 (see Petrovic, 2005; Kovacevic, 2008). Indeed, despite increasing trade volumes after 2001, Serbia's exports structure has not changed substantially; it continues to be dominated by agricultural and low processed manufacturing products. This is primarily due to limited enterprise restructuring over the past two decades. Therefore, slow changes in the supply side have also contributed quite substantially to the rising trade and current account deficit. Moreover, if Serbian products have limited success on foreign markets because of lack of non-price competitiveness - attributes such as design, quality, distribution networks, promotional activities, locations convenience or technical services that accompany the sale of a product - price competitiveness alone will not guarantee an increase in exports.

Without other measures to strengthen the supply side, a different exchange rate policy alone would not have been sufficient to improve Serbian export performance substantially (Uvalic 2011). Achieving export-led growth in Serbia requires not only price competitiveness, but also a deep restructuring of the real sector of the economy. This has been hampered by some crucial flaws in the transition strategy adopted in 2001, which we will now examine.

The flaws in Serbia's transition strategy

The transition strategy adopted by the Serbian government in 2001 was based on priorities which were very much in line with the recommendations of the so-called "Washington consensus". After a decade of highly inadequate economic policies in Serbia, that frequently were reversals of earlier transition-related reforms, the hyper-liberal model of transition was adopted which emphasised liberalization, macroeconomic stabilization and privatization; other important reforms were consequently postponed or totally neglected. Many lessons failed to be drawn from the experiences of other transition countries, the rich experience that had been accumulated by the late 1990s, known as the "post-Washington consensus" (Kolodko and Nuti, 1997). The new consensus stressed the importance not only of the privatization of existing firms, but also of easing the conditions for new entries; the importance not only of the transfer of ownership, but of effective corporate governance mechanisms; the importance not only of markets, but also of active government policies.

Limited microeconomic restructuring in Serbia can be explained by policy failures in several inter-related areas. In the first place, the new privatization strategy adopted in 2001 proved to be unsuccessful, as it was based on over-optimistic expectations regarding the arrival of foreign investors and also postponed the restructuring of the state sector. In addition, a number of other reforms were neglected, reforms that were essential for the improvement of the general business climate, increasing competition, and improved enterprise efficiency.

The core of the new privatization strategy was the new law adopted in 2001, which proposed the privatization of some 2,400 enterprises sold to strategic investors at tenders and auctions. The law encountered serious difficulties in its implementation. Although the initial deadline for the privatization program was 2005, in May 2009 some 535 firms remained unsold (23% of the total), and 272 of these were still “social property”. Moreover, there have also been a number of broken contracts - 420 since 2001 – for a variety of reasons (obligations not fulfilled by new owners, illegal sale of assets, non-payment of wages or social security contributions). Little restructuring has taken place in firms sold to domestic owners and the government has not used the proceeds of privatization to undertake major investments or enterprise restructuring.

One of the main reasons for the delays in privatization is that at the time the new privatization law was adopted, expectations regarding the arrival of foreign investors were over-optimistic. Serbia has attracted substantial FDI in the meantime, but the amounts have not been sufficient to allow for profound restructuring in large sectors of its industry. Indeed, the total FDI stock, around US\$ 19 bn, has actually been lower than emigrant remittances over the same period. Furthermore, while FDI has mainly been privatization-related there have been relatively few Greenfield investments. Of the total FDI that arrived in Serbia after 2004, two-thirds have been in services (telecommunications, banking, real estate, trade), not in manufacturing, therefore mainly in non-tradables. Despite the fact that it is precisely the manufacturing industry that provides the largest part of Serbia’s exports, many industrial firms have not been modernized or restructured. During the 1990s, in most Central East European countries, it was thanks to major foreign investments that key industries were restructured.

The 2001 privatization strategy also excluded some 550 strategic firms which had been nationalized in the 1990s and were set for subsequent restructuring and privatization. The process was initiated only in 2006, after the adoption of the new Serbian Constitution which clarified the concept of public property, thus enabling the corporatization and restructuring of public (state-owned) enterprises. However, the process has proceeded very slowly to date.

In addition to the weaknesses of the 2001 privatization strategy in Serbia, a number of other important reforms were neglected or postponed. Improvements in the business environment have only been gradual, and not in all areas. Regulations governing firm entry and exit have changed too slowly, as can be seen from the World Bank's 'Doing Business' Indicators. Serbia today still has among the worst rankings in "dealing with construction permits" and "closing a firm". The new bankruptcy law was adopted only in 2004, while the procedure for the write-off of enterprise debt was clarified only in 2006. The conditions for firm exit has remained unclear for too long, and there has even been a recent slowdown in *net firm entry*: for every firm closed, 8 new firms were created in 2006, but only 4 in 2008 (see Uvalic, 2010, p. 192).

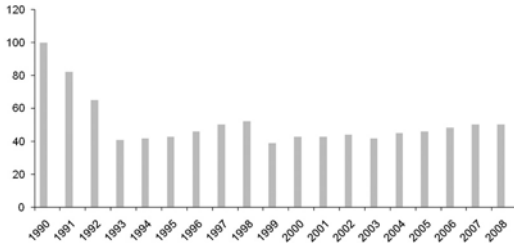
The sluggish rhythm of change in the business environment also derives from the late adoption of laws and institutions dealing with market competition: the Law on the Protection of Competition was not adopted until 2005, while the Anti-Monopoly Commission was set up even later, in 2006, its policies, moreover, have been largely ineffective and require further reforms that are presently in course. Another related issue is the selective toughening of enterprise budget constraints. Government subsidies have remain important for a number of state-owned enterprises in a variety of sectors (mining, transport, metallurgy, textiles, chemicals, construction and wood). Many of these firms are loss-making enterprises that could not survive without government support. Finally, despite the recent adoption of modern laws on corporate governance in Serbia, effective governance mechanisms are still not in place. After privatization, the new domestic owners often lack the skills to run firms efficiently or control management, they do not have a full understanding of the new corporate governance laws or they are not willing to implement them.

Two major consequences of these slow microeconomic changes ought to be highlighted, as they provide an additional explanation of Serbia's poor export performance. The first is the *slow growth of the private sector*. Between 2001 and 2010, the private sector in Serbia increased its share in GDP from 40% to 60%. At the end of 2010, Serbia was one of the seven least privatized economies among all 29 EBRD client countries – Bosnia and Herzegovina and Ukraine had the same share of private sector output, while only four countries were even lower than Serbia (Belarus, Tajikistan, Turkmenistan and Uzbekistan). Paradoxically, the privatization process had actually advanced faster in the 1990s than after 2001, considering that the private sector grew from about 10% of Serbian GDP in 1991 to 40% in late 2000.

The second consequence of limited microeconomic changes in Serbia has been *inadequate restructuring capacity*. By the change of political regime in October 2000, the Serbian economy was in extremely poor conditions. In late 2000, Serbia re-launched its transition-related economic reforms bearing a very heavy burden from the 1990s. One of the most cumbersome economic burdens was its ruined in-

dustry. Most industrial sectors underwent a marked process of de-industrialization during the early 1990s while after 2001 there had been relatively limited recovery, by 2008 industrial production was still at only 52% of its 1990 level (see *Figure 6*).

Figure 6 - Industrial production in Serbia (indices, 1990 = 100)



Source: Uvalic (2010), p.202, based on national statistics.

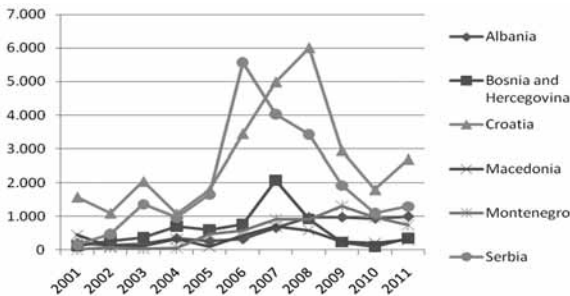
In the meantime, structural changes in Serbia primarily favoured the expansion of services, which have registered the strongest growth rates in recent years, already contributing over 64% of gross value added in 2008. Thus the importance in GDP of the productive sectors – industry and agriculture – had been reduced quite substantially, contributing to a remarkable decline in the share of tradable goods, from 41% of GDP in 2000 to 24.6% in 2007 (Stamenkovic et al, 2009). Such structural changes, strongly favouring services at the expense of industry, have undoubtedly contributed greatly to deteriorating the Serbian economy export performance.

Which growth model for the future?

The global financial and economic crisis has severely affected Serbia, leading to a 3.1% drop in GDP in 2009 (though this is much less than in some other countries in the region). The global crisis was transmitted to Serbia through two main channels: a substantial reduction in foreign capital inflows and reduced demand for its exports. Though a mild recovery is on the way, with GDP in 2010 estimated to grow by 1.6%, the global crisis has uncovered some of the structural weaknesses of the Serbian economy. By late 2008, what emerged was not only the fragility of Serbia’s economy due to the model of credit-driven growth and the resulting high dependence on capital inflows from abroad, but also more general flaws of the transition strategy pursued in Serbia after 2001. The global economic crisis hit Serbia at a moment when many economic problems were becoming unsustainable: consumption much higher than production financed by foreign savings and investment, an increasing trade and current account deficit, an high and escalating unemployment rate, limited enterprise restructuring, insufficient growth in the new private sector, growing problems in many state-owned enterprises, inadequate structural changes that favoured the fast expansion of services.

A study on a post-crisis economic growth and development model, recently prepared by a group of Serbian economists, proposes the replacement of the credit-driven consumption-based model, with a pro-investment export-oriented model of growth for Serbia until the year 2020 (see Group of authors, 2010). One of the main risks of this proposed model is that it relies heavily and rather optimistically on the arrival of substantial FDI over the coming years. Since the peak reached in 2006, FDI inflows to Serbia have continuously declined and registered a sharp fall particularly after 2008 (see *Figure 7*). Despite the remaining privatization opportunities and the expectation of some recovery of FDI inflows in 2011, Serbia cannot achieve faster economic growth by counting excessively on the arrival of foreign investors, but must rely much more instead on its own resources: undertaking investment, modernization, industrial restructuring. Regarding exports, the recent strong depreciation of the dinar and the gradual recovery of the EU economy have already facilitated a fast increase in Serbia's exports in 2010, but more lasting improvements in Serbian export performance must be sought in additional measures. The Serbian government must concentrate on the more fundamental problems of the institutional reforms that have yet to be implemented successfully. Serbia still has a low export base, a largely unmodernised manufacturing industry, and an under-sized private sector.

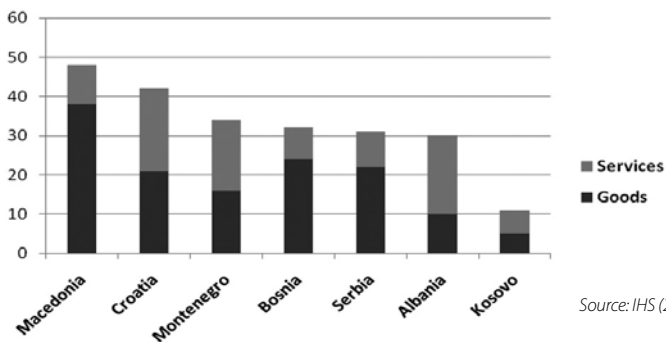
Figure 7 - Foreign Direct Investment inflows in the Western Balkans (million US dollars), 2001-2011



Source: Economist Intelligence Unit, January 2011.

There is no doubt that Serbia ought to proceed with further integration into the global economy, particularly considering that it is still a rather closed economy. Despite the recent gradual increase in Serbia's export/GDP ratio, it remains very low – 22% in 2008 - in comparison to most countries in the Balkan region (see *Figure 8*) and even more if compared to most CEE countries.

Figure 8 - Balkan countries, exports of goods and services, 2008 (% of GDP)



Source: IHS (2009).

What can be done to strengthen the real sector of the Serbian economy and facilitate more permanent export-led growth? Three areas of policy measures are particularly important to facilitate this task. First, the Serbian government needs to implement an industrial policy, not to support national champions but to promote investment, encourage innovation, R&D, protect quality and technical standards, horizontal measures, therefore, for all enterprises that would facilitate restructuring and strengthen and diversify the industrial base. This is very much in line with the current EU approach to industrial policy, as defined in its most recent documents. Second, Serbia needs a much more effective employment policy that would promote wage employment in the private sector. In order to achieve better results in this field, a thorough reform of the taxation system is necessary which would reduce labour costs and increase competitiveness. Third, Serbia needs a more efficient R&D policy that would lead to an increase in investment in science, education, skills, namely in the Research-Education-Innovation triangle, since investing in human capital does seem essential for long-term growth.

All three areas are the direct responsibility of the Serbian government. The global 2008-10 economic crisis has led to a new course in developed market economies characterized by a return to more state intervention, expansionary fiscal policies and more government regulation. Serbia also needs to reinforce the role of the state through more active and better coordinated government policies. Serbia must improve the quality of government institutions, in order to facilitate priority investments, ensure the enforcement of laws, and enable a more efficient collection of taxes and supervision of the financial sector. Without improving government efficiency in these important areas, many economic reforms will remain incomplete. Markets are highly imperfect and will not produce the desired outcomes.

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HOW CAN AN IMPROVED BUSINESS ENVIRONMENT CONTRIBUTE TO EXPORT-LED GROWTH IN SERBIA?

While political stability has been a dominant decision-making factor for international investors in the Western Balkans region in the past, it appears that now the business climate and ease of doing business prevail as the key determinants for foreign investors, and consequently export-led growth, since foreign investment remains a prerequisite for increased export in a developing economy. Serbia is a case in point, and this is confirmed in a survey undertaken in August 2008 by Strategic Marketing Research on behalf of the United States Agency for International Development – USAID¹². Compared to other investment locations, investors found Serbia's main disadvantage (alongside a number of advantages not discussed here) to be the regulatory barriers. The survey concluded as follows: *Regulatory barriers are perceived to be the greatest disadvantage for those who invested in Serbia (48%), followed by the unstable political situation (40%), and with the unstable market as the third factor (33%). The dynamics – before and after 2007 – shows that before 2007 the unstable political situation was the most important disadvantage, while after 2007 it switched places with the regulatory barriers and fell to second position.*

A more recent survey of Serbian exporters, taken in March and April 2011, confirms the perception of business climate as a barrier rather than enabler. The exporters have identified "Advocacy for regulatory reform concerning exporting" as one of the core exporting services, as shown in the table below.¹³

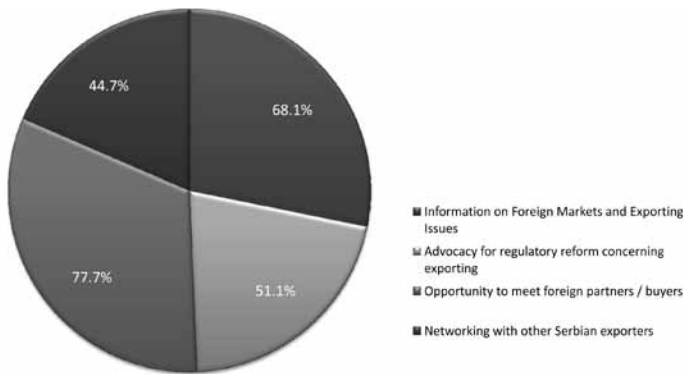
The aim of this article will therefore be to analyze the key regulatory impediments and suggest how the business climate could be improved to facilitate export-led growth. The particular economic context of the world economic crisis will also be taken into account to reflect on the dynamics of the new international trade environment.

¹¹ Dr Ana S. Trbovich is Director, Centre for European Integration and Public Administration and Associate Professor at the Faculty of Economics, Finance and Administration-FEFA, Singidunum University. This article has been produced as part of a research project "Advancing Serbia's competitiveness in the process of EU accession", supported by the Ministry of education and science of the Republic of Serbia, no. 47028 for the 2011-2014 period.

¹² The survey entitled "The Investment Climate in Serbia - Investors' Perspective" included in-depth interviews with high-level executives (who were at the same time key decision-makers on investment in Serbia) from about 120 foreign companies that chose to invest in Serbia in recent years, as well as with a small research control group of senior executives from 13 companies that actively considered making an investment in Serbia, but ultimately went elsewhere. Although the size of the control group is statistically not significant, it is still indicative, especially when comparing the views on the investment climate in Serbia to the perceptions of the target population sample (the main limitation was that respondents are high level executives who are no longer in Serbia).

¹³ "Serbian Exporter Needs Survey Analysis" by Ana S. Trbovich for the Support to Enterprise Competitiveness and Export Promotion Project (SECEP), funded by the European Union in Serbia, 2011.

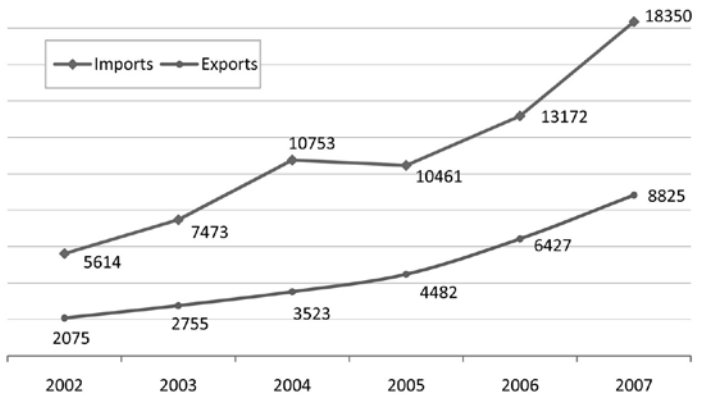
Note: A total of 106 company representatives participated and 96 completed the survey in entirety. The survey results were checked against direct interviews with several company and cluster representatives, all of who remain unanimous to maintain impartiality. This analysis thus pertains to over 100 relevant opinions of current and future exporters



Serbia's Economic Transition 2001-2008

In the period following the change of regime in Serbia in late 2000, with the overthrow of Slobodan Milosevic and the initiation of democratic reforms aimed at the international reintegration of the country, and specifically accession to the European Union, and prior to the onset of the world economic crisis in late 2008, Serbia exhibited very strong growth rates (averaging at 5.4% per year from 2000 to 2008). In the 2006 World Bank Doing Business Report, Serbia was praised as the "Number One Business Reformer in the World."¹⁴ FDI Stock in the period 2001-2007 amounted to \$13.5 bn, while exports increased at an elevated rate (21% p.a. in the period 2000-2008). Nevertheless, the trade deficit was an increasing concern since imports were also rising very rapidly:

Figure 2 - Foreign Trade in Goods (USD mn)



Source: Statistical Office of the Republic of Serbia

¹⁴ World Bank Press Release: "Doing Business in 2006: East European Nations Encourage Businesses with Aggressive Regulatory Reforms; Middle Eastern, African Nations Lag Behind", September 12, 2005, at <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20643009~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>

Integration into international markets was one of the key export growth facilitators, with autonomous trade measures with the EU (enabling duty free exports for most products) in place since 2000 (and confirmed for an indefinite period with the Stabilization and Association Agreement, with the Interim Trade Agreement in force since late 2009), the Central European Free Trade Agreement – CEFTA membership since 2007 - and a number of free trade agreements with other countries, including one with the Russian Federation. Serbia's World Trade Organization accession is expected in 2012, with delays caused by market differences and, finally, by the separation of Serbia and Montenegro in 2006. Serbia's market position is shown below (source: SIEPA):

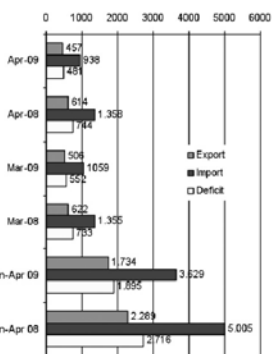


Economic Context: Post-World Economic Crisis

With the onslaught of the Global financial crisis, all the relevant indicators for Serbia were negative:¹⁵ The Stock exchange indices decreased sharply, from BELEXline 4,916 index points in April 2007 to only 848 index points in March 2009; from BEL-EX 15 highest 3,283 index points in March 2007 to only 354 index points in March 2009. The exchange rate showed a nominal depreciation of the Dinar - from 75.75 Dinars to 1 EUR in August 2007 to 94 Dinars to 1 EUR in February 2009 (~ -24%), a result of foreign capital withdrawal and other economic changes.

There was a collapse in external demand. Exports decreased from 2.36 bn EUR in March 2008 to 1.86 bn EUR in March 2009 (25.3% y/y total exports plunge in 2009), since Serbia exports mostly (more than 55%) to EU markets that have been strongly affected by the crisis. Furthermore, while Serbian exports have been improving over the years in terms of value added quality, 60% of all exports have been concentrated in just six sectors and about 65% reached just eight countries, mainly neighboring countries and geographically closer EU members such as Slovenia, Austria, Italy and Germany. The EU undoubtedly remains the key market for Serbia (along with the Western Balkans overall), facilitated by the free trade instruments, which was demonstrated most clearly when textiles were added to the list of freely traded goods not limited by quotas, a factor that significantly increased exports in this sector.

