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Competitiveness of the Serbian Economy

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Competitiveness of the Serbian Economy

Executive Summary

Our research on the competitiveness of the Serbian economy indicates that Serbia is on the 69th place of 76 countries analyzed. Several recent studies suggest that Serbia's export is far less than its potential. This gap between real and potential trade, especially to the developed markets of the European Union and the United States, is a tremendous opportunity. The tenacity of that gap is among Serbia's greatest risks. Moreover, the moment of opportunity for Serbia to exploit its low cost labor position will quickly fade, erasing existing comparative advantages in agriculture, textiles and depletable natural resources. Serbia must strive now for more competitive firms products and sectors and to give the space for the propagation of product specialization if the country is to generate the exports over time necessary to sustain growth and development.[1] A key to the success in this effort to secure market potential for export is through the stimulation of trade with neighboring countries – to dampen the temptation for nations of southeast Europe to compete with each other for trade rather than to develop product differentiation and niche specialization.

This aim of this project is to analyze the competitive position of the Serbian economy and to propose various paths for the positive development of that position. This study also examines the main channels through which competition affects aggregate economic performance in Serbia, e.g. the balance of payments and the regular servicing of foreign debt.

The competitive position of a country cannot be understood only from the macroeconomic perspective. Firms and sectors are competitive, not countries. As such, this study places a strong emphasis on microeconomic analysis as well as more traditional macroeconomic analysis. Alternative scenarios of economic politics – the dynamics and pace of institutional reforms and the restructuring of privatization of companies - are modeled and projected forward for five years to demonstrate the cost and benefit of various policy options for Serbia's competitive position.

In short, the project is divided into four main sections: Macroeconomic analysis, Microeconomic case studies, Econometric Projections of reform scenarios, and Policy Recommendations. The final product serves as a contribution to both the macroeconomic policy discourse in Serbia and to the prospective investor who considers opportunities in Serbia.

1. Competitiveness and Development

1.1. Two concepts of competitiveness. We make a distinction between two basic concepts of competitiveness: *Micro competitiveness* which refers to competitiveness of enterprises as their

[1] Growth does not always facilitate development. Serbia's policy on competitiveness must address both. See Kamal Malhotra, et al. "Making Global Trade Work for People," UNDP, 2003.

relative advantage over other enterprises and *Macro competitiveness* which purports competitiveness of economy as a whole. Our research is structured in two basic segments as well.

1.2. Policy of strengthening competitiveness and exchange rate. Selection of a currency regime for transition countries (in this context Serbia should not be an exception) depends on several economic factors that change over time. Late transition requires a different currency arrangement than what exists at the beginning of the transition process.

European transition countries pass through three common phases related to currency regime: 1) at the beginning, they adopt a fixed regime or narrow fluctuation regime, 2) after key structural changes and establishment of a market system based on higher GDP growth, they adopt a regime of managed rate fluctuation with different levels of control, 3) after fulfilling economic, social, legal and political conditions (which should enable them to enter the European Union) they adopt the fixed rate (i.e. EMR II regime, which represents some kind of «waiting room» for entering the European Monetary Union and switching from national currencies to EUR).

1.3. Development and Investments in Serbia. After negative GDP growth rates (-6% on anual basis) along with negative efficiency during the 80's, in the 1990's less than 50% of depreciated fixed assets were reinvested. The data on investment in industrial equipment in the 90's offers an even less favorable image: below 15% of depreciated value, and during the last years of the past decade this statistic fell even below 10%. Depreciation was uncritically included in current consumption, which sabotaged the basis of further economic growth, while the standard of living was sustained at an artificially high level. Some projections suggest that investments might reach 20% of GDP in Serbia by 2005. For the purposes of comparison, the European Bank for Reconstruction and Development (EBRD) evaluated that relative to all Central and Eastern European countries, in 2001 the share of investments in GDP was largest in Czech Republic at 35% and lowest in Croatia at 23%.

The structure of Serbia's economy is almost identical to that of 25 years ago. Production was dropping and fixed capital was overflowing into consumption. In terms of the level of development, measured with GDP per capita, in 2001 our position was close to 25% of the position we had compared to Slovenia in 1989. Concretely, in 1989, GDP per capita in Serbia and Montenegro (excluding Kosovo) totaled half of Slovenia's GDP per capita. In 2001 GDP of the Federal Republic of Yugoslavia totaled between 12% and 13% of Slovenian GDP. A huge gap also exists in comparison to Central European countries, which are now in the EU. Our GDP per capita is close to one quarter of the GDP of the weakest country from this group. The informal economy, the effect of which can not be precisely determined, contributed a certain extent to the moderation of negative consequences on living standard, but can not serve as the foundation for development.

Taking into consideration different versions of the average equipment lifetime, it can be concluded that industrial equipment has depreciated to 12%–15% of its real value in 1989. This technology base is now inefficient and out-of-date with modern market requirements. The lack of investments in modern equipment and technology thereby directly influenced the fall of Serbia's economic competitiveness. Together with the political and economic closing of the country, this represented the key factor of unfavorable development in the export field i.e. in the balance of payments.

2. Analysis of Dynamics of Foreign Trade

2.1. Sector Indicators of Competitiveness and Revealed Comparative Advantage (RCA). Sector analysis of the results reveals the unfavorable export structure of Serbia and Montenegro – the share of food and live animals (sector 0) is dominant in export, as well as the share of products sorted by material (sector 6) – foremost various semi-products. The analysis also shows deterioration of the structure of export during the 90s: with the share of the zero sector increasing, while the importance of machines and transportation (sector 7) and chemical products (sector 5) are declining, i.e. products with the highest level of industrial processing. During the entire period, in the export structure is dominated by labor and resource intensive products. Recent efforts at foreign trade liberalization were followed by greater diverification of export, which demonstrates Serbia's extremely low specialization.

Empirically established comparative advantage is called Revealed Comparative Advantage (RCA). At the level of total trade the RCA indicator represents the relation between foreign trade balance and the total volume of trade. In the period from 1989 to 2002 RCA reveals a major decrease of competitiveness of Serbia and Montenegro's export. While in 1989 the foreign trade deficit totaled only 7,3% of trade and in 1990 - 12,4%, in 2002 it reached 47,1%. The number of product groups with a positive RCA preactically halved after 1989. Comparative advantage was maintained predominantly in primary products.

The European Union is still the most important trading partner for Serbia and Montenegro. However, as the result of the non-competitive export position of Serbia's products, the goods deficit with the EU accounts for over 40% of total foreign trade deficit.

In general, exchange rate depreciation stimulates export. However, the structure of supply of our goods and services is very modest and therefore it is not very likely that lowering their price could stimulate import demand for those products. In the case of lowered prices of domestic products import demand elasticity is extremely small and depreciation of exchange rate woud not "pay off". The poor quality of Serbia's products, lack of certified products, small number of products adjusted to new international standards, small series, loss of former distribution network, impossibility of sale crediting, etc. prevent a larger part of the economy, especially industry, from increasing export in the short term, regardless of the exchange rate. In fact, the stimulation of export through a depreciated dinar exchange rate under present conditions is all but impossible.

The export position can expand only through improvements in the real sphere of the economy – through productivity growth and through improvement of product quality; through the use of modern technology and modern management techniques and through efficient production processes.

2.2. Export dependence and non-price competitiveness factors. Based on the results of econometric analysis, the effect of export dynamics on cycles of industrial production (as indicators of economic activity) and export's effect on the fiscal burden proxied by real public revenues per industrial production unit are in the long-term equally important. The relation between short-term export oscillations, on production oscillations, and export dependence on unit labor costs is of lesser significance. There is no significant relation between export and exchange rate, whether stated in dollars, EUR or based on the basket of currencies.

