THINK THROUGH STRATEGY: NEW VISION FOR INDUSTRIALIZATION OF ECONOMY AND MODERNIZATION OF SOCIETY

Abstract

In strategizing about Serbia’s economy, there are two related questions. Where is it now? What it could be in the future? As far as the answer to the first question is concerned, Serbia is a microscopic economy in long regression, late developer with delay in transition toward the road to higher development. Strategic audit of Serbia’s position reveals long list of vulnerability indicators. Dangerous mix of structural imbalances and geopolitical stuck in the middle exists. In import and debt dependent country, high financialization undermines its economy in many ways.

In the last 25 years, Serbia lost roughly 1/10 of population and approximately 1/6 of its territory rich with significant natural resource endowment. Output in constant prices in 2014 is almost 1/3 lower in comparison with 1989 level.

The previous facts raise a fundamental question: Why do people in the long period act against their own interest? The answer is simple: wrong system. We do not want to fix it up. We must change it. It is not easy because in the age of discontinuity great strategy and efficient model of economic growth are moving targets. In the new context the core competence for each national economy, small or large, early developer or late developer, stagnating or fast-growing, is going to be strategic flexibility. In thinking through strategy, the key question is not what is right? But, what would have to be right? In the new context, the role of government is not only to achieve greater geopolitical positioning and maintain political stability and social cohesion, but also, and predominantly, to encourage development of new model of economic growth and related economic policy platform.

The orthodoxies governing the economy in Serbia are so entrenched that we need breakthrough to articulate the paradigm change in theory and policy. In quest for solution, pendulum should not be shifted from one extreme institutional choice that the market is the best regulator to the other which assumes that the state is the only master. In our previous articles [2], [3], and [4] we opt for heterodox approach which realigns development model and economic policy platform based on conceptually more complex approach of new structural economics. Industrial policy is a crucial element of the new wisdom. In this article, we concentrate on the strategy for economic growth in Serbia supporting previous choices.

Key words: Serbia, economic policy, industrial policy, strategy choice cascade, strategy logic flow, sustainable competitive advantage

Sažetak


Prethodni značajci pružaju temeljnu pitanja: Zašto se ljudi u dugom periodu ponašaju protiv svojih interesova? Ovaj odgovor je jednostavan, pogrešan sistem. Ne treba ga popravljati. Ne treba ga promeniti. To nije jednostavan zadatak zbog toga što u vreme diskontinuiteta dobra strategija i efikasan model rasta predstavljaju pokretne mete. U
novom kontekstu, ključna kompetentnost svake nacionalne ekonomije,
male ili velike, razvijene ili nerazvijene, stagnante ili brzorastuće, postaje
strategijska fleksibilnost. U strategijskom razmišljanju ključno pitanje nije:
šta je ispravno? Već: šta bi trebalo da bude ispravno? U novom kontekstu
uloga vlade se ne sastoji u tome da se ostvari samo dobro geopolitičko
pozicioniranje i održi politička stabilnost i socijalna kohezija, već, takođe,
iz dominantno, da se podstakne razvoj novog modela ekonomskog rasta
i odgovarajuće platforme za vođenje ekonomskih politika.

Orthodoxie vođenja ekonomske politike u Srbiji su toliko ukorenjene
da je neophodno napraviti zaokret kako bi se mogla ispratiti promena
paradigme u ekonomskoj teoriji i politici. U potrazi za rešenjem, kljuto se
ne može pomeniti iz jednog ekstremnog institucionalnog izbora, po
principu da je tržište najbolji regulator, ka drugom koji podrazumeva da je
mi smo se opredelili za heterodoksni pristup koji povezuje model razvoja
i platformu za vođenje ekonomskih politika pomoću složenijeg pristupa
nove strukturne ekonomske teorije. Prema novom pogledu, industrijska
politika predstavlja kritičan elemenat. U ovom radu skoncentrisaćemo se
na strategiju ekonomskog razvoja Srbije koja podržava prethodni izbor.

Key problem of Serbia’s economy is low economic base due to output gap, both transitional and current. Moreover, economy is out of tune, full of structural imbalances like distortions in structure of prices, really appreciated FX rate, and too high cost of capital. Among them, the most important one is disharmony between real economy and financial sector. Deindustrialization along with high financialization is the main contradiction of the system. As consequence, Serbia’s economy is constantly experiencing insolvency threat.

For more than a decade in Serbia leading politicians as transition strategists, state bureaucrats as architects of the system, and economics professionals as policy and/or opinion makers have been explicitly guided by neo-liberal doctrine. Privatization, liberalization, and deregulation were the main pillars, and inflation targeting was the key tool of that wisdom. Politicians blindy following neo-liberal economic doctrine made great number of wrong decisions in setting goals of transition and corresponding strategy, bureaucrats implemented mechanically these decisions through policies, and economists were continually trying to explain the related absurd. Economists with technical skills, but without political leverage, were calculating negative consequences of wrong doing while “court” economists were engaging themselves in covering that up.

