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FROM MACROECONOMIC STABILITY TO INDUSTRIAL POLICIES AND BACK: THE CASE OF SERBIA*

Od makroekonomske stabilnosti do industrijskih
politika i nazad: slučaj Srbije

Abstract

After the 2008 economic crisis in the whole civilized world the orthodox model of macroeconomic policies has been under revision. Although the last crisis wave in Serbia was not triggered primarily by macroeconomic policies, it forces economists to question the framework for conducting broad policies in conditions of transitional recession. Without automatic stabilizers broad policies lose their purpose, particularly when massive privatization and financial deregulation take place. Hidden fractures of the uncompleted transition and mistakes inherent to the economic policies force us to develop conceptually wider framework applicable during the crisis as well as in the post-crisis period.

In the emerging heterodox model industrial policies lead over broad policies (monetary and fiscal, primarily) with extended set of tenets instead of monetary determinism of orthodox model focused exclusively on two tenets, inflation and output gap, both low and stable. In the orthodox model consumer price inflation (CPI) is approximation for inflation and output gap is defined as the distance from the level of output that would prevail in the absence of nominal rigidities of the economic system. Change of the policies framework is an imperative especially for economies that entered the 2008 economic crisis with structural imbalances and low competitiveness. Main manifestations of structural imbalances in Serbia's economy are twin output gaps (transitional gap +gap by definition) and continuous and strong inflation pressures. Unfortunately, structural imbalances could be easily deepened due to financial crisis and the "run" on the governments and banks in the EU. The shift from the orthodox model to the heterodox one in case of Serbia is not the matter of economic prosperity in terms of output expansion and competitiveness improvement but the matter of survival.

Unlike broad macroeconomic policies that affect the whole economy, industrial policies are sector specific. Namely, industrial policies are directed towards output expansion of industries with tradable goods, by promoting certain sectors for import substitution and/or subsidizing certain export oriented sectors. After output increases through industrial poli-

es, broad economic policies come into play. In many ways, in heterodox model the broad policy measures should remain the same. The main promising routes for improvement are new combination of traditional monetary policies and prudential financial regulation and design of better automatic fiscal stabilizers. In monetary policy automatic stabilizers could be developed in many ways. This article suggests currency board as monetary model for Serbia's economy in which stable and competitive exchange rate play the role of automatic stabilizer.

This is what this paper tries to do. Consequently, it proceeds in four steps. The first reviews the genesis of the economic crisis in Serbia and identifies the causes of today's vulnerability. The second and most tentative, takes a new heterodox macroeconomic policy framework (industrial policies lead, broad policies follow). The third identifies industrial policies as an important tool for elimination of structural imbalance causes. The fourth identifies the road map for exit from the crisis.

Key words: *Serbia, transitional recession, "J" curve, jobless recovery, heterodox model, real economy, industrial policies, currency board*

Sažetak

Posle globalne ekonomske krize 2008. godine u celom civilizovanom svetu ortodoksni model makroekonomskih politika je pod preispitivanjem. Iako poslednja kriza u Srbiji nije bila uzrokovana primarno makroekonomskim politikama, ona je navela ekonomiste da preispitaju okvir za vođenje osnovnih ekonomskih politika u uslovima tranzicione recesije. Bez automatskih stabilizatora, opšte ekonomske politike gube svrhu, naročito u uslovima masovne privatizacije i izgradnje liberalnog finansijskog sistema. Skriveni pukotine nezavršene privatizacije i greške u vođenju ekonomskih politika teraju nas da razvijamo konceptualno širi okvir koji se može primeniti u krizi kao i u periodu posle krize.

U novom heterodoksnom modelu koji je u nastajanju industrijske politike vode, a opšte ekonomske politike (monetarna i fiskalna, pre svega) slede, sa proširenim skupom ciljeva umesto monetarnog determinizma ortodoksnog modela koji je fokusiran na nizak i stabilan output gap i nisku

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i stabilnu inflaciju. U ortodoksnom modelu indeks potražkih cena predstavlja aproksimaciju za inflaciju dok je output gap predstavljen kao razlika između postojećeg nivoa proizvodnje i nivoa koji bi se ostvario u odsustvu nominalnih rigidnosti u sistemu.

Promena u okviru za vođenje ekonomskih politika je imperativ, posebno za privredu koje su u krizu iz 2008. godine ušle sa strukturnim neravnotežama i niskom konkurentnošću. Osnovne manifestacije strukturnih neravnoteža u Srbiji su output gap blizanci (tranzicioni + gap po definiciji) kao i trajni i snažni inflatorni pritisci. Nažalost, strukturne neravnoteže se lako mogu produbiti usled finansijske krize u EU usled nelikvidnosti banaka i države. Prelazak sa ortodoksnog na heterodoksn model u slučaju Srbije nije pitanje ekonomskog prosperiteta u smislu povećanja proizvodnje i konkurentnosti, već pitanje preživljavanja.

Za razliku od opštih makroekonomskih politika koje utiču na privredu u celini, industrijske politike su usmerene na pojedinačne sektore. Naime, industrijske politike su usmerene na ekspanziju grana sa razmenljivim dobrima promovišući određene sektore u cilju supstitucije uvoza i/ili subvencionisanja izvoza. Pošto se povećala nivo ekonomskih aktivnosti, na scenu stupaju opšte politike. U više aspekata osnovne ekonomske politike ostaju nepromenjene u heterodoksnom modelu. Kombinacija mera tradicionalne monetarne politike i finansijske regulacije kao i izrada boljih automatskih stabilizatora u fiskalnoj politici su osnovne putanje promene. U monetarnoj politici automatski stabilizatori se mogu razviti na više načina. U ovom radu se sugerise upotreba "monetarnog odbora" u kome stabilan i konkurentan devizni kurs predstavlja efikasan automatski stabilizator. Prethodnom okviru razmišljanja je posvećen ovaj rad. U prvom delu analizirani su uzroci ekonomske krize u Srbiji kao i glavni indikatori ranjivosti njene privrede. U drugom, i najvažnijem delu, predlaže se nov heterodokсни okvir za vođenje makroekonomskih politika. U trećem delu se identifikuju industrijske politike kao važno sredstvo za eliminaciju uzroka strukturnih nestabilnosti. U četvrtom delu dat je dijagram toka izlaska iz krize.

Ključne reči: *Srbija, tranziciona recesija, "J" kriva, rast uz nezaposlenost, heterodokсни model, realni sektor, industrijske politike, monetarni odbor*

Orthodox transition policies and their results

After onset of the 2008 global economic crisis the question of feasible economic solution for Serbia's transitional crisis came into the foreground. After the EU has parked Serbia's accession appeared the doubt that all economic solutions were coming from empty space.

