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SERBIA: POLICIES TO ENHANCE COMPETITIVENESS¹

Srbija: Politike za jačanje konkurentnosti

Abstract

The main purpose of the paper is to discuss an apparent erosion of competitiveness of the Serbian economy in the aftermath of the global crisis and to propose a set of policy interventions that would restore the pre-crisis level of competitiveness, as well as support the resumption of institutional and policy reforms needed to close the gap with new EU members and other candidate countries. Comprehensive measures of competitiveness (such as GCI produced by the World Economic Forum), empirical studies, and academic papers provide a wealth of information on key determinants of competitiveness, growth, and current account sustainability. GCI alone measures 111 indicators organized into 12 pillars and three blocks focusing on basic requirements, efficiency and innovation. Empirical studies identified dozens of factors that contribute to or explain import and export dynamics, and determine CA movements with large numbers of possible policy combinations (mixes) that could be associated with desirable growth outcomes. Clearly, not all factors are equally important or really binding. To identify the key binding constraints to competitiveness and sustainable growth of the Serbian economy the paper uses a diagnostic methodology advanced by Rodrik and Hausmann [9] and further developed by Hausmann et al. [1]. We confirm recent empirical findings and claims of Serbian businesses that the real effective exchange rate (REER) indeed represents an immediate binding constraint on competitiveness and growth which needs to be addressed as soon as possible. However, it should be stressed that finding and maintaining equilibrium REER is not a panacea that will cure all problems of tradable sector in Serbia. It is closely followed by high real cost of financing and inefficient financial intermediation, expensive and intrusive state (resulting in costly uncompetitive business environment), and inefficient management and labor force (manifested through high unit labor costs or low productivity). These constraints need to be addressed in short sequence to restart the engines of export led growth.

Key words: *competitiveness, real effective exchange rate, unit labor cost, growth diagnostics*

Sažetak

Glavni cilj rada je da se na osnovu analize erozije konkurentnosti srpske privrede posle globalne krize predloži paket mera ekonomske politike koji bi vaspоставio konkurentnost na nivou koji je postojao pre izbijanja krize i podržao buduće institucionalne reforme i mere ekonomske politike neophodne za hvatanje koraka sa novim članicama EU i zemljama kandidatima. Kompleksne mere konkurentnosti (kao što je GIK - globalni indeks konkurentnosti Svetskog ekonomskog foruma), empirijske studije i akademski (teorijski) članci pružaju obilje informacija o ključnim determinantama konkurentnosti, pitanjima rasta i održivosti deficit tekućeg bilansa. Samo GIK meri 111 pojedinačnih indikatora organizovanih u 12 stubova konkurentnosti i tri bloka fokusirana na bazične zahteve, efikasnost i inovacije. Empirijske studije su identifikovale desetine varijabli koje doprinose odnosno objašnjavaju dinamiku uvoza i izvoza ili određuju kretanje tekućeg bilansa, sa velikim brojem mogućih kombinacija mera ekonomske politike koje bi mogle da daju željene ishode. Očigledno, svi ovi bitni faktori nisu podjednako važni ni ograničavajući. Da bismo identifikovali glavna efektivna ograničenja konkurentnosti i održivog rasta privrede Srbije u radu koristimo metodologiju dijagnostike rasta koju su predložili Rodrik i Hausmann [9] i dalje razvili Hausmann et al. [1]. Rad potvrđuje empirijske rezultate i tvrdnje privrednika da realni efektivni devizni kurs (REDK) stvarno predstavlja neposredno efektivno ograničenje koje pod hitno mora biti uklonjeno. Nalaženje i održavanje ravnotežnog deviznog kursa nije, međutim, univerzalni lek koji će rešiti sve probleme proizvodnje razmenljivih dobara. Odmah posle kursa redom slede tri ostra ograničenja: (i) visoki realni troškovi finansiranja i neefikasno finansijsko posredovanje, (ii) skupa i remetićka država (koja podržava skupo i nekonkurentno poslovno okruženje), i (iii) neefikasno upravljanje i skupa radna snaga (koja se manifestuje kroz visoke jedinične troškove rada ili nisku produktivnost). Ova ograničenja moraju biti jedna za drugim brzo uklonjena da bi se pokrenuo izvozno orijentisani rast.

Ključne reči: *konkurentnost, realni efektivni devizni kurs, jedinični troškovi rada, dijagnostika rasta*

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Introduction

Based on the latest numbers, Serbian economy is headed for trouble. Negative GDP growth rates were recorded in the first two quarters of 2012 (-1.3% and -0.6% respectively). During the first six months of 2012 exports of goods and services grew by only 1.5% despite a strong nominal and real depreciation of the dinar. With continued growth of imports (5.7%) and declining remittances (-15%), the current account deficit increased by more than 45% (to almost 1.9 billion Euros). More importantly, external financing has almost dried up and the NBS had to use about 2 billion Euros of its foreign exchange reserves to finance the current account deficit and a 100 million Euros capital outflow. Public and total external indebtedness were flat in Euro terms but increased as share of GDP due to depreciation of the dinar and negative growth rates. By the end of June fiscal deficit stood at 110 billion dinars (or 70% of the planned annual amount) and is likely to substantially exceed the number over which the IMF put the precautionary program on hold back in February. Finally, less than six months after obtaining the EU candidate status Serbia's credit rating was lowered to BB- with negative prospect. Instead of managing or even fending off an excessive interest of global investors in the next EU accession country, Serbia is facing an unhappy prospect of recession, fiscal and financial crisis.