Current model of growth and economic policy platform in Serbia are not in line with general conditions and sustainability proposal. Focus on inflation control by using exclusively monetary measures makes sense when economy does not suffer from inherent structural imbalances which uphold recession or deflation. Moreover, when cost-push inflation dominates the system, keeping inflation (actually CPI) under control is not enough because, among all, inherent volatility in global commodity markets influences core inflation. Moreover, keeping inflation under control by monetary measures is very expensive journey. When strong transitional output gap exists, massive liberalization in financial sector, combined with ineffective privatization in commercial part of the economy and public sector protected from restructuring, leads to another deepening of structural imbalances. Without public sector restructuring and significant

**Serbia 2015: Epilogue of misconceptions and overestimations**

Strategic audit is the first step in strategic thinking. Sometimes the results of that process are not encouraging. In that case, the primary role of strategists is to declare crisis. It is the step in the right direction. After that, strategic thinking continues with searching for the solutions.

Does Serbia’s economy matter? Not particularly. Serbia is a landlocked country, microscopic economy without significant natural resource endowment and demographic dividend. Small, impotent and out of tune economy has no meaningful comparative and competitive advantage, nothing that is strong enough to counter the universe of stress factors.

Economy has slipped into recession in 2014. Forecast for Q4 shows that GDP contracted by 3.6% yoy. Industrial activity in Q4 fell 10.5% on Q/Q. Export declines 5.7% (vs. 26% growth in 2013). Import stagnates so the trade gap falls by 1.6%. Inflation is still low (2.1%) predominantly due to weak domestic demand (investment and final). RSD depreciated nominally and really, first time after 11 years, mostly as result of deteriorating export-import movement, strong bank’s deleveraging, and increased risk aversion.
investment, public debt is wagging its own tail. Low investment particularly affects the economy with high level of public debt due to difficulties to maintain fiscal balance. Austerity is additionally shrinking purchasing power and strengthening recession spiral.

After 25 years of transition toward the capitalism, Serbia’s economy has thin crust of the market (see Figure 1). So-called “partocracy sector” dominates in assets and net equity with three concentric layers (public COs, state-owned COs and mixed ownership COs). Quasi-market sector consists of privately-owned S&Ms targeting partocracy sector as business partner. In this sector, political connections are the critical success factor. Market sector is a thin layer with share in assets and net equity between 20-25%, and in net income between 30-35%. Market sector consists of subsidiaries of multinationals from finance and real economy and large companies of local entrepreneurs.

Partocracy sector is oversized. It is true burden on the economy. Inefficiencies from that sector are accumulated in budget deficit and passed through to public debt. According to the forecast for 2014, public debt of 70% GDP and budget deficit of 7% GDP are on alarming levels and bellow the EU rules [5], [6]. Unreasonably high cost of capital due to monetary policy concentrated exclusively on inflation control as well as crowding out of market sector from debt financing are the main causes of its low (many times negative) profitability. Position of the market sector is continually being eroded which is obvious from growing indebtedness and still sizable NPL level. The strong departure of prices of different kind of assets from fundamentals is clear indicator of deep structural imbalances.

Analyzing the financial health of large, medium-sized and small companies for the period 2006-2013, D. Malinić et al. [10] conclude that small companies have greater exposure to financial risk and smaller exposure to operating risk than medium-sized and large companies. Higher financial leverage, in the first case, and lower fixed costs, in the second case, are main causes of such distribution of risk exposure. Analysis of risk exposure based on EBIT margin is in line with previous finding. General conclusion is that viability of economy, independently of size of company, is very low primarily due to negative effect of financial leverage. In many cases, companies cannot generate sufficient operating income to cover high borrowing costs [8, p. 346].

Without any doubt, previous strategy of transition and economic policy were not inspired by relevant goals and, hence, did not use the efficient tools. They constantly focused on less relevant goals (for instance, low and stable inflation). More relevant goals for sustainable development, like low and stable output gap, were below the radar. In addition, policy makers regularly missed the proclaimed goals. The best example is capital market development. The capital market in Serbia is not only thin, but also in retardation. The level of savings is higher than the market capitalization on Belgrade Stock Exchange. Another example is inflation. With the exception of the last two years, in the whole period, neither the target levels were reached, nor was the inflation corridor respected.

Figure 1: Partocracy sector vs. market sector

[Diagram showing the concentric layers of the partocracy sector and the market sector with labels for Multinationals & Large Local COs, S & Ms, Mixed-ownership COs, State-owned COs, Public COs, Market sector, Quasi-market sector, and Partocracy sector.]
As far as the policy tools are concerned, good example is monetary policy treatment of capital inflow in the period of massive privatization. Namely, the treatment of privatization proceeds as an export, rather than divestment, triggers increase in money supply, creates artificial inflationary pressure, and leaves space for restrictive monetary policy measures, outcome that unequivocally acts against the real economy. Monetary policy escape from inflation, influenced partly by its own mistakes, led to cost of capital increase and really appreciated RSD. Paradoxically, maintaining FX rate stable through selling currency reserve exactly to the buyers of securities that the NBS had issued to sterilize liquidity surplus, privatization proceeds ended, through banks, out of domestic monetary system. In period 2006-2014, the level of FDI amounted to approximately EUR 13/billion and costs of defending the FX by selling currency reserves were around EUR 8/billion (see Figure 2).