Nowdays prices have much less importance in explaining competitiveness than they had in the past. However, prices are still an important competitiveness factor in countries that have low income per capita (markets sensitive to changes of prices) and also in cases of high-standardized products (such as stock products). In cases of products with a higher level of final processing, the price competitiveness factor looses its importance, while non-price factors become more important, especially quality, easy-to-use features, product life-time, safety, reliability, terms of delivery, warranty period, servicing and supply of parts. All the above mentioned characteristics are called *non-price competitiveness factors*. Precisely in processed goods Serbia, has recorded major drops of competitiveness, especially due to the influence of non-price competitiveness factors.

3. Microeconomic Aspects of Competitiveness

Microeconomic research of the competitiveness of the Serbian economy fell into two phases:

I Elite Interviews to collet qualitative attitudes of Serbian businessmen, based on the basic concepts of international competitiveness from the modern economic literature;

II Field Survey phase and construction of the Microeconomic Competitiveness Index.

3.1. Elite Interviews resulted in the following conclusions concerning the most important competitiveness factors:

Exchange rate. Labor intensive enterprises with large number of workers (for instance the textile industry) consider that the exchange rate is depreciated, since foreign currencies obtained from export are used for payment of employees' salaries. Less labor intensive companies, which have a large share of export in total sale, prefer a stable over a fluctuating exchange rate, since they prefer predictability in the realization of business plans.

Banking sector. Majority of businessmen emphasize that the banking sector in Serbia does not correspond to the modern needs of businessmen. Specific objections refer to: lack of credits and very large gap between active and passive interest rates. A more significant role of the state is expected to support export expansion, through state subsidies in crediting export and production.

Marketing Majority of enterprises emphasize that they do not have developed marketing and that they are not very oriented toward satisfying consumers' needs. Serbian businessmen emphasize they export mostly under foreign trademarks.

Consumer ethnocentrism. Consumers in Serbia express a significant tendency toward foreign trademarks, even toward those coming from the countries Serbia was in war with. In the region of the Balkans, Serbs show the highest tendency for shopping abroad. Although they do not often travel abroad, Serbs purchase products of higher value. Consumers from surrounding regions do not prefer shopping in Serbia.

Foreign trade barriers. Businessmen emphasize they are encountering: wrong structure of tariffs (high tariffs on raw materials, low tariffs on final products), import dependence, slow procedure for reimbursement of customs duties paid on raw materials, etc.

Bilateral agreements on trade preferentials (Free Trade Agreements) are signed with only five surrounding countries. Having in mind that Serbia is not a member of the World Trade Organization (WTO), conclusion of such bilateral agreements with the surrounding countries (Romania, Bulgaria and other countries) would improve Serbia's foreign trade.

Public procurements. Businessmen feel that the Law on

Public Procurements should be modified to favor domestic enterprises.

Dumped export - import. Since 1990 imported textile, clothing and footwear, household appliances and numerous consumer goods are dumped to squeeze out local brands. This practice is not sanctioned.

3.2. General conclusions of interviews conducted with businessmen are: enterprises expect state activity in terms of improving foreign trade competitive advantage, while enterprises themselves do not take enough action. Most of the demands come down to assistance in crediting of export and production.

3.3. Field Survey – The survey was conducted on a representative sample of production and trading enterprises. Collected data was analyzed individually and through indexes of aggregation. The most important individual results follow:

Motives for export. The main financial motives for export are improving business results and lowering costs. General marketing development on the market of Serbia was evaluated as poor, so marketing motives for export almost do not exist at all. The quality of management was evaluated much better.

Prices of export products very much depend on demand. Only one third of the interviewed businessmen (mainly exporters of primary and agricultural products) evaluated very positively the demand for their products, while exporters of car parts, electrotechnical products and mechanics, confection and metallurgy products have problems with demand for their products. Source of the price competitiveness lies in low costs of resources (labor and natural resources, 'draining' of the existing technology). Export is based mainly on low prices of nonbrand-name products.

Almost one half of the interviewed (45.7%) stated they pay taxes equal to 20% of annual corporate income, while 17,2% stated they pay 31%, even 40% tax.

Technological sophistication in Serbia is evaluated as extremely low. Businessmen agree that constant innovations are the source of competitive advantage, but they emphasize they do not have financial means for innovations. Enterprises themselves do not conduct much research (with the exception of pharmaceutical firms). There are no subsidies for research-development activities. Foreign Direct Investment (FDI) is perceived as the solution.

Administrative regulations are often changed, which increases the costs of their application. Corruption is present at big tenders and in public procurements. Therefore, the correspondingly very low trust in politicians is not surprising.

Foreign Trade Liberalization. In a very short period (from 2001) Serbia performed a very rapid liberalization of foreign trade. The country's antimonopoly policy was evaluated as unsuccessful and inactive. The law protects property rights, but practical application of legal protections is unsatisfactory. Protection of intellectual property is evaluated as extremely weak and inefficient. Regulations on environmental protection Serbia are weak, and their application is inadequate (chaotic).

Infrastructure. Interviewed businessmen evaluated Serbia's infrastructure (roads, railway, airports, ports) as very poor and they consider that the state priority should be improvement of information-communication technology. Businessmen also stated that the existing Government programs for promotion of information technology are not very successful.

3.4. Competitiveness Indexes – The research on microeconomic competitiveness of Serbian economy generated results utilizing two aggregate indexes:

1. Growth Competitiveness Index (GCI);
2. Microeconomic Competitiveness Index (MICI).

3.4.1. Growth Competitiveness Index (GCI). This index measures capacity of a national economy for achieving stable economic growth during a medium-term period. Various growth factors have different roles at different levels of economic development. Technology has a key role in all phases of economic development. Public institutions are especially important in the initial development phases. Macroeconomic environment has constant importance, but is foremost during the initial phases.

We have added Serbia and Montenegro to the Group of 75 countries, which the World Economic Forum (WEF) included in its research from 2001. In the final score Serbia and Montenegro holds 69th position, out of total of 76 analyzed countries. We would like to note that the WEF list includes only half of the world countries and therefore being at the bottom of this list does not mean being at the same time on the bottom of the list considered by potential investors.

Technology Subindex. With an index value of 3.16, Serbia is far behind all transition countries (Ukraine is the closest, with an index value of 3.68). Among the countries in the region, Bulgaria has the worst result, with a significantly higher index value of 4.32. The weakest subindex in this index (compared to other countries) relates to information-telecommunication technologies (ICT) – 2.15, i.e. 75th place, while the innovation subindex is just slightly better (1.79 i.e. 65th place).

Public Institutions Subindex. In case of public institutions index Serbia and Montenegro hold 51st place. Romania and Bulgaria follow right behind, but also the Czech Republic. Public institutions have significant influence on economic growth at lower levels of development.

Macroeconomic Environment Subindex. Based on macroeconomic evaluations of competitiveness, Serbia and Montenegro is ranked on the 73rd place, among 76 analyzed countries (2.96). Out of the three subindexes, our country has: a) an exceptionally good position in the subindex of share of public expenditures in GDP during 2000, ranking SCG on the 14th place; b) a disastrous credit rating – the fact that we hold 74th position and that the subindex value is lowest possible (1.01) speaks in favor of this, *and* c) fragile macroeconomic stability (74th place, index value of 2.78).