Figure 3 - Foreign Trade in € Million

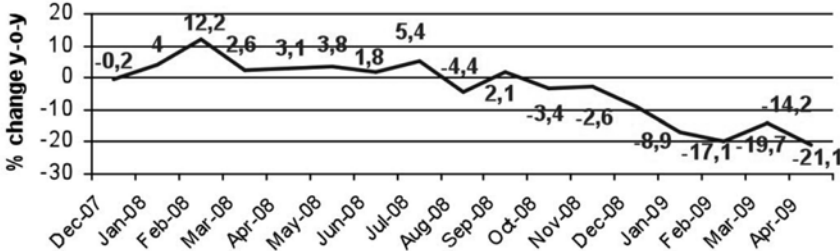


At the same time, a fall in domestic consumption by 4.2% y-o-y in December 2008 increased the

¹⁵ Unless otherwise noted, official Serbian government data is quoted, including data produced by the National Bank of Serbia, Stock Exchange, and Trade statistics.

cost of imports as the dinar continued to depreciate. This was just the initial effect, with imports decreasing in the subsequent period due to a fall in domestic demand and eventually resulting in a fall of the trade deficit, the only silver lining of the crisis, though only in terms of perception and not in real economic benefit. The real effect could be seen in a sharp fall in industrial production.

Figure 4 - Impact of export demand slump on Serbian industrial production



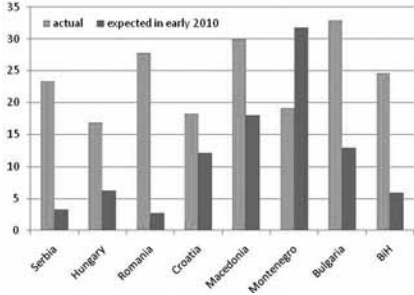
(Above chart indicates y/y change in industrial production)

Other discouraging effects of the Crisis included a 13% decrease in foreign reserves in January 2009 compared to December 2008, resulting from several factors, such as frequent interventions of the National Bank of Serbia (NBS), the trade deficit, etc. Notably, there were reduced capital inflows, and a fall in FDI led to a production cut, lower demand and slower economic growth. Serbia's FDI in 2008 was half the 2006 inflow and it decreased further in 2009 and 2010.

The privatization of major state owned companies stalled, only to be restarted in late 2010 with the announced, albeit failed privatization of Telecom Serbia. Important investments, such as that made by the Fiat group, were delayed. Finally, the unemployment rate increased, in the first period (October 2008 - April 2009) from 14 to 15.6% (according to the official data), and by 2011 it had reached almost 20 percent, becoming a key economic problem.

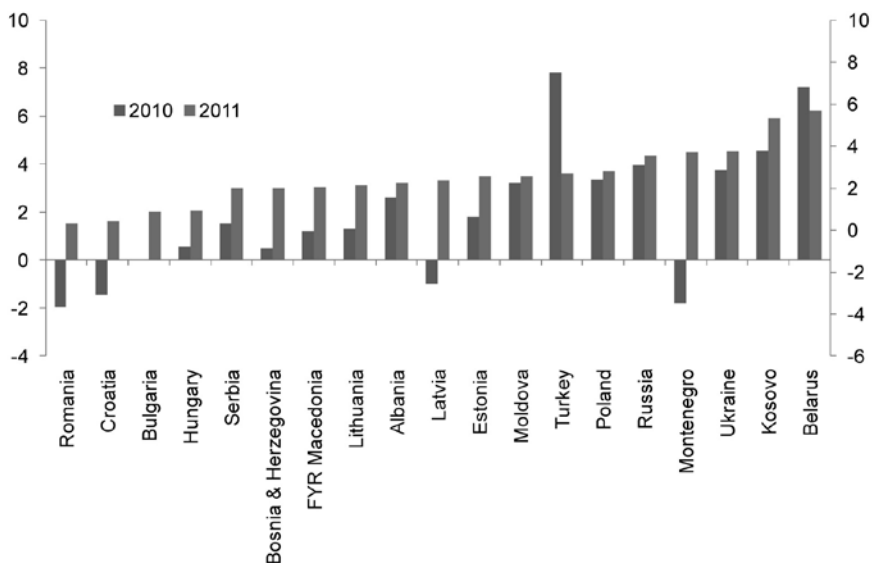
In 2010, Serbia recorded 1.8% GDP growth, which officially ended the recession, with a higher growth of 3% expected for 2011, and potential further acceleration in 2012 and thereafter. The relatively positive economic outlook is based on Serbia's progress on the path to EU accession (official EU candidacy status is expected in 2011 or 2012 based on reform progress), and additional investments that will follow. Serbian exports

Figure 6 - Export growth in 2010, yoy in percent in Euro terms



have been soaring even post-World economic crisis, superseding expectations, although this could be said for most of Serbia's neighbors.

Figure 7 - Emerging Europe. Growth Projections 2010-11 (annual percent change)



Source: IMF, World Economic Outlook, October 2010, and IMF staff calculations

Reaction of the Serbian Government and Economy to the World Economic Crisis

After an initial denial that the world economic crisis would affect Serbia, the Government took action. Notably, one of the key steps was to enter into a serious dialogue with the banking and the private sector. The product of this dialogue was a restrictive fiscal policy and support to savings and private sector loans, especially for domestically produced goods:

- The insured bank retail deposit amount was increased from € 3,000 to € 50,000;
- A temporary suspension of tax on foreign exchange savings income was enforced as of January 2009 (the tax used to be 20% of the savings income) to stimulate savings;
- Similarly, there was a temporary suspension of capital gain's tax (which used to be 20%) and of tax on stocks rights transfer (originally 0.35%) until 2012;
- The government further subsidized the balance between the market interest rate and a more favorable interest rate on private sector loans – totaling 122 bn Dinars (~€ 1.2 bn).

Immediately, in October 2008, the NBS Monetary Policy Committee tightened monetary policy, intent on sending a clear signal to the public that the National Bank remained firmly committed to achieving its objective of price stability (inflation control). Overall, the conservative stance of the NBS since 2000 and tight regulation probably had ensured a more subdued reaction of the financial sector in Serbia to the world economic crisis. In the subsequent period, dialogue with the banking sector continued and some of the more restrictive measures were relaxed to some extent. An agreement was also made with the financial sector to maintain existing credit lines for the Serbian economy in 2009-2010, which will be continued in 2011. The NBS has participated in the wider Vienna Initiative, which enabled further stabilization.

Importantly, the Government of Serbia also agreed on a standby agreement with the IMF to the amount of € 3 bn until the end of April 2011, and received macroeconomic assistance of € 100 million from the EU for 2009.

A budgetary adjustment was enacted in April 2009 to generate budget savings of 100 Bn Dinars (~€ 1 bn), whereby 85% of savings were to be generated by expenditure cuts (decreased expenditure by ministries, public companies and local authorities including cutting the number of employees/salaries in public administration) and 15% by an increase in budget revenue (increased excise duty on fuels, the introduction of excise duty on mobile operators, increased tax on yachts, aircraft and luxury vehicles). The government also announced a possible increase in Value Added Tax, but this was quickly reconsidered. The stability of the dinar exchange rate and foreign exchange reserves were achieved, with € 6.4 bn of domestic savings in June 2010, € 0.7 bn higher than before the economic crisis.

Initially, the Government also considered cutting the working week from 40 to 32 hours and, to facilitate "multilateral" debt, compensation among companies and debt-for-equity swaps to settle pre-privatization tax and other debts for illiquid businesses, but these policy proposals were abandoned.

While the reduction in public expenditure, with special emphasis on the streamlining of the administration, was hailed as a key priority, the government was not consistent in its pursuit of this goal. In contrast to the government, the general managerial response in the private sector, other than streamlining various corporate strategies and policies, was to cut staff, reduce salaries, and reduce marketing and training budgets. Based on research conducted by *PriceWaterhouseCoopers* (PWC) on the human resources (HR) management reaction to the world economic crisis in Serbia (March 2009; on a sample of 22 companies), the following conclusions could be drawn:

- All companies decided to make changes in HR management to respond to the effects of the world Economic crisis;
- The companies assessed planned to decrease: salary costs (42% of companies), costs of corporate events (58% of companies), travel costs (59% of companies), training and development (55% of companies), employment costs (35% of companies);
- To optimize the number of employees, a no hiring policy was introduced by 50% of companies, while 35% of companies reduced the current number of employees (an average -14.6% cut);
- The following measures were taken concerning salaries: salary cuts (13% of companies), salary freeze (43% of companies);
- Budget changes for bonuses were as follows: decrease (60% of companies), freezing (30% of companies), increase (10% of companies with an average rise of 9.5%).

The Business Environment and Entrepreneurship Policy as an Export Facilitator

Business Environment and Entrepreneurship Policy Indicators

Some of the most relevant international economic surveys that can be studied to assess the business climate in Serbia include the following:

- World Economic Forum (WEF) Global Competitiveness Index;
- World Bank Doing Business Report;
- EBRD Transition Report.

According to these indexes, Serbia's business climate ranks very poorly when measured against international standards. In the Western Balkans, Serbia is generally an average performer, surpassed however, by both Croatia and Montenegro.¹⁶ According to the results published in the Doing Business 2011 report, Serbia's overall ranking (89th among 183 countries) improved by 1 position compared to the previous year, mainly as a result of improvements in 2 key indicators: "Closing a Business" (+15) and "Registering Property" (+5). The previous years, "Starting a business" (+35) and "Getting credit" (+8) had improved Serbia's ranking by 2 positions. On the other hand, Serbia has been experiencing a decline in key indicators for two years in a row, for example: "Dealing with Construction Permits", "Paying taxes", "Protecting Investors", "Trading across Borders" and "Enforcing Contracts." Since Doing Business is a dynamic business climate assessment, this would imply that other countries are reforming faster.

¹⁶ For a more thorough analysis of various policies and indicators relating specifically to Serbia and the Western Balkans, see also OECD Investment Reform Index, OECD SME Policy Index, and Jennifer Blanke and Stephen Kinnock, The Lisbon Review 2010: Towards a More Competitive Europe? World Economic Forum, 2010.

| Ease of... | Doing Business 2011 rank | Doing Business 2010 rank | Change in Rank |
|-----------------------------------|--------------------------|--------------------------|----------------|
| Doing Business | 89 | 90 | ▲ 1 |
| Starting a Business | 83 | 75 | ▼ -8 |
| Dealing with Construction Permits | 176 | 174 | ▼ -2 |
| Registering Property | 100 | 105 | ▲ 5 |
| Getting Credit | 15 | 14 | ▼ -1 |
| Protecting Investors | 74 | 73 | ▼ -1 |
| Paying Taxes | 138 | 134 | ▼ -4 |
| Trading Across Borders | 74 | 71 | ▼ -3 |
| Enforcing Contracts | 94 | 94 | No change |
| Closing a Business | 86 | 101 | ▲ 15 |

The World Economic Forum Global Competitiveness Report may be even more interesting for further analysis, since it includes the opinions of business leaders to a greater extent¹⁷, although it is also often criticized for the same reason since it has a significantly higher degree of subjectivity inherent in its assessments. As pointed out in the introduction to this report, the *Global Competitiveness Report assesses the ability of countries to provide high levels of prosperity to their citizens. This, in turn, depends on how productively a country uses available resources. Therefore, the Global Competitiveness Index measures the set of institutions, policies, and factors that set the sustainable current and medium-term levels of economic prosperity.* The World Economic Forum places strong emphasis on policy as a determinant of a country's competitiveness, which are a key prerequisite for exports: "We define competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country". The Global Competitiveness Index (GCI) is "made up of over 113 variables, of which approximately two thirds come from the Executive Opinion Survey, and one third comes from publicly available sources. The variables are organized into 12 pillars, with each pillar representing an area considered as an important determinant of competitiveness: Institutions, Infrastructure, Macroeconomic stability, Health and primary education, Higher education and training, Goods market efficiency, Labor market efficiency, Financial market sophistication, Technological readiness, Market size, Business sophistication, Innovation."

¹⁷ As officially defined by the World Economic Forum – the Executive Opinion Survey is a major component of the Global Competitiveness Report and provides the key ingredient that turns the Report into a representative annual measure of a nation's economic environment and its ability to achieve sustained growth. The Survey gathers valuable information on a broad range of variables for which hard data sources are scarce or, frequently, non-existent. It is conducted annually in 131 countries, the number of respondents increases each year (currently just over 11,000).

According to WEF 2010 Global Competitiveness Report, Serbia declined by 8 places in the overall ranking (from 85th to 93rd) mostly due to a significant fall in macroeconomic stability and labor market efficiency. Another area where Serbia seriously deteriorated is innovation. In the most recent 2011 WEF Report, Serbia fell by another 3 places (to 96th place), now mainly because of stagnation in the reform process (the score remained the same):

- GCI 2008-09 Rank 85th, Score 3.9 (of 134 countries analyzed)
- GCI 2009-10 Rank 93rd, Score 3.8 (of 133 countries analyzed)
- GCI 2010-11 Rank 96th, Score 3.8 (of 139 countries analyzed)

| Global Competitiveness Index (GCI) | 2008/09 Rank | 2009/10 Rank | 2010/11 Rank | 2009/10 Score (1-7) | 2010/11 Score (1-7) |
|---|--------------|--------------|--------------|---------------------|---------------------|
| Basic requirements | 88 | 97 | 93 | 3.9 | 4.1 |
| 1 st pillar: Institutions | 108 | 110 | 120 | 3.2 | 3.2 |
| 2 nd pillar: Infrastructure | 102 | 107 | 93 | 2.8 | 3.4 |
| 3 rd pillar: Macroeconomic stability | 86 | 111 | 109 | 3.9 | 4.0 |
| 4 th pillar: Health and primary education | 46 | 46 | 50 | 5.7 | 6.0 |
| Efficiency enhancers | 78 | 86 | 93 | 3.8 | 3.7 |
| 5 th pillar: Higher education and training | 70 | 76 | 74 | 3.8 | 4.0 |
| 6 th pillar: Goods market efficiency | 115 | 112 | 125 | 3.7 | 3.6 |
| 7 th pillar: Labor market efficiency | 66 | 85 | 102 | 4.2 | 4.1 |
| 8 th pillar: Financial market sophistication | 89 | 92 | 94 | 3.9 | 3.8 |
| 9 th pillar: Technological readiness | 61 | 78 | 80 | 3.4 | 3.4 |
| 10 th pillar: Market size | 65 | 67 | 72 | 3.7 | 3.6 |
| Innovation and sophistication factors | 91 | 94 | 107 | 3.2 | 3.0 |
| 11 th pillar: Business sophistication | 100 | 102 | 125 | 3.5 | 3.2 |
| 12 th pillar: Innovation | 70 | 80 | 88 | 3.1 | 2.9 |

The most problematic factors in doing business for 2010-11 are still corruption, unstable policy and inefficient government bureaucracy. This year, tax regulation became a particularly prominent issue as a result of the continuous struggle with the effects of the World economic crisis.

| 2009-10 | | 2010-11 | |
|------------------------------------|------|------------------------------------|------|
| Corruption | 14.3 | Corruption | 16 |
| Policy instability | 12.5 | Inefficient government bureaucracy | 12.6 |
| Access to Finance | 11.7 | Policy instability | 11.3 |
| Inefficient government bureaucracy | 11.5 | Access to Finance | 9.1 |
| Inflation | 6.7 | Tax Regulations | 8.9 |
| Government instability | 5.6 | Criminal and Theft | 8.3 |

These reports highlight Serbia's economic developmental challenges, which center on the following issues:

- Structural problems – delayed restructuring of public enterprises and slow infrastructure development (including roads, railways, telecoms);
- Property rights and permit hurdles;
- Inefficient competition policy and corruption;
- Threats to political stability (active border disputes);
- Rising skills gap.

Significantly, these problems have been underscored in all reports over the past decade (since democratic change and the beginning of reforms in late 2000), and clearly prioritized in the "Recommendations towards better climate for investing and operating in Serbia" submitted to the newly-elected Government of Serbia by the leading business associations (American Chamber of Commerce, National Alliance for Local Economic Development, Foreign Investors Council and Serbian Chamber of Commerce) in July 2008:

1. Resolving property ownership issues, particularly those relating to construction
Establishment of titles on construction land, resolving expectations related to nationalized property, accelerating the process of commercialization of military property, defining the scope of local government property, resolving of the status of cooperative property, updating property registries, development of special plans, transformation of public utility companies, facilitation of concessions and more efficient protection of intellectual property rights.
2. The introduction of efficient public administration
Simplifying and standardizing procedures, enforcing more responsibility in the operation of public enterprises, creating mechanisms for the coordination of activities of national and local government institutions and public enterprises which are involved in permit processes, introducing the electronic flow and processing of documents, streamlining tax, customs and inspection procedures and building the capacities of Public Procurement Administration and the Com-

mission for the Protection of Bidders' Rights, supported by the introduction of an electronic system of public procurement.

3. Development of the financial market

The revision of the tax treatment of securities, cutting the expenses involved in issuing securities, annulling the limitations on investors relating to the purchase of municipal bonds in order to enable public sale, defining standards in revealing data for municipalities as bonds issuers, issuing new state bonds which would fuel the issuing of municipal and corporate bonds, as well as reviewing the rate schedule of the regulatory authority (Securities Commission).

4. Improvement of the labor market

The harmonization of educational profiles with present and projected economic needs, the modernization of syllabuses, support to programs for pre-qualification and permanent adult education and the liberalization of labor legislation aimed at achieving a better balance between the protection of employees' rights and the creation of the optimal business climate.

The fact that year after year, in the first decade of Serbia's market reforms, international reports highlight the very same problems demonstrates that there has been little action undertaken by the government to resolve these issues. In November 2010, the European Commission also issued a Progress Report on Serbia's Stabilization and Association Process¹⁸ which was more critical than usually, and with Serbia's application for official EU member candidacy status, the long unresolved, for the most part structural problems have now come to the center of public attention.

The Government of Serbia's Competitiveness and Entrepreneurship Policy

Serbia's policy framework, with regard to entrepreneurship and competitiveness (as preconditions for export creation), could be derived from regional documents, such as the European Charter for Small Enterprises (to which Serbia is a party since its inception), the European Union's Lisbon Strategy – Europe 2020 (which Serbia unilaterally applies), and numerous government strategies (over 75 adopted between 2001 and 2010). While the sheer number and relatively ambiguous nature of these national strategic documents (most do not have defined outcomes, and seldom quantifiable outcomes or budgeting forecasts) is often an obstacle to effective policy-making, the overarching goal of Serbia's government unequivocally remains successful EU accession which then also becomes the key policy framework.

If one takes into account the policy priorities outlined in the European Partnership and the annual progress reports on Serbia's Stabilization and Association Process, as well as specific priorities of the Europe 2020/reformed Lisbon Agenda¹⁹ and the

¹⁸ The document is publicly available at http://ec.europa.eu/enlargement/pdf/key_documents/2010/package/sr_report_2010_en.pdf

¹⁹ For more, see http://ec.europa.eu/europe2020/index_en.htm.

European Charter for Small Enterprises/Small Business Act²⁰ with regard to facilitating exports, the following policies should be given precedence in Serbia:

- Deregulation, aiming at simplified procedures, especially in permits and border-crossing, and the introduction of e-governance to render public services more effective and transparent;
- The restructuring of public enterprises, which are not only providing inefficient services, but also distorting market competition and stalling investments;
- Strengthening regulatory bodies, which are crucial for a functional market and a climate of fair competition;
- Focused and intensified education reform to bridge the rising skills gap.

Some specific policies aimed at enhancing exports have also been defined in the Government's Exports Strategy 2008-2011, several of which were identified at the annual Exporters' summits, and also implemented to the content of the business sector.

A World Bank study focusing on the Western Balkans' future development proposes the following policies:

"It points to the need for deeper integration between countries, in order to increase the region's FDI inflows and help to overcome disadvantages associated with the small size of individual country markets. Second, it calls for the developing of human capital as a centerpiece of the country strategies in the Western Balkans – to improve productivity and thereby reduce the handicap of relatively high wages, to help overcome the predominance of low skill content in exports, and to attract FDI. Third, it indicates a need to reduce telecommunication costs, which would improve competitiveness, offset disadvantages associated with small individual markets, and facilitate regional integration. Finally, it calls for action to avoid possible energy shortages, the emergence of which can negatively affect the volume and pattern of investment."