List of vulnerability indicators confirms serious missteps and oversights (see Figure 3). At the top of the list are double macro deficits (current account and budget). The most worrisome indicator is unemployment gravitating around 20%. The youth unemployment (15-24 years) rate that stands at 40% is of particular concern. The employee-to-retiree ratio of 0.9 has an adverse effect on state functioning (pensions and healthcare, education, science, culture, etc.). The NPL ratio of 22.8% crosses twice the tolerance level. Credit rating is still on the speculative (S&P BB-) and highly speculative level (Fitch B+ and Moody’s B1). Export share in GDP (35.3%) stays on the level too low to provide external liquidity of the system (< 50%). As far as the competitiveness is concerned, Serbia is considerably lagging behind near competitors from Central and Eastern Europe.

The legacy of misconceptions and overestimations in current generation tremendously burdens future generations. Economy is import and debt dependent. Output gap causes inflationary pressure, twin deficits (current account and budget), unsustainable employment and related inconveniences like depopulation. Depopulation goes hand in hand with low economic base. As consequence, quest for solution must start from the output gap.

**Economic theory and policy rethinking after 2008: New framework for strategizing**

Before the *Great Recession* 2008–, there was strong dissonance between economists from early developers and late developers regarding the question: Which institutional arrangement primarily influences development model...
and economic policy platform? Economists from the early developers preferred free market, while economists from the late developers opted for government intervention through industrial policies.

In post-crisis period convergence emerged in opinions. The last crisis was the signal that the model of liberal capitalism was broken. Anti-crisis measures confirmed that the government’s intervention providing lifelines to economy was the only way of escaping collapse, even in early developers with high income and well-functioning capital market. Namely, crisis resolution requires proactive government instead of passive one choosing wait-and-see behavior against what the market forces dictate. Previous leads to rejuvenation of industrial policy as a common sense institutional choice.

According to neo-liberal doctrine, the government is not welcome in the economy even when market prices do not reflect general policy tenets like equal opportunities, technology-driven competitiveness, pollution control, etc. Market imperfections, asymmetric information and character of externalities are well-known defects of the invisible hand. Most important defect is ignorance of technological change. In case of technology-driven competition, market forces exist in vacuum. Namely, high-tech industries tend to be imperfectly competitive. Connected problem is character of knowledge and best practice, more or less as a public good. Market forces are not efficient in public goods spillover. It means that marginal cost of next economic agent acquiring the knowledge is zero, excluding transfer costs. In technology-driven industries industrial policy, instead of market forces, helps in creation of more competitive economy with cost efficient technology, spillover of high value added products, and lower gap between best practice and average competitors.

In post-crisis period, there is major rethinking of orthodox economic wisdom based on market fundamentalism. Additional factor in rethinking is unquestionable success of the countries that did not follow neo-liberal doctrine nor inflation targeting led policy platform, and their growing share in the global economy (BRICS and “next 11”, primarily). Previous facts inspired conclusion that core macroeconomic policies (monetary and fiscal) and industrial policies are unavoidable parts of comprehensive economic policy platform called heterodox approach.

Industrial policies have been used to correct market failures as well as previous government failures. They are

<table>
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<tr>
<th>Indicators</th>
<th>Value</th>
<th>Reference point</th>
<th>Type of vulnerability</th>
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<tbody>
<tr>
<td>Transitional output gap</td>
<td>28%</td>
<td>0%</td>
<td>OPERATIONAL</td>
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<tr>
<td>Okun index</td>
<td>19.7%</td>
<td>&lt;12%</td>
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<td>Macro deficits</td>
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<tr>
<td>Current account</td>
<td>6.1%</td>
<td>&lt;5%</td>
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<tr>
<td>Budget (off budget items excluded)</td>
<td>4.8%</td>
<td>&lt;3%</td>
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<tr>
<td>Employee to retiree</td>
<td>0.9</td>
<td>2</td>
<td></td>
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<tr>
<td>Youth unemployment</td>
<td>41.7%</td>
<td>&lt;20%</td>
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<tr>
<td>Indebtedness</td>
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<tr>
<td>Public debt/GDP</td>
<td>68.8%</td>
<td>&lt;45%</td>
<td>FINANCIAL</td>
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<tr>
<td>Foreign debt/GDP</td>
<td>79.1%</td>
<td>&lt;90%</td>
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<tr>
<td>Foreign debt/Export</td>
<td>184.2%</td>
<td>&lt;220%</td>
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<td>NPL ratio</td>
<td>23.0%</td>
<td>&lt;10%</td>
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<td>S&amp;P</td>
<td>BB-/stable</td>
<td>investment ranking &gt; BB+</td>
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<td>Fitch</td>
<td>B+/stable</td>
<td>investment ranking &gt; BB+</td>
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<td>Moody’s</td>
<td>B1</td>
<td>investment ranking &gt; Ba1</td>
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<tr>
<td>Export (goods)/GDP</td>
<td>33.7%</td>
<td>&gt;50%</td>
<td>COMPETITIVENESS</td>
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<tr>
<td>Currency change yoy</td>
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<tr>
<td>Nominal depreciation</td>
<td>5.5%</td>
<td>&lt;5%</td>
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<tr>
<td>Real depreciation</td>
<td>3.6%</td>
<td>&lt;0%</td>
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<tr>
<td>Global competitiveness index</td>
<td>94th of 144</td>
<td>65-SEE average</td>
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<tr>
<td>Corruption perception index</td>
<td>78th of 175</td>
<td>59-SEE average</td>
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<tr>
<td>Ease of doing business</td>
<td>91st of 189</td>
<td>60-SEE average</td>
<td></td>
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<tr>
<td>Economic freedom index</td>
<td>90th of 178</td>
<td>62-SEE average</td>
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Source: NBS database & authors’ own calculations
not just about manufacturing. Support to technological change and support of infant industries (export expansion and import substitution) are also critical tenets in agri-food and service industries (ICT, finance and life science). Competitive exchange rate policy and infrastructure development are typical examples of sector neutral (or horizontal) policy. But, these policies are mistakenly presented as “neutral”, even though related decisions always involve some value judgments of policy makers. As recently J. Stiglitz pointed out, "the question is not whether any government should engage in industrial policies, but how to do it right?" [14, p. 9].