Regression analysis indicates that economies based on technological products recorded faster growth than commodities-based economies, which is the case with Serbia for which key export products are: frozen fruit, grain, ore, semi-products, etc. Achieving technologically advanced production becomes an imperative of economic development policy.

3.4.2. Microeconomic Competitiveness Index (MICI). *The Microeconomic Competitiveness Index (MICI) provides conceptual framework for comparative analysis of basic current competitiveness of national economies.* MICI examines microeconomic basis of a national prosperity, measured by level of gross domestic product *per capita (GDP pc PPP).* It is obtained from the indicators included in the Questionnaire on attitudes of managers/businessmen and from two indicators from the official statistics: GDP *pc* PPP and the number of patents *per capita.*

Statistically, the most important variables of microeconomic competitiveness for countries with low GDP *per capita* (such as Serbia) are:

a) Variables of business development and enterprise strategies: marketing development, quality of production process, development of trademarks and nature of competitive advantage (competitiveness based on cheap resources or innovation-based competitiveness).

b) The national business environment was analyzed through elements of a "diamond of competitiveness". Among variables of availability of production factors, infrastructure has the greatest significance (ports, airports, telecommunications, public schools). Among the terms of demand, the most important statistical variables are: presense of regulatory standards and stringency of ecological standards. Within the factor “linked and supporting industries” most important is quality of domestic suppliers and availability of domestic components and parts. Among variables of the context for shaping strategy important are: hidden trade barriers and efficiency of antimonopoly policy.

Based on our analysis, the domestic economy is ranked in the following manner (in relation to 76 observed countries):

Ranking according to GDP level (PPP principle)	72
Ranking according to Microeconomic Competitiveness Index	71
Ranking according to business subindex and enterprise strategy	75
Ranking according to quality of national business environment subindex	69

Based on the business subindex and enterprise strategy, in 2000 our country held the next to the last place - 75th place, ahead of Bolivia. The weak position, based on the MICI index, is the result of poor business subindex and enterprise strategy. The business environment (although incomplete and undeveloped) offers more than companies are ready or capable to use. All transition countries we are trying to compare ourselves with (Hungary, Poland, Czech Republic, Slovenia, Slovak Republic) are far ahead of us – according to the total index and also according to both subindexes. A few places ahead of us are Romaina and Bulgaria, according to all the indexes. Serbia belongs to a group of countries having appreciated GDP per capita. That means that our current level of GDP pc exceeds our real microeconomic competitiveness given by MICI index and that is unsustainable in the long term.

4. Sustainability of the Balance of Payment

According to the current plan, payment of interest and principal of the inherited foreign debt, a critical burden on export and GDP, is to occur in the period 2007-2009.

By analyzing different scenarios, it is quite certain that, during the entire next decade and even after that period, Serbia will encounter the problem of foreign investment inflow and supporting the deficit of current transactions in the balance of payment. Projection of the balance, based on all needs (before all the balance between consumption and investments in development) will depend on the type of development strategy and economic policy; resources from domestic GDP, domestic savings and foreign savings invested, foreign debt servicing (this also includes budget sustainability), as well as the level of consumption and the relative social acceptance of limiting consumption under the existing circumstances. The general political climate and political stability in Serbia should provide an environment in which this will be realistic.

Based on the experiences of successful transition countries, the share of investments in the GDP could reach 25% till the end of the decade. In 2005, that share should reach at least 20%, while the share of foreign savings in financing should total approximately 1/3 of total investments.

Foreign debt servicing is sustainable only provided foreign saving inflows through investments from abroad (in the period 2003 - 2010 they should cover at least 25% of total investments), while the commercial debt before 2009 should not exceed (on average) 10% of the value of investments.

Long-term stability should not be jeopardized since it may lead to efforts to stabilize the balance of payments through real depreciation of the dinar. Even if it temporarily reduces the deficit, later it increases obligations in the balance of payments and in the budget, especially during a critical period of major a burden of export and GDP.

There are critical lower limits of average economic growth (3%) and export growth (12%). They are mutually dependant. Faling below either limit, irrespective of the other, leads to (during the second five-year period of this decade) exceeding critical limits in terms of the debt servicing rate and burdening GDP with debt servicing - i.e. it leads to new external insolvency, to new reprograms and to new recession.

5. General conclusions

Basically, the issue of increasing competitiveness comes down to choosing between two development strategies. *The first strategy:* to make profitable a critical number of enterprises that are 'below the margin' through depreciation of the domestic currency, parallel with strengthening tariffs and non-tariff protection (protectionism). This strategy can be used to preserve and reproduce the inherited economic structure. In the Serbian economy this structure is out-of-date and predominantly compatible with the market that existed two or three decades ago. *The second strategy* starts off from a market value exchange rate and from the liberalization of foreign trade. It stimulates enterprises that are below the margin of profitability to increase productivity and efficiency, to change production programs and to achieve competitiveness through technological development and development of quality. Enterprises that can not achieve this are closed down. At the same time new enterprises emerge that are capable of profit under the given conditions. This way, investments are directed at establishing a new, modern structure of economy; competitive both on domestic and on foreign markets. But this requires an open economy and sound market environment, which will be suitable for foreign investments and domestic savings that are aimed at establishing small and medium enterprises to absorb manpower from enterprises closed down. This also requires good social programs, instead of the social function of subsidizing enterprises 'below the margin'.

Serbia has to build a modern material and information infrastructure and to modernize its enterprises in order to increase the value-added per employee. Without foreign capital, our enterprises can renovate their programs over an average period of 20 to 25 years. Enterprises in which foreign savings and management participate can do this in 3 to 5 years. Relative to the European industrial countries, the technological lag of our economy totals 5–6 technological years, which is equivalent to 30-35 years in time.

Investments in the modernization of equipment and production processes is the key presumption for improving competitiveness and for achieving higher export growth. And - the increase of export revenues is the first precondition for foreign debt servicing and for providing resources for financing import of equipment and technology. It is also the precondition for economic development in the years to come. In order to achieve economic growth, to realize constant GDP growth and to increase the standard of employees, Serbia has to reach global competitiveness – foremost on markets of the EU countries with which it realizes the greatest part of its foreign trade and capital flow and to which it has major foreign debt. Economic policy has to develop both competitive and comparative advantages of Serbian economy.

The creation of a favorable climate for foreign investments transcends 'standard' macroeconomic surmises. FDI requires application of development policy free from influence of bureaucracy and free from slow administrative procedure (registration procedure, employment procedure, export procedure, profit repatriation, providing legal protection, etc.). Further, the existence of transparent and appropriate legal regulations and efficient banking (i.e. a finance sector) is assumed. The state should stimulate and support all changes that lead to strengthening the production base and real competitiveness of export. Only additional investments in modern technology and human capital (knowledge, specialization, etc.) could increase the growth rate and thereby ensure two objectives: a) an increase of the living standard (income *per capita*) and b) enabling regular fulfillment of obligations toward foreign creditors (debt servicing).

Serbia must prepare a complex development policy (in which one of the parametars will be attracting foreign savings – foremost foreign direct investments which bring, apart from capital, modern technology and management processes), to provide export market and to activate processes that improve the business of domestic enterprises. For this purpose, intervention is needed in many fields. Tax burden for the use (exploitation) of natural resources and unrestorable energy sources should be increased. State financial support should be preserved only in cases of producers that realize higher added value. This would stop economically unjustified increases of capital intensive production, for which results are modest, from the aspect of value-added growth.