Based on pre-election promises and post-election statements, the first policy choice of the new coalition government would be to blame the poor outcomes on the previous government and raise additional financing on the promises of future reforms on continued EU accession path. This approach may not gain sufficient traction in the EU, the financial markets, or the IMF. Instead, the IMF could offer additional balance-of-payments and possibly budget support financing conditioned on a tight fiscal and monetary program and the resumption of pending structural reforms, focusing in particular on key structural weaknesses (weak supply side, high wages relative to productivity, and large and inefficient government) that constantly gave rise to macroeconomic tensions in the past. This approach, in turn, is not likely to gain much political or social support in Serbia at this

time due to implied fiscal restraint and the necessary downward adjustment in real incomes. This will lead to prolonged negotiations and reluctant acceptance of IMF terms on the short-term aggregate demand management side, and weak effort at implementing structural reforms across the board.

As in the past, the Fund and the World Bank will seek to strengthen the supply side through continued privatization, enterprise restructuring, and lowering the costs and risks of doing business. In reality, despite many advances in privatizations and improvements in the business environment, we failed to observe the emergence of a vibrant and competitive private tradable sector expanding into new products and technologies, thriving to expand and export. Shedding labor and asset stripping made the news much more than successful privatizations and efficient restructuring programs. Declining employment numbers (255,000 or almost 13% of all jobs lost since 2008), record levels of unemployment (25%), and constantly declining GDP share of all tradable sectors and especially manufacturing (down by 1/3 since 2000) confirm that impression.

Clearly, Serbia, like other transition and emerging economies, faces multiple structural problems, institutional and policy constraints on growth. Removing all of them is economically and politically costly, and close to impossible in the short run. Random partial removal of some constraints may be possible but it calls for an evaluation of the resulting second-best position as it may be inferior to the initial situation. Hence, a genuine policy challenge is to identify and remove only the most binding constraints. This is not easy. Rodrik and Hausmann offered a growth diagnostic framework to guide the process of „identifying and removing binding constraints” on growth. Although the framework is straightforward and the underlying model relatively simple, Rodrik warns potential users that it cannot be applied mechanically and requires an inquisitive, detective's mindset. One needs to use economic theory and evidence judiciously to look for a series of clues that will identify the most likely suspect (i.e. cause of growth problems). The decision tree appearance calls for more than just checking a series of boxes. There is an

element of craft in doing the diagnostics right, but it is a craft solidly based on economic science.

The critical question Serbia faces today is how to identify priority policy responses that would remove key obstacles to growth and secure better economic performance in the future, with minimal pain in the short run. Before systematically addressing this question on the basis of growth diagnostic methodology in section four of the paper, next section will review the evolution of Serbia's growth competitiveness since 2008 based on World Economic Forum methodology, and the third section will discuss the causes of recent adverse developments and the economic decline observed since the start of the global crisis in 2008.

Unmasking institutional failures behind eroding competitiveness

World Economic Forum defines *competitiveness* as *the set of institutions, policies, and factors that determine the level of productivity of a country*. On the static side, productivity determines country's ability to sustain its *level* of income; on the dynamic side, it is one of the central determinants of returns to investment, a key factor explaining an economy's *growth potential* [19, p. 4].

This comprehensive definition provides an excellent basis for the measurement of competitiveness and cross country comparisons (rankings) based on the Global Competitiveness Index (GCI). As detailed in Table 1 below,

GCI is a comprehensive measure based on twelve pillars organized into three blocks corresponding to Rostov-like stages of development defined by the level of GDP per capita.

"Basic requirements" have a 60% weight in the factor-driven stage (GDP p/c < \$2000), 40% in the efficiency-driven economies (GDP p/c from \$3000-9000), and only 20% in innovation-driven stage (GDP p/c > \$17000). The weight of "Efficiency enhancers" is 35% in factor-driven stage and 50% in the higher stages of development. Finally, the weight of "Innovation and sophistication factors" increases from only 5% in the factor-driven stage, to 10% in the efficiency-driven stage, and, finally, reaches 30% in the innovation-driven stage. Interim weights are used during transition from stages 1 and 2, and from stages 2 and 3. For details see WEF [19, p.10]. Throughout the 2008-2011 period Serbia was in the group of efficiency-driven economies and, thus had a 40% weight for "basic requirements", 50% for "efficiency enhancers", and 10% for "innovation and sophistication factors."

