

Transition towards a Market Economy in a Post-Conflict Context -The Case of Serbia

Martin Stålhandske

School of Economics and Management
Department of Economics
Lund University
Bachelor Thesis 2007

Supervisor: Yves Bourdet

Abstract

In 2001, Serbia presented a program that intended to move the country from a plan economy to a market economy. Prior reform, four overall objectives were set: restoring macroeconomic stability and balances, stimulating growth, creating a basis for sustainable supply response and investing in improved governance and effective institutions. The Serbian transition was based on the post Washington-consensus, which emphasises the importance of institutional building.

In this study, I focus on the Serbian transition towards a market economy. Serbia has obtained control over the macroeconomic balances and is currently experiencing healthy growth figures. Per capita income is growing and the living standard has increased since transition initiated. However, five years into the transition, I conclude that the Serbian progress was sluggish due to a deficient legal framework, i.e. the lack of efficient protection of property rights. The effects are a private sector trapped with low skilled labour and low value production. The difficulties acquiring working capital has forced many private entrepreneurs to rely more on the informal sector than the formal one. Consequently, a major challenge for Serbia is to reintegrate the informal economy within the formal economy. Additionally, the political effects (i.e. the post war sentiments) have had a negative effect on reform and economic development.

Keywords: Serbia; Transition Economics; Post-conflict; Development Policy

Table of Content

<i>ABSTRACT</i>	2
<i>TABLE OF CONTENT</i>	3
<i>TABLES AND FIGURES</i>	4
<i>ABBREVIATIONS AND ACRONYMS</i>	3
<i>1. INTRODUCTION</i>	5
<i>1.1 PURPOSE</i>	6
<i>1.2 DELIMITATION</i>	7
<i>1.3 DISPOSITION</i>	7
<i>2 THEORETICAL FRAMEWORKS</i>	8
<i>2.1 INSTITUTIONAL APPROACH</i>	8
<i>2.2 INITIAL CONDITIONS AND SEQUENCING</i>	9
<i>2.3 FROM PLAN TO MARKET ECONOMY</i>	10
<i>2.4 PRICE LIBERALISATION</i>	11
<i>2.5 EXTERNAL LIBERALISATION</i>	12
<i>2.6 MACROECONOMIC STABILITY AND THE FISCAL SYSTEM</i>	13
<i>2.7 PRIVATISATIONS OF THE STATE OWNED ENTERPRISES</i>	15
<i>2.8 SUMMARY</i>	16
<i>3. THE SERBIAN TRANSITION MIX</i>	16
<i>3.1 THE SERBIAN TRANSITION PROGRAM: A BACKGROUND</i>	17
<i>3.2 INITIAL CONDITIONS</i>	17
<i>3.3 FISCAL POLICY</i>	21
<i>3.4 THE NEW ROLE OF THE STATE</i>	22
<i>3.5 PRIVATE SECTOR REFORM</i>	23
<i>3.6 TRADE AND EXCHANGE RATE POLICY</i>	24
<i>3.7 FINANCIAL SECTOR REFORM</i>	25
<i>3.8 SUMMARY</i>	26
<i>4. TRANSITIONAL DEVELOPMENTS: THE OUTCOME ON SERBIA</i>	27
<i>4.1 INTRODUCTION</i>	27
<i>4.2 MACROECONOMIC PROGRESS</i>	27
<i>4.3 ECONOMIC GROWTH</i>	29
<i>4.4 TRADE AND INTERNATIONAL INTEGRATION</i>	30
<i>4.5 PRIVATE SECTOR DEVELOPMENT AND PRIVATISATION</i>	33
<i>4.6 BANK SECTOR PROGRESS</i>	36
<i>4.7 SUMMARY</i>	36
<i>5. CONCLUSIONS</i>	37
<i>REFERENCE</i>	40

Tables and Figures

TABLE 2.3.1.	11
TABLE 3.1.1	19
TABLE 4.2.1	28
TABLE 4.2.2	29
TABLE 4.4.1	32
TABLE 4.4.2	33
TABLE 4.5.1	34
FIGURE 1	28
FIGURE 2	30
FIGURE 3	30
FIGURE 4	31
FIGURE 5	35

Abbreviations and Acronyms

CEFTA	Central European Free Trade Area
EBRD	European Bank of Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GDP	Gross Domestic Product
IFI	International Financial Institutions
IMF	International Monetary Fund
NBS	National Bank of Serbia
OECD	Organisation for Economic Cooperation and Development
SEE	South East Europe
SOE	State Owned Enterprise
TFP	Total Factor Productivity
VAT	Value Added Tax
WTO	World Trade Organization