But, there are some problems with government intervention in an economy, notably institutional overhang, rent-seeking mindset, corruption, uncontrolled indebtedness, etc. Critics of conventional industrial policies argued subsidies to some industries, sectors and even companies as a main distortion in shaping the structure of the economy. Indirect subsidies, as sector neutral measures, regularly involve overvaluation of FX rate or suppressing interest rate for high priority sectors. To reduce the burden of indirect subsidies, government sometimes resorts to administrative measures, granting companies in some industries (high priority infant industries from strategic perspective or important for national security) monopolistic position and/or introduces price control for basic inputs connected with them. By doing so, government actually introduces further distortions in price structure causing shortages in commodities and foreign currency or crowding out of other companies from debt financing.

According to the new structural economics, two main choices lie ahead of late developers trying to perform industrial policy as a part of the quest for higher and sustainable growth [9, pp.162-163]. First, a focus on sectors with tradable goods and services that have been nurturing economic growth (for about 20 years) in countries with similar endowment and of at least twice as high per capita income. The logic that stands behind that reasoning is that late developer has the opportunity to produce these goods and services with lower costs by using comparative advantage. But, breakthroughs in economic development are not possible by making improvements in already familiar fields but “by traversing empirically infrequent distances” [7, p. 7]. In knowledge-intensive technologically advanced and fast-moving industries there is no chance to make a breakthrough from periphery to the core by producing goods and services that are close to those currently produced. It leads to the second option for late developer to take considerable strategic risk to jump into non-mature, emerging industries to be able to compete with early developers, this time, on competitive advantage base. Competitiveness improvement of ICT sector in China is good example.

Repetitive imitation in the first solution hides the danger for the economy of falling into so-called “middle income trap”. Industrial policy is not only the way of energizing the growth, industrialization of the economy and modernization of the society, but also an antidote to dragginess in catching up the leaders in competitiveness after the late developer country reaches middle income status. Technology and capabilities failure, rather that market failures, are the main causes of middle income trap. As a consequence, industrial policy is a way to move from trade-based to technology-based specialization. According to [11], the strategy to build technological breakthrough in the middle-income countries includes three following stages. First, assimilation of the state of the art technology by using licensing, technology transfer, FDI, etc. Second, co-development of leading edge technology through PPP. Third, “leap frogging” to emerging technologies which involve PPP in R&D.

History reveals that late developers usually start their industrialization in the assembly or production segment of the value chain in labor-intensive industries. Namely, policy makers neglected the possibility (and necessity) of wide government support in education, R&D and infrastructure development (digitalization, for example). But, industrial policy based on import of technology for tradable sectors does not lead to sustainable balance of payment. Import of technology and financing of that import cause deficits in both current account and capital account. Development of own technology in sectors reaching technological frontiers leads to surpluses and balance of payment sustainability.

No doubt, for late developers industrial policy can play critical role in creation of competitive advantage through development of strategically important sectors
and industries based on complex technologies and ICT driven transformation. The new structural economics tends to emphasize “winners picking themselves” principle through experimentation and positive reinforcement. So-called “technological platforms” are the essence of the new approach.

According to [14, pp. 7-8], industrial policies can have three focuses on: a. particular sectors (sector specific or vertical industrial policies), b. the economy as a whole (non-discriminatory, neutral or horizontal industrial policies), and c. future opportunities (e.g. creation of new strategically important industries).

The effectuation of industrial policy depends largely on tenets and measures that must be in harmony with current level of development. Vertical policies are most suitable for late developers. Horizontal policies that provide better conditions for all sectors in the economy come with higher income level. Namely, as capacity of the private sector improves, the government gains the opportunity to shift to sector neutral approach which supports overall competitiveness improvement. The last type of policies, usually, appears as the last stage of government interventionism. Economies that wish to go through structural adjustment have to implement industrial policies in coordination with compatible macro management measures and follow lead-edge technologies for priority sectors.