Two important facts underpin the last dilemma. First, Serbia has been excommunicated, more or less, for a longer period of time and this fact crucially affects viability and performances of its economy. Second, the EU, the guiding star of Serbia's transition architects in the last decade is slowly going dark. Namely, the ongoing "run" on banks and governments in the EU has increased vulnerability of

the system. Eclipse of the EU influences its potential for further absorption and, consequently, the likelihood of Serbia's accession to the EU. Parking aside the problem of Serbia's accession to the EU in 2011 might be understood as a new manifestation of excommunication.

Transition toward the capitalism in Serbia started in 1990, the same year when transition started in other socialist countries. The transition was followed by disintegration of Yugoslavia and the chain of civil wars for its heritage. In 1992 Serbia was imposed sanctions. Sanctions largely caused *Serbian factor* to become irrelevant in transformation of republics of former Yugoslavia into independent states and their successive geopolitical repositioning. Whether it was the tenet set up from the outside centers of power or the consequence of wrong internal policy, or both, is left to historians and politicians to argue. Nevertheless, the economic consequences of such situation were significant. After disintegration of Yugoslavia and the break-up of the State Union of Serbia and Montenegro, as one of its temporary successor, Serbia got the status of land-locked country. Because of the sanctions Serbia also became a land-locked country.

From the economic perspective, the main consequence of sanctions was structural instability manifested in continuous and strong inflationary pressures and transitional output gap.¹ Concretely, in 1993, the first year of sanctions, the output dropped for 60% compared to pre-transition 1989 along with record inflation of 313 million %, second highest in the monetary history. To compare, in the Great Depression during 1929-1933 at the bottom of the downturn in the US, the output gap was 40% compared to the pre-crisis level, with unemployment rate of 25%, and, interestingly, 27% deflation. Evidently, the transition output gap in Serbia was more devastating than the output gap during the Great Depression. It is well known that transition process assumes transitional recession in the first stage and output recovery above the pre-transition level in the following period (so called output "J" curve). Contrary to the other economies in transition Serbia's economy has never left transition recession it entered at

¹ See more in Đurić, D., Vuksanović, I. (2010): "The World After the Crisis: Lessons for Serbia's Exit Strategy from Permanent Crisis", *Ekonomika preduzeća*, jan-feb, pp. 1-14 Đurić, D. (2011): "Anti-crisis Program and Sustainable development: An economic practitioner's Perspective", *Ekonomika preduzeća*, sept-oct, pp. 201-218

the beginning of the process. For the year 2011 transitional output gap amounts to 30%.²

In the period 1989-2011 the unemployment rate in Serbia increased from 12% to 23%. Today many economists, for example, *J. Stiglitz*³, point out that the unemployment rate more colorfully depicts the health of national economy than the GDP growth.

During period of sanctions, *Milosevic's* regime tried to play *chasse* with the EU by buying time and sacrificing interests of Serbia's economy for the sake of regime's proclaimed interests of Serbian nation. Yet, the EU played geopolitical poker game instead, often bluffing and even playing its trump card when it takes. The bombing campaign in 1999 wasn't just the last round of the game in which the regime lost credibility and left the game without the entire initial political stake. More importantly, it was the final blow in systemic devastation of the economy.

During the whole period of geopolitical transition Serbia stayed stuck in the middle between main strategic players. Economic transition is not effective, without geopolitical transition completion. After political changes in 2000, there were signals that Serbia would be able to quickly complete its geopolitical repositioning toward the EU. However, although the level of foreign investment increased they mostly had the wrong focus (acquisition of best positioned local monopolies instead of producers of tradable goods). Consequently, the deficit in tradable sector was inevitable. In the meantime great majority of transitional countries successively completed transition (geopolitical and economic) and their process of catching up to the EU started. Compatible institutional settings, productivity improvement and sufficient level of tradable goods triggered the EU expansion. Former socialist countries now newcomers of the EU entered the 2008 global economic crisis fully geopolitically repositioned and with economic performances stronger than before transition. According to *Eurostat*⁴ the average level of GDP in 2008 relative to 1989 in these countries was 1.4 times higher followed by significant improvement in

productivity. Interestingly, the unemployment was not a victim of radical reforms. The average unemployment rate for these economies stays close to EU27 average of 10%.

After political changes in Serbia in 2000, despite accelerated economic reforms and clear signals of geopolitical repositioning toward the EU, economy still remains impotent and relatively isolated. The results of reforms are disappointing. The low of gravity holds in the economy (when you lose velocity, altitude should be rapidly lost and regained with difficulties). To be precise, after 21 years of transition Serbia still has significant inflationary pressures and output gap. In the last two years anemic growth along with rising unemployment took the character of jobless recovery. In 2011 growth rate of 1.5% was followed by 15% jobs lost compared to the previous year. Restructuring of the public sector has not been completed yet and epicenters of inflation pressures have not been eliminated. Widespread use of wage and pension indexation regardless the productivity growth, magnifies inflationary shocks, reduces investments and leads to the slowdown of the rhythm of transition. The justification for this behavior maybe lies in the fact that due to the consequences of the sanctions up to 2000 the living standard was at the absurd level. However, in the period succeeding the abolishment of sanctions there was no excuse for mistakes in the economic policies that manifested, primarily, in exclusive focus on maintaining macroeconomic stability through monetary measures without adequate industrial and regional policy, public sector restructuring and fiscal reforms. In a word, Serbia's transition architects obsessed with social cohesion were biased toward monetary policy measures and quick privatization completely neglecting business and fiscal perspective of reforms. Consequently, reforms' achievements as well as reforms were reversible.

A quick look of macroeconomic indicators for 2011 shows that the economy is full of imbalances. Transitional output gap is on significant 30% level. The share of real economy in GDP during transition decreased from 70 to 40%. The share of tradable sector also fell down to 20% of GDP. For the countries of similar size and level of debt this share is supposed to be 50-70%. The share of public sector in diminishing GDP stayed on considerably high level, more

2 The level of output in 2011 compared to the level of output in 1989

3 Stiglitz, J., Sen, A., Fitoussi, J. (2010): *Mismeasuring Our Lives: Why GDP Doesn't Add Up*, New Press, New York

4 European Commission Eurostat, available at http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=lfqs_urgan&lang=en

than 40% of GDP. Investments are insufficient, 22% of GDP and FDI partake only 3%. Considering the social safety net, things went from bad to worse. From the financial perspective, the social safety net is not sustainable when the ratio of pensioners to working population is 1.1: 1.0.

Previous problems trigger unfavorable vicious circle. Without industrial policies and public sector restructuring, real appreciation of the local currency and high cost of capital deepened structural imbalances. High value added industries disappeared (aircraft, tool machinery, vehicles, project engineering, ship construction, military equipment, etc.), traditional exporters lost competitiveness (hard and soft chemistry, confectionary, durables, etc.), while the infant and lead edge industries haven't appeared (renewable energy, life science, etc.).