Priority support should be given to non-material investments based on knowledge, modern know-how, innovations and new production techniques. Serbia should commence production cooperation and development cooperation with the surrounding countries, aimed at creating synergistic effects in some industries and activities. Foreign investors express great interest in such cooperation. The examples of the Czech Republic, Slovak Republic, and transition Baltic countries offer important lessons here. For this purpose, one should define potential production nuclei which could include enterprises in private and public ownership. It would be necessary to offer a concrete assistance in penetrating regional markets. It is necessary to stimulate - in cooperation with foreign partners - regional development of concentrated economic zones attractive for foreign investors (clusters).

Since gross labor costs can be compensated only with greater productivity, economic policy must favor all those processes and activities that contribute to increase the volume of production per employee. The problem of loss of competitiveness occurs in cases where an increase in costs is not amortized with an increased productivity. Non-price competitiveness factors, such as quality, design, terms of delivery, servicing, and international quality (certification) logos can be crucial for increasing export, but they alone can not amortize high relative costs.

As in the case of other transition countries, the selection of currency regime is of great importance for Serbia's economic growth and economic stability. There is no 'best' version of currency regime that is set in advance and which would maintain constant advantage or which would represent the best solution for each individual country. At that, it is not necessary to make a difference between fully fixed and fully fluctuating currency regime, but it is necessary to make a difference between different levels of flexibility. The successful development of a transition economy (especially based on the experience of the Central European countries) is reflected in the real appreciation of the domestic currency. Increased productivity in the trading sector reduces unit costs of production, equivalent to the real appreciation of the exchange rate.

Further, various measures for the sterilization of money can for some time reduce the increase of the exchange rate and ease inflationary pressure, but none of these measures can fully prevent real appreciation of a national currency exchange rate in conditions of constant and major foreign capital inflow. It is of special importance that the Central bank strictly supervises the behavior and financial balance of commercial banks, and – if necessary - establishes a special fund for the insurance of deposits. Also, realization of regulatory norms and accounting standards, in commpliance with the Basel Standards, should be considered a element of protection of the country's financial policy.

The more the Serbian economy integrates to markets of the EU countries and to markets of developed transition countries, the more it will encounter greater oscillations in capital flow toward its own financial space and beyond it. This raises a question on how to control such flows. The experiences of other countries indicate that the reduction of short-term capital inflows/outflows is a reliable way for soothing capital flows in domestic financial space and for preventing its uncontrolled flow at the will of speculative interests.

6. Agenda for increasing competitiveness of Serbian economy

Under the circumstances of mutually connected and dependant systems, no individually performed economic policy can lead to an increase of Serbia's competitiveness. There is a *set of measures*, which would be synchronized, functionally harmonized and aimed at the same objective.

6.1. Monetary policy

i. Follow a neutral currency policy i.e. to maintain monetary balance as the key to stability of prices and a balanced exchange rate of the national currency.
ii. Transfer to a controlled fluctuation regime instead of the 'quasi fixed' regime as teh export base increases.
iii. Conduct monetary policy with the greatest possible reliance on open market operations and with the least possible manipulation with obligatory reserves and credit limits policy.
iv. Add elements of sterilization of primary cash created from foreign capital inflow.
v. Develop to the maximum the control functions of the Central bank.
vi. Develop a securities market.
vii. Perform additional capitalization of banks and, afterwards, to offer them for sale to a strategic partner (in principle - up to 49% of ownership rights).
viii. Protect the financial system from any kind of influence from state bodies or interest groups.
ix. Set limits to business banks for redemption of state bonds for covering the budget deficit.
x Modernize and to educate staff in banking and non-banking financial institutions, e.g. insurance agencies, pension funds.

6.2. Fiscal policy

i. Commence transfer of a part of the burden of social protection from the state to the private sector (which will indirectly influence development of the financial market).
ii. Develop the Second and pillar of pension insurance.
iii. Introduce the VAT, which will broaden the tax base.
iv. Introduce two VAT rates: a lower rate for medicines, children's accessories, public transportation, basic food products (e.g. 8% and a standard 20%).
v. Provide instruments for allround tax collection, along with improvement of the working organization of tax institutions.
vi. Redefine fiscal policy from a short-term (1 year) to a medium-term financial strategy (3-4 years).
vii. Direct reform of the tax system to two main directions: broadening the tax base and lowering marginal tax rates in all activities, sectors and industries that directly contribute to economic development.
viii. Determine the development budget i.e. to gradually redirect one part of public expenditures from consumption to investments.
ix. Build the human capacity of the tax administration and its supervision bodies.

6.3. Privatization

i. Improve the existing privatization model in terms of:
   a. Evaluation of offers that include a development effect - both on a bought company and on the entire economy.
   b. Allowing participation of portfolio investors, which have to revitalize a bought company prior to next sale.
ii. Restructure unsuccessful companies prior to privatization only in exceptional cases, when this does not require large resources and when there is a small risk of failure.
iii. Enact the Bankruptcy Law –necessary for 'cleaning' the economy. In application of this law it is necessary to conduct training of bankruptcy administrators and to establish social programs and programs for the recovery of SMEs.
iv. Resources acquired from sale of companies should be directed at crediting export-development projects.

6.4. Foreign Direct Investment

i. Ensure non-disriminatory treatment of foreign investors.
ii. Simplify the entire legal-administrative procedure related to foreign investments; from the preparation for production to profit repatriation.
iii. Offer to foreign investors qualified legal assistance and other kind of assistance.
iv. Prepare a transparent system of legal protection of foreign investors.
v. Form special export zones (with tax and other benefits) aimed at attracting FDI for stimulating development of some of the country's regions.

6.5. Development of Small and Medium Enterprises

Small and medium-size enterprises (SMEs) will take over the key role in the transformation of Serbia's economic structure. Their role is especially distinctive in the sector of services and capital unintensive activities. Achieving appropriate proportion between SMEs and large enterprises is of vital interest for the long-term growth of the Serbian economy's competitiveness. Therefore, it is necessary to realize several synchronized programs for stimulating SMEs.

i. Stimulate the development of SMEs through an Agency for Small and Medium Enterprises. Small and medium enterprises should be provided with:
   a. Assistance in crediting – verifica-

tion of business plans and assistance in conducting business policy (financial management);

b. Assistance in marketing – small enterprises should use these services from outsourcing and terms for exporters should be more favorable;
c. Assistance in human resources management – especially in education:
   - management courses and sales courses, marketing and business organization courses,
   - courses on the use of modern technology, information technology, logistics,
   - new ways of financial business (new financial instruments, new modes for obtaining financial resources, risk management, etc.);
d. Technical assistance in achieving export – assistance in realization of complex administrative procedures.

ii. Stimulating cluster development - regional and economic development, by creating conditions for cooperation of small and large enterprises in a planned environment.

iii. Stimulating cooperation between domestic SMEs and transnational companies (TNC) that are investing in Serbia through FDI.

iv. Financial support.
   - Guarantees for obtaining necessary bank credits;
   - Co-financing specific products and services rather than financing enterprises (high value-added products, products for market sectors, products for certain attractive markets, tourist services, etc.).

v. Program for quality.
   - Budget co-financing of organizational, production, technological and other changes necessary for improving quality;
   - Facilitating increased information flow from the international market, aimed at achieving International Quality Standards;
   - Facilitating increased information flow on new production procedures, and technological solutions.

6.6. Foreign Trade Strategy

i. Improve technological foundation of export-oriented enterprises through state subsidies for the introduction of modern technology in SMEs and by stimulating the inflow of foreign technology through complex foreign trade businesses (leasing, franchising, FDI).

ii. Stimulate innovations and improvement of quality and standardization systems.

iii. Establish an Export Agency for export insurance, export crediting and marketing.

iv. Stimulate export-oriented FDI, through production in free export zones.

v. Regional specialization of export – conclusion of bilateral agreements with target countries; development of business and political partnerships.

vi. Improvement of infrastructure of the foreign trade network and foreign trade operations through education programs.

vii. Pass the Law on Monopolies.