According to [13, p. 348], structural adjustments depend on three main externalities. First, the coordination externalities in combined institutional choices of market and government interventionism (invisible hand of the market and the visible hand of the state). Second, innovation externalities in creation of technological breakthrough and utilization of its results (spillover of innovation and product diversification). Finally, institutional externalities influenced by the quality of institutional settings. As far as coordination is concerned, in early stages of development the benefits of visible hand of the government exceed the costs of its action but it is expected to decline in influence as the rhythm of development starts to accelerate. Things are different when it comes to innovation externalities. Namely, as the economy grows at higher rates and approaches technological frontier, the role of government as a risk taker in technological development remains critical. Particularly, the government stays important player in providing support to technological change until the capacity of private sector improves.

Fostering industrial policy assumes numerous institutional advances. The main purpose is providing technical support and filling institutional gaps that hinder policy implementation. These include creation of bodies responsible for reindustrialization (Industrial Development Agency, for example). Providing easier access to finance, as well. Usually, Development Bank facilitated implementation of industrial policy and coordinated distribution of available funds to priority sectors by lower cost of debt, concessional financing, etc. In the case when Development Bank was not providing credits directly, the government used guarantees given to financial institutions that provided credit financing for priority sectors.

Now we stand on the brink of the new wave of ICT transformation. There is general recognition that without close integration of ICT solutions and industrialization (implementation of breakthrough innovations through investment and their spillover across different industries), no economy in the world has been able to close the development gap between themselves and those at the frontier. In this stage ICT becomes an integral part of the product itself in so-called “smart connected products” and, by doing this, ICT has the capacity to unleash a new era of industrialization [11]. The phrase “internet of things” has risen to reflect the growing power of smart connected products in business ecosystem.

Smart connected products will have a broader impact on economic growth than post-crisis innovations (mainly cost leadership innovation and muted innovations across large part of the economy). They have capability to deal with output gap and jobless recovery, and by doing so, to substantially affect the trajectory of the overall economy toward sustainable employment.

The impact of innovations on growth shifts the categorization of innovations to performance-improving, efficiency, and market-creating innovations [1, pp. 62-63]. Performance-improving innovations replace old products with new and better models. They generally create few jobs because they are substitutive by nature. Efficiency
innovations help company make and sell mature, established products to the same customer at lower prices. So-called “low-end disruptions” involve the creation of the new business model. Efficiency innovations play two important roles: they increase productivity, which is essential for maintaining competitiveness, and they free up capital for more productive use. Market-creating innovations transform complicated or costly products so radically that they create a new class of customers or new markets.

The extent of government intervention in economy via industrial policies is demarcation line between early developers and late developers. Minimum density of relevant economic agents is prerequisite for multiplicative effect of new investments on output level and sustainability of growth. “Smart” industrial policies are at the center of the rejuvenated wisdom known as the new structural economics. The economic system following the new economic policy platform is known as “managed capitalism” in terms of R. Rajan [12]. It is different from free-market capitalism based on neo-liberal doctrine and state capitalism following conventional structural economics.

From the very beginning in case of late developers, and recently for early developers, industrial policy is treated as common sense policy choice by mainstream economists and politicians from all sides of ideological spectrum.

In the case of Serbia, industrial policy is relevant platform for economic policy, too. Serbia is a good example that universal efficiency of the market is not common in cases of major macroeconomic distortions like output gap. In such situation, invisible hand of market unleashed recession, instead of booming prospects. Namely, anti-crisis measures based on market forces did not follow sustainable employment and led to the jobless recovery, at best. Economic growth model in Serbia must respect microeconomic (or business) perspective, while not ignoring macroeconomic one. In corresponding strategy framework, industrial policy supports expansion of tradable sectors. Cost leadership in sectors with comparative advantage and technology development, spillover of innovation and product/service diversification in sectors with competitive advantage are the ways to substitute import and expand export and, by doing that, to eliminate liquidity problem due to double macro deficits. In the new context the government could not escape responsibility in choosing priority sectors and defining adequate policy measures.

Given the aforementioned, comprehensive framework for economic policies has to be based on three pillars (see Figure 4). First pillar refers to industrial policies. In defining list of priority sectors focus must be shifted from services to infrastructure and real economy both in state and private sector. Industrial policies are sector based and are dedicated toward tradable sectors. Tradable sectors are sectors with comparative advantages, competitive advantages, and sustainable competitive advantages. Second pillar represents macroeconomic policies (monetary and fiscal). Macroeconomic policies lubricate industrial policies and operate on automatic stabilizers basis. In monetary policy, for example, fixed and competitive (real or slowly changing) exchange rates (“fixed and competitive FX”) are crucial for macroeconomic stability. Prudential rules (e.g., capital adequacy rules) are also important to ensure financial stability. In fiscal policy, pure automatic stabilizers (e.g., unemployment benefits) and non-automatic stabilizers (e.g., tax relief for reinvested profit, investment tax credits) are crucial to smooth economic fluctuations.