Real economy and financial sector are two different stories. Real economy and tradable goods stayed below radar of policy makers. Well-positioned local companies from that sector were privatization targets of multinationals. The capital market served only as an infrastructure for privatization. On bank-centric financial market local entrepreneurs and companies from public sector were forced on debt financing. The whole institutional settings, from laws to regulatory bodies, readjusted to that fact. The capital market, shallow as explained, went into a retreat with the slowing pace of privatization. Economic theory teaches us that capital market is a brain of an economy. Does it mean that Serbia's economy during transition was left with no brain?

Despite exclusive focus of broad economic policies on macroeconomic stability reduced to CPI control, reform achievements are not encouraging. Behind these policies were hidden fractures like real appreciation of local currency

and high cost of capital. Namely, the cumulative inflation for the period December 2001-November 2011 was 174% while in the same period cumulative nominal depreciation of local currency was 43%.⁵ Real appreciation of local currency was primarily the consequence of massive capital inflow in a form of privatization proceeds and FDI. Large appreciation may squeeze the tradable sector and make difficult for it to grow back when the FX rate returns to normality.

On the other hand, the lack of confidence in local currency due to unfinished geopolitical transition caused more than 70% of business transactions to be euro denominated. Since the FX rate fluctuated significantly in the last decade, periodic depreciations when majority of domestic contracts are euro denominated caused severe balance sheet consequences (FX gains/losses) and, consequently, negative impact on the level of activity. It is not logical that the cost of borrowed capital is so high (the average interest rate in 2011 is around 10%) when currency convertibility and tools for FX hedge exist. It is partly the consequence of the central bank prudential policy (high level of obligatory reserves, high policy rate, high repo rate, classification of risky assets, etc.) and partly the result of commercial bank's policies. Paradoxically, interest rates and appreciation as the main consequences of the broad policies are, actually, the main stress factors for the real economy. Their combination leads to a final blow to tradable sector competitiveness.

Table 1 presents specific interest rates. Evidently, there is a positive trend in a way that the total average

⁵ National Bank of Serbia available at www.nbs.rs

Table 1: Interest rates in 2011 (by duration of credit period, by purpose, and total average), in %

Duration of credit period					Purpose of credit								Total average interest rate
	Up to1 year	1-5 years	More than 5 years	Total	Credits in dinars					Credits in foreign currency			
Month					Working capital	Export	Invest ment	Other	Total	Import	Other	Total	
Jan	13.01	9.22	7.30	10.29	12.40	11.89	8.15	10.44	10.49	7.56	5.77	6.65	10.77
Feb	13.41	9.22	7.34	10.48	12.79	11.30	8.21	10.57	10.69	7.74	5.87	6.82	10.92
Mar	13.44	9.32	7.37	10.48	12.81	9.87	8.19	10.70	10.67	7.67	6.00	6.81	10.87
Apr	13.83	9.47	7.46	10.66	13.19	9.05	8.25	10.88	10.86	7.84	5.94	6.87	11.09
May	13.61	9.54	7.48	10.59	13.17	8.16	8.28	10.60	10.78	7.96	5.99	6.95	11.04
Jun	12.63	9.46	7.54	10.10	12.21	7.66	8.26	10.37	10.28	7.63	5.71	6.65	10.53
Jul	12.49	9.51	7.66	10.02	11.96	7.70	8.27	10.43	10.18	7.80	5.70	6.79	10.41
Aug	12.28	9.46	7.45	9.70	11.65	7.67	8.26	9.76	9.84	7.93	5.59	6.85	10.11
Sept	12.06	9.38	7.38	9.55	11.35	7.44	8.24	9.59	9.70	7.48	5.50	6.57	9.99
Oct	11.84	9.27	7.40	9.40	11.05	7.23	8.16	9.46	9.53	7.53	5.64	6.67	9.86

Source: National Bank of Serbia

interest rate for the corporate sector is slightly falling in 2011, from 10.77 to 9.86%. Still, this decline does not match with policy rate decrease in the same period (for 2%). Another positive trend refers to the export loans. Interest rate on the loans assigned to export is in decline, it fell for more than 5% in the last year, from 12.26% to 7.23%. To compare, interest rates for the loans assigned to import in the same period went from 8% to 7.53%. Such costs of borrowing capital raise risk aversion for investments in the real economy.

In labor market there are too many people of the wrong kind and not enough people of the right kind. Refugee influx, brain drain, population concentration in urban areas and desertion of rural areas dramatically increased population risk.⁶ In tradable sector, controversially, despite of high level of unemployment, human capital is a scarce factor, which determines its inflationary rather than deflationary character. It is a labor market paradox in a sense that due to adverse structure good news from the labor market is a bad news for competitiveness.

Besides the human capital, Serbia also has insufficient deposits of ultimate resources (energy, food and capital). Growing strategic dependency of the country regarding these resources hinders the capacity for reindustrialization. Also, unsustainable character of contributions to the social funds decreases additionally overall level of labor force motivation as a prerequisite for human capital development.

In a word, vulnerability of Serbia's economy is high in absolute and relative terms. The absolute vulnerability could be depicted by key performance indicators presented in the Table 2, structured in three segments: operational performance, financial performance and competitiveness. Reference points for each indicator are available in the last column of the figure.

Relative vulnerability is presented in Figure 1 with Serbia vs. the EU benchmark analysis of key performance indicators. Referent points above which the economy enters the increased vulnerability zone are: 4% for current

Table 2: Serbia's vulnerability indicators, 2Q 2011

Performances	Indicator	Reference point
Operational performance		
· Transitional output gap	30%	0%
· Unemployment	22.2%	<10%
· Inflation		
· Core	13.6%	<10%
· CPI	12.7%	<10%
· Okun index	34.9%	<12%
· Twin deficits		
· Current account	7.7%	< 10%
· Budget	4.5%	< 3%
Financial performance		
· Indebtedness		
· Public debt/GDP	46%	<45%
· Foreign debt/GDP	78%	<90%
· Foreign debt/Export	206.2%	<220%
· Credit rating		
· S&P	BB-/Stable/B	investment rang > BB
· Fitch	BB- out. neg.	investment rang > BB
Competitiveness		
· Export (goods)/GDP	27.3%	>50%
· Currency depreciation		
· Nominal	3.9%	< 5%
· Real	9%	< 3%
· Global competitiveness index	96 th (139)	65 th (CEE average)
· Corruption perception index	78 th (178)	59 th (CEE average)
· Ease of doing a business	89 th (183)	60 th (CEE average)
· Economic freedom index	101 th (179)	62 nd (CEE average)

Sources: Ministry of Finance Republic of Serbia, National Bank of Serbia, World Bank, Heritage Foundation, Trans World Economic Forum & Transition Report

account deficit, 3% for fiscal deficit, 60% for public debt, 60% for external debt, 60% for trade openness, 80% for foreign funding of banks. Vulnerability can be estimated as extremely high (considering foreign funding of banks, trade openness and external debt), moderate (considering current account deficit and fiscal deficit) and low (considering public debt). Also, radar diagram portrays that the most vulnerable positions are those that are direct consequences of broad economic policies. Paradoxically, Serbia's problem does not stem from the gaps up to the reference points. The problem is generally low level of activity at which balance is achieved (18% of EU27 GDP pc).