Serbia's overall RCI score changed only marginally during the past four years, from the highest score of 3.90 recorded in 2008 to the lowest score of 3.77 in 2009. The effects of these small changes of RCI scores on the ranking were amplified by the increased number of countries in that narrow score range (3.75-3.90). Hence, Serbia GCI rank fell from the 85-th position in 2008 to 96-th position in 2010, and inched back to 95-th position in 2011. Although the overall GCI score and, even more, the overall GCI rankings tend to attract most political and

Table 1: The structure of Global Competitiveness Index

BASIC REQUIREMENTS	
Institutions (21 indicators)	KEY FOR FACTOR-DRIVEN ECONOMIES
Infrastructure (9 indicators)	
Macro-environment (6 indicators)	
Health & primary education (10 indicators)	
EFFICIENCY ENHANCERS	
Higher education and training (8 indicators)	KEY FOR EFFICIENCY-DRIVEN ECONOMIES
Goods market efficiency (15 indicators)	
Labor market efficiency (9 indicators)	
Financial market development (9 indicators)	
Technological readiness (6 indicators)	
Market size (2 indicators)	
INNOVATION AND SOPHISTICATION FACTORS	
Business sophistication (9 indicators)	KEY FOR INNOVATION-DRIVEN ECONOMIES
Innovation (7 indicators)	
TOTAL: 3 blocks, 12 pillars and 111 indicators	

Source: WEF, [19, p. 9].

media attention, they represent third order aggregation that can only be understood by looking at 12 individual pillars and 111 indicators on which they are based.

Although the block pillars grouped under *Basic requirements* retained the same ranking (88th) between 2008 and 2011 and recorded only marginally improved score (from 4.15 to 4.28), the simple average formula on which it is based masked out much of the variability of individual pillars. Adverse developments in the scores of “institutions” and instability of scores awarded to “macro” are largely compensated numerically by improvements in (soft) “infrastructure” and “health and primary education.” In reality these trade-offs do not exist and this is one of weaknesses in the construction of GCI-style composite indexes.

Pillar 1 (Institutions) followed a declining trend in both score (from 3.40 to 3.15) and rank (from 108th to 121st position). This trend is even more worrisome when we look at the 21 indicators comprising this pillar. Serbia is moving in the wrong direction (lower score and rank) on some key institutions and now approaches the bottom of the world (see Table 2 below). It appears that some of the key institutions of public and private (corporate) governance have not been well developed. A decade after the start of reforms Serbia’s institutions seriously lag behind comparator countries and continue to deteriorate towards the bottom of some 140 countries covered by the WEF’s global competitiveness screening process.

Pillar 2 (Infrastructure) continuously increases average score (from 2.68 to 3.67) and shows improved ranking in all years but 2009. This progress is mainly owed to quality of electricity supply, fixed and mobile telephony. The quality

of classical physical infrastructure is low and continues to deteriorate compared to most countries: roads rank 131, railroads 102, ports 133 and airports 132.

Pillar 3 (Macro environment) shows a great deal of instability both in score and rank. The score dropped from a high value of 4.72 (rank 84) achieved in 2008 to as low as 3.88 in 2009 (rank 111) and then gradually improved to 4.05 (rank 109) and a solid 4.48 (rank 91) in the last two years. This pillar is entirely dependent on hard data covering key aspects of macroeconomic performance. The main reason for deterioration in 2009 as well as for weaker performance in subsequent years is owed to exceptionally low level of national savings, high interest rate spreads, and continued inflationary pressures.

Pillar 4 (Health and primary education) shows very high score (between 5.71 and 5.95 out of 6.0) and the highest average rank among the 12 pillars. Despite a slide in rank (from 46th to 52nd position) and the fact that Serbs (rightly) may not be very happy with the quality of their health care and primary education, this is one area where Serbia performs at par with its capacity and development level. Obviously, there is a huge scope for improvement in health and primary education, but compared to other countries Serbia has a much better starting position in this dimension of competitiveness.

Pillars grouped under *Efficiency enhancers* recorded a mildly declining score (from 3.82 in 2008 to 3.73) which resulted in much more visible losses in the rankings (from 78th position in 2008 to 93rd position in 2010 and back to 90th position in 2011). Such large and unpredictable changes in rankings (where 0.02 lower score in 2010 produced a drop in ranking by 7 positions, and an equal 0.02 drop in

Table 2: Serbia: Selected indicators of the institutional pillar

Pillar	Indicator	Rank in 2011	Score in 2011	Change in rank
1	INSTITUTIONS	121	3.15	-1
1	01 Property rights	126	3.1	-4
1	06 Judicial independence	128	2.4	-4
1	07 Favoritism in decisions of government officials	124	2.3	1
1	08 Wastefulness of government spending	130	2.2	-6
1	09 Burden of government regulation	134	2.3	-3
1	10 Efficiency of legal framework in settling disputes	137	2.5	-5
1	11 Efficiency of legal framework in challenging regulators	127	2.6	-2
1	17 Ethical behavior of firms	130	3.0	-10
1	19 Efficacy of corporate boards	136	3.7	-2
1	20 Protection of minority shareholders’ interests	140	2.8	-3

Source: WEF, [18,19].

2011 resulted in improved ranking by 3 positions) ought to be interpreted very carefully since they are entirely caused by (sometimes haphazard) developments in other countries. If indeed we observe a stable growing trend in efficiency enhancers globally, then lagging behind can be treated as a weakness and a loss of competitiveness. If, however, the same minor decline produces a large ranking loss (-7) in one year and a modest ranking gain (+3) in the next year, then the main problem probably lies in the instability of country scores and the simplistic aggregation formula since these problems tend to fade away in the pillar-based analysis.