Similarly, the European bank for Reconstruction and Development (EBRD) also underscores the improvement of secondary education as a prerequisite for building a skilled workforce and one of the key factors for mid-term growth. Other EBRD policy proposals focus on price liberalization and an upgraded public procurement system, the finalization of WTO accession, advancing privatization and ensuring the conditions for effective corporate governance for large enterprises post-privatization, additional banking reform and capital market development, improved state aid and competition policy, with enforcement mechanisms to protect against the abuse of market power, and finally the completion of priority infrastructure proj-

²⁰ For more, see <http://ec.europa.eu/enterprise/policies/sme/best-practices/charter/>.

ects such as Corridor X, etc.²¹ In 2011, combating corruption came to the fore of reform priorities advocated by EBRD as well as other relevant institutions.²²

A special policy area that deserves more attention in the aftermath of the world economic crisis is access to finance. However, it is difficult to define specific measures that are different or more effective than what governments generally do to support business (such as those outlined above), and generally this policy area improves if the business climate is improved resulting in a greater attraction of foreign capital. A specific improvement in the case of Serbia and the region of Western Balkans has been the establishment of the Western Balkans Investment Framework (WBIF). Officially launched in December 2009, the WBIF is a joint initiative of the European Commission (EC), the Council of Europe Development Bank (CEB), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and bilateral donors endorsed by the European Council. It has been hailed as “an innovative financing initiative that pools grant resources in order to leverage loans for the financing of priority infrastructure in the Western Balkans. Its scope is likely to expand beyond infrastructure into socio-economic and energy efficiency related areas.”²³ Furthermore, Serbia has benefited from a relatively large EBRD and European Investment Bank loans for the development of research and development capacities.

Finally, the Opportunities and Constraints Study of 12 (Sub)Sectors of the Serbian Economy (tourism, ICT, renewable energy, film and production, construction services, building materials, education, textile and apparel, wood processing and furniture, logistics and transport, auto-parts), undertaken by USAID Serbia Competitiveness Project in late 2007, demonstrated that there are specific opportunities and policy interventions required at the sector-level, as well as some cross-cutting efforts to enhance workforce development and promotion. The promotion policy, including a country’s branding, merits additional attention in any export policy and especially in Serbia which still suffers from a negative image resulting from recent conflicts in the Balkans.²⁴

National Competitiveness Council of Serbia: Business-Government Cooperation

The National Competitiveness Council of Serbia (NCCS) was established to enhance Serbia’s competitiveness, first in 2003 with the assistance of the USAID, but only for a relatively short period (activities ceased with the change of government in 2004), it was re-established in 2008 by government leaders, namely Deputy Prime Minister Bozidar Djelic, who became the President of the NCCS. He expressed the goal of this

²¹ Transition Report 2008, presented by Erik Berglof, EBRD Chief Economist, Serbia Competitiveness Council, November 28, 2008.

²² EBRD presentation in Belgrade, Serbia, by Erik Berglof, EBRD Chief Economist, June 2011

²³ For more, see <http://www.wbifeu>

²⁴ For more, see www.compete.rs

advisory government council to be *“to move up on the World Economic Forum’s list and become of the top 70 highest ranking countries by 2011.”* The more formal objective, as written in the organization’s founding act, became *“to analyze the current situation and propose an annual program for enhancing Serbia’s competitiveness.”* The Council has 33 members, including relevant government representatives at the highest level, representatives of business associations and academic institutions.²⁵

Five Working groups were established in autumn 2009 to render NCCS more effective:

1. Energy Efficiency;
2. Infrastructure;
3. Internal Market Efficiency;
4. Labor Market Efficiency, Human Capital and Innovations and
5. Public Administration Reform.

These groups are composed of government representatives (technical level), academic experts, private sector representatives, and experts from international organizations (e.g. World Bank, USAID, etc). A series of constructive meetings have been held to define initial policy proposals based on World Economic Forum measures; the results have been mixed. On the one hand, the working groups defined and successfully advocated for a set of measures to improve Serbia’s competitiveness in 2010, the Serbian National Competitiveness Council adopted these measures on December 14, 2009 and the Government subsequently adopted the plan of action, with some minor changes, on January 21, 2010²⁶. On the other hand, while some measures were fully implemented, many have not yet been seriously considered or applied. In November of the same year (2010), Serbia fell by three places on the WEF Global Competitiveness Index, which was a further discouragement, though it will take time for policy to show its results in the rankings.

The most disappointing policy results were in the area of streamlining administration, identified by NCCS as a priority, in the regulatory reform framework defined by

²⁵ For more, see the official Internet presentation of the National Competitiveness Council of Serbia, <http://www.konkurentnasrbija.gov.rs/>

²⁶ These policies are in line with the recommendations noted above, and have been defined more specifically, in an attempt to address the weaknesses demonstrated in the international business climate reports. The full text of the recommendations is available on-line at this web address: http://www.konkurentnasrbija.gov.rs/pdf/Conclusion_Government_Competitiveness.pdf. A summary of the measures is noted here: “A total of 38 measures are envisaged in the field of infrastructure, energy efficiency, the efficiency of goods and labor markets, the development of human capital, innovations and the improvement of efficiency in public administration. These are measures that will eliminate administrative barriers to businesses and ensure effective law enforcement, through the adoption of missing laws and improvements in transparency of state institutions. Among other measures proposed is the harmonization of local utility fees in accordance with the practice in the region (since countries from the region compete with Serbia in attracting foreign investment), to prepare the Law on rational use of energy, to encourage investments in innovation and the effective funding of result-driven education. It is also recommended that the recognition of foreign diplomas be facilitated in order to reduce the brain drain, this would include free or minimal payment for the recognition procedure.”

the Government's regulatory reform unit in December 2009. Though the deadline envisaged for this was one year, in December 2010, when the deadline had been surpassed, business leaders were disappointed: based on publicly available data, out of 214 recommendations for improvements to the regulatory framework adopted by the Serbian Government, only 31 had actually been implemented²⁷. The size of the public sector has not been reduced in substance; indeed, some nominal reductions were followed by new engagements in consulting contracts and even full employment. The latest announcement of 100 new engagements in the Pension fund of January 2011 has created a particularly adverse reaction among the public. At the same time, toward the end of 2010, the government took additional measures to increase revenue, namely by imposing high increases in property tax (up to 60%), based on changes introduced to tax regulations.

Two important lessons can be drawn from this experience:

- There can be no significant results if the government is not fully focused on raising competitiveness. Political will is crucial to the economic development of a country. If this argument is turned around, resolute government policy could appreciably facilitate export-led growth. A source of this type of political will could be found in the upcoming elections and a desire to reach official candidacy status for EU membership. Increased effectiveness of the government in 2011 strongly supports this argument.
- Private sector and international expert contribution to the improved competitiveness, and thus improved exports of a country can be invaluable. In the case of Serbia, the interest and expertise provided by businesses and international development agencies' can only be commended, and cherished. Therefore, the work of the National Competitiveness Council should be further supported and encouraged.

According to a recent London School of Economics publication that analyses South Eastern Europe after the Crisis: "The real lesson of the economic crisis seems to be that the days of easy growth are over, and new policies must be designed and introduced to cope with the new realities. These will involve much delayed reforms in some countries, including structural reforms to improve the business environment and competitiveness, as well as institutional reforms to improve the functioning of the judicial system, reduce the shadow of the informal economy and tackle the widespread problems of institutionalized, high-level corruption, as well

²⁷ For more on the government's efforts, see <http://www.srp.gov.rs/srp/default.aspx>. For more on the monitoring of implementation, see activities of the National Alliance for Local Economic Development, which initiated an advocacy campaign for a regulatory reform in Serbia called "Out of the Maze": <http://www.naled-serbia.org>.

²⁸ Will Bartlett and Vassilis Monastiriotis, *South Eastern Europe after the Crisis; A New Dawn or Back to Business as Usual?* (London: LSEE – Research on South Eastern Europe, European Institute, London School of Economics, November 2010), 4.

as embedded organized crime, which in some countries undermines the trust and confidence needed to underpin modern economic growth.”²⁸

The editors of this volume, Will Bartlett and Vassilis Monastiriotis, suggest that a new growth model be considered for Southeast Europe following the world economic crisis, and they accentuate regional trade growth as a possible source of development. Nonetheless, other than reducing red tape, here with an emphasis on border crossings, no new solutions are on the horizon. An improved way of doing business seems to be both the least expensive policy available to the government at present, and the most effective one within the perspective of attaining export-led growth.

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DISTRIBUTIVE CONSEQUENCES OF THE 'NEW GROWTH MODEL' IN SERBIA

It is axiomatic, that always the affluent will hope to use their money power to resist populist demands to have the government help the masses, at their expense'

Paul A. Samuelson, 2000.

Introduction

In this brief paper we shall look at and try to analyze the distributive aspects of the 'New growth model' in Serbia. Here, 'New growth model' is a generic expression for a number of proposals which have been developed since the start of the economic crisis in Fall 2008 and which seem to reflect a wide 'diagnostic' consensus of economic experts in Serbia. In essence, these proposals emphasize the need to make a decisive shift from a consumption oriented, demand and import driven development paradigm to a new, savings and investment-oriented, supply and export driven growth and development model.

The most comprehensive proposal of this type was put forward within the 'Serbian Post-Crisis Economic Growth and Development Model 2011-2020' (Post-crisis model hereafter, USAID et al, 2010), which was publicly presented and endorsed by the Prime Minister in September 2010. Although distributional considerations are not dealt with explicitly, this extensive document gives a lot of clues regarding the changing size and structure of both public expenditures and fiscal revenues conducive to the new model. However, what is clearly lacking is an assessment of likely winners and losers based on these changes. As most programmatic and politically charged documents, it assumes that overall societal benefits far outweigh private costs, which are, in any case, expected to be only temporary. Contrary to this approach, we start from the premise that an honest assessment of winners and losers of reform is a precondition not only to assessing its political viability, but also its impact on economic equality and social cohesion.

The rest of the paper is organized as follows. First, we explain the motivation behind the New growth model and describe the principal features of its most elaborate form: the Post-crisis model. Then we move on to describe concrete proposals put forward within the Post-crisis model regarding the reform of public expenditures and public revenues and analyse, ex-ante, their distributional consequences. We then try to compile a list of population groups which stand to lose from the reform, as well as the likely winners. Eventually, we will show how the proposed reform

²⁹ Mihail Arandarenko is a professor of Labour Economics, Belgrade University and chairman of the board, Foundation for the Advancement of Economics.

within the Post-crisis model is not consistent with the societal values of equality and social cohesion. We conclude with the suggestion that the New growth model for Serbia should be formulated in such a manner as to support efficiency and equity at the same time – which is not the case with the Post-crisis model in its present form.

New growth model

In Fall 2008, the global economic crisis hit Serbia, at first in the form of a mild episode of bank panic. But it soon became clear that the root causes of the Serbian economic problems were not related to the crisis and that they had only been brought to light by the crisis somewhat sooner and in a more dramatic fashion. Faced with a sudden stop in foreign capital inflows, Serbia ran into the archetypical problem of developing countries: a deficit in the balance of payments.

In the last decade, the economic reforms were carried out in Serbia with a dual aim, on the one hand, to achieve substantial increases in both personal and public consumption and, on the other hand, to create the institutional and material conditions for sustainable development through market reforms, privatization and inflows of foreign investment. However, looking at the results achieved over the period 2001-2008, it can be concluded that the reforms were much more successful in increasing consumption than in creating the preconditions for sustainable growth. At 5.4%, the average annual GDP growth rate seems to be solid, but it was still insufficient to compensate for a large development gap stemming from the 90's. However, the most serious problem was the unfavorable structure of the creation and use of that growing GDP, which led to an increasing exports imbalance due to growing foreign trade and balance of payments deficits. The major components of the economic growth were non-tradable services (USAID et al, 2010).

The impact of foreign trade imbalances on economic growth prospects is best captured from the ratio of growth and participation of tradable and non-tradable goods in GDP. In 2001, the tradable goods (roughly agriculture and manufacturing) participated in the formation of GDP with 32%, and in 2008 the share dropped to below 24%. Structurally, this meant a reduced supply of goods for exports and increased demand for imported goods. Furthermore, internal demand and consumption grew faster than GDP - which contributed to the continuous expansion of the deficit in the balance of payment. Such a model is sustainable only if there is a sufficient net inflow of foreign capital, creating the surplus in the balance of financial and capital transactions, and thus covering the current account deficit. This growth is clearly not sustainable once sources of capital account surplus have been exhausted.

The growth in domestic demand (7.5% per year) and consumption (7.3%), until 2008 when the global crisis erupted, was significantly faster than the growth in GDP (5.4% per year). Thus, in 2007 and 2008, the value of domestic demand ex-

ceeded the value of the gross domestic product by over 23%. About 19% of the total domestic demand was covered by the excess of imports over exports, i.e. a deficit of goods and services, which grew by 10.9% per year (USAID et al, 2010).

The well-known remedy for this situation is to shift resources from non-tradable goods and services to capital-intensive tradable goods sectors. The least costly way to do this is to devalue the currency, which would raise the price of tradable goods and services relative to non-tradable goods and services and thus attract resources into the tradable sectors. As long as tradable goods are capital intensive, this would also shift the income distribution toward capital. The fear might be that unions or other wage-preserving institutions would stop relative prices from moving in the desired direction. Without a price-induced shift in resources, the country would have to suffer a recession to reduce imports and raise exports, which would be significantly more costly than a real devaluation (Freeman, 2009).

Serbia was indeed able to reduce the balance of payments deficit through a real devaluation in 2009; however, the adjustment was mostly downward in terms of trade volumes, with a short-term shift to the tradable sectors, which resulted in a growth in export and a drop in the foreign trade deficit. But, the adjustment in monetary policy was far from sufficient to remove all the imbalances and distortions in the Serbian economy. So attention during 2009 moved to fiscal policy – both expenditure and revenue – and to the ‘real sector’. Early consensus among economists on what the basic content of a shift from ‘old’ to ‘new’ growth model would be, is summarized below, in *Table 1*.

Table 1 - New Growth Model in Serbia – Generic Scenario

| Area | Old model | New model |
|-----------------------------------|--|--|
| Main sources of growth | Demand, consumption, Imports; Non-tradables; Services; | Investments; Exports; Tradables; Manufacturing; |
| Monetary and exchange rate policy | Appreciation of the dinar to absorb FDI and remittances | Depreciation of the dinar to lower ULC and boost exports |
| Fiscal policy | Expansionary in good times, led by increase in public sector salaries and pensions | Reduction in public spending and restructuring in favor of public investment |
| Sectoral policies, Institutions | Captured by interest groups | Supportive to sustainable growth |

Since Serbia missed the chance to change its growth paradigm during the ‘good times’, it became clear that the government would have to start structural reforms which would be very painful, requiring sacrifices from a wide range, if not all, of

economic agents and population groups. Under these circumstances, the issues of distributional justice and how the burden and costs of the necessary reforms would be shared would naturally come to the forefront of any public debate or expert assessments. Interestingly enough, distributional issues have not been an integral part of the debate related to the new growth paradigm.

True, in the Post-crisis model there is repeated reference, among the risk factors, to the danger that an increase in unemployment and decline in earnings may lead to wider social problems, political turmoil and a government orientation towards short-term (populist) goals. However, since there is no explicit elaboration on how to handle any potential broader social dissatisfaction, the implicit answer to this challenge is simple – once the optimal model has been found, the government should simply stick to the recipe suggested in the document. Distributional issues are exogenous to the model. Efficiency is the key. The new growth model, based on healthier and firmer foundations, will bring benefits to all, at least in the long term.

This approach is flawed. Distributional issues are not exogenous or second-rated in the Serbian context, or any other context for that matter. On the contrary, they represent a major source of imbalances that have been accumulated over the past decade. In a recent paper (Arandarenko, 2010) we sketched an alternative view of the transition decade in Serbia (2000–2010), in which market reforms and privatization, as they have been conducted in Serbia, are viewed as a gigantic redistributive vehicle, rather than the means of economic transformation and growth. The massive redistribution of income was enacted from the ‘lower’ to ‘middle’ classes, from private to public sector employees, from families with many children to pensioners, from beneficiaries to providers of public services, from underdeveloped regions to the capital city, etc. Fiscal policy – both the regressive taxation of labor and public expenditures directed toward public sector employees and pensioners – was the main, but far from the only, vehicle of this redistribution. At the same time, an even more impressive transfer of wealth was carried out via the privatization of ill-defined ‘social’ property (which was, according to the former ideological fiction, both *everybody’s* and *nobody’s* property), to the closely intertwined political, economic and technocratic elites.

In any case, the Post-crisis model calls for credible medium-term fiscal adjustment, or more precisely a reduction of the fiscal deficit, in terms of a relative (to GDP) reduction of current public expenditures. The fiscal deficit of almost 5% of GDP in 2010 should be reduced to slightly more than 1% in 2015. The main adjustment is to be achieved through a relative decrease (relative to GDP) in current public expenditures, and in a parallel change in structure. Part of that change will be involuntary, since interest payments will inevitably grow due to increased public debt. On the other hand, as part of the new model, the relative share of public investment would have to be increased significantly. Consequently, current public spending

should be cut much more than the fiscal deficit. Since its main components are public sector salaries and pensions, it appears that, given the relatively modest growth rates expected in the first half of the current decade, they would have to be cut both in relative and in absolute terms.

On the revenue side, the main problem will be the relative reduction (as % of GDP) in tax revenues if tax rates remain unchanged. Future economic growth, to be sustainable, requires diverting the economy from imports and consumption towards exports and investment. This will lead to a reduction in the tax base, in areas such as imports and consumption, which will result in reduced revenues (customs fees and VAT) if the same rates are maintained. If the tax rate does not change, it implies that current public expenditure must be cut further to achieve this necessary fiscal adjustment.

According to the Post-crisis model, the extent of fiscal restructuring Serbia is going to face in the next five years will require the introduction of firm legal rules to ensure the adjustment. Legally introduced rules increase the credibility of the planned reduction in fiscal deficit and keep public debt under control. Furthermore, the rules should help maintain the counter-cyclical fiscal policy, i.e. that a country in good times creates a reserve (budgetary surplus), which is then used in bad times. Legally introduced fiscal rules should support these policy goals. There will be two different periods: first, a period of fiscal consolidation, i.e. a significant reduction of deficit and control of growth in public debt (until 2015), and then, from 2016 onward, maintenance of the prudent fiscal position and policy. Thus, two groups of rules are proposed, to match the challenges set: (1) Transitional fiscal rules by 2015, and (2) Permanent rules, afterwards. The transitional fiscal rules should provide for a reduction in the current consolidated fiscal deficit from almost 5% GDP, to approximately 1% by 2015. In order to achieve this, the plan is to reduce the deficit by 0.75% of GDP every year. Taking into account the current public debt in Serbia and the possible impact of greater debt (debt intolerance) – public and external – on the potential crisis and economic growth, the ceiling for public debt is set at 45% of GDP.

The control of public sector salaries and pensions through 2012 has already been agreed with the IMF. The new Pensions law envisages that after 2012 average pensions should be indexed according to inflation plus GDP growth above 4%. Growth of public sector salaries after 2012 also should be limited to inflation plus half the growth in GDP. The share of public sector salaries in GDP should be reduced from slightly above 10% in 2010 to 8% by 2015, and in the same period the share of pensions should drop from some 13% to around 10% of GDP.

Another extremely important shift envisaged within the Post-crisis model is the reform of the tax system, aimed at reducing taxes on labor and increasing taxes on

consumption in order to 'contribute to creating favorable conditions for employment, investment and exports' (USAID et al, 2010). These objectives, according to the model, should be achieved by reducing the rate of social security contributions by a third or a quarter, and increasing the VAT rate by 3 or 4 percentage points. Such a simultaneous change would preserve the revenue neutrality of the tax system, or slightly increase the tax revenues by 0.5 to 1% of GDP.

Impact of the Post-crisis model on income distribution

Let us try to 'deconstruct' the overall distributional impact of the reforms proposed in the Post-crisis model. On the one hand, reforms related to monetary policy and fiscal expenditures, if carried out fully, imply that the distributional coalitions, interest groups and classes which were privileged in the course of the last decade, should voluntarily give up a significant portion of the income and/or resources they control. On the other hand, the reform of fiscal revenues implies that the heaviest price of taxation reform will be paid by the most vulnerable groups. Let us analyze the distributional impact of the model, policy by policy.