As far as activity level is concerned, in the Figure 2 one can observe the trend for industrial output in Serbia compared to the same indicator for EU 27 for the five-year period. The period encompasses both years before as well as after the first crisis shock.

Serbia's industrial output is highly correlated to the EU's industrial output. It can be seen on the upper figure that the ups and downs in industrial output in the EU are

⁶ Đuričin, D., Vuksanović, I. (2010): "Population risk and sustainable development in combined economic crisis: The case of Serbia", Facing the future of South-East Europe, Croatian Academy of science and arts and Croatian Institute of finance and accounting, Zagreb

Figure 1: Serbia's vulnerability indicators compared to the EU's reference points

followed by ups and downs in industrial output of Serbia. Things complicate furthermore the “run” on banks and governments that overmasters the entire EU. Namely, the latest credit crunch and sovereign debt crisis in the EU predicts no good future for Serbia, and it is already observable in industrial output fall in 2011 compared to 2010 (0.9% in October 2011).⁷ There is no better indication that the new crisis wave is about to strike.

Economy that spends more than it produces is not sustainable. Twin deficits are clear manifestation of structural imbalances. In 2011 current account and budget deficits are 7.7% and 4.5%, respectively. Jobless recovery is partially a consequence of the fact that liquidity was used for debt repayment instead of investments. Jobless recovery along with slowing rhythm of investment can quickly bring Serbia's economy into recession, maybe depression.

Another major source of concern that reinforces the dilemma from the beginning of the article refers to possibility of Serbia's accession to the EU. New generation of Serbian politicians after 2000 behaves like the sailors navigated by the stars. The main, and probably the only one, guiding star has been the EU. However, the 2008 global economic crisis along with structural defects across the EU and implemented

recovering measures undoubtedly indicate that this star is slowly fading away. Frequent use of “too big to fail” argument led to monetary expansion, massive bailouts, unselective fiscal stimuli, which along with fiscal chaos and confusion related to sovereign debt restructuring model increased euro volatility. All of this indicated serious system flaws and lack of adequate policies that together drive the EU into a double dip recession.

In the end of 2011 it has definitely become obvious that prevailing tenet of geopolitical repositioning of pro-EU Serbia has been call into question. The fact is that Serbia gave all on the EU card, while the EU parked Serbia's accession for the coming period. Besides the inertia concerning geopolitical solution that was imposed during the Yugoslav crisis, the new situation includes impotent Serbia's economy with high population risk, unable to cut dependency on capital, energy and food from abroad. Combination of previous facts with the “run” on banks and governments in the EU could postpone Serbia's accession.

On the other hand, ignoring Russia and China on the path of geopolitical repositioning turned political support of these countries, which always comes along with investments, into wait-and-see pattern. In a word, today Serbia is geopolitically stuck in the middle between important strategic players and this fact primarily affects

Figure 2: Industrial output for EU27 and Serbia, indices 2005=100

⁷ Statistical office of Republic of Serbia, available at <http://webzs.stat.gov.rs/WebSite/>

Source: Eurostat and Statistical Office of Republic of Serbia

its economic performance and the outlook for the future. In the global world, especially in times of crisis, it is more important to whom you are connected than who you are.

Parking aside the problem of Serbia's accession from the EU does not imply lowering interest of Serbia for the EU and turning towards other conceptual extreme. The EU is going through changes, but compatibility with the EU remains imperative. That is something Serbia must accomplish not as a manifestation of the respect towards the EU and its values, but, primarily, in its own interest, in order to reach imperative of full compatibility with its near environment.

Heterodox economic policies framework and expectations

The conceptual grounds for economic transition in Serbia referred to neo-liberalism (or free-market fundamentalism), while the precise framework for conducting economic policies was Washington Consensus. The essential elements of the Washington Consensus⁸, although there exist different interpretations, are: market liberalization (trade, capital and labor) and macroeconomic management focused exclusively on inflation control as a prerequisite for macroeconomic stability and sustainable development. In Serbia, this framework was extended to one more element, quick and massive privatization.

Previous analysis has shown that the orthodox model for conducting economic policies in Serbia was based primarily on monetary tools. As a result, prevailing policy tenet has been inflation control, and prevailing instrument policy interest rate, that is, the short term interest rate controlled by the central bank through open market operations. Fiscal policy plays secondary role with political constraints sharply limiting its usefulness while financial market liberalization was, simply, a consequence of value judgment of certain expert circles.

Inflation (stable and low) was presented as primary tenet of monetary policy along with maintenance of stability of financial system. Actually, it was flexible inflation targeting or returning of inflation to stable target

over some corridor. The central bank's focus on inflation rather than on activity coincided with the IMF conceptual support as core reform sponsor as well as expert circles support provided by the New Keynesian model of inflation targeting embodied in Washington Consensus. Constantly repeated mantra was that low and stable inflation is good in itself and good for economic activity, in terms of low and stable output gap.

Also, architects of Serbia's transition forgot that countercyclical fiscal stance is extremely desirable for economies with limited number of automatic stabilizers. Partly it was the consequence of the fact that the buildup of the institutional settings and financial regulation were mostly outsourced to international financial organizations and advisors independent of local policy makers. Consequently, primary focus of broad policies did not go further than debt sustainability and fiscal rules to achieve such sustainability.

To conclude, the model of economic policies hitherto was embodied with some delusions. First, that the foreign investments are panacea for sustainable development. This standpoint ignores the reality. The net capital inflow is not permanent. In the last period the level of capital migration from CEE countries is significant. For example, in 2010 profit repatriation was three times higher than the FDI inflows. Second, the respect toward the IMF's advice regarding broad policies tenets is crucial for achieving macroeconomic stabilization. This standpoint neglects the fact that the IMF is, first and foremost, a creditor which pays attention to balanced budget in order to assure debtor will repay its debt. Third, that the EU accession guarantees massive fund influx for restructuring of public sector, social funds recapitalization and competitiveness increase. On the contrary, today the EU has its own problems, credit crunch and sovereign debt crisis. Furthermore, hypothetically speaking, Serbia's accession to the EU automatically leads only to nominal (or price) convergence. Real (or competitive) convergence is time consuming process with constant negative effects on twin deficits. Fourth, orthodox stabilization measures like budget cuts, tax increases, and improving of labor market flexibility are prerequisites for the sustainable employment. On the contrary, these measures lead to "fear from fear", risk

⁸ Williamson, J., Mahar, M. (1998): *A Survey of financial liberalization*, Essays in International Finance 211, Princeton

aversion increase, demand squeeze, which together leads to high and volatile output gap.