Pillar 5 (Higher education and training) has markedly lower scores (3.91 to 4.01) than “health and primary education” and its ranking follows a declining trend (from 70th place in 2008 to 81st place in 2011). With one notable exception (i.e. “internet access in schools” where Serbia has made good progress in recent years), this decline is observed in most indicators under this pillar. As summarized in Table 3 below, the main reasons for declining rankings are weak staff training programs in companies, and inability to keep pace with dynamic improvements other countries are introducing to improve the quality of the education system, improve the quality of management schools, provide research and training

services to companies, and better prepare students in math and science.

Pillar 6 (Goods markets efficiency) demonstrated a disappointing performance both through declining scores (3.68 to 3.49) and substantially lower rankings (132nd position in 2011, 7 positions down from 2010 and 20 down from 2009 (see Table 4)). The main reasons for inefficient goods markets are low level of local competition, presence of monopolies, and ineffective anti-monopoly policy where Serbia ranks among the bottom 5-7 countries in the world. Combined with low level of buyer sophistication and weak customer orientation this gives a really pessimistic assessment of the market operation in Serbia. The impact of these indicators on the country’s overall GCI score may be marginal, but their importance in the efficiency-driven stage of development driven by domestic and export demand must not be underestimated.

Pillar 7 (Labor market efficiency) sharply declined in scores (from 4.36 to 3.94) and fell from 66th position in 2008 to 112th position in 2011. Aside from achieving “greater flexibility in wage determination”, all other indicators of labor market efficiency deteriorated over the past four years (see Table 5). “Cooperation between employers and labor” went from bad to worse and so did “reliance on professional management”. Serbia has become the worst

Table 3: Serbia: Selected indicators of the higher education and training pillar

Pillar	Indicator	Rank in 2011	Score in 2011	Change in rank
5	HIGHER EDUCATION AND TRAINING	81	3.98	-7
5	03 Quality of the educational system	111	3.1	-25
5	04 Quality of math and science education	58	4.2	-10
5	05 Quality of management schools	114	3.5	-13
5	06 Internet access in schools	83	3.8	4
5	07 Availability of research and training services	113	3.2	-13
5	08 Extent of staff training	132	2.9	-2

Source: WEF, [18,19].

Table 4: Serbia: Selected indicators of the goods markets efficiency pillar

Pillar	Indicator	Rank in 2011	Score in 2011	Change in rank
6	GOODS MARKET EFFICIENCY	132	3.49	-7
6	01 Intensity of local competition	136	3.6	-5
6	02 Extent of market dominance	139	2.5	-1
6	03 Effectiveness of anti-monopoly policy	137	2.8	0
6	08 Agricultural policy costs	112	3.4	-9
6	11 Prevalence of foreign ownership	116	3.9	-9
6	12 Business impact of rules on FDI	125	3.5	-2
6	15 Degree of customer orientation	131	3.6	-12
6	16 Buyer sophistication	136	2.2	-5

Source: WEF, [18,19].

case of brain-drain (139th position) and share of women in the labor force continues to fall.

Pillar 8 (Financial market development) went through a slight but continuous decline both in scores (from 3.94 to 3.74) and in rankings (from 89th to 96th position). Despite an improvement in the availability of financial services (score of 4.0 and rank 103 in 2011 compared to 111th position in 2010), the financial sector pillar on average declined due to shallow local equity market, lower availability of venture capital, and weaker control of securities exchanges. In tandem with high interest rate spreads covered under the macro pillar, this completes a relatively bleak picture of the financial sector.

Pillar 9 (Technological readiness) showed a mild variability in scores (around 3.40) during 2008-2010 and a marginal increase (to 3.63) in 2011. Rankings followed a similar pattern ending with the 71st position in 2011. Individual indicators supporting this pillar suggest that the main constraints continue to be limited firm-level capacity for technology absorption (with a very weak 137th position) and poor availability of latest technologies (123rd position).

Pillar 10 (Market size) had a small variation in score (3.59 to 3.69) and rank (65 – 72) based on combined impact

of domestic growth and relative export performance (foreign market size) enabled by both supply and demand factors (such as free-trade and custom union agreements that came into effect during the 2008-2011 period).

Pillar 11 (Business sophistication) declined persistently both in score (from 3.51 to 3.08) and in rank (from 100th to 130th position). Aside from improvements in quantity and quality of local supply, and greater “value chain breadth,” all other aspects of business sophistication deteriorated over the past four years and some indicators approach the very bottom of the world rankings (as detailed in the Table 6).

Pillar 12 (Innovation) shows a similar declining trend in both score and rankings, albeit the lowest ranking recorded in 2011 stops at a more acceptable 97th position despite a large improvement in the relative number of utility patents granted (67th rank in 2011 compared to 77th rank in 2010). The main factors behind declining overall innovation performance are low and fast eroding “innovation capacity” (110th position in 2011 compared to 82nd position in 2010), very low “company spending on R&D” (130th position), and relatively weak R&D collaboration between universities and companies (81st position in 2011 compared to 71st in 2010). Improvements were recorded in the “government procurement of advanced tech products”

Table 5: Serbia: Selected indicators of the labor market efficiency pillar

Pillar	Indicator	Rank in 2011	Score in 2011	Change in rank
7	LABOR MARKET EFFICIENCY	112	3.94	-10
7	01 Cooperation in labor-employer relations	136	3.3	-1
7	03 Rigidity of employment index, 0–100 (worst)*	90	35.0	-4
7	04 Hiring and firing practices	89	3.6	-9
7	05 Redundancy costs, weeks of salary*	50	25.0	-3
7	06 Pay and productivity	103	3.4	-12
7	07 Reliance on professional management	133	3.3	-5
7	08 Brain drain	139	1.8	-3
7	09 Women in labor force, ratio to men*	69	7.8	-10

Source: WEF, [18,19].