Introduction: Economic Crisis in Serbia

1) The sources of chronic crisis

Chronic economic crisis in Serbia, inherited from the former communist regime, emerged from the nature of the economic system and from the development and economic policy congruent with such a system: based on social ownership defended by a closed, self-sufficient economy. Those factors led to deep structural inefficiencies. Most essentially, investment fell to negative values during the 80's, when their share of GDP halved.

After soverign indebtedness reached a pinnacle at the end of 1981 (21,1 billion dollars or 15,7 billion dollars more than at the end of 1974) a blockade on financial transactions was imposed in 1982 and, beginning in 1983, a series of arrangements with the International Monetary Fund (IMF) was negotiated. In the period of 1980 to 1984, annual growth of monetary mass was 28% and during that five-year period annual inflation reached 44%.

The result: during the 80s (1979-1989) annual GDP growth averaed 0,6% (0% *per capita*). In 1989 fixed investments dropped to 15-16% of GDP and their efficiency became negative – i.e. the invested dinar was not recovered through GDP growth.

2) Economic activity and economic policy in the period 1990-1998

The chronic crisis became critical with disintegration of Yugoslavia. Initially, the flow of goods between the republics was hindered (for instance, 1989 boycott of Slovenian goods in Serbia, the response of Slovenia, etc.). In 1990, republic central banks conducted an effort at redistribution in their favor through unauthorized emission of money. The defensive mechanism to conteract this was the suspension of payment operations between the republics, which was followed by further reduction in the flow of goods. In the second half of 1991 the country was in the civil war, which resulted in significant destruction of infrastructure and the complete suspension of formal economic cooperation between individual republics.

At the end of 1991 the European Economic Community (EEC) imposed sanctiones that were only an introduction into the UN sanctions (imposed in May 1992). Those sanctions included a trade and financial embargo. Each phase of the UN sanctions yielded stronger negative effects on the country's economy. Supply chains and foreign trade were interrupted. The

*Chart 0-1: Efficiency of investments**

	Growth in dinars (prices - 1972)			
	1952-60.	1961-70.	1971-80.	1981-90.
SFRY	38.8	26.8	21.1	-3.5
Bosnia and Herzegovina	28.0	23.8	16.4	-1.2
Montenegro	10.2	16.6	14.9	-5.1
Croatia	44.8	28.7	21.4	-5.9
Macedonia	26.4	21.6	18.7	-3.2
Slovenia	45.3	35.4	24.2	-3.8
Serbia	43.5	26.0	22.5	-2.7
- Central Serbia	37.0	25.7	25.7	-1.2
- Kosovo	36.4	17.0	11.3	-6.8
- Vojvodina	68.7	30.3	19.9	-5.1

* GDP growth on 100 dinars of gross economic investments in fixed assets

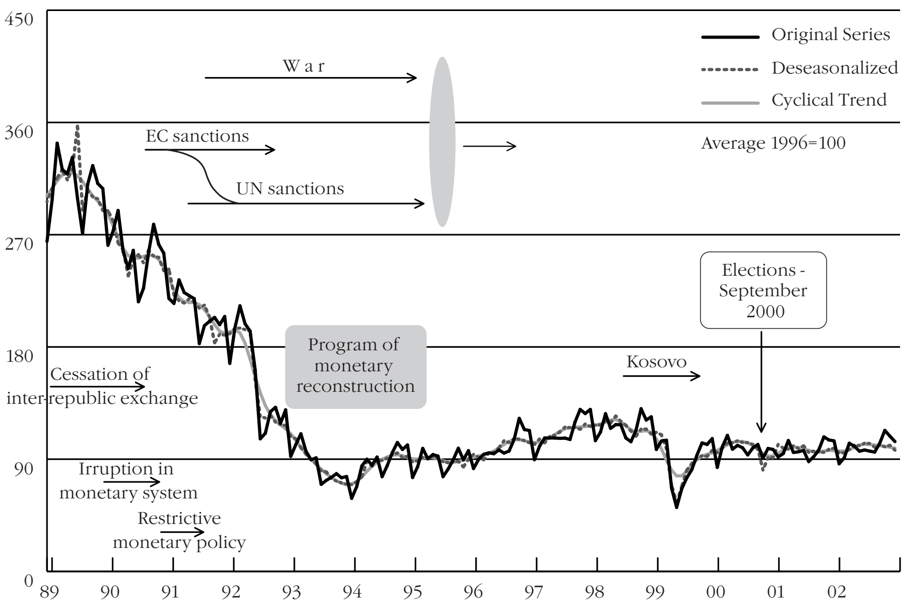
Source: Development of former SFRY republics; Federal Office for Statistics, 1996

Institute for Economic Sciences estimated the reduction in industrial production of about 40%, which occured in only few months, was a direct result of the Security Council sanctions. Insufficient flexibility of socially-owned enterprises and the management model in such enterprises also contributed to the dramatic fall in production – socially-owned enterprise mangement expected the state to solve their problems.

Economic policy was entirely incompatible with the new situation. At first, it hesitated to accept the new objective situation in the economy. When economic policy finally recognized the new situation, it did not undertake the necessary radical measures. This applies foremost to the radical reduction of public consumption and its deficit. Instead, the state (and its economic policy) supported the social model of emission-based financing and state operations based on inflation tax. This was followed by frequent radical destabilizing shifts between the state adjusting the official rate to match the black market exchange rate to rigid financing of the official exchange rate; control and liberalization of prices; etc. Once financing based on primary emission was broadened to include the entire public sector and a number of large socially-owned enterprises, hyperinflation reached a point when the inflation tax collected by the state was rapidly vanishing. Forcing enterprises (August 1993) to sell their goods at maximized prices resulted in destruction of the economy's floating capital. Production almost stopped. The market was suspended and its remains were suppressed in the zone of grey economy. In 1993 Yugoslav GDP dropped to 9,5 billion dollars (author's estimate)with a strong downward trend. We estimate that Yugoslavia entered 1994 with a GDP of approximately 700 dollars *per capita*.

The January 1994 Avramovic program for reconstruction of the monetary system cut uncontrolled monetary emission. Instead of the old currency, which was nullified with hyperinflation when monetary mass (M1) was reduced to a symbolic 50 million DEM. a new dinar was created and tied to DEM. Over several months, *remonetization* (the injection of new money into an empty space) enabled a fast increase in salaries, growth of the monetary mass

Graph 0-1: Industrial Production Index



and the crediting of enterprises that were selling out their reserves. Production epanded for nine months, untill October 1994, when it was interrupted by teh suspension of monetary emission due to movement in prices and the creation of a black market exchange rate. By that time, the black market DEM exchange rate was 35% higher than the official exchange rate.

The second wave of production growth in the 1980's came after the suspension of sanctions and prior to the final lifting of sanctions (this was followed with devaluation in November 1995). This second wave lasted for five months, mostly during the second half of 1996. It faded with the suspension of monetary expansion which followed this growth. Shortly after, a third wave of growth emerged - from the second quarter of 1997 through the first half of 1998. This growth was connected with the inflow of up to US$ 1 billion from the sale of one part of Telekom Srbija and the injection of that capital into consumption. Foreign currency solvency was also assured for an increased import of raw materials. Furthermore, EU countries granted preferentials for import of certain products from Yugoslavia, which sparked a recovery of export. All these factors drove industrial production and GDP growth. Industrial production increased at 7,5%, and then 9,5% in 1997 and 1998. However, the economy fell back into recession in the second half of 1998. The only significant exception in this trend was the growth of industrial production from mid-1999 till mid-2000, based on inflatory financing. This growth was only a partial compensation to the drop that occured during the NATO intervention.