Figure 4: Heterodox economic policy framework

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<th>Industrial Policies</th>
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<td>Industries with sustainable competitive advantages</td>
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<th>Fiscal Policy</th>
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<td>Pure automatic stabilizers</td>
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<td>Tax relief for reinvested profit</td>
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<th>Supporting Policies</th>
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<td>Science &amp; education</td>
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<th>Regional Policy</th>
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<td>Population policy</td>
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<td>Infrastructure (physical and digital)</td>
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<td>Cluster development</td>
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<th>Strategy 2015-30</th>
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<tr>
<td>Financial consolidation</td>
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<td>Industrial development</td>
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<td>Social development</td>
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Depreciated) FX rate is automatic stabilizer. Within tax policy, treatment of investment income like ordinary income could be automatic stabilizer. Lower tax rate on reinvested profit could be also fiscal automatic stabilizer. Competitiveness policy, competition policy and science and education constitute the third pillar of supporting policies. Regional policy is fourth pillar. Strategy of economic growth and social development acts as framework for all pillars of economic policy.

Serbia 2015-30: Thinking through strategy

Sometimes “strategy” is a confusing notion. At its core, it is choosing to do some things and not to do other things. Sometimes strategy can seem mystical and mysterious, unknowable and unexplainable in advance but obvious in retrospect [6, p. 3]. A key part of strategy is to do something that is inimitable. Achieving extraordinary results by doing ordinary things is not logical.

Strategy is a set of choices about winning. If you do not try to win, somebody else inevitably will. If somebody else is winning, the results of your actions will not be sustainable. You will not aspire to play. You will aspire to win. That is strategy. Great organizations, whether state, company, political party, whatever you do, choose playing to win instead playing to play.

To be effective, national strategy of economic growth and social development must be rooted in a desire to meet people’s needs for prosperity in a way that creates value for both the state and citizens. To survive and prosper Serbia must be: a decent place to leave, a decent place to work, and a decent place to invest.

The strategy playbook can guide strategic thinking. Creation of strategy is a holistic process. To think strategically means making the choices. It is thought provoking process, which acts as catalyst in making choices for controlling events instead of allowing events to control the choices. Namely, strategy formulation is methodology for thinking through choices.

Strategy is a coordinated and integrated set of choices that uniquely positions the organization in its environment to create sustainable advantage and superior value relative to the competition. Following the idea of A. Lafley & R. Martin [8, pp. 14-30], national strategy for economic growth could be the answer to the following five interrelated questions:

1. What is winning aspiration?
2. Where to play, and where not to play?
3. How to win?
4. What capabilities must be in place?
5. Do macro management system and key macroeconomic and vulnerability indicators support previous strategic choices?

It is a reinforcing cascade, with the choices at the top of the cascade setting the context for the choices below, and the choices at the bottom influencing and refining the choices above. For a national economy, there are multiple levels of choices and interconnected cascades. Strategy on each level articulates the strategic choices. Each strategy influences and is influenced by the choices above and below it. For instance, state level where to play choices guide complementary choices at the regional level, which in turn affect city (or municipality) level choices. The result is a set of nested cascades that cover the full national economy (see Figure 5).

A government must understand existing core capabilities (connected with comparative and competitive advantages) of national economy and consider them when deciding where to play and how to win. However, it may need to generate and invest in new core capabilities to support important, forward-looking strategic choices (sustainable competitive advantage) considering dynamic feedback loop between them.

A/ Winning aspirations

The first question from cascade (What is our winning aspiration?), sets the framework for the following choices. Aspirations exist to align policy measures consistently, so they must be design to last for some time. They should not change day to day.

Winning aspiration defines the purpose of economy, its guiding mission, and aspiration, in strategic terms. To play merely to participate is self-defeating. It is recipe for mediocrity. Winning is what matters, and it is criterion for success. A too-modest aspiration is far more dangerous than too-lofty one.
Aspirations are statements about desirable future. The abstract concept of winning is translating into aspirations. National economy, in general, and tradable sectors in particular, tie to those aspirations some specific benchmarks that measure progress toward them.

For each national economy the winning aspirations mean sustainable employment. In the process of setting the speed of growth and investment intensity, strategists must respect so-called "3+ & 40+" principle. Namely, CAGR > 3%, and ratio Investment/GDP > 40%.

A national economy must seek to win in tradable sector and, notably, through industrial policies for high priority industries. Clarity about the winning aspirations means that actions and measures in industrial policies for priority sectors are directed towards pro-export and anti-import ideal.

To set winning aspirations properly, it is important to understand whom you are playing with, and against. When setting winning aspirations, you must look at all competitors, not just at competitor you know best.

B/ Where to play

The next two questions from cascade are where to play, and how to win. These two choices, which are tightly bound up with one another, form the hard core of the strategy. Winning aspiration implicitly defines the priority sectors of national economy. Where to play and how to win define the specific activities to achieve its aspirations. Choosing where to play explicitly involves choosing where not to play, as well.

Where to play choice means choosing the segments of tradable sector for implementation of industrial policies and corresponding markets. Figure 6 shows landscape of tradable sector presented in [4, p. 247] for industrial policies enhancing comparative advantage, competitive advantage and sustainable competitive advantage.