1. Introduction

The transition process in East and Southeast Europe commenced in the early 1990s with the collapse of the Soviet Union. It implied the end of the economic system that had been put in to force for over four decades: the plan economy. The progress towards a new economic system, a market economy, was initiated immediately. The main objectives were to create a decentralized and incentive based economy, in which the private sector dominates the state sector in the economy. Both political and economic obstacles generated highly different outcomes among the transition countries. However, the “great transformation” of the former communist countries in Europe was unprecedented in world history (Kornai, 2006: 222). The complete transformation of the economic structure advanced with an extraordinary speed and with a non-violent character, never experienced before in Europe.

Fifteen years on, many of the former communist countries are either members or negotiating membership of the European Union. From that, the final phase for the transition countries appears to be the integration in the world markets.

Many countries may have overcome the initial obstacles in the transition process, but still face continued economic obstacles originating from the former economic system. Consequently, as the transition process continues, new reforms need to be implemented in order to overcome potential obstacles.

The Serbian experience has raised new questions about transition, which will be stated in the purpose of this study (1.1). Although the first wave of transition to a market economy was characterised by swift reforms and non-violence, Serbia’s transition in the early 90s halted due to armed conflicts with its neighbouring countries: Bosnia and Croatia, and a civil war in Kosovo. The start of its transition process in a post conflict environment posed new and different problems in designing and implementing reforms necessary to create a market economy. Besides the evident problems of rebuilding the infrastructure and the physical capital, the previous wars had displaced a large number of people and left the already inefficient economy in a state of disorder. The World Bank (2004e: 3) notes that the living standard in 2000 was only 45 per cent of its 1989 standard, which confirms the deep economic decline.

The ruling elite in Serbia hindered the popular demand for change regarding both the political and the economic system during the 90s. This was accentuated by domestic conflicts in the Republic of Yugoslavia. However, new encouraging prospects came from the general election in 2000. This election generated a new political leadership who stood behind the demand for reform. From that, the authoritarian rule in Serbia ended and the newly elected government gained the political mandate to enact economic reform.

1.1 Purpose

The aim of this study is to enhance the knowledge of the economic transition from a plan economy to a market economy in a post conflict environment. This is exemplified by a focus on the Serbian development process. The choice of Serbia is based on the fact that the major economic focus during the 90's has been on East Europe and its transition process (see Sachs and Lipton, 1990; Kornai, 1992; Roland, 2001; Fisher et al., 1996; Campos and Coricelli, 2002), but little has been written about the Serbian process. With its initial difference in economic and political structure, Serbia provides a new perspective on how to look at the transition process.

As a country in a post conflict environment, the initial conditions of Serbia were radically different from other transition countries. Its transition commenced ten year after the first East European countries, offering an earlier experience from which Serbia could rely on when designing its transition program.

Therefore, the main research question of this study aims to investigate how the Serbian economy has developed after initiating its reform program in a post-conflict environment, identifying key aspects for developing a positive income per capita level.

Subsequently, the following sub-questions emerge:

- ii) Which were the principal difficulties encountered in the transition process?
- iii) Could one identify major differences in the Serbian reform design from the East European reform designs?
- iv) Are there lessons to be drawn from the Serbian case for future transition countries?

1.2 Delimitation

In order to present the Serbian development, I will describe the Serbian reform program, which the Federal Republic of Serbia & Montenegro presented in collaboration with the IMF and World Bank in the document “Breaking with the Past”. Since early 2006, Montenegro does no longer belong to the Republic of Serbia and therefore, this study will exclude it. The exclusion of Montenegro in the data collected has been facilitated by the IFI’s reports and policy documents, which clearly separate Serbia from Montenegro.

The years surveyed in this study range from 2001 to 2005-6. The reform started in 2000 with the ‘velvet revolution’, which gave the victory to the opposition parties. From that, the fact that five years in transition is a short period of time to generalize conclusions is acknowledged as the main limitation of this study. Therefore, this study presents a narrowed overview of the Serbian economic situation, which needs to be interpreted as an initial first step to gain understanding on the future positioning of Serbia on the international scene.

1.3 Disposition

In chapter 2, I will present a theoretical framework from which key conclusions of the Serbian transition program will be drawn. In chapter 3, I will present an overview of the transition program implemented in Serbia. I will discuss concisely the underlying ideas of the program and articulate them on five core sectors in the economy. Chapter 4 will explore the outcome of initial reform. Finally, chapter 5 will conclude and attempt to ascertain transition lessons for the future.