In monetary and exchange rate policy, the Post-crisis model envisages tight monetary policy and moderate depreciation of the dinar, as the means to achieve stable prices and to boost exports. However, price stability is a relative category in Serbia and may well imply an average annual inflation of some 5% until 2015. Coupled with a real depreciation of the dinar, that will have negative effects on families on fixed incomes as well as families with foreign denominated debts, including mortgages. Relative winners would, conversely, be families with significant foreign currency savings and families living on euroized incomes. However, the overall impact on income distribution of the new regime in monetary and exchange rate policy is hard to predict – although it appears that the winners already belong to the wealthier part of the population, it is also the case with an important group of losers – for example, those who were able to get a mortgage. Uncertainty is underlined further, since the Post-crisis model shies away from offering any full-blown quantifications and simulations in monetary and exchange rate policy areas. Nevertheless, our assessment indicates that the application of a monetary and exchange rate policy that is conducive to the goals of the new model will most likely have a neutral or somewhat negative impact on income distribution.

Moving on to the new public expenditures policy, it is easy to identify two groups which can be expected to suffer the highest relative losses: public sector employees and pensioners. While families with public sector employees clearly have an above-average position in the income distribution rankings as a group, families with pensioners are widely dispersed across the cumulative distribution line. Overall, the impact of the planned reduction in public expenditures could therefore be assessed as slightly favorable to greater equality, because of a clearly equalizing

effect of a reduction in the relative size of the public sector wage bill, and at best an ambiguous effect on income distribution of a reduction in the relative size of the pension bill.

The most interesting and yet at the same time most worrisome distributional impact is that of the taxation system reform envisaged by the Post crisis model. It was widely marketed as a pro-employment, pro-working poor and pro-export reform (Arsic et al, 2010). Putting aside a rather unusual claim that a revenue-neutral tax reform based on a reduction in social security contributions and an increase in VAT would decisively boost employment and growth, let us focus on its true distributional impact as well as its impact on poverty, using the simplest ex-ante static analysis.

In Serbia, formal non-agricultural employment comprises less than 1,800,000 persons. Compared with a total population of some 7,400,000, this means that less than 25% of the population would benefit directly from a reduction in social security contributions. On the other hand, the welfare losses caused by an increase in VAT will be borne by everyone.

Informal employment is widespread in Serbia. According to LSMS 2007, some 35% of total employment is informal. Such workers tend to have much lower incomes and their families are at much greater risk of poverty. We can assume that around a third of the entire population in Serbia lives in families with no formal employees – note that all families whose head is a pensioner or unemployed or informally employed fall into this category. Such families would, by definition, be absolute losers from the taxation reform – they would suffer immediate welfare losses from higher VAT and would not gain anything from lower social security contributions.

Moving from absolute to relative losers, it is most likely that families with only one formal employee and more than three members will be among the net losers – roughly, the more dependents, such as children, the larger the overall welfare loss for the family. Such families tend to be found more frequently in poorer regions, rural areas, among the deprived Roma ethnic minority, etc. Pensioners and all persons above working age as a group will also only experience losses, and as a consequence poverty among the elderly will increase.

Formal employment is at its historical minimum in Serbia today. Consequently, the number and share of families without formal employees (one of the Laeken indicators not widely used in Serbia) is at a historical maximum. Even in a long term perspective, the absorption capacity of formal Serbia will remain very limited – according to the optimistic projections of the Post-crisis model, by 2020 total employment will increase by a mere 440,000 jobs (most of them formal), the majority of which will be created after 2015.

The overall impact of the Post-crisis model on income distribution within three main policy areas – monetary and exchange rate policy, public expenditures reform and taxation reform – is summarized in *Table 2*.

Table 2 - Post-crisis Model – Ex-ante Assessment of Winners and Losers within the Population

| Policy area | Winners | Losers | Impact on income distribution |
|---|---|---|----------------------------------|
| Monetary and exchange rate policy | Forex creditors; Families on euroized incomes | Forex debtors; Families on fixed incomes | Ambivalent to greater inequality |
| Public expenditures reduction | Population at large in the long term | Public sector employees; Pensioners; Population at large in the short term | Greater equality to ambivalent |
| Taxation reform (lower SSC, higher VAT) | Public sector employees; Families with a higher share of formal employees (e.g. an employed couple without children) | Families without formal employees; Families with a lower share of formal employees (e.g. a single mother with four children) | Greater inequality |

Conclusion and alternative taxation reform proposal

Our main concern regarding the distribution effects of the Post-crisis model relates to the suggested direction of the taxation reform. Our firm conclusion, based on a simple ex-ante analysis, but also supported by micro-simulations, based on the Living Standard Measurement Survey Data, is that a *significant increase in the VAT rate will widen the divide between the first and the second Serbia – one privileged and formal, the other vulnerable and informal*. The impact of such a measure on inequality and poverty could be assessed as ranging from very serious to dramatic, and morally and politically unacceptable.

What should be done in order to make the Post-crisis model more equitable, without losing efficiency gains? We feel that an alternative taxation reform would enhance efficiency and equity in parallel. Instead of centering reform around an increase in the VAT rate by 4 (or 3) percentage points, it should be based on the following pillars:

1. The assumption of revenue neutrality should be abandoned – cutting public expenditures should be accompanied by cuts in public revenue – somewhat milder, to allow for a gradual reduction in fiscal deficit.
2. The introduction of progressive income taxation, which would in terms of tax wedge imply collecting slightly more from the middle class and much more

from the rich (instead of proposing, as in current Post-crisis model, an across-the-board labor tax reduction). A tax-based incomes policy maybe sounds old fashioned, but it is well suited to Serbia's huge public sector.

3. An increase in excise on luxury and harmful goods, such as tobacco and alcoholic beverages, etc.
4. Increase effective (not necessarily headline) tax rate on corporate income.

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A CROATIAN QUESTION: WHY SHOULD INDUSTRIAL POLICY BE SOCIAL DEMOCRATS' PRIORITY?

It could seem obvious, yet I shall offer three answers: because of the global crisis, because of the domestic crisis and eventually because of the crisis of political ideas. Aware that most arguments are not that much social democratic, but mostly commonsensical, I hope they will fit together. Anyway, its other advocates also cannot agree about what social democracy is today, if not just an attempt to agree about common sense in politics.

Why do we need industrial policy?³¹ And who should determine what kind of it? The questions are not rhetorical at all. If production in Croatia is not an EU priority as well as it is not a priority of the Croatian state, whose priority it actually is? Many people would say: If anything should be produced at all, it is to be decided upon by the private sector – this time free of tax and “parafiscal burdens”. Shouldn't we search for an answer in the withdrawal of the state in favour of the private sector? “Simultaneously, with less employees in the state administration, the burdens which are currently slowing down the new business incentives and the creation of new jobs would decrease”, says one Croatian daily's columnist, summarizing his standpoint: “It is presumed that once they are free of burdens, and with a redundant labour on the market, the investors would be encouraged to start new businesses.” (Jutarnji list, 2009).

If we leave behind the cynicism of this policy that acknowledges itself that it does not work without “redundant labour on the market”, what makes such “presumption” problematic? Immanuel Wallerstein explained it nicely: “There's the little problem of what Keynes and Kalecki wrote about – effective demand. In any medium-run calculation, if there are not enough customers, there will not be enough sales, and very soon the profits will dry up. The industries that are increasing their profits by reducing their work force and squeezing their remaining labourers are going to have surging profits for a very short run until they run into the hard brick wall of serious deflation. And then they'll crash. Can't they see this? Sure, some can, but

³⁰ Milan Živković is the Secretary of the National Policy Commission of the Social Democratic Party of Croatia and the President of its Culture and Media Policy Commission. He is also the Director of the social democratic Political Academy New Society.

³¹ The term “industrial policy” refers here very broadly to any strategic behaviour of the government with regard to economic activity. These activities include even “cultural industries” like audio-visual services, tourism and agriculture – not just manufacturing of internationally tradable goods. Even the absence of any evident “no, we're not going to deal with it, but cut the taxes and let everything to the business sector” government policy is, of course, an industrial policy as well. However, it is a quite aggressive one. Giving up the possibility to record and strategically/in sustainable manner utilize local resources in favour of the active, future and pension generations – well, that exhausts the same resources at an accelerated and inefficient manner, while just redirecting the profits to the few and/or elsewhere. Such approach, to say the truth, could favour the owners of some corporation or perhaps – I would agree – even workers too, but the majority of the inhabitants of certain territory are likely to experience unemployment, debt or higher prices.

they (...) hope they'll escape with their personal profits before the whole industry collapses. Good luck!" (Wallerstein, 2010).

The Age of Stimulus:

Why do We Need an Active Policy to Overcome the Crisis?

"There were good grounds for some of the disillusion with state-managed industries and public administration that became so common in the 1980s. (...) Nevertheless, the mere belief that business was good and government bad (in president Reagan's words 'government was not the solution but the problem') was not an alternative economic policy. (...) In any case most neo-liberal governments were obliged to manage and steer their economies, while claiming that they were only encouraging market forces."

Eric J. Hobsbawm: The Age of Extremes, 1996

"Barack Obama said in 2009 that the government must make 'strategic decisions about strategic industries'. His stimulus plan last year earmarked bn for innovation in sectors such as renewable energy, high-speed rail and advanced vehicles. Japan's prime minister, Naoto Kan, said in April that the government wanted to create a new 'Japan Inc', deepening the links between business and the state. In June the Ministry of Economy, Trade and Industry (METI) announced a strategy to combat the 'increasingly aggressive' industrial policies of America, Britain, China, France, Germany and South Korea."

The Economist: The Global Revival of Industrial Policy, 2010

Promoting 59 bn dollar government investments in the clean energy and technology in March 2009, the American president Barack Obama used effective synecdoche (part for the whole). Among others, he gave an example of an insulated-windows manufacturer. "Last year, that factory was shuttered and more than one hundred jobs were lost." The whole picture is much worse: "We've lost 4.4 million jobs since this recession began." And then, because of the government's measures, the same factory "is rehiring the folks who lost their jobs. And these workers will now have a new mission: producing some of the most energy-efficient windows in the world." The other examples include manufacturers of more reliable solar-energy technology, energy-saving computer chips, and batteries for electric vehicles as well as construction companies refurbishing office and school buildings to be more energy-efficient. These examples speak for all government policies: "My administration has begun implementing the American Recovery and Reinvestment Act, which will create or save 3.5 million jobs - and 90% of those, will be in the private sector."

On www.recovery.gov we may track the increase of jobs supported by the law. Although such number will hardly reach the optimistic announcement given by the President, which his opponents will probably often gloatingly remind about, it is important to clearly see the goal: employment. In fact, the word is about the

nominal amount of 787 bn dollars for stimulation of employment, investments and spending, which the American Congress approved in 2009 based on the mentioned Act. Such so-called stimulus foresees investments in infrastructure and energy, science and education, tax relieves, support to the poor and unemployed... in the amount of 2% of the American GDP (IMF, 2009: 18). The other highly developed countries showed similar antirecession gestures: Great Britain with the amount of 1.4 % of GDP (in 2009), Germany 1.5, Japan 1.4, and Spain 2.3 etc. (Drezgic, 2010: 204). With somewhat different accentuation – “trust” instead of “employment” – the European Economic Recovery Plan foresaw the stimulus in the amount of app. 2 % of GDP in 2009 and 2010. Among the transition states, the Czech Republic and Romania preceded (Roeger and in ‘t Veld, 2010), and the newspaper articles recycled the phrase that the American President said some forty years ago, saying that we are all now Keynesians – again.

One of them, John Kenneth Galbraith, did not live to see our crisis; however, studying the previous ones made him sure about the simplicity of the political antirecession alternatives. Taxes can be reduced, writes Galbraith père, but nobody “is believed to be so inclined to desuetude, so aroused by the prospect of mere income, as the affluent taxpayer” (Galbraith, 1997: 36). Interest can be decreased, although “it may have little or no effect on the flow of aggregate demand” (Galbraith, 1997: 38), because “the broader perspective is too much insecure”. Eventually, “the government can contribute directly to flow of demand by new expenditure in excess of tax receipts – by deliberately accepted or deliberately increased deficit” (Galbraith, 1997: 36-37). Now, if we want such deficit to represent anything but an additional burden to the new generations, the antirecession stimuli must not be intended for financing of the current state expenditures. In other words, we need industrial policy. If that means insulated-windows, all right. If it means production of renewable energy, the better; but in any case, it must be clear that the discretionary decision about deficit financing is intended for the (economic) activity that encourages future wellbeing and economic growth.

In the economic crises the markets cannot offer an answer to the core question of capitalism – what should be produced? Namely, at the time of the economic crises the markets keep silent, which is also the definition of crisis. The honourable investor is “in big trouble”, even the lower interest rates are not of much help. Does he want lower taxes? Of course, but it still does not mean he is willing and has an idea of where to invest. Who is going to show “the investment direction” to our “responsible investor”? Where do the future profits hide? In new models of mobile phones? Insulated windows? Marketing? Public transport? Financial operations? Quality food? With all reasonable doubts about our ability to solve the problem collectively, we shall hardly find a more reliable framework than the developmental

state. Or maybe even the developmental region or town³²; but, someone has to make a list of common resources, assess their potential and merge two of them by an investment line of industrial policy.

Whole such factory revival as well as rebalancing of the national economies away from finance and property (see *The Economist*, 2010) and closer to the production and thereto related services has, of course, not ended without various opinions, or attempts to use stimuli for the bank bailouts, or fierce criticism from the left and right. The latter summarizes the traditional ideological “red card” that the state receives from the editorial board of *The Economist*. It all can seem very reasonable, theoretical and proven in practice, but such a historic passiveness can always tell that “the governments rarely assess the expenditures and benefits correctly”³³. Of course, the left criticism is not attacking the stimulus itself, but its possible delay, small scope or certain structural indecisiveness. Even if we leave all money intended for the rescuing of banks aside, you do not have to be Paul Krugman to see “strayings” in all recession plans, in the form of concessions to the rich trapped by liquidity.

How do you call “stimulus” in Croatian? – We don’t, because there isn’t one. The entire absurdity about staggering of the majority of the Croatian business community, the supporting media, economic “experts” and actual Government advised by all of them, is only an illustration of the campaign at the beginning of 2011 which announces *30 projects searching for their investor*. “Many potential investors gave up long time ago because of the bureaucracy. How could they be persuaded to change their mind?” wonders one Croatian daily in the genre of its 13.8 bn Euro *fantasy* (one third of GDP (Jutarnji, 2011)). “A paradox of fiscal policy” in most transition countries whose space to manoeuvre has been limited by their previous debts, warns the young economist Sasa Drezgic, is that “the share of the public spending in GDP rises in times of conjuncture, and falls in times of recession” (Drezgic, 2010: 208). Instead of balancing their spending and their production during the good times, and now

³² Or maybe, for member-states, European Union? “Now more than ever, Europe needs industry and industry needs Europe,” proudly declares European Integrated Industrial Policy (European Commission, 2010:3). The advantages, i.e. disadvantages, of the narrower, local, or broader, national and supranational focus, have been obvious. Namely, all resources and all future jobs are local, whereas more significant amount of money and coordination are on the national and supranational levels. The same as it was at the time of those “original” Keynesians. What should this time be taken into account are crises in the 1970s and 1980s. If all dimensions of oil shocks, interest crises and currency wars could be reduced to one moral, such moral would be: inability of the national economy. Regardless of how difficult it is for us to accept it, as precisely warned by Hobsbawm, the state-nation has not been the place of the Keynesian consensus ever since. Do we have to look for a new “state” on the global or local level, by creation of more food and energy sustainable communities – or do we have “to break down the antisocial conspiracy” on the level of the state-nation? – this will probably be a matter of dispute for a long time. What seems certain though, is that there is still a need of and possibility to make the collective answer to the question what should be produced?

³³ Criticizing the Economist, Steven Ezell suggests that “it would be more constructive to envision a continuum of government-market engagement, increasing from left to right in four steps from a ‘laissez faire, leave it to the market’ approach to ‘supporting factor conditions for innovation (such as education); to going further by ‘supporting key technologies/industries; to at the most extreme ‘picking specific national champion companies; that is, ‘picking winners’” (Ezell, 2010).

using stimuli³⁴, the transition *deficit hawks* literally compete whose *cuts* will be more *painful*. IMF's new Neo-Keynesian face, if existing at all, is clandestine from the transition perspective: the West is just encouraging the cuts. As with the crisis on the Balkans backyard of Europe, we shall see that there is nothing new in it.

Huge Problems and Disturbances³⁵

“In the period from 1500 and 2000, Croatia had just two short periods - we shall call them episodes - during which it “caught up” with the developed countries. That was between 1870 and 1913 - when GDP per capita multiplied 2.3 times, and between 1950 and 1980, when it mounted up four times. About that fact we should give ourselves a proper think, analyse it and learn our lessons.”

Gordan Druzic: Croatian Tropic, 2004

“Postponement of understanding the hazards of such an extensive development and its limited resources was possible as long as the excessive sources of spending and external loans has not reached and went beyond our capacities.”

Starting points of the long-term policy of economic stabilisation, 1982

If the decades after 1973 – an era of decay of the nation-state's economic power – meant a period of more or less awkward failure and fix of social consensus (Hobsbawm, 1996: 403), the crisis hit ex-Yugoslavia in a more than obvious manner, though some years later. The Breakdown of the Bretton-Woods regime, the Yom Kippur war and the first oil shock - when the price for a barrel went from three to twelve USD in the last three months of 1973 – Yugoslavia passed through these crises quite painless, mostly thanks to “friendly” oil from Libya. However, the offer of cheap credits in petro-dollars was much harder to resist. External debt rose from just 1.2 bn USD in 1971 to significant 20.8 bn in 1981. Although a lot of people around still remember the seventies as - in their memory maybe the only - era of progress, social mobility and general optimism, all of it turned to be very tricky when the second oil shock struck in 1979 (40 USD per barrel), followed by FED's rise of the price of the dollar and the interest rate (from 8 to 22 % between 1980 and 1982). Countries in development then started to export everything they could. Agricultural products, crude materials... what else - whose prices sunk even more, because of that collective export-offensive. It was in the beginning of the eighties when such a sad anecdote spread, the one with the message from the worker of

³⁴ “Spend now, while the economy remains depressed; save later, once it has recovered. How hard is that to understand?” writes Krugman in one of his most effective activist-contributions to the new developmental paradigm, “But if we need to raise taxes and cut spending eventually, shouldn't we start now? No, we shouldn't. Right now, we have a severely depressed economy - and that depressed economy is inflicting long-run damage. Every year that goes by with extremely high unemployment increases the chance that many of the long-term unemployed will never come back to the work force, and become a permanent underclass” (Krugman, 2010a).

³⁵ “An outline of report on activities of Alliance of Communists of Croatia and its bodies between 10th and 11th congress”, cited according to Duda, 2010: 387.

the Zastava Kragujevac car factory which a buyer of the “Yugo”, that undesirable symbol-car, found later on a piece of paper in the broken car-door: “My payment is like your compartment”. Well, in period 1980 - 1983 “payment” fell to the end of sixties level, in real terms (see Druzic, 2004 and Duda, 2010). The story about political elites hiding the crisis not to spoil the last days of Tito and not to add fuel of economic crisis to the fire of the Yugoslav coat of arms belongs probably to the local mythology.

Today we know that it is all about indigenous inability of most constituents of business, economic sciences and political elites to admit that the crisis is not just a temporary disturbance in their careers that have just started to develop. (“There was no need to change the policies that had served so well for a generation,” Hobsbawm, 1996: 408). The fact is, however, that the collapse of the whole developmental model based on external debt, was for at least two years ignored with legendary euphemism: “The situation is complex”. The first counter-measures were prolonged until 1983. Although Yugoslavia, of course, was not among the worse cases of debt crisis – Brazil, Mexico and Argentina with 60 to 110 bn USD of debt – but among some thirty countries in the middle category, the International Monetary Fund scenario was there for it. The IMF’s domestic proponents were not proud owners of “expert’s” tags at the time. The idiom of the era set them with the quite unpromising title of “federal commission”. “Austerity” and “fiscal discipline” was not titled “stand-by arrangement”, but “long-term economic stabilisation program” at the time. But everything else was pretty much the same. Open call to restructuring by privatisation was not possible in socialism, but the market was for sure precisely recognized as “a precondition to development of the system of socialist self-determination” (Duda, 2010: 30). The Fund was, like in Stiglitz’s classic analysis, taking in account just the account balance, not the real life. Actually, at the decade’s end, the only positive outcome of the long-term programme was the improvement of the external trade account deficit: Almost 90% of imports were covered by exports. However, as noted by the Croatian economist Gordan Druzic, “there were lots of negative consequences for the Croatian economy stemming from the fact that the improvement of the foreign trade balance was mostly thanks to the decrease of imports and not to the increase of exports” (Druzic, 2004: 38). The Fund entered collective memory with odd rationing of car-fuel, comical shortages of coffee and light bulb - supplies (or it was dark just because reductions of electricity?), and certain sort of “sugar-bars” instead of chocolate-bars on the shelves of supermarkets just recently opened. Now, for a long time silent factory-buildings remind of the first shortages of raw materials, yet an interesting aspect of stabilisation instead of industrial policy was outlined by the theatre-artist Zlatko Buric in his recent Diary of a Railwayman. It reminds us on ultra-modern high-speed train, produced domestically and called Silver Arrow. That kin of Japanese Shinkansen and peer to French TGV, produced in Slavonski Brod, was namely stuck at the prototype-stage. Import

restrictions of Yugoslavia in the eighties prevented the supply of a minimum of necessary parts. Three trains of futurist design (even for today's taste) were powered by totally inappropriate tank engines, which broke all the time. The trains were riding just because of the enthusiasm of its designer-engineers, who were repairing it at the rail, during their travel, resisting for a moment the "bigger and bigger technological decline and lack of innovation in the manufacturing process (...) as a result of the stabilisation programme" (Druzic, 2004: 38). To make bad thing worse, unemployment was swept under the carpet of an already unproductive economy. As investments declined, all workers coming from the village or the classroom has to be swallowed by the existing companies. The total number of employed grew 15% during the decade, while the domestic production stagnated. Gordan Druzic suggests that managerial performance of self-managed companies was measured more by number of the newly employed than by the financial records. It is not my intent to speculate here about the social cost comparison between real and hidden unemployment. Likewise, it will be inappropriate to compare such policy of socialist instinct of full employment with the recent, for example, German agreements on shorter working hours to preserve jobs during the crisis (Kurzarbeit). The fact is however that ever since 1980 the politics and economy of Croatia have been unable to find a job for some half million of its workers. At least in the case of 1980s stabilization program, IMF did not show any intent to help them.