Keeping inflation low and stable predominantly with monetary measures was considered as a prerequisite for high economic expectations and investments that were supposed to lead to sustainable employment. Unfortunately, such policy was inappropriate for Serbia, primarily, due to structural imbalances and output gap. Moreover, the last crisis confirms that this policy didn't succeed even in some over-heated economies. In Serbia, as under-heated economy, this policy was boiled down to naïve liberalism in trade and capital flows and expensive policy of inflation targeting as a core policy for maintaining macroeconomic stability. These policies followed by appreciated FX rate and high cost of capital lead to the real economy destruction. Also, this policy was extremely costly because partially fluctuating FX rate was regularly defended with open market intervention of the central bank and high repo rate. Last but not least, these policies do not have automatic stabilizers and cannot be efficient in times when economic downturn reduces privatization proceeds, FDI and remittances.

For the long time Serbia's transition architects ignore the elephant in the room. Again, the rhetoric exceeded reality. Inflation control is necessary but it is not sufficient for sustainable employment. Moreover, the trade-off between inflation and activity is complex, especially in long-term recession. In case of output gap low inflation limits the scope of monetary policy. Also, low inflation is not a firm barrier to undesirable consequences of wrong financial regulation in real economy like other assets prices deviation from fundamentals, endogenous credit expansion, adverse composition of output, etc. Too high level of consumption, too large twin deficits, dominance of services against real economy, too high level of investment in construction and real estate triggered major macroeconomic adjustments later on. In a word, monetary policy is not well equipped for asset prices bust and demand squeeze typical for recession.

The new heterodox model is an epilogue of the repercussions of the orthodox one. New people create new mindset. The new mindset assumes that mistakes of policy makers from the past must be corrected. Also, the new mindset must respect

prevailing geopolitical and regulatory trends. Current Serbia's economic model is impotent and unsustainable. This model was based on services, consumption, import, and credits. The new model requires new set of priorities: real economy, investments, export and savings.

As far as the economic profession is concerned, it is still valid that democracy and market economy are not incompatible. All national economies compete in global context in order to develop business friendly environment. Productivity of national economy arises as the consequence of combined influence of domestic companies and foreign investors. Productivity of domestic companies is fundamental for competitiveness since the competitive domestic business creates new jobs, generates satisfying returns on investments, increases purchase power of domestic currency and augments wealth of the nation. In that context, private and public sectors have different but complementary roles. Domestic business elite cannot be substituted with foreign technocrats.

Now the crucial question is how to avoid deadly interaction of large cost of capital and huge inflation pressure on real economy. Experience from prosperous economies is the blueprint for the new heterodox model. Unfortunately, today, majority of economies from the Western hemisphere does not belong to that group. The prosperous economies matched investments in tradable sectors with comparative advantages through industrial policies. Consequently, besides the invisible hand (so-called "Great Moderation") of the market, the visible hand of the state is also necessary. State plays primarily regulatory role. Also, with active investment policy state plays the automatic stabilizer role.

Without industrial policies and adjustment of broad policies to them, growth based primarily on privatization proceeds and expansion of services will stay anemic and unsustainable due to jobless recovery effect. For quick completion of transition and catching up to the EU Serbia has to change orthodox model with heterodox one. In order to eliminate jobless recovery effect, heterodox model has to be based on three pillars. The primary pillar refers to industrial policies. Industrial policies must be focused on the real economy, both in private and public sector. Regional and population policy follow. Finally, the third

pillar represents broad policies (monetary, financial, and fiscal). In developing world broad policies are not concerned as wheels of prosperity but as the “oil” which lubricates the expansion of output of tradable goods and renders the motion of tradable sectors, as a principal wheel of prosperity, more smoothly and easily. Automatic stabilizers referring to broad policies are correctors of possible imbalances because the ultimate tenets in the new context must remain the same, low and stable inflation and output gap. In order to achieve that, broad policies must have additional tenets.⁹ The main purpose is to decide which instruments to allocate to which tenet, between monetary, fiscal and financial policies.

Why industrial policies are so important in the new mindset? In the conditions of recession, radical reforms in settings with appreciated currency and high cost of capital cannot be based on budget cuts and flexible labor market because these measures lead to further deterioration of activity level. Thus, the steps to be undertaken should take the following order. First, the overall level of economic activity is to be increased *via* industrial policies. Impotent economy with relatively high debt should firstly take into account investment with anti import tenets, and after that export ones. Generally, investments in tradable sector should increase output and productivity.

Standing between comparative advantage and possible competitive advantage built on innovation momentum, Serbia has no choice. Namely, policy makers primarily have to take into account the current level of economic development. With 18% of the EU27 GDP per capita radical competitive advantage improvement based on innovation in new technologies and investment in infant industries is not feasible. Serbia has to found its economic growth on the strengths it already possesses, to boost investments and energize activities in the industries where comparative advantage already exists. The first precondition in the case of Serbia comes down to identifying sectors of the economy where comparative advantages exist. The list of priorities includes: (1) energy sector, (2) agriculture, (3) food processing, (4) telecommunications, (5) infrastructure and logistics, and (6) tourism.

⁹ Blanchard, O., Dell’Ariccia, G., Mauro, P. (2010) “Rethinking Macroeconomic Policy”, *IMF Staff Position Note, SPN/10/03*, 12 February 2010

Different industries offer different wealth prospects. On the low level of economic development, as in the case of Serbia, wealth prospects primarily depend on comparative advantage in terms of massive resource deposits, cheap factor prices, position rent, etc. Resource driven development is a logical choice. On the other side, industrial policy is almost always directed towards industries with capacity to produce tradable goods. Hence, industrial policy tends to centralize interventions on the country level.¹⁰

The notion of clusters offers similar but alternative view. The concept of clusters rests on a broader and more dynamic view of competition based primarily on competitive advantage. The source of competitive advantage is high perceived value as a superior difference between value created and cost of production incurred. In accordance with the notion of competitive advantage the effects of the cluster policies are evaluated based on productivity growth.¹¹ In this sense, clusters refer to interconnected companies, suppliers, service providers and firms in supporting industries as well as broader institutions such as universities, scientific institutes, trade and export organizations, etc.