2 Theoretical Frameworks

This chapter provides the theoretical tools employed in the study in order to analyse the outcome of the Serbian economy.

2.1 Institutional Approach

Since the work of North and Thomas (1973), economists have agreed on the fact that property rights and the legal system play a significant part in the development of economic growth. The new ‘rules of the game’ have to be implemented by the state, which creates the institutional environment through legislation. These formal rules are easy to set up but can be difficult to implement if they do not correspond to the informal norms existing in the society (North, D., 1990: 37). Consequently, the choice of reform design is influenced by self-enforced norms, i.e. informal ones, in a country. Property rights and the legal framework from which the incentive-based economy is found upon are of utter importance. Gros and Steinherr (2004: 75) even conclude, “property rights are fundamental defining element of any organised country”.

These arguments raise the question of how the government should implement these property rules. Should it be made through ‘shock therapy’ or implemented more gradually? Before answering this question, the general rule made by economists is that reform should be launched at an early stage. Then, the answer to the latter question is that the fast implementation of the reforms does not necessarily show the best results (Steinherr and Gros 2004: p 105), suggesting that a gradual approach may have more favourable results. One soon realize, when studying the subject of transition, that the two approaches are very country and policy specific. Qian et al. (1999: 1093) suggest that a ‘big bang’ approach dominates a gradual approach when there is perfect information in the country, but that the gradual approach works better when uncertainties dominate.

East Europe experienced a general output and investment decline at the start of transition a so-called J-curve effect (Hernandez, 1997: 4). A vacuum in the production sector following transition produced this effect. The state owned enterprises (SOE) became privatised but the economic system did not completely adjust to the market economy. Hence, the relative decline in output and investment. Jones (2002: 137) illustrates this problem. Using the cost

benefit analysis, F is a one time set up cost and Π is the expected present discounted value of the profit. Then the decision made by the business community is straightforward: invest in the project if Π is greater than F . In the East European countries, F was (at the time) larger than Π due to economic as well as political uncertainty. The result was obvious: decline in investment and production. Then, to refer to the previous discussion, the logical question is: was there any connection between the speed of reform and output decline? In an analysis conducted by Gros and Vandille (1997), no link between the speed of reform and output decline was found.¹ However, the difference in depth and length of output decline in the former communist countries was attributed to four factors: intra communist bloc trade, level of development, macroeconomic distortion and distance from Western Europe (EBRD, 1999). Others do argue that the decline was in fact due to a shock therapy with no therapy. Even though reform under the Washington consensus was put to work, the institutional setting was not in place, thus provoking a contraction in output (Kolodko, 1999: 240).

2.2 Initial Conditions and Sequencing

When embarking upon reform there are primarily, differences between the initial conditions of the countries. These initial conditions are largely political, but the economic condition plays a greater part in designing the transition program (Bourdet, 1995: 33). To determine the economic initial conditions it is helpful in analysing the economic situation before designing an appropriate transition program for a specific country. When commencing a reform programme, focus should lie on the most urgent economic problems faced by the country. An economy with great macroeconomic imbalances must therefore concentrate to control these before continuing its reform, while other countries may concentrate on long-term issues such as privatisation and property right reform. Starting with popular reforms makes it possible to gain support and momentum for the forthcoming reforms, which tends to be problematic. This is due to the fact that the interdependence between the reform program creates issues regarding complementary and irreversibility. On the one hand, irreversibility of reforms force the population to advance rather than retreat, thus accepting more difficult reforms (Roland, 2001: 35). On the other hand, if the reform turns out to be inefficient, the government finds it difficult to reverse the earlier decision due to a high sunk-cost and popular support for the overall program. Political and psychological arguments thus prove to be large threats to

¹ See also Fischer et al., (1998)

reform. Sequencing of reform therefore has to consider these aspects when designing a transition program (Kolodko, 1999: 242).

2.3 From Plan to Market Economy

The generalisations made by economists concerning transition reform have resulted in four key policy areas that are prerequisite to create a market economy.² These reforms are: price liberalisation, external liberalisation, macroeconomic stability and fiscal system, and privatisation.³ In retrospect, these aspects may not have lost their importance, but many academics have argued that more focus on institutional building is needed.⁴ Liberalisation, stabilisation and privatisation would not result in a smooth transition towards a market economy if the institutional setting were not adjusted to the new conditions. Macroeconomic stabilisation is ‘an endless war’ and the lack of appropriate institution reforms, makes it a lost battle (Kornai, 2000: 24). The process towards a market economy is problematic and time consuming. Table 2.3.1 illustrates the transition process, by comparing the different elements of transition.