Under the Auspices of Expertise

"If production costs of an item produced in Croatia were 4 HRD (HRK nowadays), and the price of the same item in Germany was 1 DM, the relation between the prices in Croatia and Europe would be determined by the exchange rate. Should the exchange rate of DM be five HRK, the price of a German product on the Croatian market would be five, and of a Croatian one four HRK. Thus, the Croatian product on the domestic market would be more competitive. On the other hand, the price of the German product on the German market would be 1 DM, and with the exchange rate of 5 HRK, the Croatian product on the German market would be 0.8 DM. The Croatian product in Germany would be more competitive. Unfortunately, the exchange rate of DM is "fixed" at 3.7 HRK, with minor deviation. The consequences of such a low exchange rate were that domestic products have become expensive, both on domestic market as well as on foreign markets, while imported products have become cheaper in Croatia. The import has been growing faster than the export. Due to the unfavourable exchange rate, the structure of the export has been changing – from more complex to relatively simple products."

Ljubo Jurcic: Croatia. A Great Transformation, 2009

"Should we look for the main reason for negative tendencies in Croatian economy, especially since 1994, then, in the first place, it is macroeconomic policy whose main goal was stability of prices and exchange rate, and not the development."

Gordan Druzic: Croatian Tropic, 2004

“What will you do with the economy after winning the elections?” – “Well, open (insert here a really huge number) of new workplaces,” – was a standard answer by a politician in the transition country during the 1990s – given the fact that someone actually cared to ask for the economy in 1990s. That motto was relatively sufficient until recently, when it was replaced by the rhetoric of painful cuts and dismissals. If the journalist was really hostile asking “how do you plan to achieve that goal?” a few of most successful (actual election winners) were prepared: “Obviously, by abolishing the administrative barriers and creating a positive environment for FDI, especially greenfield investments, together with encouraging SME’s!” (Adding “old crafts” from time to time.)

Even before I became more familiar with the work of Jozse Mencinger, a renowned Slovenian economist who argued against FDI in transition economies – I was convinced that Croatia is not Hungary and that “greenfield” and “export oriented” will not work. As far as SME’s are concerned, I had a privilege to discuss with Ljubo Jurcic, who was former minister of economy and the social democratic candidate for PM in spe. No way, he said, sharing with me the example of the Slovenian Government, which was not interested in selling Gorenje, the Slovenian manufacturer of home appliances. German Siemens - which was ambitiously acquiring similar factories in the Central and Eastern Europe, laying off thereafter a significant number of workers and retaining quite a few, introducing new technology, and only then selling the factory to a multinational with a powerful design and marketing – was ready to offer more. And even more. Luckily, Slovenian economists and politicians were not bluffing. They argued, according to Ljubo, that many Slovenian families, in their backyards, assemble parts of future Gorenje washing machines. Until, together with Gorenje, they do not switch to digital programmers (i.e. “higher level of competitiveness”), we will not be able to talk about “restructuring by privatization”.

Following the principle *first things first* in neighbouring Croatia, the war in the nineties put the industrial policy off the agenda. In the same way, crawling interethnic conflict dominated the political agenda of the decade before. We could not have an authentic development policy until we settled our complex relationship with Belgrade, then we could not have it until we regained our freedom, but why we could not have it afterwards? On one hand, the answer to that question should be looked for in the “negative heritage of our past system” (always described quite easily, as with amnesia, and as if that yesterday’s soup was cooked without any Croatian ingredient), in the vast collapse caused by the war, and on the other hand, in the stabilization program which the Croatian Government adopted on 4th October 1993.

The result of such policy of imbalance between (lower) domestic production and consumption is most visible in the constant growth of current the account deficit that “pumped” the foreign debt in 2009 to more than 43 bn EUR, i.e. 95% of GDP (HNB, 2010). Steady retreat of production can be illustrated by the fact that in over-

all export of transition countries Croatia's part has decreased from 3.2% in 2001 to 2.9% in 2006, whereas export of complex products has been replaced mainly with raw materials (Jurcic, 2009: 746). Instead of producing furniture, for example, we mostly just export wood! Only beverages and tobacco have a positive balance. And food is another story. Cereal production between 1985 and 1989 compared to the period between 1995 and 1999 decreased from 3,826 to 3,086 thousand tons (Druzic, 2009: 328).

What happened to those apparently employed in the eighties? They are, of course, not "hiding" somewhere in the "factory circle", since most of the neglected factories have been replaced by shopping malls. "Guys in blue caps", as the popular rock group Haustor announced in the eighties, "have hit the road". Those who survived the war became redundant, early retired or simply long-term unemployed and socially excluded. In the same way, the Communist Alliance of Croatia (SKH) concluded about "huge problems and disturbances" in the eighties, and "quite a comprehensive book or two could and actually has been written about war and privatization profiteers".³⁶ Since it is quite widely and in the same time quite precisely understood that these processes have negatively influenced the development perspective of Croatia, I will here focus on the relatively concise view of the fiscal and monetary policy of the Croatian National Bank, based on the analysis by Ljubo Jurcic, Gordan Druzic and Stjepan Zdunic. To ignore its pro-recession effects is also quite widespread. Certainly independent when interests of Croatian society are concerned, the policy of the Croatian National Bank is often described in the private media as "the only light" on the dark transition horizon, and its governor, Zeljko Rohatinski, as a kind of a superhero known by its nickname "Roha" ("His colleagues remember that nobody wanted to take the exam together with Roha because nobody could beat him. He was also given the Zagreb University Rector's Award"; Globus, 2010; see Perisic, 2010).

Becoming a part of the brave, new world of the global market, the transition economy desperately needed to replace the old protective measures (customs), at least to some extent, with the exchange rate – most Croatian development economists go along with Mencinger's policy. Jurcic argues that "the exchange rate is the strongest economic policy instrument". It is even more important for small, open countries that naturally depend on export. Starting with the Stabilization programme in 1993, Croatia gave up the exchange rate as "the most powerful instrument, trans-

³⁶ "This generation is certainly a crisis generation", Communist Alliance of Croatia not at all optimistically concluded in its Annual Report in 1989 (Duda, 2009: 387). Gordan Druzic in his analysis shows that the "Croatian economy is in crisis that has been constantly increasing, sometimes in leaps, during the last 30 years". With many evidences for that, his books contain a precisely documented war and privatization "damage list". Let me hereby mention only a comparison of total costs of bank rehabilitation, that "main instrument of robbery and devastation of Croatian economy", which is estimated at more than 10 bn dollars – and public income from selling the same banks: 3.9 bn, but HRK, not dollars. "How could have that happened?", the usually quite calm author doubts, "would not it have been smarter and cheaper just giving the banks to new owners together with, let's say a 100 million US dollars 'just as allowance?'" (Druzic, 2004: 97).

forming it into the aim" (Jurcic, 2009: 748). Why should the exchange rate be the instrument? – It was supposed to preserve domestic production and employment, of course. It was supposed to give a chance for surviving, like Slovenia provided for Gorenje washing machines and the subcontractors. Zvonimir Baletic and colleagues (Radosevic, 2010: 22), also notice that Croatia has given up on that possibility, leaving its transition *Enterprise* – already shaken by the meteor rain of debt crises in the eighties and privatization during nineties – without any shields against a heavy attack from the imperial *Borgs* and their local compradors (see Vujic, 2009). Anchored to German mark and, afterwards, to the Euro – at a level that abolishes the competitiveness of the domestic production – the exchange rate was created for import dependant elites who defend it by all means. From spreading fear among citizens encumbered by loans to creating illusions that middleclass aspirants will develop thanks to a stable exchange rate, the rhetoric remains the same: "If Roha falls, property loans will break down!"; "Look at the prices – they will increase if the kuna falls and inflation will be on the way!" the columnists in the daily newspapers shouted out loudly (Jutarnji, 2010a, Vecernji, 2010), while dr. Darko Polsek warns: "Inflation is opium for the masses." (Obucina, 2010). If some trade unionist, without any real chance for electoral positioning asked whether the currency clause is in accordance with the Constitution since Croatia has its national currency, they will not wait to make a threat: "Banks will increase interest rates!" (Jutarnji, 2010a).

Let's leave the question of whether it is possible to increase interest rates even more in a recession and in a country, where the interest rate spread (the difference between interest rate that you pay to the bank and pocket money that bank is paying to you) is the biggest in Universe, anyway (Druzic, 2004:109). Seriously, why are interest rates we pay that high?

Besides the bank earnings, the main reason for that are high foreign currency reserves needed for the "protection" of the fixed exchange rate and the interests of importers. "Most people believe that money reserves belong to the state, i. e. Croatian National Bank", Druzic explains, "but most of it belong to the commercial banks. The Croatian National Bank has taken that money and immobilized it." There are more of these bn of dollars and euros than the huge loans that we have taken "unadvisedly" and following our "debt mentality" that we now have to finance through interest rates. In 2005, for example, the share of "sterile" deposits in money supply (M1) was higher than 80%! It means that if you had taken a 20 thousand euro loan, the bank would calculate an interest rate as if you have taken a 100 thousand euro loan! And this is not the end: high interest rates in Croatia should be added to artificially created lack of loans and an insolvent economy, old losses in bank sector, various "wages for fear" (i.e. premium risks) as well as a system of transferring money from Croatia to mother banks, and placing foreign money via their Croatian branches (daughter banks).

In 1993 – approximately ten years after first stabilization programme – macroeconomic policy that has not changed ever since it has been put in place. “The experts” said: it is not worthwhile producing in Croatia. During the last years of global crisis, devastating effects of that policy have been accompanied with the long lasting domestic crisis that has its roots back in 1980. Not even the first years of the last decade, a period of economic growth, boosted by imports and infrastructure projects of the former social democratic dominated government, could solve the basic structural problem: We have more consumption than production. Quickly all growth went back to where we used to be. Rising unemployment reminds of the nineties, while the atmosphere of pessimism and collective guilt remind on the decade before. In preparations for winning the elections in 2011, the social democrats in Croatia must answer these questions – what is to be produced and what (macroeconomic) conditions should be created for such a production to be successful?

Why are political ideas so important for Finding the way out of crisis?

“Contrary to the seventies, when economic and technological development was perceived as an advantage for all, whilst the state steered an economic policy - today, in the era of globalisation, there is a dominant sector of round 20% of population (financial-owner-managerial elite plus workers supplying them with labour on competitive market) not being geographically limited but mobile across national and regional borders (in another words, incorporating also peripheral elite). The biggest sector consists of round 50% of population nevertheless excluded from the global system, not being of service to any manufacturing function, neither contributing to the market. The worst is, however, that there is not a single idea, program or action to involve that majority into global development which practically makes progress an empty word.”

“It even seem that the sphere of thought which should correspond to the needs of periphery have been hit by a stroke.”

*Vjeran Katunaric: Colonised Thought.
Periphery without Developmental Perspective, 2007*

So the progressive optimism – which served the official communist party to carpet the “deviations” of the last decades of Yugoslavia – got the transition slap into its face from which it still has not recovered. Effusive and illusionary confidence about the high education level of all the barefoot kids playing football in the dust – while cold war superpowers obstruct them in fulfilling all their talents – has declined to peripheral “self-colonisation”, as described by the Croatian social scientist Vjeran Katunaric referring, among others, to his Bulgarian colleague Aleksandar Kiossev. That interspace has lost its authentic developmental prospect with the change of geopolitical balance that took place between 1989 and 1991. It was left - in the best case scenario - deep into the peripheral anonymity of *accelerating the association process* to the western mainstream “which now acts as hierarchically higher instance to the former East” (Katunaric, 2007: 385).

New peripheral elites engage themselves “routinely” with finance and marketing. Their constituents would observe the adventure of the Silver Arrow engineers – if only they knew about it - with the feigned *languor* of someone whose grandparents also have been through the mills of the Wall Street. They do not know what the local economy should produce, but they are sure that “not being competitive in the knowledge society” has been the workers’ own fault. And they do know that the trains, or, even better, the cars, should be imported!

Under such rules of the game, the question of industrial policy becomes high a ranking question on the ideological menu. On the level of the political idea it is not enough any more just to tell the followers *what is to be done?* It requires an answer to the question – equally inspiring whilst economically compelling – *what is to be produced?!*

For the mainstream political parties it was more than enough, all until recently, just to define the subject (let’s say, the coalition of working and the middle classes), their values (e. g. solidarity) and objectives (income equality and full employment), while redistribution policies were bringing social theory into reality. If the national economy needed some step on the gas to get going, one could reach for Keynesian stimulus or consensual wage policy, and the things were working. There always were, as Paul Krugman says, wealthy families who hate taxes (Krugman, 2007: 169), and all that welfare state situation must have been getting on their nerves, but they have not been worse off. They were just rich.

Such policy, however, is not sustainable any more. Usual explanations all sum up to – in the neo-liberal attacks regularly exaggerated - political elites’ incompetence to use deficit spending just for developmental projects and not for the current service of the state – or, even worse, their household-budget. In the same package, politicians are guilty for not being able to switch to middle and long term stability, too. However, there are reasons which, I’m afraid, are not problems of human error, but of more structural nature (although quite a lot of people do identify with it). These are the problems stemming from the change of geo-political relations of the post-war (or Cold War, if you like) world. Such change was followed by the disappearance of “any effective barriers to the global mobility of capital” (Gray, 1996: 5). At one point of New Deal policies, the highest inheritance tax rate was 79% - it was 91% for some time during Cold War mid-fifties (Krugman, 2007: 47). The question how to perform such policy under conditions of *tight nerves* of capital’s *electronic herd*, still remains unanswered, of course. Eric Hobsbawm, as I already mentioned, locate the collapse of the social democratic consensus as early as at the beginning of the seventies (Hobsbawm, 1996: 403-432).

Social democrats face profound changes in their voter base since. They have witnessed the rise of a new white-collar middle class, which apparently appeared not

to be such a good ally to the workers as peasants were. They were caught by culturalisation of politics, ascent of individuals and identities, but nothing struck them so hard as the free market. Even in most competitive Western economies the jobs went away and we stayed, still in need of work and protection from the risks of the market. We can continue trying to switch responsibility for fulfilling that need on an individual, European union or private sector. We can blame immigrants, the state or the bad business climate, but the solution will, anyway, be just in new economic activities. It is not another issue of economic or technological expertise, but the issue of the political idea. It is not the matter of any new or high added value technology, but the matter of workplace at a certain place. Not the case for industry, but rather policy.

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THE NEXUS BETWEEN POLITICS AND SOCIO-ECONOMIC DEVELOPMENT IN SOUTH-EASTERN EUROPEAN TRANSITION – THE MACEDONIAN CASE

Two decades after the fall of communism, the countries of South-Eastern Europe are still lagging behind the rest of the former communist countries in Europe. This is especially the case for some of the former Yugoslav countries and Albania. Just when the region was starting to slowly pick up, the world was shaken by another crisis. The fact that these countries had experienced a painful regression and had barely recovered, even to the level of development that had been achieved in 1989, testifies to the prolonged situation of crisis in the region. In this sense, at first glance, one might have the impression that these countries are not particularly affected by the current crisis. Nevertheless, a serious threat is posed to the pace of progress over the last few years, considering that within the constellation of the global crisis, South-Eastern Europe would have to make an extra effort in attracting investment and improving its trade performance, something at which it had not been particularly successful in any case. Consequently, one has to ask what has hindered development of the region so far. Before coming up with adequate policy recommendations concerning the region's reaction to the latest challenge, this paper seeks to identify the factors which have influenced the transformations and explore the links between politics and the economy. This will be done primarily through the prism of the Macedonian case.

What happened to the Economies – the Current Situation

According to data the economic situation in South-Eastern Europe after the fall of communism was devastating. Economic activity fell, inflation and unemployment rose. The nineties in particular were detrimental to the region's economies³⁸. Economic recovery resumed only after 2000. Nevertheless, it was still not enough to reach the level of GDP achieved in 1989; it has taken some countries two decades to return to the 1989 level, for example Macedonia, while some, like Bosnia and Herzegovina, Montenegro and Serbia, have yet to recover. Over the last few years, the GDP growth rates had stabilized, up until 2009 when the global financial crisis took its toll in the region and growth rates turned negative. While inflation soared at the beginning of the nineties, prices were stabilized, mostly through the help of IMF arrangements, towards the end of the decade. Inflation in 2000 was still tremendously high in Serbia and Montenegro and only started to gradually stabilize

³⁷ Marija Stambolieva is a PhD candidate in Political Science at the University of Kassel in Germany.

³⁸ The data demonstrated in the following paragraphs are from the EBRD Economic data. The data provided by LFS surveys may differ from the data given by EBRD, which, for example, may explain the decline in the unemployment rate in Bosnia and Herzegovina from 44.8% in 2006 to 28.9 in 2007 when the LFS was first carried out. The data on unemployment in Macedonia, Serbia and Montenegro are taken from their State Statistical Offices and given according to the LFS.

afterwards. As a result of the economic decline, unemployment grew. Unemployment rates were especially high in Bosnia and Herzegovina, Macedonia and Kosovo, and to some extent also in Serbia and Montenegro. In Bosnia and Herzegovina, the registered unemployment rate remained stable at around 40% until 2007, when it dropped to 28,9%. After 1992, and for the whole transition period, unemployment remained stable in Macedonia at around 30%. In Serbia and Montenegro the unemployment rate has been declining in the last few years: 20,8% in Serbia and 30,3% in Montenegro in 2005, and 13,6% in Serbia and 16,8% in Montenegro in 2008.

Trade performance during transition was poor. While preexisting commercial links were disrupted, new ones were hard to create. The value of total exports and imports of goods and services has steadily expanded over the past decade. Growth has been faster in Slovenia, Bulgaria and Romania than in the rest of the South-Eastern Europe region. The export to import coverage of goods and services remains below 60% in SEE5 - Albania, Bosnia and Herzegovina, Macedonia, Montenegro, Serbia - (see table 1), compared to an average of about 95% in Slovenia. The ratio of goods and service exports to GDP (in Purchasing Power Parity terms) in 2005 varied from highs of 32 and 23% in Croatia and Bulgaria respectively, to lows of 17% in Romania and Macedonia, and only 11% in Albania, Bosnia and Herzegovina, and Serbia and Montenegro. Despite recent growth, overall export and trade volumes have fallen short of their potential. In 2003, South-Eastern Europe was trading at only 77% of its potential, while comparatively EU8 was trading at 133%. Albania was at 53%; Bosnia and Herzegovina at 56%; Macedonia at 61%; and Bulgaria, Croatia, and Romania were at 94, 98 and 102% respectively (Kathuria 2008, 27-29).