As far as market is concerned, there are two broad choices: expand into domestic market when anti-import goals dominate in strategy formulation, and expand into foreign markets when export goals dominate strategy formulation. For the second choice, there are three options. First, growth in core business with the focus on existing international core consumer segments, channels, and geographies. Second, higher penetration in fast growing emerging markets with demographic dividend. Third, to build position of niche player through diversification in structurally attractive market segments.

Tradable sector may compete in any number of demographic segments and geographies (local, national, global, early developer, late developer, fast growing, etc.). It can compete in a myriad of services, product lines and categories. It can participate in different channels (direct to consumer, on-line, mass merchandise, grocery, department store). It can participate in the upstream part of its industry, downstream, or can be vertically integrated.

According to [8, pp. 61-65], there are three dangerous temptations in connection with this choice. First, failing to choose. Attempting to form competitive champions in
every industry of tradable sector at once is wrong. Focus is critical. Second, trying to play your way in an unattractive field. Third, accepting a current choice as inevitable or unchangeable. It is not easy to change playing fields, but it is doable and can make all the difference. Avoiding previous pitfalls requires deep understanding of the competitive landscape, leading trends, and core capabilities.

C/ How to win
Where to play is half of the strategy. The second half is how to win. Where to play selects playing field. How to win defines the choices for winning on that playing field. It is formula for success.

To determine how to win, priority industry from tradable sector must determine what will enable it to create unique value and sustainably deliver that value to customers. It is the specific way a priority industry utilizes its advantages to create superior value for consumer and, by doing so, superior returns to owners.

Winning means providing better consumer and customer value proposition than competitors do. In addition, it means providing it on a sustainable basis. There are just two generic ways of doing so: cost leadership and differentiation.

In cost leadership strategy, value is driven by having a lower cost structure than competitors do. Competitor reaching cost leadership position does not necessarily charge the lowest prices. Low cost players have the option to reinvest the margin differential in ways that create sustainable competitive advantage.

The alternative to cost leadership is differentiation. In great strategy, the priority industry offers products or services that are perceived to be distinctively more valuable to customers than are competitive offerings and is able to do so with approximately same cost structure competitors have. In this strategy, different offerings have different consumer value proposition and different prices associated with them.

Differentiation advantage means that when a competitor wants to gain market share, it can cut its prices without destroying profitability, and its competition will not have the resources to respond. Alternatively, it can invest some of the premium to add new, desirable feature to products. In doing so, it can actually reinforce its differentiation advantage.

In some cases, priority industry can employ both generic strategies at the same time, driving a significant price premium over competitors and producing at lower cost than those same competitors. This dual strategy approach is rare, but it is possible if industry in question has overwhelming share advantage and substantial scale-sensitive costs. In the last decade, the strategy winner-takes-all has gained credibility. The notion is that the industry in question finds the killer way to compete and generates such scale that the player can continue to press its advantage until it takes the entire market.
Where to play and how to win choices do not function independently. The two choices should reinforce one another to create a distinctive combination. If, after lots of searching, one cannot create a credible how-to-win choice, he should find a new playing field or get out the industry from priority list.

Tenets of fiscal policy complementary with how to win choice in tradable sectors includes: a. expansion of public investment in tradable sectors in order to reach balance of payments and budget robustness, b. encouragement of private investments in missing gaps in tradable sectors value chains, c. innovation capacity increase through PPP in ICT and digital infrastructure.

For any industry from priority list, there is almost an infinite amount of data that could be crunched, a wide area of strategic tools that might be brought to bear on the problem, and many possible strategic choices that could be selected. Sometimes it could be overwhelming, even paralyzing. The bad news is that there is no simple algorithm for choice. The good news is that there is a framework for thinking (see Figure 7).

Ultimately, there are four critical dimensions in choosing where to play and how to win: industry, customers, relative position, and competitor’s reaction. These four dimensions can be understood through the framework we call the “strategy logic flow”. This process ends with the formulation of the strategy for the current context (“as is” strategy). Strategy logic flow starts with strategic attractiveness of the industry in question and its existing market segments. Strategic attractiveness is measured by average profitability (EBIT margin, for example) and probability of default (z-score, for example). Analysis continues with customer side along with distribution channels and end consumers. Afterwards, focus is shifted towards internal aspects of tradable sector under question (capabilities and relative cost position). The last step, before formulation of feasible strategy options, is anticipation of competitors’ reaction. The “as is” strategy formulation requires at least two alternatives with precise core elements (where to play, and how to win).

It is shown that the logic flow starts from the existing context and picks the best solution from the scope of strategies that adequately fit the current context organization is operating within.

However, there is parallel path in thinking through strategy, the reverse order. Ever changing and dynamic context requires proactive thinking, meaning ability to foresee possible changes in the environment and adapt proposed solution to it. Reverse order in strategy formulation might be even more suitable. It assumes formulation of a “to-be” strategy based of future trends as well as inflection points.

When the “as is” or “to be” strategy are determined, capabilities and management system are adopted to fit it (see Figure 8). Capabilities and management system are examined to determine whether they support selected solution. Alternatively, eventual constraints in terms of capabilities and systems provide reshaping of the initial solution to come to the final one.

Figure 7: Strategy logic flow according to [8, p. 161]
D/ Core capabilities
The capability choice relates to the range and quality of activities that will enable a tradable sector to win where it chooses to play.