Social function were left to enterprises in this period. During the sanctions, dismissal from work was prohibited by law. In 1996, the number of workers in industry was down 22% relative to 1989. In production of transportation means, production was reduced to 7% of 1989levels, but 83% of the number of employees from 1989 were still on the job.. Costs were lessened with the moratorium on paying foreign debts. Activation of due and payable debts would have stoped the economy.

This history is important. During the 90's, investments were lower than the write off of the fixed assets and the structure of the Serbian economy was the same as at the end of the 70's. The capacity of the Serbian economy can be illustared with its relative status compared to Slovenia. Concretely, in 1989 GDP per capita in Serbia and Montenegro (excluding Kosovo) totaled half of GDP in Slovenia. In 2001 GDP of FRY totaled between 12 and 13% of Slovenian GDP. A huge gap also emerged between our country and the Central European countries (countries now entering the EU). Serbia's GDP per capita is close to one quarter of the GDP of the "weakest" of those countries.

During the last decade of the 20th century the economy was under invested and less than half of amortization was flowing back into it. The situation in industry is especially difficult. Taking into consideration different models on the average lifetime of equipment, it can be concluded that industrial equipment has depreciated to 12%–15% of its real value from 1989. Its operational capability is approximately the same. Some argue that especially industry has low level of capacity utilization of the capacities but the argument that activation of the existing capacities, through the inflow of sufficient floating capital, can provide higher growth rates – is a pure illusion. Our economy needs large investments and new equipment. Therefore the problem of investments is linked with the problem of economic growth.

Chart 0-2: Investments according to depreciation in FRY (%): 1990–1998

	1990.	1991.	1992.	1993.	1994.	1995.	1996.	1997.	1998.	Average
Total	**48,3**	**50,9**	**51,7**	**48,6**	**46,7**	**41,6**	**35,3**	**33,6**	**32,3**	**43,2**
Industry	36,4	35,1	31,9	31,0	30,1	28,6	25,2	22,2	21,2	29,1
Equipment	20,7	19,4	17,7	13,6	10,2	13,7	11,5	9,7	9,2	14,0

Source: Statistical Yearbook of Yugoslavia (several issues), Federal Office for Statistics, Belgrade

3) Foreign Direct Investment and Development

European countries passed through two technological cycles during Serbia's process of disinvestment. This produced several negative effects. The most distinctive are slower growth, a drop of aggregate production, and falling export competitiveness. Slower GDP growth disabled domestic savings necessary for local initiation of new investments and narrowing the space for production growth. Consequently, savings fall still further, local investment drops even lower, which leads to still lowewr GDP growth rates. This viscious cycle can only be broken by foreign investment capital.

During the last two years, FDI inflow in Serbia was as follows: 195 million dollars in 2001 and 475 million dollars in 2002. For comparitive purposes – in 2001, Croatia registered a FDI inflow of 1,4 billion dollars, Romania 1,1 billion dollars, Bulgaria 0,7 billion dollars, Macedonia 0,5 billion dollars, Hungary 2,4 billion dollars, Czech Republic 4,9 billion dollars. A large share of foreign investment in Serbia is directed to the tertiary sector, e.g. real estate. Greater FDI inflow in production i.e. in the processing sector would influence faster inflow of modern technology and know-how, which would have a direct impact on the improvement of competitiveness of the Serbian economy and the faster growth of export of goods, and ultimately on GDP growth. The practice of all transition countries shows that enterprises with FDI have better access to foreign markets than domestically owned enterprises. In the 1999 structure of total export, the share companies with foreign ownership is: 60,5% in the Czech Republic, 89% in Hungary, 60% in Poland, 30% in Slovenia.

FDI greatly contributes to enterprise productivity growth. In Hungary, firms with FDI are three tims as productive as comparable domestically held firms. In Poland the ratio is- 2,3 times higher and in the Czech Republic two times higher. FDI brings high capital intensive technology. When matched with a high skill low cost labor force, this yields a comparative advantage in international markets and subsequently, high GDP growth rates.

Since gross labor costs can only be be compensated with greater productivity, economic policy has to favor all processes and activities that contribute to increasing production per employee. The problem of loss of competitiveness occurs in cases when the rising cost of production is not exc eeded by a faster rate of increased productivity. At present, Serbia has a comparative advantage in terms of labor costs, but this advantage is the reflection of low wages and modest social services financed from gross incomes. Without higher wages, it is not possible to motivate workers to work harder and better, to give their contribution to innovations and development in general. This requires superior products and constant productivity growth. The domestic economy is not able to achieve this growth without massive FDI inflow.

6. Conclusion – Strategy for a Competitive Serbian Economy

6.1. General conclusions

The issue of increasing competitiveness comes down to choosing between two development strategies. *The first strategy* purports depreciation of the national currency aimed at creating profitable "critical mass" of enterprises that are "below the margin", parallel to strengthening tariff and non-tariff protection (protectionism). This strategy would seek to preserve and reproduce the existing structure of economy. In the case of Serbia – this structure is out-of-date. *The second strategy* starts off from a market value exchange rate and foreign trade liberalization. It stimulates enterprises which are below the margin of profitability to increase their productivity and efficiency; to modify their production programs and to achieve competitiveness based on technological improvements and quality. Enterprises which can not achieve profit are closed down. At the same time, new enterprises emerge which are capable of profit under the given conditions. In this way, investments are directed toward establishing a new, modern structure of economy, competitive both on domestic and on foreign markets. But, this requires an open economy and sound market environment, which is suitable for foreign investments and for initiating domestic savings aimed at establishing many small and medium enterprises that will absorb the manpower from enterprises closed down. This strategy also requires social programs centered on individuals, instead of the social function of subsidizing unprofitable enterprises.

Serbia must build a modern material and information infrastructure, modernize its enterprises, and ultimately increase the value-added per employee. Compared to the European industrial countries, technological lag of our economy totals 5–6 technological years, which is equivalent to 30-35 years in the time dimension. Without foreign capital inflow, our enterprises can modernize their production capacities over an average period of 20 to 25 years. Enterprises in which FDI contribues capital and management know how can achieve this modernization in 3 to 5 years.

Investments in modernization of equipment and production processes are the key to improving competitiveness and for achieving higher export growth. And - the increase of export revenues is the first precondition for foreign debt servicing and for providing resources for financing import of equipment and technology. Export is the precondition for economic development in the years to come. In order to achieve economic growth, to realize constant GDP growth and to increase the employees' standard of living, Serbia has to achieve global competitiveness – foremost on markets of the EU with which Serbia realizes the greatest part of its foreign trade and capital flow and to which it has major foreign debt. Economic policy must target and support both competitive and comparative advantages of the Serbian economy.

Serbia must prepare a complex development policy. One of the parameters of this policy should be attracting foreign savings – foremost foreign direct investments, which bring in capital, modern technology and management processes, opens export markets and activates processes for improving the businesses of domestic enterprises. In order to achieve this aim, intervene is required in many fields.

The state should prioritize support to non-material investments based on knowledge, modern know-how, innovations and new production techniques. Serbia should facilitate cooperation with the surrounding countries, aimed at creating synergistic effects in some industries and activities. For this purpose, the state should define potential production nuclei that could include private and public enterprises and offer concrete assistance in penetrating regional markets. Also, it is necessary to stimulate - in cooperation with foreign partners – the regional development of concentrated economic zones attractive for foreign investors (clusters).