Table 6: Serbia: Selected indicators of business sophistication pillar

Pillar	Indicator	Rank in 2011	Score in 2011	Change in rank
11	BUSINESS SOPHISTICATION	130	3.08	-5
11	03 State of cluster development	128	2.5	-6
11	04 Nature of competitive advantage	136	2.4	-3
11	06 Control of international distribution	126	3.3	-6
11	07 Production process sophistication	129	2.6	-4
11	08 Extent of marketing	128	2.8	-6
11	09 Willingness to delegate authority	136	2.6	-9
11	03 State of cluster development	128	2.5	-6

Source: WEF, [18,19].

and in the “availability of scientists,” although the rankings remain modest.

Overall, this analysis reveals that Serbia’s lingering GCI ranking around the 90th position hides a set of diverse and worrisome developments on the broad institutional and policy front. More than a decade after the late start of transition Serbia’s key market institutions seriously lag behind comparator countries and in most cases continue to deteriorate towards the bottom of some 140 countries covered by the WEF’s global screening process. Crippling weaknesses are found in general market institutions, low efficiency of goods and labor markets, and in the quality of the business sector (low capacity to absorb new technology, low level of business sophistication and insufficient innovative capacity).

Combined with increasingly unstable macroeconomic environment, underdeveloped and expensive financial intermediation and poor quality of key physical infrastructure, this completes the bleak institutional and policy picture left after the global financial crisis. Many of the troubled institutional reforms require strong political will as well as time and substantial implementation capacity. But time may be limited by adverse macroeconomic developments discussed in the next section. The option to postpone difficult reforms and sail over wrecked institutions and unrealistic political and social expectations on a financial tide fed by the capital inflows and workers remittances is no longer available.

Macroeconomic developments since 2008: the demise of consumption-driven growth

Serbia’s true economic problems were largely subdued during the first five years of renewed transition. Partly this was due to a large dose of IMF-led policy assistance under the stand-by arrangement (June 2001-May 2002) and the extended arrangement (April 2002 – February 2006). Partly, this was enabled by substantial donor (grant) assistance, concessional and other financing.

A true test of Serbia’s ability to independently manage its monetary and fiscal policy, and continue to implement institutional reforms came in 2006. Government confidence was running high at the time based on fiscal surplus

recorded in 2005, high foreign exchange reserves (9 months of imports), and large expected inflows of remittances and foreign capital. Faced with strong political and social pressures to increase pensions and public sector wages, and reverse the trend of rising unemployment (20.9%), the government relaxed both fiscal and monetary policy, and allowed a large real appreciation.

The resulting GDP growth was entirely led by domestic absorption, although the growth rates turned out to be less impressive than expected (3.6% in 2006, 5.4% in 2007 and 3.8% in 2008). Nevertheless, GDP growth and relaxed public sector hiring policies helped reduce unemployment (to 18.1% in 2007 and 13.6% in 2008) and allowed a large increase in wages: Average wages almost doubles in euro terms between 2005 (210 Euros) and 2008 (402 Euros). Expectedly, due to appreciation of the dinar, ample foreign financing, and sluggish supply response, this type of consumption-led growth produced large trade and current account deficits. As shown in Figure 1 below, current account deficit quickly increased from -10.1% of GDP in 2006 to -17.7% in 2007 and -21.6% in 2008.

The main contributor to such a huge increase in current account deficit was an unusually high growth of imports in 2007-2009 period. Official data sources (NBS and RSO) report almost US\$11.6 billion of imports that have not been classified to this date. What could Serbia import for that much money that is not a consumer good, nor a capital or intermediate good, and it does not belong to any of the goods under standard trade classification? This hump in imports is clearly indicated in Figure 1: dotted line M’ indicates the value of imports without the excessive increases, and line marked as CAB’ indicates the lower level of current account deficit without the excessive increases in imports.

On the supply side this type of consumption-led growth produced a very uneven sector response. Nontradeable sectors (marked light gray in Figure 2) responded to consumer demand and contributed the brunt (over 95%) of increased value added, while the tradeable sectors contributed less than 5%. By mid-2008 it became clear that this pattern of consumption-based growth is not sustainable in the long run.

Figure 1: Serbian imports, exports, and current account balance

Source: NBS and RSO databases.

M = Imports of Goods in million USD (light grey -- lhs); E = Exports of Goods in million USD (dark grey -- lhs)

M' = Imports of Goods net of exceptional non-classified Imports (dashed line -- lhs)

CAB = Current Account Balance in million USD (full line w square markers -- based on M import values -- lhs)

CAB' = Adjusted Current Account Balance in million USD (dotted line -- based on M' import values -- lhs)

REER = Real Effective Exchange Rate index (2000=100, double line w circle markers -- rhs)

Figure 2: Serbia - Contributions of tradeable and nontradeable sectors to GDP growth

Source: RSO database.