Contrary to the classical industrial policy approach, cluster provides foreign firms participation since they contribute to a large extent to positive externalities and boost local investment and employment. Today, high perceived value as mark for uniqueness is hard to be found among countries like Serbia. Hence, strengths are to be found in unique connections among different participants in the value chain, both domestic, as well as from the near environment (CEFTA, for example). Serbia has many good companies and institutions, which are dominant exporters around which clusters could be made.¹²

Heterodox policy model needs some changes in terms of so-called “lubricators”, first of all monetary policy. In the current setting the ultimate tenets of monetary

¹⁰ Porter, M. (2000): “Location, Competition, and Economic Development: Local Clusters in a Global Economy”, *Economic Development Quarterly* 14, pp. 15-34

¹¹ Porter, M. (2011): *Competition, Competitive advantage and Clusters*, Oxford University Press, pp. 173-192

¹² Tarkett in floor coverings, Imlek in dairy, MK Commerc, Soya Protein, Victoria Group in food processing, Pionir in confectionery, Fiat in automotive, Metalac in pots and pans, Bell packaging in can production, Belgrade Medical Center, Galenika and Institut Vinca in life science, etc.

policy should not be only CPI control but also sustainable employment. It means widening the policy tenets for the central bank from price stability to other asset prices (including currency) stability, structure of the output (in terms of real economy and private sector expansion), and sustainable growth rate, etc.¹³

Extension of the list of tenets requires monetary model change, a switch from inflation targeting to currency board monetary model. Currency board model with automatic adjustments ensures stable and realistic exchange rate correlated with the level of competitiveness. In the new mindset, the exchange rate is not a tenet but the instrument. Last but not least, if Serbia chooses the monetary policy of a currency board system, it will adopt the monetary policy of the euro zone.

Industrial policies: the road to competitiveness improvement

The purpose of industrial policy is to influence industry development, and consequently, national industry portfolio.¹⁴ Unlike broad macroeconomic policies that affect the whole economy, industrial policies are sector specific. Namely, industrial policies are directed towards expansion of industries with tradable goods by promoting certain sectors for import substitution and/or subsidizing certain export-oriented sectors.

The crucial role of well formulated industrial policy was promoted in early works of development economics.¹⁵ Yet, the rise and flourish of the free-market fundamentalism in the 1970s objected to any form of interventionism with much criticism, while glorifying in the same time the invisible hand of the market in conducting structural change.¹⁶ That was prevailing mantra until the 2008 global economic crisis broke out. The undesirable scar that invisible hand left behind on the face of the economies (even the developed ones) around the world fostered

endogenous growth advocates to stand for the role of state in correcting and dealing with negative externalities of market failures.¹⁷

In the world after the 2008 crisis, industrial policies are aimed at few important goals: to reduce unemployment and stipulate growth, to strengthen the share of real economy *vis-à-vis* financial sector, and to signal the governments' preparedness to cope with structural instabilities.

The only thing worse than the absence of any industrial policy when required for further growth is wrong policy choices or government failure in implementing good policy choices. The reasons for government failures range from lack of information and capabilities to conflict of interest due to symbiosis of political and business elite. The fact that industrial policies are supposed to correct invisible hand's mistakes does not mean that the allocation of resources provided for that purpose should not be market efficient.

Evidence indicates that vast majority of the most developed countries, but especially newly industrialized countries (BRICS and Asian tigers) were conducting industrial policies that selectively fostered activity in the real economy as well as technology transfer.¹⁸ Interestingly, at the bottom of the first wave of the 2008 crisis, economic models of the newly industrialized countries served as universal blueprint for sustainable solution to the crisis. Moreover, most developed economies in the world (U.S, Germany, Japan, and France) reconfigured their after-crisis economic models in an effort to respond to apparently effectual industrial policies of China as the leader of the newly industrial countries. Since financial burden from previous period is tremendous, this policy is not fully effective.

Since the organizations that regulate international trade policy (like WTO) find certain industrial policies rather harmful in terms of protectionism and competition, majority of industrial policies today focuses on building the economy's strength *via* local clusters and value chain optimization.¹⁹

13 Blanchard, O., Dell' Ariccia, G., Mauro, P. (2010) "Rethinking Macroeconomic Policy", *IMF Staff Position Note, SPN/10/03*, 12 February 2010

14 Graham, O. (1994) *Losing Time: The Industrial Policy Debate*, Harvard University Press, pp. 3, 27

15 See more in Hirschman, A. (1958) *The Strategy of Economic Development*. New Haven, Conn, Yale University Press

16 See more in Blanchard, O. J. (1987) *The New Palgrave: A Dictionary of Economics*, v. 3, pp. 634-36

17 Robert, L., (1988) "On the Mechanics of Economic Development". *Journal of Monetary Economics* 22 (1), pp 3-42

18 Robert, W. (1992). *Governing the market*. Princeton: Princeton University Press

19 Porter, M. (2000): "Location, Competition, and Economic Development: Local Clusters in a Global Economy, *Economic Development Quarterly* 14, pages 15-34

One of the hottest issues considering industrial policies refer to whether industrial policies should be comparative advantage defying or comparative advantage conforming.²⁰ In other words, this question stands for the choice between infant industry protection and industries with current comparative advantage. The advocates of the first standpoint argue that comparative advantage, no matter how important, represents a base for economic survival of the country while economic development is possible only through technological development and innovations, and thus defiance of comparative advantage. In short, poor countries cannot become richer unless through the use and development of technologies.²¹ The second point of view is much more grounded into current reality. The key is to make use of the country's current comparative advantage. It is important to base the growth on the production factors that the country possesses at the particular moment, not the factors that the country might have one day.²² Previous is particularly important in the time when crisis threatens to further erode countries' existing economic position. By neglecting or distorting market signals and moving resources from sectors with comparative advantage to those without it, government policies redirect energy from productive entrepreneurship towards rent seeking which only contributes to corrupted institutions and slows down investments.

Sound industrial policy has to be based on real drivers of export and economic growth on the first place. The second important thing is tailoring that policy and its implementation in closest collaboration with private sector. Only by taking such approach can policy makers increase their odds of effective intervention without being too costly for already poor public purse.

Regardless previous considerations, we can conclude that competitiveness has two main connotations. First, it determines country's global market share, as it represents the attractiveness of a location for investments (institutions,

legal and financial framework etc.), and capacity of local companies to compete regionally or globally. Second, it determines domestic market growth. Namely, economic growth is *inter alia* a consequence of creation and expansion of a domestic market. Only companies that can offer products and services in an efficient manner with attractive prices can create new jobs and increase productivity.

When it comes to industrial policies "one-size-fits-all" approach has no appliance. In Serbia, before establishing set of policy measures to boost growth and employment various factors should be taken into consideration. Serbia is a lower middle-income country with industry share in of less than 20% and 23% unemployment rate. The notion that GDP pc has been taken first place by unemployment rate among economic development indicators is already widespread. Furthermore, evidence proves that practically entire new job creation in the period before the 2008 crisis came from the service sectors. That services are critical for job creation demonstrates the fact that in the 1995-2005 period 85% of new jobs in middle-income countries with industry share of around half of GDP came from service sectors.²³ In case of Serbia increasing share of service sectors (both public and private) in GDP was probably a source of employment increase after 2000. Yet, while taking care of services and employment after 2000, policy makers in Serbia forgot about fundamentals. It is hard to base the growth on services in a country that imports energy and food to such substantial extent. Furthermore, it is paradoxical that the same country enjoys abundance of resources for food and energy production.