Table 1 - Growth of Goods and Services Trade in South-Eastern Europe

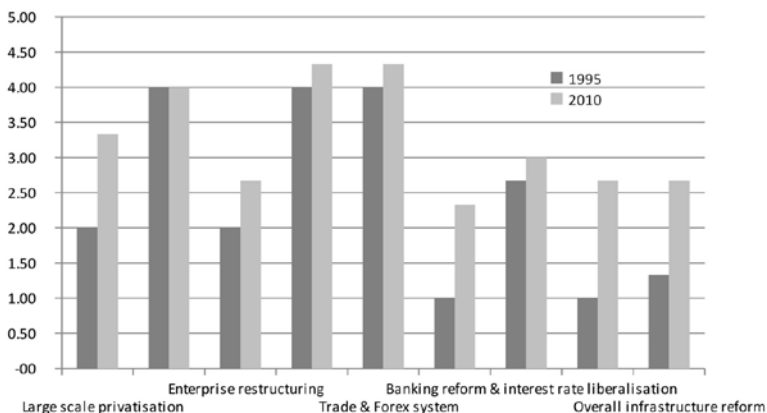
| Country / Region | Export growth (%) | | Import growth (%) | | Total trade (\$ millions) | | |
|------------------------|-------------------|---------|-------------------|---------|---------------------------|--------|---------|
| | 1996-2005 | 2000-05 | 1996-2005 | 2000-05 | 1996 | 2000 | 2005 |
| Albania | 22.9 | 19.8 | 17.3 | 20.0 | 1,468 | 2,228 | 5,844 |
| Bosnia and Herzegovina | 14.6 | 19.9 | 12.0 | 18.4 | 2,592 | 4,269 | 10,960 |
| Bulgaria | 10.9 | 18.2 | 14.2 | 20.6 | 12,576 | 15,171 | 37,608 |
| Croatia | 10.2 | 17.4 | 9.2 | 17.6 | 17,200 | 18,211 | 40,653 |
| Macedonia | 5.6 | 10.1 | 6.4 | 11.6 | 3,258 | 4,001 | 6,247 |
| Romania | 14.2 | 20.9 | 14.1 | 23.0 | 23,031 | 27,161 | 78,582 |
| Serbia and Montenegro | 10.4 | 22.5 | 10.4 | 20.1 | 5,944 | 6,339 | 17,796 |
| Western Balkans | 10.8 | 18.0 | 9.9 | 17.9 | 30,441 | 35,047 | 81,501 |
| SEE | 12.0 | 19.2 | 12.1 | 20.3 | 66,048 | 77,379 | 197,691 |

Source: (Kathuria 2008, 28)

The slowest growth in per-capita exports has occurred in Macedonia. This suggests low foreign investor confidence (thus smaller capital inflows) or low domestic demand for foreign savings, or both (Kathuria 2008, 14). Inflows of foreign direct investment rose by about 2% of the regional GDP between 2000 and 2005. Out of the SEE5 the FDI inflow, as a%age of GDP, was strongest in Serbia and weakest in Macedonia, with changes in FDI inflows in 2000-2005 amounting to 5.7% of GDP and -3,2% respectively. Domestic investment rates also rose by 4.4% of the regional GDP. Outside SEE5 the strongest growth in investment rates was in Croatia (the change between 2000 and 2005 was 8.1% of GDP) and the weakest in Albania (-3,9% between 2000 and 2005), followed by Macedonia (-2,3%). The participation of domestic investments in GDP was smallest in Bosnia and Herzegovina and Serbia, with Serbia showing a growing trend also in this field. After 2005, these indicators began to rise in the region, though at different paces in different countries, until the global financial crisis.

The selected economic indicators (GDP, unemployment rates, price stability, trade performance and investments) show the region's level of economic success. However, they do not show the kind of regime that was being developed throughout the transition period. From an economic point of view, the former communist countries chose the path towards a market economy. The EBRD has developed a set of indicators to measure reform progress and macroeconomic developments in transitional countries. Each indicator is scored from 1 to 4 and +, where 1 means little progress and 4+ indicates standards and performances typical of advanced industrial economies. Figure 1 shows the opening up of the Macedonian economy according to this EBRD classification system. Compared to other countries in the region, Macedonia's reform rate is somewhere in the middle, between the most and least successful reformers.

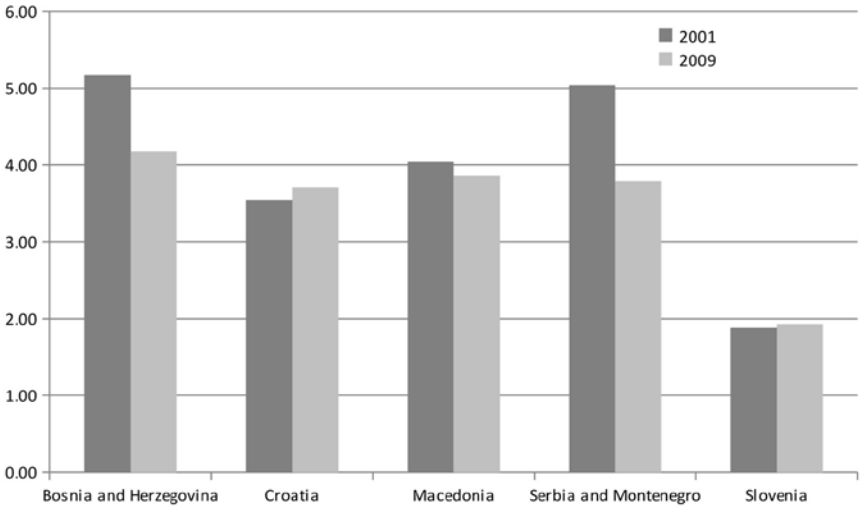
Figure 1 - Macedonia-Transition indicators in 1995 and 2010



Source: EBRD

In the political sense, after the fall of communism the countries chose to develop democratic political systems. In figure 2 a democracy score, developed by Freedom House, shows the success rate of democratization in the South-Eastern European countries. The score is based on a selected number of indicators, such as the electoral process, civil society, independent media, governance (national and local), the judicial framework and its independence and finally corruption. The ratings are based on a scale of 1 to 7, with 1 representing the highest level of democratic progress and 7 the lowest.

Figure 2 - Democracy score for selected South-Eastern European countries



Source: Freedom House

What matters – Explaining the Transformations

To analyze economic performance and reform data, one first has to identify the influential factors and then establish the correlation between influence and outcome. Two dominant factors which certainly influenced transformation in South-Eastern Europe are tradition and context. First, it is important to understand the point of departure for each of the countries, and then to examine the general or specific conditions under which transition occurred.

Tradition

Initially, the countries of the former Yugoslavia shared a common institutional framework. The former Yugoslavia developed a specific kind of socialist economy, which was a quasi-market-economy. This concept was in contrast with the rest of the Communist Bloc, to which Albania, Bulgaria and Romania belonged, which

practiced a soviet-type planned economy. The semi-openness of the Yugoslav economy allowed for a transformation process to commence even before the political dissolution of the federal state and the time which is commonly referred to as the fall of communism. Under the 1988 law, popularly known as Markovic law, the transformation of self-managed enterprises through the privatization of social capital had already been initiated. After the break-up of Yugoslavia, the successor states then adopted their own national privatization laws.

Despite the fact that the countries of the former Yugoslavia were part of one economic and political system, inside the federation they were relatively diverse. In the economic sense, the differences were most apparent on the level of economic development. Post-war industrial development had not been homogeneous in the common state and already in 1947 certain republics or regions were less developed than others. These imbalances were partly due to the federal policies of allocating economic resources and capacities, policies which were less favorable to primary industry and agriculture and were aimed at stimulating the export of products with a higher value added, and partly due to the concept of the decentralized self-management in enterprises and the managerial abilities and preferences of the national political elites (Blazevski 2003). These disparities were to remain more or less unaltered so that the underdeveloped areas, such as Macedonia, Kosovo, Montenegro and Bosnia and Herzegovina, continued to depend on federal transfers until the very end.

The Yugoslav political and economic model was based on what was called the self-management principle. This concept was developed as an alternative to soviet communism and its main intention was to bring power closer to the citizens (workers) through decision-making in a decentralized manner. In practice, it was the national political elites which steered the socio-economic and political life of the republic/province, either through direct decision-making in the national and local political communities or indirectly by appointing party members to top economic positions. It was inevitable, therefore, that certain national actors' specificities and cultural differences would have already come to the fore under the common system.

Kitschelt et al. have published a typology of former communist regimes, which according to them, appear consequential to the transition to democracy (Kitschelt, et al. 1999). The three types of rule they distinguish are: bureaucratic-authoritarian, national-accommodative and patrimonial communism. Contrary perhaps to what might be expected, among the states included in the research, not all the member states of the former Yugoslavia are classified under the same type. Slovenia and Croatia are placed under national-accommodative communism, Macedonia in the framework of patrimonial communism and Serbia as a mix of both types. This has to do with the characteristics attributed to the different types. Bureaucratic-authoritarian communism was a totalitarian model of party state which relied on

powerful bureaucratic machinery to govern a planned economy. It developed in countries where the pre-communist political economy already relied on a relatively developed industrial capitalism, with less than 40% of the population working in agriculture. It was the organizational discipline and encapsulation of the already developed working class that allowed for the hegemony of the ruling communist parties. National-accommodative communism produced regimes with partially separated party rule and technical state administration. It developed in countries with a partially industrialized pre-communist market economy. Patrimonial communism relied on personal chains of dependence between leaders in the state and party apparatus and their entourage, buttressed by extensive patronage and clientelist networks. It was present in countries whose pre-communist economy depended primarily on agriculture. As these regimes relied strongly on personal ties, corruption was also widespread.

Kitschelt et al. created this typology to demonstrate how history is important and influences future developments. The pre-communist economic, cultural and political traditions had an effect over subsequent communist rule, which, following this same reasoning, was bound to have its effect on the way transformation would be undertaken in seceding countries. In political terms, the argument of Kitschelt et al. complements the argument of different levels of economic development inherited by the various countries and provides a useful tool in understanding the nexus between politics and socio-economic development.

Context

Given their starting points it is not difficult to see why some countries managed to recuperate faster from the economic downturn in the eighties and were economically more successful in the aftermath of transition. Bearing the above mentioned arguments in mind, it was the economic traditions and the national actors' attitudes which accounted for the specific transformation of each country towards market economy and democracy. Other aspects, whether connected to national circumstances or of external nature, were not insignificant for transition either, for example the constellation of war and its relative consequences, and the international setting.

Towards the end, the economic situation in former Yugoslavia was severe and national antagonisms escalated into war. Slovenia was the first to secede with minor tensions. The main conflicts were on the territory of Croatia and Bosnia and Herzegovina and they created serious damage to their economies. These effects were particularly damaging in Bosnia and Herzegovina, also because the war lasted longest there. From 1993 to 1995 the level of GDP in Bosnia and Herzegovina dropped as low as 10 to 20% of the 1989 GDP³⁹ while in Croatia the drop in 1993 was 60% of the 1989 GDP. The other states of the former Yugoslavia were also affected by the war.

³⁹ The data on the GDP levels are from the EBRD 2009 Transition report.

As direct participants in the war, Serbia and Montenegro, at that time still within the Federal Republic of Yugoslavia, had respective declines of GDP in 1993 of as much as 40 and 50% of the 1989 level. In 1992, the sanctions imposed against the Federal Republic of Yugoslavia by the UN and the EU were felt in Macedonia as well, as its primary trade partner was Serbia. During the same period, the EU members from the Balkans also fueled the conflicts which accompanied the dissolution of Yugoslavia: Greece imposed a trade embargo against Macedonia and frequently closed its border, thus blocking the flow of goods and supply of petrol. In 1995, Macedonia's GDP fell to 70% of the 1989 level. In 1998, UN and EU sanctions were again imposed against the Federal Republic of Yugoslavia, in connection with Kosovo. Therefore, it has taken longer for the Serbian, Montenegrin and Macedonian economies to pick up. Furthermore, Macedonia experienced its own civil conflict in 2001, which had a negative effect on the restoration of its economy. Apart from GDP levels, other macroeconomic indicators complete the negative economic picture above: a decline in trading performance and rising inflation and unemployment.

On the international stage, the 80s was a period when the popularity of Keynesianism was diminishing. Keynes's concept of demand stimulation through public spending was in a crisis of its own. State debt which occurred for the sake of financing public spending was not returned during times of economic growth or grew much faster than revenue, which contributed to a further increase of the state deficit. Another problem was the appearance of stagflation, a combination of inflation due to increased wages and stagnation of economic growth due to the oil crisis. This made way for the neo-liberals on the world stage, promoting a reduction of government spending, price stabilization, liberalization and the deregulation of markets. This trend, originally from the US and the UK, spread quickly to other market economy countries. The opening of markets facilitated the global mobility of capital and thus put additional pressure on national governments. This was primarily the case for developed⁴⁰ countries, where both Keynesian and neo-liberal policies had emerged and had been applied. For developed countries in Europe, the economic recession, accumulated debt, the neo-liberal political trends, the collapse of neighboring communist countries, German reunification and the creation of the European Monetary Union had contributed to the adoption of austere monetary and fiscal policies (Huber und Stephens D. 2001, 234). The group of countries that were defined as emerging and developing economies⁴¹ were extremely diverse and therefore had diverse reactions to these new conditions. Some of these countries turned to the international financial institutions. The International Financial Institutions, such as the IMF and the World Bank, to which countries in trouble turn or which offer their help in line with the main trend, had a free market policy

⁴⁰ For a list of developed countries, refer to the IMF classification 'advanced economies'

⁴¹ For a list of countries classified as 'emerging and developing economies', refer to the IMF classification. It includes the list of the former communist regimes. Of these, in recent years Slovenia, Slovakia and the Czech Republic have been moved to the 'advanced economies' list.

agenda. The reasoning of the International Financial Institutions was that it is first necessary to achieve macroeconomic stability and “once prices are set right, the state will be efficient in its task of rule enforcement, protection of property rights and public administration. Market actors could then invest, generate growth and reduce poverty” (United Nations Research Institute for Social Development 2010, 257). Regarding post-communist countries, the priority of the International Financial Institutions was to facilitate the opening of formerly closed economies by means of liberalization and privatization, paying little attention to the quality of these processes, under the assumption that the free markets would lead to growth and good governance in any case.

Between Tradition and Context – the Macedonian Case

In the subsequent text I will establish a connection between the above-identified factors and demonstrate the influence of each one on post-communist transition. The Macedonian case is a good illustration of this.

In the traditional sense, Macedonia was among the least developed republics of the former Yugoslavia. Nevertheless, within the federation the country developed and advanced economically as never before and the population’s standard of living improved significantly. At the end of the eighties, the economy was doing poorly, because, among other problems, technology was underdeveloped, there was a high dependence on imports and the export orientation was insufficient, quality products were absent and competitiveness was weak (Blazevski 2003, 115). Part of this situation was rooted in general federal policies, but a greater part of the problem could be ascribed to the competence and preferences of the internal decision-makers in the different republics. In the classification of Kitschelt et al. (1999), Macedonian communism was classified as patrimonial. The country had had a long history of authoritarian rule before communism and there was a lack of collective memory among the population of any civic or political participation. After the establishment of the new political regime, it took the Yugoslav authorities some time to introduce the self-management concept. The authoritarian practices assumed during the administrative period⁴² in Yugoslavia were difficult to break, especially in Macedonia where there was an absence of any pluralist traditions. Self-management in Macedonia translated into a formal confirmation by the workers’ councils of decisions already taken by the League of Communists of Macedonia. Because of this specific legacy and the form that the communist regime was to develop, political monism in Macedonia was an obstacle to the full realization of self-management-driven pluralism. Ultimately, this concept of self-managed socialism was flawed, its economic and political failures contributed to the break-up of Yugosla-

⁴² There were two phases in the development of the economic and political system in the Socialist Federal Republic of Yugoslavia: the period of administrative socialism, which took after the soviet model, and the period of self-management introduced after 1950, which was a unique Yugoslav socialist model.

via, and the seceding countries initiated their transition towards a market economy and democracy.

Transition itself took on various forms, depending primarily on the social and political relations existent in the various post-communist societies. Where the civic maturity of the masses was lacking, the path to democracy was besieged by the elites, who manipulated the political arena to their advantage without encountering much resistance. Thus the continuity of patrimonial politics in Macedonia was secured yet again under these new conditions. "Macedonian parties are atypical members of a particular *famille spirituelle* as a result of the interaction of the politics of patronage and the politics of ideology. They are very much under the personal control of their leaders and the party *camarillas*" (Siljanovska-Davkova 2005, 28). The capture of parties within patronage-clientelist relations reproduces the capture of public institutions and perpetuates a behavior pattern that hinders the path to full democratization and development.

In a contextual sense, Macedonia was affected by the violent and painful break-up of Yugoslavia. Its economic performance suffered significantly during the sanctions against Federal Republic of Yugoslavia and the Greek embargo. At the same time, a transformation of social capital into private ownership was taking place. For most of the citizens, who lacked experience in taking action, this new historical moment was a leap into the unknown and once again it was guaranteed that the political elites would have the main say. The combination of economic blockade and political uncertainty set the stage for manipulation of the privatization process and dubious business deals. The primary method of privatization was management and employee buy-outs, which in practice turned out to be management take-overs of formerly common enterprises. As Bartlett points: "In several cases, managers subsequently acquired employee shareholders' shares using dubious methods or simply appropriated the employees' voting rights and consolidating majority holdings for the management group" (Bartlett 2008, 68). During the same period a vicious circle of corrupt links among large enterprises, state organs and political parties was created and such behavior patterns were difficult to overcome in the subsequent period (International Crisis Group 2002). The ICG report attributes this to the country's political culture and not to any group in particular. Thus, the new elites, which came to power after the 1998 elections, maintained these patterns of corruption in further privatizations and business methods to create advantages for themselves and their supporters. The nexus between the main choice of internal privatization model, political instability, both within and surrounding the country, and corruption discouraged foreign investors. Some of the foreign investors that did come may have even exacerbated the problem by exploiting the political situation to attain a privileged position on the market. An example is the case of the Okta refinery which was sold under direct negotiations, without an open tender and at a price believed to be extremely favorable for the buyer, allowing not only

to gain ownership of the refinery, but also a monopoly over the import and pricing of oil. An internal investigation into Deutsche Telecom AG and its Hungarian unit, through which Deutsche Telecom became the owner of the privatized Macedonian Telekom, has revealed large spending on contracts, "a number of which were undertaken to obtain specific regulatory and other benefits from the government of Macedonia"⁴³. An additional investigation was carried out by German authorities to see if officials in Deutsche Telecom AG had been involved in the bribery payments. These payments had taken place in a period when other parties than in the Oka case were in government. Furthermore, the development of the domestic small business sector was also hindered by the adverse influence of political parties, significant resistance from established business interests, a lack of government support and unfair competition from the informal economy (Bartlett 2008).

Beginning from 1992, the Republic of Macedonia established relations with the International Financial Institutions and started making agreements (for a more detailed description of these see Mojsavska 2005). At first these agreements, especially with the IMF, targeted the macroeconomic stabilization of the country. In accordance with the dominant international trends, these policies were intended to serve as a precondition for successful transition towards a market economy through stabilization, liberalization and privatization. The goals of stabilization, liberalization and privatization were thus being approached simultaneously; however, the modest results of Macedonia's economic performance showed that other important aspects were being neglected. In global terms, the response to the policy reforms of the 80s and the 90s in developing countries' growth rates had not been as expected. There was an ongoing debate among researchers and in the International Financial Institutions themselves about the effectiveness of their adjustment lending (Easterly 2001, World Bank 2001). The weaknesses of these policies had been an incentive to link certain regulatory aspects to market performance expectations. In other words, internal structural and institutional reforms were seen as a necessity for the development of market economies. The concepts of good governance, managerial reforms and decentralization emerged during the 90s as addenda to the programs of international organizations (United Nations Research Institute for Social Development 2010). These good governance goals concentrated on the enforcement of property rights, the rule of law, efficiency and accountability of governments and curbing corruption. Managerial reforms were promoted primarily to make public services more efficient by incorporating private sector techniques into the delivery of services. Decentralization, as a feature of good governance, was intended to reduce rent-seeking behavior and inefficient resource allocation by dispersing powers to lower levels of government, where local actors would more likely have an influence. Such reform projects were primarily part of the World Bank agenda in Macedonia.

⁴³ <http://www.bbc.co.uk/news/business-11311325>.

It is clear that all of the abovementioned factors, the economic legacy, political culture, regional instability and international policies, played a specific role in shaping national policies and their related economic output during transition. The fact that Macedonia inherited a relatively weak economic base meant it was disadvantaged from the start. The war, the conflicts and their consequences were a serious hurdle to be overcome in achieving economic progress throughout the region. Not only were the wars a physical obstacle to economic activities, they also fostered profiteering in certain structures at the expense of overall economic performance. Inherited social relations also had an impact on the development of political culture in the new regime. The interweaving of economics and politics through patronage and corruption slowed down the country's economic development. While the international policies that came with loans and aid focused on stabilization and liberalization, they did not tackle these correlated impediments. Some structural reform projects were in place but their priority was on the efficiency of institutions and the transfer of experiences from the private to the public sphere. This was consistent with the dominant belief that liberalization and privatization are sufficient prerequisites for economic growth. It was perhaps therefore that the international community, though occasionally critical towards Macedonian officials, gave "few indications that it recognizes how powerfully corruption works against its fundamental objectives in Macedonia" (International Crisis Group 2002, i).