Growth based on consumer demand and other elements of domestic absorption depended heavily on external and budget financing main and created demand for domestic nontradeable activities and imports. Tradeable sectors, weak, unreformed and inefficient, were largely left out as they were unable to compete with the influx of imports and mount a credible export expansion. With such an imbalance between tradeable and nontradeable sectors the Serbian economy would not be able to deliver fast consumption-based growth and also maintain reasonable price stability, and sustainable fiscal and external balance in the long-run. In the presence of growing external downside risks (lower global demand and higher cost of financing) the sustainability issues grew even stronger.

Against that background Serbian authorities requested IMF assistance. Based on still optimistic growth outlook, very solid reserve position, low exposure to risky financial instruments, and projected strong capital inflow, the authorities opted for light precautionary arrangement (requested in September 2008 and eventually approved in January 2009). To caution authorities and increase their awareness about the true risks faced by the Serbian economy, the IMF team issued a special aide memoire on September 24, 2008 with a very candid assessment of an unsustainable external current account deficit caused by massive overspending. Although the large 2008 deficit of 21.4% of GDP has been fully covered by capital inflows, the resulting build-up of private debt raised serious concerns and increased exposure to external risks in worsening global financial conditions.

Going beyond immediate risks, the IMF team rightly identified three endemic weaknesses of the Serbian economy that continuously give rise to macroeconomic tensions, prevent the orderly completion of institutional reforms [3].

First is the chronically weak supply side caused by: (a) the late start of transition (both in terms of lagging behind key competitors among transition and emerging economies, and in properly understanding the scope of adjustment and restructuring needed after a decade of wars, sanctions and massive economic mismanagement), (b) ineffective privatization, both in terms of meager post-privatization production and export performance, and widespread cancellations of past privatizations and (c) a

difficult investment climate as evidenced through Doing business, BEEPS and other assessments.

Second weakness comes from inefficient labor force – high wages relative to productivity, both in terms of initial level and recent upward adjustments beyond productivity growth. Surprisingly, high unemployment does not seem to drive down market wages. Rather, union pressures to adjust wages upwards are based on “cost of living” and “foreign exchange indexation” claims. This directly undermines the external cost competitiveness of Serbian firms, export led growth, and job creation but this is seldom recognized in domestic policy debates.

Third weakness is large and inefficient government sector tuned toward redistributing resources and spending instead of investing in the country’s future. As a rule, fiscal position has amplified macroeconomic tensions through deficits, high wages, and inefficient spending. Except for 2005, when a small fiscal surplus was achieved, public finances have remained in deficit until today. Gradually deficits increased from about 2 percent of GDP (which seemed acceptable and was largely financed by privatization receipts) to 4 and 5 percent in recent years. Increased fiscal deficits coincided with a huge increase in private sector debt and widened Serbia’s external deficits just before the global crisis.

With these weaknesses Serbian economy was not able to generate much supply response and vibrant export growth, and mobilize sufficient national (and especially) domestic savings. High unit-labor-cost and sluggish tradable sector response push Serbian economy onto a path where faster GDP growth, lower unemployment, and stable macro can be generated only by building up external debt and stability risks. Until 2008 capital inflows have smoothly bridged the rapidly widening gap between spending and income, containing excess demand pressures that would have otherwise fuelled inflation. With tighter remittances and more limited access to new capital flows after 2009 Serbian economy suffered from slower growth, inflation pressures and increasing unemployment culminating in the macroeconomic deterioration described at the beginning of this paper.

The apparent paradox is that the growing external deficits and fast build-up of private debt in 2007-2009

period did not finance a private investment boom, which could now pay off in an improved supply side and higher exports growth, but have rather served to finance high levels of consumption. This makes the need for prompt policy intervention quite urgent.

Growth diagnostics: enhancing competitiveness and overcoming binding constraints on growth

In the previous two sections of the paper we have identified and discussed a long list of institutional, policy and structural weaknesses of the Serbian economy. Many of these are contained in structural reform strategy of the previous government and are likely to be present in the evolving program of the new government. These will probably include: (i) deeper and faster EU integration process; (ii) better performance and restructuring of state and former socially owned enterprises; (iii) improved infrastructure; and (iv) pruning Serbia's regulatory jungle. Clearly, views on how to best strengthen the supply side may differ. IFIs (the IMF and the World Bank) are likely to recommend continued (albeit more efficient) privatization efforts, enterprise restructuring, and lowering the costs

and risks of doing business. The new government may put more emphasis on enhancing supply response through restructuring of SOEs and active industrial policy.

As in the past the real challenge will be how to implement structural reforms in a difficult (and volatile) political and social environment, marred by vested (private sector) interests, and limited administrative capacities. Most importantly, it is crucial to avoid a situation in which limited resources and reform capacity are spread too thinly across many institutional, policy and structural issues identified thus far. The WEF definition of competitiveness should be expanded to mean the institutional ability of a country to constantly predict and overcome binding constraints on growth.

That is the essence of growth diagnostics methodology advanced by *Rodrik et al.* [9] and further developed by *Hausmann et al.* [1]. It seeks to answer an applied question: what is preventing a particular country, at a particular time from achieving higher sustained and shared growth? Countries usually face multiple structural problems, institutional and policy constraints on growth. Removing all of them is economically and politically costly, and close to impossible in the short run. Random partial

Figure 3: Diagnostic framework for growth and competitiveness

Source: [9, p. 27].

removal of some constraints may be possible but it calls for an evaluation of the resulting second-best position as it may be inferior to the initial situation. A genuine policy challenge is to identify and remove only the most binding constraints. Growth diagnostic framework is design to guide the process of „identifying and removing binding constraints” on growth.