Thus, the overarching priority for policy makers should be to pull their weight in the tradable sectors over the coming period. When the base is solid, investment in the labor-intensive service sector can be accelerated. Investments in innovative emerging sectors in a country like Serbia can make a little difference. International competitiveness can hardly be attained, and sectors are also too small to boost employment and growth. What is important is to raise activity and performance in innovative sectors whose

20 See more in Lin, J., Chang, H.J. (2009) "DPR Debate: Should Industrial Policy in Developing Countries Conform to Comparative Advantage or Defy it?" *Development Policy Review*, 2009, 27 (5)

21 Chang, H.J. (2002) *Kicking Away the Ladder: Development Strategy in Historical Perspective*, Anthem Press

22 Lin, J. (2009) *Economic Development and Transition: Thought, Strategy, and Viability*, Cambridge University Press

23 McKinsey MGI (2010): *How to compete and grow: A sector guide to policy*, McKinsey Global Institute

technology and products represent enablers for other sectors by improving their business processes and productivity.

The spectrum of possible policies ranges from so-called “hands-off” approach limited to procreating necessary environment in terms of market and legal institutions to approach which assumes that the state is a key role participant in a sector. In reality governments took one or more of the following measures in order to promote national priorities. First, through establishing state-owned or subsidized companies, funding of existing state owned businesses, and providing restructuring of existing private businesses. Second, by establishing development seed and the flow diagram for exit from the crisis. Third, by building enablers and expanding hard and soft infrastructure for research and development. Fourth, through protection from foreign competition, financial provisions, and increasing of public demand. Fifth, by setting the regulatory environment.

In many instances, we emphasized that the investment priorities in Serbia should be sectors in which comparative advantages exist. Each sector requires different approach by a bearer of an industrial policy. In resource-intensive industries like agriculture or energy, governments have demonstrated support through competitive pricing, anti damping regulation, trade barriers, financial support including subsidizing and public investments. In technology intensive industries like telecommunications, the aim of support is to ensure high quality regulation services. That is why it is necessary to find the right balance between protectionism and open competition since large economies of scale represent the highest entry barrier in these industries and thus key success factor, but the lack of competition leads to inefficiency, decreased quality, and corruption. In manufacturing the success of the companies on both domestic and international market depends on their ability to deliver high quality product with competitive costs. Measures in such sectors include supportive trade policies and long term subsidies. Evidence speaks to the contrary. These policy measures require balanced approach. Namely, too much protection and support leads to significant costs without productivity improvement.

It is not possible to foretell the outcome in case of implementing industrial policies in Serbia, but it is

possible to observe and learn from successful examples from the practice. One of the most informative examples is the case of South Korea. In 1968 when South Korea started with industrial policy implementation its per capita income was a mere 5.5% of per capita income in the US. Even in 1983 when *Samsung* started designing semiconductors after being importer for a long period, the per capita income in South Korea was 14% of that in the US. Taking more developed EU countries from the same period as an example, in the case of Finland in 1960 when the government decided to support by various measures growth and development of the sector of electronics, the per capita income was 41% of per capita income in the US, the frontier country in electronics. In the case of Japan, who started with broad reindustrialization right after the WWII, in the same 1960 year, per capita income was 19% of that in the US. Still, the most dramatic example is that of China. China had become the largest producer of steel in the world by 2000, at a time when its per capita income was only about 2.5% of the US level.²⁴ Previous data undoubtedly depicts the necessity for industrial policy, especially in the time of crisis.

Roadmap for exit from the crisis

Instead of summarizing what have been wrong in Serbia in conducting economic policy hitherto we will try to offer a draft for feasible solution. The importance of such a roadmap is amplified by the second crisis wave that is approaching. Solution to Serbia's twofold crisis (geopolitical + economic) is not simple. Actually, the crisis is a consequence of the flaws and mistakes inherited from the precedent period of geopolitical transition and serious problems emerged during the 2008 global economic crisis. Such kind of crisis cannot be solved with “one-hit” approach. Sustainable solution for structural imbalances requires step-by-step approach. The first step in this approach is identification of the seed of the problem. It is the reason why we decided to develop the flow diagram, whose start node must eliminate output gap as a seed of the current crisis.

24 Lin, J., Chang, H.J. (2009) “DPR Debate: Should Industrial Policy in Developing Countries Conform to Comparative Advantage or Defy it?” *Development Policy Review*, 2009, 27 (5)

The new model has to be based on three types of policies positioned in inverse order, compared to the orthodox approach. The primary policy refers to industrial policy. Focus must be shifted from services toward real economy, in private and public sector both. Industrial policies are sector based (energy, agriculture, food processing, infrastructure, telecommunication, logistic, tourism, etc). The second type of policy represents broad policies (monetary and fiscal). Competitiveness policy and regional policy as support policies follow. Development strategy is conceptual base for all previously mentioned policies (see Figure 3).

Unlike broad macroeconomic policies that affect whole economy, industrial policies are sector specific. Industrial policies are directed towards expansion of output in tradable sectors by promoting for import substitution and/or subsidizing export.

For example, in energy sector, the first measure could be measure competitive pricing. With EUR 57 per MWh compared to the average EUR 190 per MWh in EU27, investing in energy in Serbia is not attractive.²⁵ Competitive pricing will attract investments in the existing capacities based on fossil fuels and water, as well as in the renewable energy. Investment in new energy and efficiency technologies, or NEET, is formidable counter cyclical stimulus. Consequently, the role of the government in fostering activity in the energy sector could come down to regulation of adequate feed-in tariffs. Even by taking only regulatory role, the government could foster considerable

investment in this area. We are talking about immense investments with high investment multiplier. Potential for investments in renewable energy in Serbia is quite significant.²⁶ Furthermore, global demand for energy is rising every year, so the expansion in the energy sector could play both its export and anti import role. Following measures include investment strategy (balance between fossil fuels and renewable energy, alternative models of financing and role of the state).

Other measures in energy sector could include proactive role of the government in sector development. It assumes investment in state owned enterprises, subsidies for privately owned enterprises, and promotion of public private partnership, or PPP, for emerging projects. Furthermore, the supportive role refers to constructive activities of business incubators, technology parks, science networks etc. Although making plans concerning previous governmental activities requires government with talented and skilled people with vision, financing plan poses no easier challenge. Internal reserves for financing attractive investment projects almost always exist in each national economy. For example savings in Serbia are currently approaching EUR 7.6 billion (one fourth of GDP).

The effects of such industrial policy on the economy are considerable. First, energy dependency diminishes and exports increases thus putting favorable impact on

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

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

Figure 3: Flow diagram for exit strategy

current account balance. Second, although it represents capital-intensive industry, the impact on employment is also significant.²⁷ The noticeable demand for professionals like engineers, geophysicists, programmers, electricians, designers etc. could lessen the brain drain from the country and preserving human capital base.

Moreover, for competitive tradable sector Serbia wants dynamic financial system constantly promoting discipline but without excess risk and the outrageous behavior against real economy. That will be hard to achieve, but it will be worthwhile.