Latest Trends, Perceptions and Remaining Challenges

Over the last few years, critical voices on the neo-liberal policies of the IFIs have become more prominent and visible. Nevertheless, it is debatable whether, especially in the wake of the global financial crisis, this has brought about any changes in the International Financial Institutions policies. On the other hand, some other factors identified as inhibitors of the economy, such as the regional instability in South-Eastern Europe, have diminished. Furthermore, Macedonia has resumed the path towards EU membership and the EU has been especially critical regarding the country's corruption, identifying anti-corruption measures as a condition for candidate status⁴⁴, negotiations and eventual membership.

Since 2005, there has also been a shift in public perception in Macedonia. Among the business community, some of the problems which were ranked⁴⁵ as most severe in 2005 were no longer seen as such in 2008. Similar problems did reach the top of the ranks, however the order was different: in 2008, the business community

⁴⁴ (The Former Yugoslav) Republic of Macedonia was granted candidate status in 2005. The European Commission decided to postpone recommending the opening of negotiations until the country has reached a sufficient degree of compliance with membership criteria. The 'name-issue' was not part of the agenda at that time. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2005:0562:FIN:EN:PDF>.

⁴⁵ The data are from the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). One has to bear in mind that the BEEPS questionnaire and sampling methodology was modified between the 2005 and 2008 cycles. The comparison is therefore illustrative and should be interpreted with caution.

in Macedonia rated access to finance, the judicial system, tax rates and corruption (in that order) as the most problematic issues, while in 2005 corruption had been at the top of the list. Currently, the issues of access to finance together with unprofitable business account for 70% of the reasons behind discontinued business (Global Entrepreneurship Monitor 2009). This study, which measured citizens' perceptions and attitudes towards entrepreneurship, found that entrepreneurship enjoyed high indexes in Macedonia. 80% of respondents consider entrepreneurship as a good career choice.

These are among the highest figures world-wide (in the countries where the Global Entrepreneurship Monitor survey has been carried out). By way of comparison with other countries in Europe and the region, the percentages of people that consider entrepreneurship as a good career choice are as follows: Serbia 31%, Bosnia and Herzegovina 25%, Croatia 10% and Slovenia 7% while in the EU the percentage is most often a single digit. Thirty nine% of non-entrepreneurs in Macedonia expect to start a business within the next 3 years. Only 9.19% of respondents described themselves as nascent entrepreneurs, which highlights a gap between desire and reality. Furthermore, half the entrepreneurs in Macedonia are entrepreneurs by necessity whereas the other half is motivated by opportunity. In conditions of high unemployment and low economic growth, people choose to start a business primarily out of need.

Further corroboration of this fact is provided by the general level of distrust⁴⁶ shown towards economic and political institutions. In 2010, 51.7% of respondents expressed little or no trust in financial institutions. Even taking the effects of the global financial crisis into account, the percentage one year earlier was 41.2%, which is already high enough. To exclude the possible effects on citizens' perceptions of the crisis, I am using data from 2009. Likewise, trust in the political institutions is rather low: 53.7% of respondents expressed little or no trust in the judicial system and 58.6 had little or no trust in the political parties. Corruption is still considered wide-spread: 41.8% believe that corruption is the same as it was 5 years earlier, 26.2% consider the level of corruption higher and 24.6% consider it lower. The only institutions that enjoy an improved level of trust are international organizations, such as NATO, the EU and the UN. Among the national political institutions the government also enjoys a higher degree of trust: 52.2% have a lot or some trust in the Government; 45.2% evaluate the work of the current government as excellent or good - this is higher than in 2006 when the percentage was 37.6.

The party which came to power in 2006 and was reelected in 2008 was elected mainly based on their pre-electoral promises of economic development. The new government initiated a project called 'Invest in Macedonia'⁴⁷, aimed at attracting

⁴⁶ The following data presented are from the Gallup Balkan Monitor: <http://www.balkan-monitor.eu/>.

⁴⁷ More on the project at <http://www.investinmacedonia.com/Default.aspx>.

foreign investment to the country. The World Bank 'Doing Business'⁴⁸ ranking positioned Macedonia at 36th and 38th position in 2010 and 2011 respectively. This is a better ranking than all the other countries in the South-Eastern European region, some of which are EU members. However, despite these promotions and positive reports, investments have been dropping. What is more, the only Greenfield investment dated 2006, the Dairy factory Swedmill, a project supported by both the Swedish and Macedonian governments, went bankrupt under mysterious circumstances; the debts arising from the case have not been paid off to date nor has the case been clarified to the public. Regarding the 'Doing Business' Ranking, former finance minister Xhevdet Hajredini stated that "it is clear that such ranking and actual praxis do not match"⁴⁹. The government used the global financial crisis to justify the mismatch and chose to concentrate on being the country's most substantial investor, thanks to public spending on cultural objects within the project 'Skopje 2014', a project which has been severely criticized by the opposition and some civic organizations.

Such logic is in contrast with the transition efforts over the last twenty years, especially on the part of international organizations, to boost the market economy in the country. Nevertheless, public trust in the government remains high, while trust in political parties is low, which raises some legitimate and concrete questions regarding the credibility of the opposition parties and their ability to act as a democratic counterweight to the parties in power. Furthermore, such questions are inherently connected to some fundamental concerns about the political capture of the economy, the citizens' inherited and acquired immunity to corruption and the country's overall slow democratization.

Conclusion and suggestions

As this paper shows, the interconnectedness of politics and the country's economic performance may be more significant than has been officially recognized. Achieving a relatively favorable placement on certain international reform ratings does not necessarily guarantee economic development. This also means that economic development cannot be fostered through economic measures alone. There are other factors which must not be overlooked and it is high time for them to be taken into account.

If a fertile grounding has not been inherited, suitable conditions for future development need to be created. The factors identified in this text show how the proper regional and international setting is a prerequisite for the necessary shift in national political culture.

⁴⁸ The Doing Business project measures business regulations and their enforcement across 183 economies and selected cities at the sub-national and regional levels: <http://www.doingbusiness.org/>.

⁴⁹ Statement given in the Macedonian daily newspaper "Dnevnik", 20th November 2010, p.6.

In light of the financial crisis, the position of the International Financial Institutions is critical. As the experience from the 90s has shown, policies of unconditional privatization and liberalization did not give the expected results. To simply insist upon a good governance agenda and managerial reforms is most likely not an adequate response (United Nations Research Institute for Social Development 2010). Rather than having efficiency as the main goal, it is much more important to build political and administrative capacities, which will then be able to mobilize resources and implement policies. The UNRISD report points to some successful East-Asian cases where states chose to develop services in infrastructure, credit, research, investments in health, education and social security etc. In democratic regimes there has been greater citizen participation in capacity building and the formulation of public policies, thus ensuring greater sustainability of the goals achieved.

Considering that the above is easier said than done, it is obvious that pressure needs to come from outside as well as from within. Now the region has more or less achieved stability, though there are still unresolved issues that hinder progress. In the Macedonian case this is the bilateral dispute between Macedonia and Greece over the name of the country, which has become a serious threat to Macedonia's economic and political integration in Europe. Then, there is skepticism regarding the willingness of the International Financial Institutions and ability to reform their agendas (Wallerstein 2010), the eurozone crisis and the role that the EU will assume in the region's future (Bartlett and Monastiriots (Eds.) 2010). Regarding internal pressures, it is imperative that Macedonian society abandons the vicious circle of patronage politics and improves institutional capacity.

Considering what has been achieved to date, all the tasks mentioned above are extremely challenging. However, to fulfill the expectations of further reform they do have to be recognized. Some concrete recommendations which could be included in this sense are:

Small successes should be presented as example to be followed and celebrated as good starting points. Sectors or areas in which reforms have achieved most advancement and given positive results, need to be studied and multiplied;

The focus of international partners (not necessarily only the International Financial Institutions) should be on the democratic empowerment of the population, given that patronage politics, as practiced by the political elites, hinders economic development. One way of improving civic participation and creating the conditions for democratic alternatives is through a more equitable distribution of funds in order to curb corruption.

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JENS BASTIAN⁵⁰

RECOVERY THROUGH EXPORTS?

OPPORTUNITIES IN AND OBSTACLES FOR THE WESTERN BALKANS

Introduction

Is exporting to become the new way forward for economies in the Western Balkans? At first glance, a policy focused on exports appears easy to subscribe to. Prescribing it as a feasible solution to the economic challenges to countries in the region in search of ways out of economic recession, is becoming increasingly the order of the day. But such ready-made remedies and text book alternatives are much harder (and much more complex) to implement over time and face manifest obstacles.

Ever since the global economic recession and the financial crisis hit the region of the Western Balkans,⁵¹ with some delay in the second half of 2008, international trade has been significantly affected in the countries of the region. After years of current account deficits at levels of 8-18%, a sharp decline in imports and reduced export capacity in 2008/09, shifted the focus of debate on the region's trajectory, from crisis to recovery. As imports across the region fell faster than exports, the merchandise trade deficit simultaneously narrowed, in particular for countries such as Serbia and Montenegro, which had registered staggering levels of above 20% (Anastasakis, Bastian and Watson, 2011).

While economic growth is gradually coming back to the region, recovery is fragile and un-even. Precisely for this reason it remains fragile across South-East European economies. In 2010, as the international economic environment gradually improved, for the European Union in particular, regarding the economic turnaround in Germany, the external position of countries in the region returned to more solid foundations. In the wake of improving export growth, following a revitalized industrial demand from the EU, the main trading bloc of the region, is contributing to an economic turnaround that nevertheless needs further domestic consolidation, deeper institutional anchors and sustainability over time.

Moreover, advocacy of export-led growth must bear in mind that countries in the region risk becoming excessively dependent on one country, i.e. Germany as an export destination at a time of growing concern over inflation pressure, inequality of living standards and inflated property and food commodity markets. If history is any indication, then countries in the region should consider the lessons learned from previous experiences in export-led growth drives.⁵²

⁵⁰ Alpha Bank Visiting Fellow for the Political Economy of Southeast Europe St. Antony's College, Oxford, U.K.

⁵¹ The term Western Balkans encompasses Albania, Bosnia-Herzegovina, Croatia, Macedonia, Montenegro, Serbia and Kosovo.

⁵² See Raghuram, Rajan (2010): *Fault Lines*. Chapter 2: 'Exporting to Grow', pp. 46-67, Princeton University Press, Princeton 2010.

A more worrying aspect for the region and the sustainability of economic performance is the fact the recovery – so far – has been a jobless recovery. GDP growth in whatever form, export-led, through domestic consumption or investment-driven must convert into employment gains for the population at large. Already during the past decade most countries in the region have witnessed an economic performance that is based on credit growth but much less so on employment gains.

The EU [trade] dimension in an export-led growth agenda

Designing an export-led growth agenda for countries in the region of the Western Balkans is difficult to achieve without taking economic integration through trade facilitation into consideration. A crucial determinant for the formulation of such an agenda is the nature of the trade policies that countries have between each other and with EU member states.

Mobilizing the institutional, regulatory and corporate resources for an export-led growth agenda in the region cannot happen in isolation from a deeper consideration of the EU dimension, i.e. involvement in the shaping of such an agenda. The EU's toolbox has expanded over time and is becoming increasingly diversified. Initially, the EU's (trade) relations with the Western Balkans were governed by the *Stabilization and Association Process* (SAP) launched at the Zagreb Summit in November 2000 and reiterated at the watershed EU summit in Thessaloniki, Greece in 2003, which provided a roadmap towards Brussels – but no timetable - for countries from the region. There are currently four *Stabilization and Association Agreements* (SAA) in force: with Macedonia (since 2004), Croatia (since 2005), Albania (since 2009) and Montenegro (since 2010). The trade part of the SAA came into force through a so-called Interim Agreement with Bosnia and Herzegovina (2007) and Serbia (2010). The agreements aim to progressively establish a free-trade area between the EU and the Western Balkan countries. Where trade is specifically concerned, the SAA focuses on liberalizing trade in goods and services, aligning rules to EU standards and practice as well as protecting intellectual property.

The *Central European Free Trade Agreement* (CEFTA) is a single free trade arrangement linking all the Western Balkan countries and Moldova. It replaced a previous network of more than 30 bilateral agreements, thereby setting uniform trade rules across the whole region of South Eastern Europe. CEFTA came into force in November 2007. Although not a party to CEFTA, the EU supports the process, which it sees as complementing the Stabilization and Association process.

In addition, the *Lisbon Treaty* (December 2009) extends the Union's external policy-making competences in *Common Commercial Policy* (CCP) to the entirety of trade in services, the commercial aspects of intellectual property rights and foreign direct investment, insofar as the latter is connected to international trade law.

In this respect, one of the most important instruments of EU trade policy within the region is the *regional trade agreements*. These RTAs may have different political and economic objectives for individual countries; however, their common aim is to reinforce internal regulatory [trade] reforms through external treaty obligations with the EU, and on a bilateral basis between participating countries. RTAs can have positive or negative effects on trade depending on their design and implementation requirements as well as their timetables. Therefore, the determinants for success can vary and the broader policy context within which an RTA is adopted is of crucial importance for its medium-term performance. Agreements that have been designed to complement a general problem of economic reform have been most effective in raising trade volumes. The most important ingredient for the success of a RTA is low non-tariff trade barriers among and between trading partners and intermediary institutions, such as the EU serving as trade facilitators.⁵³

Moreover, the EU strongly supports the Western Balkan countries' membership in the *World Trade Organization* (WTO). Albania (2000), Croatia (2000) and Macedonia (2003) are already members; Bosnia and Herzegovina applied in May 1999, Montenegro's application was submitted in February 2005, while Serbia's accession process commenced in December 2004 and is currently the most advanced. In all cases, bilateral market access negotiations are underway on the basis of revised offers on goods and services. Multilateral work is proceeding on the basis of revised draft Working Party Reports. Examinations of the countries' foreign trade regimes continue as a key precondition for WTO membership. Only Kosovo has yet to submit a WTO membership application.

Considering the dynamics of trade over the past decade, in 2000 the EU granted autonomous trade preferences to the whole Western Balkans, thereby allowing nearly all exports to enter the EU without customs duties or limitations of quantity. Some exceptions were applied which continue to be in force. Only wine, sugar, veal and certain fish products enter the EU under preferential tariff quotas. These preferences, which were renewed in 2005 until the end of 2010, have contributed to an increase in the Western Balkans' share of exports to the EU. In 2009, the EU was the region's largest trading partner for both imports (64.9%) and exports (69.1%).

⁵³ I am grateful to Ms Kristina Cuculoska, MPhil candidate at St. Peter's College in Oxford, U.K. for pointing out various aspects of EU trade agreements to me.

Table 1 - European Union, Trade with Western Balkan Countries, 2005-2010 (millions of € %)*

| Period | Imports | Variation (%, y-o-y) | Share of Total EU Imports (%) | Exports | Variation (%, y-o-y) | Share of Total EU Exports (%) | Balance | Trade |
|-----------------------------|-------------------|-------------------------|--|---------|-------------------------|--|---------|--------|
| 2005 | 9,003 | 11.5 | 0.8 | 21,584 | 5.0 | 2.1 | 12,581 | 30,587 |
| 2006 | 11,573 | 28.6 | 0.9 | 25,204 | 16.8 | 2.2 | 13,631 | 36,777 |
| 2007 | 13,340 | 15.3 | 0.9 | 29,374 | 16.5 | 2.4 | 16,034 | 42,714 |
| 2008 | 13,928 | 4.4 | 0.9 | 33,030 | 12.4 | 2.5 | 19,102 | 46,957 |
| 2009 | 11,180 | -19.7 | 0.9 | 25,455 | -22.9 | 2.3 | 14,275 | 36,635 |
| 2009 Q1 | 2,688 | | 0.9 | 6,079 | | 2.4 | 3,391 | 8,767 |
| 2009 Q2 | 2,683 | | 0.9 | 6,576 | | 2.4 | 3,894 | 9,259 |
| 2009 Q3 | 2,898 | | 1.0 | 6,375 | | 2.3 | 3,477 | 9,273 |
| 2009 Q4 | 2,912 | | 0.9 | 6,424 | | 2.2 | 3,513 | 9,336 |
| 2010 Q1 | 3,019 | 12.3 | 0.9 | 5,788 | -4.8 | 2.0 | 2,769 | 8,807 |
| 2010 Q2 | 3,442 | 28.3 | 0.9 | 6,767 | 2.9 | 2.0 | 3,325 | 10,208 |
| 2010 Q3 | 3,556 | 22.7 | 0.9 | 6,749 | 5.9 | 1.9 | 3,193 | 10,305 |
| Average annual growth | 2005 - 2009 | 5.6 | | | 4.2 | | | 4.6 |

Source: Eurostat (Comext, Statistical regime 4), Trade A2 – CG/MP, January 18, 2011.

* Trade figures for Western Balkan countries from Eurostat include Croatia.

When looking in more detail at the EU's main trading partners in 2009 (for which the latest comparative data is available), the dynamics and ranking of trade with the Western Balkans is rather sobering, to say the least. More specifically, among the EU's major export partners (out of a list of the 50 leading countries), the first country to appear in the ranking is Croatia, in 24th position (1.0% of the total), followed by Serbia in 31st place (0.6%) and then Bosnia and Herzegovina at 49th (0.3%). Only 2.3%, or € 25.5 bn of the EU's exports went to the Western Balkans in 2009 and Croatia's share alone accounts for 40% of the total.

Among the EU's major import partners (out of a list of the 50 leading countries), the first country from the region to appear is Croatia in 39th position, followed by Serbia in 45th place. The overall share of imports to the EU in 2009 from the Western Balkans reached € 11.2 bn, equivalent to 0.9% of total imports to the EU. If Croatia's share (as an accession country) were subtracted from the ranking, imports from the Western Balkans would reach roughly € 7.8 bn or 0.6% of total imports to the EU.

Table 2 - Western Balkan Countries, Trade with the European Union 2005-10 (millions of €, %)*

| Period | Imports | Variation (%, y-o-y) | EU Share of Total Imports (%) | Exports | Variation (%, y-o-y) | EU Share of Total Exports (%) | Balance | Trade |
|-----------------------------|-------------------|-------------------------|---|---------|-------------------------|---|---------|-------------|
| 2005 | 19,196 | -4.0 | 67.9 | 8,170 | 3.7 | 66.4 | -11,025 | 27,366 |
| 2006 | 17,839 | -7.1 | 66.5 | 8,577 | 5.0 | 68.9 | -9,262 | 26,416 |
| 2007 | 19,635 | 10.1 | 65.5 | 9,379 | 9.4 | 67.2 | -10,256 | 29,015 |
| 2008 | 22,457 | 14.4 | 66.5 | 9,827 | 4.8 | 69.5 | -12,630 | 32,284 |
| 2009 | 16,779 | -25.3 | 64.9 | 7,591 | -22.8 | 69.1 | -9,188 | 24,370 |
| 2009 Q1 | 3,971 | | 64.6 | 1,892 | | 70.5 | -2,078 | 5,863 |
| 2009 Q2 | 4,328 | | 65.4 | 1,829 | | 67.9 | -2,500 | 6,157 |
| 2009 Q3 | 4,285 | | 64.9 | 1,925 | | 69.4 | -2,270 | 6,119 |
| 2009 Q4 | 3,702 | | 64.6 | 1,945 | | 68.5 | -2,340 | 6,231 |
| 2010 Q1 | 4,417 | -6.8 | 64.7 | 2,045 | 8.1 | 69.2 | -1,657 | 5,748 |
| 2010 Q2 | | 2.1 | 65.7 | 2,502 | 36.8 | 72.5 | -1,915 | 6,919 |
| 2010 Q3 | | 22.7 | | | | | | |
| Average annual growth | 2005 - 2009 | -3.3 | | | -1.8 | | | -4.5 |

Source: Eurostat (Comext, Statistical regime 4), Trade A2 – CG/MP, January 18, 2011.

* Trade figures for Western Balkan countries from Eurostat include Croatia.

Taking imports and exports together, in 2009 only two countries from the 50 country ranking of the EU's major trading partners originated from the region of the Western Balkans. The 'usual suspects', if one could call them as such, are Croatia in 33rd place (accounting for 0.7%) and Serbia in 38th (accounting for 0.4%), respectively. In total, the Western Balkans had a volume of trade with the EU in 2009 that reached € 36.7 bn or 1.6% of the EU's total trade across a 50 country ranking.