Growth diagnostics follows a simple decision tree structure presented in Figure 3. In the first level it poses the key question reflecting the central growth problem in a given country such as: What is the cause of low level of private investment and entrepreneurship? In the case of Serbia we may add: in general or in tradeable sectors.

In the next level of the decision tree one can systematically pursue either a branch exploring possible causes of “Low returns to economic activity” or a branch focused on “High cost of finance”. The rest of the tree is straightforward and serves as a framework to organize thinking about binding constraints on growth, rather than a checklist of issues (listed at the lowest level).

The logic of binding constraints can easily be explained with a simple graph.

Standard growth models assume that factors and/or determinants of growth are substitutes. This is consistent with the graphical presentation of the left barrel where a 1% improvement of, for example, infrastructure (or any other factor) will proportionately improve the growth rate

(i.e. the amount of water in the barrel). By contrast, the growth diagnostic approach assumes that an improvement in a binding constraint will have a multiple effect on the growth rate. In this example, a 1% improvement in infrastructure will increase growth by 6% since the level of water will be increased across six factors.

Although the underlying model is relatively simple [9, p. 8] and the decision tree straightforward, this framework cannot be applied mechanically and requires an inquisitive, detective’s mind-set. One needs to use economic theory and evidence judiciously to look for a series of clues that will identify the most likely suspect (i.e. cause of growth problems). The decision tree appearance calls for more than just checking a series of boxes. There is an element of craft in doing the diagnostics right, but it is a craft solidly based on economic science.

Applied to Serbia, growth diagnostics framework yields the following potential insights.

First, since we observe diverse growth performance across sectors it appears improbable that any of the cross cutting institutional and policy issues (albeit important) are truly a binding constraint. Hence, it is not obvious that general “protection of property rights” could be the key binding constraint as suggested by the Jefferson Institute study [4, p. 8].

Second, lagging tradeable sectors and apparent dynamic of exports and imports suggests that real effective

Figure 4: Binding and non-bindings factors/constraints on growth

exchange rate (REER) may indeed be the first binding constraint on growth in Serbia. The importance of REER for trade and CA sustainability has been confirmed in recent empirical studies [7, 8, and 5]. This empirical conclusion may be gaining strength as external financing becomes more constrained and many consumers have already reached their credit limits, thereby limiting the basis for consumption-led growth.

Third, it is important to find and maintain the equilibrium REER, but this is not a panacea that will cure all problems of tradable sectors in Serbia. As confirmed by an OECD study of Argentina, Brazil, and Chile [6] and many empirical studies, REER has a strong impact on export performance of homogenous goods (commodities) and a moderate impact on differentiated goods where

product design, marketing, R&D and innovations also play an important role.

Fourth, limited availability of credit, high real cost of financing and inefficient financial intermediation appear to be a severe constraint on growth, both in terms of securing basic liquidity and payments for goods and services, to finance investment. Serbia has the second lowest level of monetization (broad money to GDP, see Table 7) among a broad range of comparator countries and select EU economies.

Similar pattern emerges in the availability and cost of credit. Serbia has among the highest nominal spreads in the world (see Table 8 below).

This conclusion is strongly confirmed by the fact that Serbian enterprises rushed to obtain cross-border

Table 7: Broad money (as % of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
BIH	21.0	28.6	34.8	36.0	38.5	42.7	46.2	50.0	49.3	52.3	53.6	55.1
BGR	31.7	36.7	39.6	42.5	46.4	50.2	55.3	61.6	63.4	68.5	69.8	71.6
AUT	136.7	143.8	146.8	149.7	152.4	158.7	164.6	171.6	186.4	203.0	193.9	184.5
CHN	129.5	133.3	138.5	142.8	141.8	142.1	145.3	140.9	139.9	159.2	166.4	167.3
HRV	36.2	46.5	53.2	53.5	54.5	55.6	58.4	63.1	64.4	67.5	68.9	70.2
CZE	59.3	62.3	59.1	54.9	53.9	55.4	57.6	60.5	66.0	72.4	72.4	73.5
GRC	n.a.	n.a.	89.3	81.3	80.2	85.8	89.0	93.0	101.7	112.4	111.5	103.2
DEU	166.6	167.2	169.3	172.8	174.2	178.6	178.7	178.3	183.9	194.7	185.5	180.1
HUN	43.2	42.9	43.5	46.7	47.8	49.2	51.7	54.8	56.6	62.0	61.7	61.7
MKD	17.2	25.6	29.5	29.2	32.4	34.7	38.6	43.3	45.9	49.7	52.3	54.8
MNE	n.a.	n.a.	n.a.	11.1	12.1	17.4	30.3	49.9	54.8	51.3	47.7	46.4
RUS	17.6	20.8	23.1	25.8	27.1	28.9	32.2	36.6	37.0	45.6	47.5	48.2
ROM	27.7	24.3	25.0	25.2	27.4	30.8	30.1	31.3	32.0	37.0	38.2	38.2
SRB	11.7	12.5	16.3	19.4	20.6	23.2	27.9	33.8	35.6	40.5	42.9	43.3
SVN	41.1	46.3	50.0	50.4	50.6	52.0	51.8	56.6	62.2	72.4	79.7	82.0
UKR	15.7	18.9	24.6	30.0	32.0	36.2	41.8	45.6	48.1	54.9	50.1	48.7