Since only rising productivity can compensate gross labor costs, economic policy must favor all processes and activities that contribute to increasing of volume of production per employee. The problem of loss of competitiveness occurs in cases when rising costs are not amortized with rising productivity. Non-price competitiveness factors, such as quality, design, terms of delivery, servicing, attests and international quality (certification) logos can be crucial for increasing export, but they alone can not amortize high relative costs.

As in the case of other transition countries, the choice of currency regime has a great importance for Serbia's economic growth and economic stability. There is no best choice of currency regime. That said, it is not productive to debate the ideal positions of a fully fixed vs a fully fluctuating currency regime. Rather, the policy question revolves around the relative merits of different levels of flexibility. Successful development of a transition economy (especially based on the experience of the Central European countries) is evident in a real appreciation of the domestic currency. Increased productivity in the trading sector reduces unit costs of production, equivalent in the same percentage to real exchange rate appreciation.

Various measures for the sterilization of money can for some time reduce the increase of the exchange rate and ease inflationary pressure, but none of the measures can fully prevent real appreciation of a national currency exchange rate when there is a constant and major foreign capital inflow. It is of special importance that the Central Bank strictly supervises the behavior and financial balance of commercial banks, and – if necessary - establishes a special fund for deposits insurance. Also, realization of regulatory norms and accounting standards, in commpliance with the Basel Standards, should be considered an essential element of the country's financial policy.

The ultimate objective of economic policy is to increase the GDP growth rate and to maintain it at the level necessary for reducing the gap between *per capita* income in Serbia and in the EU countries, as well as the gap existing between Serbia and the transition countries. It is necessary to provide as many conditions as possible to achieve this objective. Except under special circumstances and in the short term, the process of increasing Serbia's GDP *per capita* toward the income in the EU is only possible through constant productivity growth.

The stability of prices is the basic postulate of long-term development - always and in every arrangement of economic policy. Only long-term stability of prices can create a framework for rising domestic and foreign investment.

6.2. Harmonization of economic policy on macro and micro level

Opinion surveys conducted in transition Central European countries indicate that enterprises specify three strategic objectives as the most important for increasing competitiveness: improvement in the quality of employees, reducing business costs and improving the quality of products. All these objectives can be understood as the postulates for achieving competitive advanatage on the decentralized international market.

In order to build the basis for strengthening competitiveness of the Serbian economy and to secure its positive effects on economic growth and employment, it is necessary to act in the following manner:

1) State intervention in industry should focus on development of activities in which Serbia can surely realize dynamic development, such as: accompanying industry in engineering, electrical engineering, electronics, car industry, telecommunications. At the same time, this requires Foreign Direct Investment and appropriate manpower training.

2) The state must redefine the tax burden for certain activities in different segments of economy: one part of marginal tax burden should be transferred from manpower to the use of natural resources. Direct state financial support should not depend on the type of enterprise, or number of employees, or capital intensity, but rather on the value-added the enterprise can potentially realize.

3) Cooperation with surrounding countries should be encouraged to establish functional relations between enterprises. This is especially important for the development of production, which requires ecological protection that can be performed by regionally connected production units rather by a locally-based enterprise.

4) Priority should be given to cluster development of competitive activities, aimed at strengthening regional advantages, along with strengthening standard export competitiveness (The Europe of Regions concept requires this).

6.2.1. Monetary policy

i. Follow the policy of neutral currency i.e. to maintain monetary balance as the foundation of price stability and a balanced exchange rate of national currency.
ii. Aime at progressive transfer to the controlled fluctuation regime instead of the quasi-fixed regime.
iii. Conduct monetary policy with the greatest possible reliance on open market operations and with the least possible manipulation of obligatory reserves and credit limits policy.
iv. Add elements of sterilization of primary cash created from the foreign capital inflow.
v. Maximize the control functions of the Central Bank.
vi. Develop a securities market.
vii. Recapitalize banks and then offer them for sale (in principle - up to 49% of ownership rights).
viii. Protect the financial system from any kind of influence from state bodies or interest groups.
ix. Set limits on commercial banks for redemption of state bonds for covering a budget deficit.
x. Educate the staff of bank and non-bank finnacial institutions in the operations of a modern financial market.

6.2.2. Fiscal policy

i. Develop the Second and the Third pillars of pension insurance (to influence development of the financial market).
ii. Introduce a VAT, which will broaden the tax base.

iii. Introduce two VAT rates: a lower for medicines, children's accessories, public transportation, basic food products (e.g. at 8% and a standard 20%).
iv. Provide better instruments for tax collection, along with improved working organization of the tax institutions.
v. Redefine fiscal policy from a short-term (1 year) to a medium-term financial strategy (3-4 years).
vi. Reform the tax system in two main directions: broadening the tax base and lowering marginal tax rates in all activities, sectors and industries that directly contribute to economic development.
vii. Build a development budget i.e. to gradually redirect one part of public expenditures from consumption to investments.
viii. Educate the tax administration staff and its supervision bodies.

6.3. Special policies

6.3.1. Privatization

Privatization is often singled out as the most important step in the process of transition to market economy. The share of private-owned enterprises in the economy structure, measured by the profit share in the economy during a one-year period and measured by the share in total capital of economy, should rise in order to increase the economy's efficieny and effectiveness.

We argue that the privatization process in Serbia has neglected the small domestic share holders. In Slovenia domestic capital is stimulated to participate in privatization in order to have the least possible number of enterprises owned by foreigners. There exists a certain number of the citizens in Serbia who would be willing to invest small amounts of money in prosperous domestic enterprises through investment funds. The problem is the lack of infrastructure and lack of regulations that regulate the establishment and functioning of investment funds. The state must be more engaged in establishing plans and issuing guarantees to citizens who are willing to invest smaller amounts of capital.

From privatized entreprises one expects more efficient business, which should have an impact on increase of efficiency of the entire Serbian economy and consequently – on its competitiveness on the world market. The collapse of private enterprises represents the loss to their (private) owners. In order to secure our economy's competitiveness, it is necessary to secure passage of an adequate law that regulates bankruptcy of enterprises. That way, the "bad tissue" will be removed from the economy and liberate assets to be reallocated to development and growth.

However, it is not good for a country if a large number of enterprises collapse frequently. That yields manpower fluctuation, variations in the number of employees, as well as variations in incomes realized from taxes and transactions and from profit of corporations. There are some enterprises that can survive in the long term, with small financial and organizational assistance. Therefore, measures are needed for the recovery of enterprises that face troubles, but whose existence is not jeopardized. A great responsibility lies on those who should evaluate the enterprises. Saving enterprises that are not worth saving since they can not be recovered in the long term can have very negative effects on efficiency of domestic economy and on its competitiveness on the world market.

Foreign capital inflow in Serbia during the privatization process is a positive thing. But we have to protect ourselves from cases when Serbian enterprises are beeing bought (privatized) and then closed down, which results in monopolization of the market of Serbia on the part of foreign enterprises entering our market during the privatization process. The contracts according to which foreign investors are obligated to invest and to perform some other activities are not sufficient instruments for preventing monopolization of the market. This can be done through passing adequate Antimonopoly laws i.e. free competition laws. On the other hand, one should follow the experience and regulations of the EU and mentioned laws should not be an obstacle to enterprises aimed at increasing their competitiveness on the world market.