The configuration of EU *imports* from the Western Balkan countries is heavily tilted towards manufactured products, which accounts for over 67% of the total. Within this product group, machinery & transport equipment accounts for 21.2% of the total, followed by other machinery (12.8%), and clothing (11.4%). The second largest product category of EU imports from the region is primary products (28.6%). The leading category among these is agricultural products, making up 14.5% of the total in 2009, followed by fuels and mining products (14.1%).

In terms of exports delivered to EU-27, during the past years these have been focused on base metals, machinery and mechanical appliances, electrical equipment and textiles. Any shift advocated in favor of an export-led recovery will have to take this specific trade configuration into account and identify both the opportunities and the obstacles to reshaping this export composition in the Western Balkans.

The EU has remained the main trading partner for every country of the Western Balkans.⁵⁴ In 2009 the EU accounted for

- 62% of FYR of Macedonia's total exports and 53% of total imports;
- 60% of Croatia's total exports and 63% of total imports;
- 58% of Serbia's total exports and 57% of total imports;
- roughly 70% of traded goods in Albania;
- 54.5% of Bosnia & Herzegovina's total exports and 45.9% of total imports (first eight months of 2010);
- 48% of Montenegro's total exports and 40% of total imports;
- 41.5% of Kosovo's total exports and 38.7% of total imports;

Let us now look at the Western Balkan countries' exports and imports with their main trading partners. As the graph below illustrates, the bulk of the trading volume of the Western Balkan economies is concentrated within the 27 members of the EU, followed by Russia in a distant second position. The first country from the region to register as a major trading partner of the Western Balkan countries, not surprisingly considering the data on the previous page, is Croatia. China follows in fourth place with a share of slightly over 4% of total trade. Somewhat surprisingly, given its geographical proximity, increasing diplomatic activity in the region and assertiveness as a foreign direct investor, Turkey continues to rank behind Bosnia and Herzegovina and Serbia in seventh place with a total share of only 2.6%.

Concluding this overview, let us take a final look at intra-regional trade activity and developments. How much do Western Balkan economies trade with each other and with Turkey? To what degree does this reflect increased regional cooperation and trade integration? The short hand answer is that while the volumes are increasing, they are still rather minuscule when compared to the primary trading destinations in the EU-27, i.e. Germany, France, Austria and Italy.

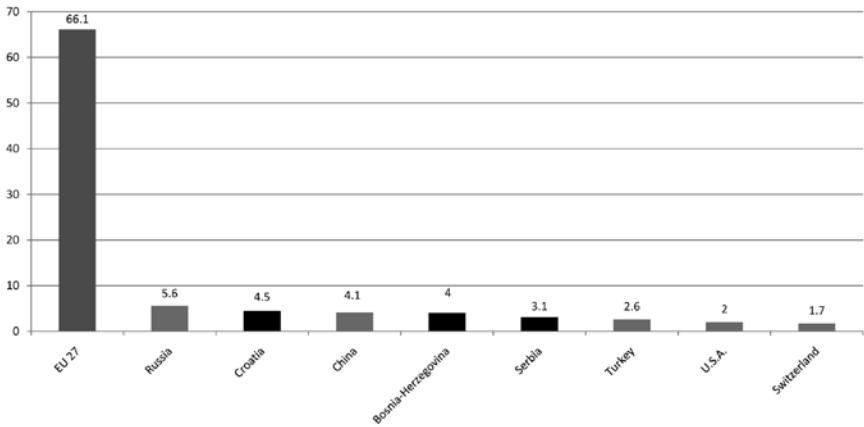
Table 3 - Western Balkan Countries' Trade in Southeast Europe (2009, in million of €)

| Croatia | Bosnia and Herzegovina | Serbia | Turkey | FYR Macedonia | Kosovo | Montenegro | Albania |
|---------|------------------------|--------|--------|---------------|--------|------------|---------|
| 1.66 | 1.48 | 1.18 | 951 | 395 | 232 | 184 | 11 |

Source: IMF (DoTS), DG Trade, European Commission, January 18, 2011.

⁵⁴ See the annual Progress Reports prepared by the European Commission for each individual country in the region, Brussels, November 9, 2010, SEC (2010), http://ec.europa.eu/enlargement/press_corner/key_documents/reports_nov_2010_en.htm

Figure 1 - Western Balkans Major Trade Partners 2009 (in %)



Source: IMF (DoTS), DG Trade, European Commission, January 18th 2011.

What is striking about the country-by-country differentiation of trade volumes among Western Balkan economies is the sheer distance between, for example, Bosnia and Herzegovina on the one hand and Albania as the regional ‘laggard’ on the other. The former trades roughly 11 times more with regional partners than the latter! Even Kosovo, a country that has existed for only two years, has a higher trade volume with regional peers than Albania and Montenegro. The exports from Western Balkan countries to the four candidate countries (i.e. Croatia, FYR Macedonia, Turkey and Montenegro) amounted to 7.2% of their total exports in 2009, accounting for approximately € 950 million, half of which was attributed to Croatia.

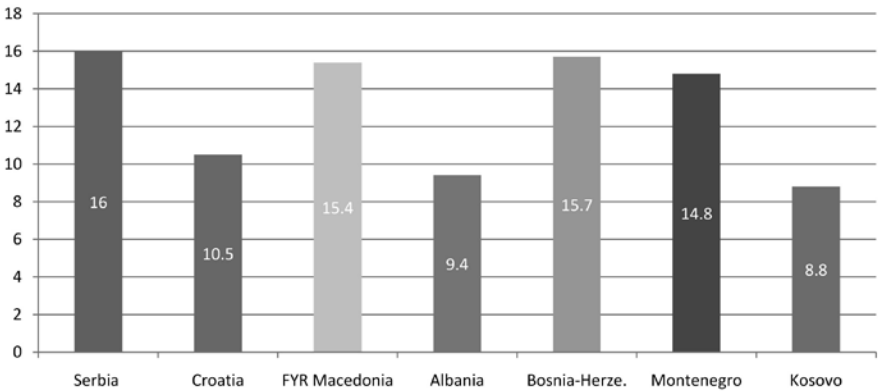
The EU-27 and CEFTA remain the two most important trading partners for countries in the Western Balkans. With the secondary effects of the global economic recession manifesting itself in the region, 2009 witnessed a significant decline in trade and current account imbalances between individual countries and their two main trading blocs. In particular, declining trade volumes with the EU could not be compensated for by CEFTA.⁵⁵

Regarding comparative trade volumes with CEFTA member countries, the regional configuration shows how trade with the countries in the region remains a critical benchmark. In the case of the FYR Macedonia, CEFTA is the country’s second most important trading partner after the EU-27. Regarding Albania, the EU remains by far the major trading partner, representing roughly 70% of total trade, while exports and imports with CEFTA countries accounts for 9.4%. The country facing the big-

⁵⁵ However, there are noticeable exceptions. Regarding Montenegro, exports to CEFTA countries increased from 33% in 2008 to 46% in 2009

gest challenge in CEFTA trade is evidently Kosovo, where difficulties related to the recognition of customs stamps with Serbia constrain trade volumes.

Figure 2 - Trade with CEFTA countries, 2009 (in % of total trade)



Source: Progress Reports prepared by the European Commission for each individual country in the region, Brussels, 9th November 2010, SEC (2010), http://ec.europa.eu/enlargement/press_corner/key-documents/reports_nov_2010_en.htm

However, though the dynamics in CEFTA trade volumes are guaranteed to increase, some countries in the region have recently illustrated a reverse trend. According to the European Commission, in Croatia the share of trade with CEFTA countries decreased to 9.7% in the first seven months of 2010. Over this period, CEFTA countries generated 5% of total imports into Croatia and 18% of all exports from Croatia (European Commission, Progress Report on Croatia, November 2010, p. 26).

Regional [economic] cooperation

This is another cornerstone of the work towards sustainable export-led growth in the region, yet is often more difficult to identify and does not feature prominently on observers' 'radar', even if it is constantly at play. It concerns the growing importance of regional and/or bilateral economic cooperation in South-Eastern Europe. One of the striking – and for that matter, often underreported – developments in the region during the past five years is the level and intensity of cross-border economic activity, increasing trade flows and the coordination of joint investment, in particular in large-scale infrastructure projects.

More specifically, this new narrative emerging in regional economic cooperation has been termed the return of the 'Yugosphere'. Tim Judah coined the expression, but does not apply it to developments in the economic and financial sectors. Rather, he focuses on countries in the former Yugoslav federation and highlights the re-emergence of the Yugosphere in the arts, culture and tourism. However, over and above this particular focus, other countries in the wider region are engaging in-

creasingly in economic cooperation and cross border investments. Some examples to illustrate the case in point:

Slovenia, Croatia and Serbia have recently created a joint venture in rail transport. After nearly 18 years of involuntary interruption and disruption, the train line from Sarajevo to Belgrade reopened in January 2010. A year later, in January 2011, Serbia and Hungary held auctions of cross-border electricity supplies. The Croatian consumer goods group *Atlantic Grupa* acquired the Slovenian food processor *Droga Kolinska* for € 243 million in 2010; the single largest takeover in South-Eastern Europe during the five year period.

Even in the military-industrial sector, recent foes in former Yugoslavia are now working together to build military facilities and modernize tanks in Arab countries. A Serbia-Croatia defense agreement was signed in June 2010, which also includes cooperation. Serbia is currently trying to win a US\$400 million contract to modernize 149 M-84 tanks that Yugoslavia exported to Kuwait in 1991. If the procurement contract is awarded to Serbia, some of the work will be shared between Bosnian, Croatian and Slovenian companies.

What do these examples of growing and diversified regional economic cooperation among countries tell us about the prospects for a Balkan recovery? First and foremost, as Cviic & Sanfey (2010) emphasized, the political and economic recovery under way in the region might lead one to a thought-provoking exercise in reconsideration of the stereotypes and cheap prejudice held regarding the individual countries of South-Eastern Europe. This is no longer a 'powder keg' waiting to explode. Rather, the region is steadily turning into a laboratory for the achievement of multiple objectives: integration into the EU, completion of the political and economic transition process and reconciliation through cross-border investments and coordination.

This will take time, and will still require considerable resources from the international [financial] community. There will be challenges and contradictions along the way, even slippage at times. The unfinished business of Kosovo, its stalled recognition process and cross-border relations with neighboring Serbia and the institutional stability of Bosnia and Herzegovina remain pressing issues on domestic and international agendas. However, these challenges are being addressed today in the 'courts' of public opinion, while solutions are sought in legal proceedings as well as in the myriad corridors of Brussels. Politically, at times, they persist as highly-charged issues.

Nonetheless, these issues and challenges no longer mobilize the region's citizenry which has moved on emotionally and is now preoccupied with more urgent and mundane issues, such as jobs, repaying foreign currency mortgages, using the ad-

vantages of visa-free travel inside the EU and making a decent living despite persistent corruption, the continued presence of oligarchs in economic affairs and a prevailing clientelism in the public sector.

Regional cooperation even extends beyond the region of South-East Europe and may serve other purposes. Recently, and for the first time, Serbia contributed seven soldiers to UNFICIP, the United Nations peace-keeping force on Cyprus. This token participation may appear insignificant at first sight when compared to other nations' contributions. Nonetheless, putting the Serbian flag on the ground in a UN mission in Cyprus provides a small contribution to regional peace keeping, bilateral cooperation and the active practice of synergies. It also includes greater rewards and serves far-reaching objectives. The fact that Serbia can gain additional international credibility and prestige should not be underestimated, especially considering that involvement in Cyprus enhances Serbia's standing with regard to its ultimate prize, i.e. EU integration.⁵⁶

Spill over effects from Greece?

As the twin fiscal and public debt crises unfold in Greece and the country's recession deepens, neighbors in South Eastern Europe are anxiously trying to determine how they will be affected by the developments in Athens. In light of Greece's track record of foreign direct investment, its foreign policy focus on the region and growing trade volumes between neighboring countries, Serbia, Albania, FYR Macedonia, Romania, Bulgaria and Turkey cannot remain indifferent to the magnitude of the crisis next door. Nor can they cast a blind eye to the possible solutions being addressed in Athens or advocated in Brussels, Berlin and Washington.

Serbia, Kosovo, Bosnia and Herzegovina and the EU member Romania currently have IMF-led stand-by agreements. These facilities have been in place since early 2009 (mid-2010 in the case of Kosovo). As regards Romania, the IMF program is being supplemented by financial assistance from the European Union, the EBRD in London and the World Bank. The same holds for Hungary and Latvia, another two EU members with multi-year IMF-led macroeconomic stabilization programs in operation.

What could be the short to medium-term repercussions of the Greek fiscal and public debt crises for its neighbors? Is the risk of contagion limited or imminent? Some spill-over effects have already started to manifest themselves. As Greek 10-year bond values fall and yields continue to remain above double-digit percentage levels, sovereign debt issuance and the risk premium investors demand to hold securities issued by Romania, Serbia, Bulgaria and Turkey have been adversely affected.

⁵⁶ I am grateful to Katharina Coleman from the University of British Columbia for pointing out this additional element of regional and/or bilateral cooperation.

Moreover, the ripple effects of the Greek crisis are being felt in three other key areas, namely the impact on foreign trade volumes, the level of remittances being sent back home from Greece and the cost of lending by the local subsidiaries of Greek parent banks operating in the region. As the 2010 reports from Greek commercial banks illustrate, they are being confronted with mounting problems concerning non-performing loans (NPLs) in their domestic market (in excess of 10% of the total loan portfolio) and in their main external markets, i.e. next door in Serbia, Romania and Bulgaria in particular (see Anastasakis et al. 2011).

Thus, these institutions have to increase the level of provisions, which reflect declining asset quality (e.g. in NPLs) and will impact their profitability for 2011 and beyond. Moreover, such provisioning also adversely influences available capital for banks' lending activities in Serbia, Romania, Albania, Bulgaria and FYR Macedonia. A return to the annual lending growth rates (reaching 50% and above), as seen across the region up until 2008, will not be repeated by commercial banks, in particular those from Greece and Austria, the Netherlands and Italy.

Between 2003 and 2008, Greece was the main source of foreign direct investment in Albania, accounting for more than half of the total. As regards bilateral trade volumes, merchandise trade with Greece reached 9% of exports and 15% of Albanian imports, respectively. However, already before the onset of the sovereign debt crisis in Greece and the deepening economic recession, the share of trade between both countries had started to decline, in particular because Albania had begun to move towards greater EU trade integration and regional trade diversification.

Despite the challenges they are facing in their domestic and external markets, Greek banks participated in the so-called "Vienna initiative" of 2009. More specifically, both public institutions such as the IMF, EBRD, the World Bank and the European Investment Bank (EIB) (the financing arm of the European Commission) and a host of private commercial banks are jointly providing unprecedented levels of financial assistance, grant funding and flexible credit facilities to partner institutions operating in the region.

Such cooperation between International Financial Institutions (IFIs) and private sector banks serves a dual purpose. On the one hand, it provides governments and businesses in the region with financial resources at affordable prices for onward lending to the corporate sector. On the other hand, the non-financial dimension of this intervention is not to be underestimated. As Cviiic and Sanfey (2010, p. 187) observe, IFIs and private banks are "helping in a major way, not just through the provision of hard cash but also by voicing confidence in the long-term future of the region".

In that respect, the facilities provided by the Vienna Initiative provide an external anchor, striving to stabilize the political and economic re-emergence of South-

Eastern Europe. Greek banks are thus committed to maintaining their exposure to these countries, even if this takes place with considerable financial assistance through multilateral financial institutions, such as the EBRD, which is providing critical capital resources to Greek subsidiaries in the region for onward lending to enterprises in Bulgaria, Romania and Serbia.

We also have to bear in mind that the recession-hit markets in South East Europe still have a long way to go until they can legitimately claim to be on safer economic ground. The secondary effects of the global economic and financial sector crises in the region can be felt in the real economies of these countries, e.g. in terms of declining consumer demand, indebtedness of private households and corporate entities as well as growing unemployment.

Under these difficult conditions, the economic crisis in Greece risks affecting the recovery potential of its neighbors. Over the past decade, foreign direct investment from Greece, rising trade volumes with each other and labor migration to Greece have all contributed to assisting the economic transition of its neighbors. This positive impact may be put on hold for some time to come.

However, possibly the most important issue on the minds of policy makers and central bank governors in neighboring countries is the potential consequences for the most crucial political project in the region: there is a growing concern across capital cities, from Tirana to Skopje, Belgrade and Ankara that the EU accession perspectives for countries in South East Europe could be affected, with the EU becoming rather cautious about enlargement and more rigorous regarding the economic conditionalities of membership.

It is in this area of foreign policy making where Greek leadership will be most crucial in the coming months. Sending out clear signals of engagement with the region, sustaining these with practical efforts of support for its neighbors can underscore this crucial message: despite the crisis and the challenges it poses, Greece will not become inward looking nor forget its neighbors!

Conclusions

Over the past two years, as policy makers and central banks from the Western Balkans groped for policy responses to the consequences of the global economic recession in their region, they increasingly latched on to a common idea: export-led growth.

Increased integration into the global economy and a successful transition towards trade openness with the European Union has become one of the defining hallmarks of countries in the Western Balkans. However, the export structure of all the countries in the Western Balkans continues to be unbalanced, i.e. highly concentrated

on a specific and limited range of products. For the FYR Macedonia, this imbalance concerns mostly textiles, clothing and manufactured iron products.

When the configuration of exports remains concentrated on a few selected products, this concentration has consequences on price sensitivity, in particular with regard to rising or declining commodity prices. Retaining international price competitiveness is therefore a key policy agenda of an export-led growth agenda. But this objective is tied to the exchange rate of domestic currencies to the Euro and/or the USD (oil imports are in USD).

Furthermore, addressing the countries' deterioration in international competitiveness remains a paramount issue on the national level of policy making as much as in regional arenas, e.g. CEFTA and the Regional Cooperation Council (RCC) located in Sarajevo. On the broader international level, completing negotiations for the remaining countries seeking accession to the WTO is critical. While they are making progress on the bilateral track with most existing WTO members, the finalization of this process will also depend on solving outstanding issues between countries within the region (e.g. non-tariff barriers, Serbia's relationship with Kosovo) and the continuation of internal reforms.

In the course of 2010 and during the first quarter of 2011, import demands from EU member states as well export capacity to neighboring CEFTA countries have continued to witness a recovery. In some countries of the region this dual development is more pronounced than in others. A functional regional market within the CEFTA architecture will continue to be important for trade integration and improving export capacities. In this respect, the planned liberalization of trade in agricultural products and services across the Western Balkans constitutes a key benchmark in increasing the region's trade potential and economic prospects (European Commission, November 2010, Enlargement Strategy).

Finally, the definition and implementation of an export-led growth agenda in the region is taking place against the background of limited public resources and fiscal policy making capacity among the various countries. Hence, due to the magnitude of investment needed, leveraging capital inflows from third party institutions with sustained capacity, building initiatives are required. This is where financial resources, through a combination of the EU's *Instrument of Pre-accession Assistance* (IPA), the *Western Balkans Investment Framework* (WBIF) and the *European Fund for South-East Europe* (EFSE), can and must seek to make a difference.⁵⁷ Together, they constitute a diversified platform of investment templates that are good examples how to link external finance with project-driven initiatives.

⁵⁷ Between 2007 and 2013 IPA assistance is making €11.6 bn available to participating countries. IPA has a trade component in its portfolio of activities. WBIF was established in December 2009 as a joint initiative of the EU Commission and partner IFIs (International Financial Institutions). It is designed to channel investments into infrastructure in the region.

How to foster growth through the strategic use of exports, IFIs' resource provisions for trade facilitation, credit financing of trade and competitiveness aspects, such as licensing requirements, rules of origin and non-tariff barriers are issues that will continue to occupy policy makers in the region in the coming years. It is a tall order to grow out of recession through exports that lack key elements of international competitiveness standards. Executing such a strategy at the expense of generating strong and sustainable domestic demand has various inbuilt risks. Until the region can combine both aspects of such a revised growth agenda, we will have to wait for the answer as to why no Taiwan or Singapore has emerged in the Western Balkans to date?

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From 2000 to 2007, economic growth in the Western Balkans had seen growth without change in employment or exports. The growth was accompanied by continuously high trade and current account deficits that had to be financed by the remittances of migrant workers, foreign direct investment and foreign loans; these sources all rapidly dried out after the global crisis erupted. Therefore, future growth of the region needs to be based on a recovery in exports. It must be asked then as to whether the export-led growth that has been experienced by Central European countries in the last 20 years is a paradigm which Western Balkan countries can follow. In this book, authors from both regions - from Hungary, Slovenia, Slovakia, as well as from Serbia, Croatia, Macedonia and Greece - analyze the individual economic experiences of their own countries and try to find a way out of the current crisis.