Source: World Bank development data bank

Table 8: Serbia – Deposit and loan interest rates and spreads

	Deposit rates		Loan rates	Simple spread		Compounded	
	HHLDS	Comp		HHLDS	Comp	HHLDS	Comp
2000	5.69	6.31	77.90	72.21	71.59	68.3%	67.3%
2001	6.42	4.08	32.97	26.55	28.89	24.9%	27.8%
2002	3.83	2.62	19.30	15.47	16.68	14.9%	16.3%
2003	2.14	2.74	15.75	13.61	13.01	13.3%	12.7%
2004	2.03	3.60	14.45	12.42	10.85	12.2%	10.5%
2005	1.54	3.71	13.61	12.07	9.90	11.9%	9.5%
2006	1.90	5.06	15.88	13.98	10.82	13.7%	10.3%
2007	2.26	4.08	14.81	12.55	10.73	12.3%	10.3%
2008	2.39	7.32	17.56	15.17	10.24	14.8%	9.5%
2009	2.26	5.06	15.08	12.82	10.02	12.5%	9.5%
2010	3.23	5.55	13.61	10.38	8.06	10.1%	7.6%
2011e	2.68	6.44	16.65	13.97	10.21	13.6%	9.6%

Source: NBS database

loans as soon as that opportunity presented itself in 2006. This squarely puts the constraint on the supply side (high cost of financing driven by non-performing assets, high level of reserves, and high provisioning for other real or perceived risks). Likewise, many enterprises and households took loans under government provided subsidies on interest rates.

Fifth, expensive, large and intrusive state is increasingly becoming a binding constraint on growth. The most damaging aspect is the creation of a costly business environment and failure to consistently implement proper competition policies. As discussed under pillar 6, the state generally failed to prevent the creation of monopolies and promote competition. Additionally, the state disrupts the operation of the labor market by providing higher wages than the private sector and diverting young talent away from productive private sector employment, erodes financial discipline by not paying their bills on time, and often crowds out private sector.

Sixth, inefficient (and often unprofessional) corporate management and unproductive labor force (manifested through high unit labor costs or low productivity) have been a huge deterrent to FDI and business deals, as well as a cause of weak price competitiveness in many sectors. As illustrated by GCI indicators, this is partly due to the lack of proper company restructuring and access to modern technologies and work patterns. And partly depends on the lack of training, wrong attitudes and poor worker-manager relations. In reforming higher education and training it is important to first focus on removing barriers to higher productivity growth (i.e. improve staff training programs in companies, improve business schools, provide research and training services to companies).

These constraints need to be addressed as soon as possible and in short sequence to restart the engines of export led growth, obviously based on tradable sectors.

Conclusion

It took less than three years and a heavy external shock to show that consumption-led growth based on non-tradeables and imported consumer goods, rising unit-labor costs, real appreciation, twin deficits (trade and

current account on the one side and fiscal on the other) and growing external indebtedness are not sustainable. Three structural weaknesses of the Serbian economy (weak supply side, unproductive labor, and inefficient state) combined with a huge unfinished institutional reform agenda, inefficient goods and factor markets, and suboptimal policies create an endless list on needed interventions to restore competitiveness and growth.

Starting from a premise that not all factors are equally important or really binding, this paper uses a diagnostic methodology advanced by *Rodrik and Hausmann* [9] and further developed by *Hausmann et. al.* [1] to identify the key binding constraints to competitiveness and sustainable growth of the Serbian economy. The paper finds that:

1. Protection of property rights and other key market institutions indeed represent a basis of a modern and efficient economy but do not constitute a really binding constraint since nontradeable sectors seem to grow despite obvious institutional flaws;
2. REER represents a real binding constraint as it strongly affects the tradeable sector which in turn now represents a bottleneck in moving the economy to a sustainable growth path with macro stability, sustainable fiscal and external balance.
3. Equilibrium REER is not a panacea that will cure all problems of tradable sectors in Serbia. As confirmed by other countries, REER strongly impacts homogenous goods (commodities) but works in tandem with product design, marketing, R&D and innovations in case of differentiated industrial goods.
4. Limited availability of credit, high real cost of financing and inefficient financial intermediation have become severe constraints on growth, both in terms of securing orderly payments and investment financing. Serbia has one of the lowest levels of monetization (broad money to GDP) and highest interest rate spreads which now severely limit operation and growth of the economy.
5. Expensive, large and intrusive state has become

a binding constraint on growth. It creates a costly business environment, fails to secure and promote competition policies, bids up wages and diverts young talent from productive private sector employment, erodes financial discipline, and crowds out private sector.

6. Inefficient corporate management and expensive labor force (manifested through high unit labor costs or low productivity) have been a huge deterrent to FDI and business deals, as well as a cause of weak price competitiveness in many sectors. Decisive action is needed to remove barriers to higher productivity growth (through staff training programs, better business schools, research and innovation for company needs).

These constraints need to be addressed as soon as possible and in short sequence to restart the engines of export led growth.

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