The root cause of the problem is inadequate monetary model. Instead of price stability reduced to CPI, ultimate tenet of the broad policies at this stage of development must be sustainable employment. Also, instead of being a tenet, FX rate must be an instrument. Previous assumes switch from inflation targeting to "currency board". The new monetary model must be currency board with automatic adjustments that ensures stable and realistic exchange rate. Implementation of currency board means not only the choice of FX rate that is competitive, but also a balanced budget and managing the FX rate determinants. Real FX rate is a barrier to entry and stimulus for export. It is opposite to current monetary model where drastically appreciated currency is a stimulus for import and barrier for export. Also, stable FX rate is a prerequisite for investments. In currency board monetary model real and stable FX rate plays the role automatic stabilizer. Its main function is to keep the output gap low and stable.

As far as financial regulation is concerned the main targets are fiscal discipline and lowering cost of capital. Due to long term structural imbalances tight budget discipline is not possible in the short to medium run. Still, reference point is around 3% budget deficit.

In the financial sector, interest rates should be lower and acceptable for the real sector financing. So far, bank's potential was not development oriented because majority of transactions fall under retail line instead of corporate one. That way, banks have been financing import consumption. On the other side cost of debt to the corporate sector is

unacceptably high. The average annual interest rate for corporate sector is unsustainably high. Monetary policy measures are supposed to make the return on repo papers less attractive than investments in real economy. Also, financing of the budget deficit by issuing treasury bonds should be avoided. Such policy makes debt financing for real economy harder for two reasons. First, capital assigned to real economy is limited and scarce. Second, as any scarce resource it becomes expensive. Lowering the cost of capital could be achieved through risk-assets reclassification on bank's balance sheet and by reducing obligatory reserves. With lower cost of capital, economic activity accelerates and new jobs and standard rising commence. On the higher level of economic activity and living standard it is possible to claim competitive pricing. It is especially important in sectors where Serbia has comparative advantage, like energy, agriculture, food processing etc.

The last crisis shows that the space for improvement of discretionary fiscal measures (or automatic stabilizers) exists. There is a difference between pure automatic stabilizers and unconventional automatic stabilizers.

Pure automatic stabilizers are those that imply pro-cyclical decrease in transfers or increase in taxes. In contrast, other group of stabilizers refers to the rules that allow some transfers to vary based on pre-specified triggers connected to the stage of economic cycle (boom or bust). Pure automatic stabilizers come from the combination of rigid government expenditures with elasticity in revenues with respect to output, and they range from social insurance programs to progressive income taxes. Unconventional group of automatic stabilizers is more promising in the time of crisis. They can be applied to tax or expenditure items with significant multipliers. Concretely, on the tax side, we can think of tax measures affecting the businesses such as cyclical investment-tax credit. On the expenditure side there are temporary transfers targeted to liquidity constrained businesses. Issuance of these sorts of taxes and transfers would be triggered by crossing of the threshold connected to leading macro indicators (GDP, for example).

Conceptual platform for road map is new development strategy including strategic goals, vision of economic and social development, institutional settings, and regulatory framework.

²⁷ Building of the wind-park requires 15 man-years (1 man-year equals 2000 working hours) for 1MWh capacity, while construction of a solar park requires 38 man-years for 1MWh. Operation and maintenance also require new jobs.

Conclusion

Serbia would be among the hardest hit by the transition. There are, at least, two crucial reasons. First, the geopolitical transition has not been completed yet. Second, the main impact of transitional recession has been unprecedented drop in the output.

Structural imbalances emerged in the past period were related to the interplay of previous factors. Macroeconomic management would be the critical issue going forward. As a consequence, the orthodox model of economic policies should be under revision. For economy with significant output gap macroeconomic stability in terms of CPI control is necessary but not sufficient condition for sustainable development, especially when vulnerability indicators are too high. In transitional recession there is illusionary sustainability because short term imbalances are regularly solved using limited sources, from privatization proceeds and sovereign debt issuance.

Economic transition in Serbia is proceeding under the financial support and mentorship of the IMF. Its assistance had been accompanied by rapid privatization and procyclical conditionality in terms of reductions of budget and tightening of monetary policy. Raising interest rates to counter the rising prices of tradable goods influences high cost of capital especially in interest sensitive non-traded sectors, without providing sustainable price stability.

Output (and real economy) was below the radar of policy makers and, consequently, the main tenet was inflation control through monetary tools. Such policies are not only inefficient but also counterproductive, since one of the purposes of the IMF assistance should be macroeconomic stability, which in Serbia's case means elimination of output gap. More interestingly, these policies were just the opposite of the Keynesian policies advised by the developed economies in the last crisis. To remember, adequate policies in recession must be expansionary, not restrictive but in normal time the purpose of economic policies is introduction of automatic stabilizers for aggregate demand and implementation of discretionary policy frameworks to reduce instability. Serbia has greater external dependence and vulnerability to external cycles and, consequently, much weaker capacity to undertake

counter-cyclical policies. Moreover, insufficient attention has been paid to strengthening the built-in stabilizers (competitive and stable FX rate, for example), in some cases there have been built-in destabilizers (fluctuating FX rate, for example).

What happened as the consequence of these policies was predictable and predicted. In impotent economy in terms of output which is additionally slowed down after the 2008 crisis banks face the prospect of high default rates on existing nonperforming loans and they are not disposed to continue the lending. An episode of excessive lending before 2008 may be followed by an episode of credit crunch this year. Serbia is desperately in need to undertake a variety of counter-cyclical measures in real economy including the Development Bank (credit guaranties to infant industries, for example) infrastructure development, investments in public sector with tradable goods, etc.

In the last year the NBS had shown some wisdom in managing currency risk by insisting that companies did not have excessive exposure to the FX risk. It is good, but it is too late because the NBS is actually disarmed against this issue because great majority of credits are euro denominated. More broadly, as the economy slowed down confidence is eroding and risk premiums increase substantially. To retain foreign capital, the NBS must keep interest rates on a high level with adverse effects on real economy. In the emerging heterodox model of economic policies currency board plays a role of crucial automatic stabilizer.

Invisible hand of the market is rather philosophy than the structure. Economy which is impotent and out of tune needs regulation based on rules, not based on principles. Moreover, in times of recession no economist has ever said to let the markets take care of themselves. Even the free market fundamentalists within the market came running to the government for help. Through industrial policies policy makers in Serbia must restore the balance between the market and the government.

A return to common sense and rational behavior in accordance with the true diagnosis of the seed of the problem, prevailing trends in regulatory framework and realistic vision for the future will help Serbia to return to itself and to reposition successfully. In the new mindset

economics should not be a gizmo science any more, a toy in the hands of politicians, but a science in a full capacity with clear paradigm, efficient methods, and programmable results of policy choices. Industrial policies can trigger positive expectations and help bring the economy back to its potentials.

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