Since Serbia has a big problem with the trade deficit and balance of payments deficit and with capital outflow based on the payments of foreign credits, it is recommended that capital inflow from abroad arrive in the form of foreign direct investments that do not cause imbalance of capital balance, for example when capital arrives in the form of loans.

Urgent measures, in terms of the privatization, are:

i. Improve the existing privatization model:
   a. Evaluate positively offers that include development effect – both on a privatized enterprise and on the entire economy.
   b. Allow participation of portfolio investors, which have to revitalize a privatized enterprise prior to next sale.
ii. Restructure unsuccessful enterprises prior to privatization only in exceptional cases, when this does not require large resources and when there is a small risk of failure.
iii. Enact the Bankruptcy Law. Train bankruptcy administrators and establish social programs and programs for recovery of SMEs.
iv. Resources acquired from sale/privatization of enterprises should be directed at crediting export-development projects.

6.3.2. Foreign Direct Investment

Today, when there is a lack of domestic capital, when the economy suffers from a chronic balance of payments deficit – FDI is considered the most suitable means of capital inflow. These investments are considered a good instrument for increasing the employment rate, especially in cases when foreigners establish new enterprises (greenfield operation). FDI is suitable for the transfer of knowledge, modern technology, quality and the development of export-oriented production, since very often the domestic market is too small to support a profitable volume of production. A majority of countries are trying to attract foreign direct investments by giving various allowances to foreign investors doing business on their territories. Due to strong world competition, these allowances become more and more significant and sometimes, when starting a business, foreign investors are given more favorable conditions for doing business than domestic businessmen .

However, while developed countries have almost no limitations concerning foreign capital, developing countries tend to keep some limitations in order to preserve economic sovereignty. Developed countries acknowledge one to another the status of the most favored nation (in the field of investments as well), which purports that there exists no discrimination of foreign investors compared to domestic investors. But developing countries refuse to accept this principle in the international financial relations by refusing to sign the Multilateral Agreement on Investments – MAI, passed under the auspices of the OECD.

There are some standard terms that countries have to fulfill when attracting foreign private capital. These standards are mainly related to the freedom in business of foreign investors (except in some fields concerning national safety), freedom of initial investment repatriation and profit remittances, freedom of employment and discharge and the like. All these measures are important for efficient business of enterprises.

For attracting FDIs, many countries establish specialized agencies aimed at promotion of a country as an ideal destination for investments. Those agencies provide all necessary information to foreign investors who want to get information about the business environment of a certain country. Serbia already has one such agency and its work should be made more efficient.

A country's participation in regional economic integration can be an important factor for attracting investments. Serbia should conclude Free Trade Agreements with the Western Balkan countries that will be out of the EU after 2004 and create possibilities for regional economic integration with these countries. In this way, Serbia would improve its position in terms of foreign direct investments inflow. Large foreign companies usually establish branches in central countries of a regional economic integration, aimed at supplying the market of the entire integration.

Another factor which can be important for attracting FDI is the existance of special export zones in which enterprises with foreign capital have special customs and tax allowances. Sherbia has a large number of these zones and the Government should support their work and create conditions for their future growth and development.

Specifically:

i. Ensure non-disriminatory treatment of foreign investors.
ii. Simplify the entire legal-administrative procedure related to foreign investments - from the preparation for production to profit repatriation.
iii. Offer to foreign investors qualified legal assistance and other kind of assistance.
iv. Prepare a transparent system of legal protection of foreign investors.
v. Form special export zones (with tax and other benefits/allowances) aimed at attracting FDI to stimulate development of some of the country's regions.

6.3.3. Development of Small and Medium Enterprises

At the beginning of the 21st century small and medium enterprises are taking over the dominant position in the structure of Serbia's economy. This process is characteristic of the production sector, the service sector and also for the country's foreign trade network.

The emerging structure is the result of the collapse of large production systems (from the period of socialism), the privatization process and stimulation of entrepreneurial activity in a significant part of the working population. Entrepreneurial businesses engage fewer workers, they are flexible and they do not require a large cash reserve.

Foreign capital will come from two main channels: through venture capital – during the initial phases of opening of the economy and through investments of Transnational Companies (TNC), which are financially powerful since they cover the markets of a large number of countries and since they act globally.

This raises the question: how to reconcile on the Serbian market the dominant transnational capital and the prevailing structure of small and medium local entreprises? Foreign capital inflow and the entry of transnational companies can be stimulative, but also destructive for the development of a country's small and medium enterprises. The destruction of the market structure of small and medium enterprises can be the result of monopoly behavior of TNCs. In order to prevent this scenario, it is necessary to support the development of small and medium enterprises with economic policy measures (foremost targeted at enterprises from competitive sectors) through the establishment of an *Agency for Small and Medium Enterprises Support.* This agency should:

i. Help improve businesses of SMEs through a system of consulting;
ii. Improve cooperation between SMEs;
iii. Facilitate cooperation between SMEs and the financial sector;
iv. Support development of export competitive SMEs;
v. Support development of small and medium enterprises that fufill conditions to become part of the supply chain of incoming transnational companies;
vi. Support modern technology inflow to small and medium enterprises;
vii. Support improved structure of employees employed with small and medium enterprises.

Small and medium enterprises can be irreplaceable sub-suppliers of large companies that locate their production in a host-country. It is necessary to provide support to the sector structure of small and medium enterprises that would be compatible with large transnational companies. Since transnational companies are oriented toward global business, small and medium enterprises - as their suppliers – realize through this cooperation:

i. Possibility for direct export production (through incorporation in final product);
ii. Improvement of production competitiveness, since SMEs can be suppliers of large companies only provided they fulfill criteria of the determined standards and quality. This increases competitiveness of small and medium enterprises and domestic economy in general;
iii. Increased engagement of domestic capacities and additional manpower.

Small and medium enterprises do not have the critical mass of high-technology components necessary for increasing competitiveness. Therefore we recommend that small and medium enterprises be encouraged to locate in technology parks in determined zones, in order to enable greater use of the most important modern resource – research and development that lead to technological development.

In these clusters – if possible in free export zones – small and medium enterprises would be gather around a certain number of transnational companies (and a smaller number of domestic ones) which are protagonists of development and organized research-development activity. Research-development laboratories and the concentration of scientists in technology parks reduce waste of national research potentials and enable small and medium enterprises to keep the pace with the modern technology (despite their relatively limited resources).

In those zones small and medium enterprises would be given special benefits and allowances in terms of customs and tax duties. This is especially important since the World Trade Organization is not restrictive toward subsidies aimed at development of undeveloped regions and introduction of modern technology in companies.

Such development strategy of small and medium enterprises within technology parks and special industrial or free export-production zones is also present in the European Union, while Serbia's neighbour, Hungary, has established over 144 zones, in which production is realized under more favorable terms. In Serbia about 13 free export - production zones exist that have satisfactory infrastructure and that could be used for development of small and medium enterprises.

One such zone, a technology park, was established by a major manufacturer of pharmaceutical products –

Hemofarm from Vršac, in the Vršac industrial zone. The idea is to locate near Hemofarm, as the developement leader, small and medium enterprises which would be supported by Hemofarm, while small and medium enterprises would be included in Hemofarm supply chain through a complementary production program.

Small and medium-size enterprises – SMEs - will take over the key role in the transformation of Serbia's economic structure. Their role is especially distinctive in the sector of services and capital unintensive activities. Achieving appropriate proportion between SMEs and large enterprises is of vital interest for the long-term growth of the Serbian economy's competitiveness. Therefore, it is necessary to realize several synchronized programs for stimulating SMEs.