Identifying the capabilities required to deliver on the where to play and how to win choices crystalizes the area for investment. It enables an industry to continue to invest in its current capabilities, to build up others, and to reduce the investment in capabilities that are not essential to the strategy.

The range of capabilities is broad and diverse. Nevertheless, only a few capabilities are fundamental to winning in the places and manner that are chosen: consumer understanding, innovation, go-to-market ability, and sale crediting.

Capabilities are the map of activities and competencies that critically underpin specifics of strategy. An integrated and mutually reinforcing set of capabilities that underpin the where to play and how to win choices must be feasible, distinctive, and defensible.

E/ Management system
The final choice in the strategic cascade focuses on management system. It is a key piece of the strategy puzzle. It fosters, supports, and measures the effects of strategy. It is an old saying that what gets measured gets done. There is more than a little truth to this. If aspirations are to be achieved, capabilities developed, and management systems created, progress needs to be measured. Measurement provides focus and feedback.

The last box in the strategic choice cascade is the most neglected one. Often, government formulates national strategy of economic development and then broadcasts the main subjects to the rest of the economy. Strategy can fail spectacularly if you fail to establish management systems that support those choices and capabilities. Without supporting structures, systems, and measures, a strategy remains a wish list, a set of goals that may or may not ever be achieved. To truly win in the global marketplace for creating, reviewing, and communicating about strategy, it requires structures to supports its core capabilities and
it requires specific measures to ensure that the strategy is working.

Every industry from priority list needs systems to formulate, refine, and clearly communicate the essentials of its strategy. It requires systems to measure attainment of its goals. In addition, it requires systems to support and invest in its core capabilities.

Due to strong involvement of government in implementation of industrial policies, state budget must be in line with EU anti-crisis governance model, namely, new surveillance systems for budgetary and economic policies. The new EU’s rules introduced through the Six Pack [5] in December 2011 and the Two Pack [6] in May 2013. The previous regulations respect the following rules:

a. Headline deficit (3% of GDP) and debt limit (60% of GDP)
b. Focus on debt (reduction of 5% on average over three years in case that debt is above 60% of GDP)
c. Public costs benchmark (public spending must not rise faster than medium-term growth)
d. Stricter budgetary objectives (introduction of safety margin against breaching the 3% headline limit in case when public debt is over 60% of GDP)
e. Strict structural deficit (0.5% limit, in exceptional circumstances 1% of GDP)
f. Budget resilience (extra time for correction of deficit in case when budget deficit is more than 3% of GDP)

Policy toward hard budget constraints and corresponding indicators should be respectable on all levels of governance (state, region, and city/municipality).

**Conclusion**

Serbia’s economy is permanently under the threat of insolvency, primarily due to low economic base. In the last period, new challenges are geopolitical spillover on economy and deglobalization. They have strong impact on capital and trade flows. From Serbia’s perspective, it leads to the fundamental question: How to transform the economy from import and debt dependent to balanced and sustainable in the new context? In looking for strategic flexibility of the economic system, we must start with rethinking conventional development model and related policy platform. It is a question of new strategy of economic growth and social development.

Complex and interrelated problems require systematic approach. To do that, Serbia, first of all, must return to itself. Serbia must reshape the growth model and economic policy platform and discover new transmission mechanisms to energize investments and, by doing this, expand economic base. The new strategy could solve the crisis of investor’s confidence, enabling the creation of level playing field compatible with industrial economy growth model. Such strategy is unavoidable if Serbia intends to be a part of the EU club. Serbia will be compatible with the EU only if it significantly expands the output by using its comparative and competitive advantages, if it creates stable currency and financial system, and develops an investment-friendly environment. Previous preconditions are critical for social development because economy is foundation of a society.

For strategist the current times with shifting balance of power, radical technological changes and various security threats, seem to be more challenging than ever. The new context calls for the government to be visionary, proactive, and not afraid to step outside the comfort zone. Strategy can help to win, but it is not a guarantee for that. Strategy can shorten odds considerably. To be responsive to challenges, the government must be responsible. Invisible hand of the market should not be alibi for inert government anymore.

Starting point must be to consider what legacy of previous strategy and macro management we leave behind. Serbia desperately needs breakthrough in thinking. In thinking through strategy, the government should be striving for sustainability in all relevant aspects of its responsibilities (confident state, social cohesion, and viability of economic system). Sustainability should be long-term vision. It means that country intends to operate with the respect for both current and future generations, and economy with respect for not only macroeconomic, but also, and, predominantly, microeconomic (or business) perspective.

Certain hard choices are components of new strategy. Government must decide to take decisive measures and
step out of the comfort zone of soft budget constraints and financing consequences of previous mistakes by raising debt. In doing this, austerity is inescapable. Nevertheless, it is not the only solution. Restructuring of public sector and infrastructure development (including digitalization) are absolute must.

New strategy in ambiguous times and with legacy of past misconceptions and overestimations requires contextual skills and constructive mindset in searching for solutions with international stakeholders (from the EU to the WB/IMF). At home, we need to reinvent ourselves, so as to follow changes in theory and competitive arena.

References


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