Table 2.3.1.

Main dimensions of economic systems

Decentralization	↔	Centralization
Markets	↔	Administrative Process
Private Ownership	↔	Collective ownership
Incentives (Individuals and firms)	↔	Orders
Competition (individuals and firms)	↔	Non-competition
Internationalisation	↔	Autarky

Lindbeck (1973: 5)

The factors (in table 2.3.1.) are interdependent. For example, the level of decentralisation owes a great deal to the functioning of the market in terms of allocation. In addition, competition is highly dependent on the openness of the economy (Bourdet, 1992: 65). Incentives are dependent on the degree of private ownership and the interdependence of the

² Termed the Washington Consensus; outlined by Williamson (1990)

³ See Havryshlyn (1998) and Fisher et al. (1998) for a theoretical background

⁴ See Kolodko (1999); Kornai (2000); Roland (2001)

different elements helps us to understand the problems assigned to transition. Different degrees of development among the fundamentals in table 2.3.1 result in imbalances in the economy. Reforms should proceed simultaneously in order to avoid production contraction or macroeconomic imbalances.

The overall aims of the transition process have been briefly explained. At this time, the four key elements of the transition process are set to be described: price liberalisation, external liberalisation, macroeconomic stability and fiscal system, and privatisation.

2.4 Price Liberalisation

From now on, the market will set the price on goods and services, and not the bureaucrats in the different ministries. In many cases, the price liberalisation process led to high inflation. Since high inflation limit strong growth, the reforms must follow a plan, which takes into consideration inflation's unavoidable effects. As a result, "reducing high inflation is a precondition for the revival of growth" (Fischer et al, 1996: 47). Even though many scholars approve price liberalisation, there is opposition concerning the implementation of price liberalisation. According to the post-Keynesian school, too much concern was made on price equilibrium, when in fact the economy was in a state of disequilibrium. As a result, inappropriate models were used to analyze the transition process generating unnecessary inflation (Marangos, 2003: 455).

The implementation of price liberalisation appears straightforward at first. It generally implies that the policy makers of the country agree with the firms and producers that they are free to set their own prices on the products. However, the effects are more difficult to distinguish straight afterwards. The most apparent change is visible in income distribution. At the beginning of the reform, the distribution system usually collapses, and as a result, only a few people will obtain high profits due to a market failure. Consequently, people in general look upon the reform programme with dislike when there are only a few who stand to gain from price liberalisation.

The positive economic effects should prevail over the "bad" inexorable in times of reform. The first apparent gain is generally the elimination of the queues, in other words: efficiency gains. Another efficiency gain comes from the market clearing. The world market will set the

price on tradable domestic products. Subsequently, the price on these products will be the marginal cost (MC). Before the price liberalisation, marginal utility (MU) equalled marginal cost (MC) plus time in the queue. With price liberalisation the queues were brought to an end and therefore $MC=MU$. This change left the consumers in the post communist countries better off than before. Regarding the non-tradable products, the price liberalisation had positive effects on these too. Consumers were able to find within their budget constraint the products they demanded (Gross and Steinherr, 2004: 63). From that, price liberalisation, together with trade liberalisation (see 2.5), work as two sides on the same coin in an effort to allow international competition to affect the domestic prices (Fischer et al., 1996: 46). The creation of an efficient and competitive market economy is thus the overall goal of price liberalisation.

2.5 External Liberalisation

The positive effects of trade liberalisation on growth are well documented.⁵ Before even thinking of opening up for trade, the post communist countries had to eradicate the state monopoly, unify the exchange rate, and eradicate all quantitative restrictions. This also meant unrestricted exchange convertibility for current account transactions. Even if eliminating the quantitative restrictions is a way towards free trade, protection is necessary during a transition period. According to Gros and Steinherr (2004: 69), the country should have a uniformed ad valorem tariff of 20-40%. They recognise, however, the difficulties in doing accordingly, due to varying strength of existing lobbying groups in the economy. However, the main (note: second-best) arguments in keeping tariffs are:

- 1) Revenues for the state.
- 2) Help state owned enterprises adjust to trade.

The revenues that the government collects from the tariffs are supposed to be used as a redistribution measure. Trade shocks can have severe consequences on the fiscal policy of the country and therefore the revenues are a much-needed element in keeping the reforms process going despite these shocks (Gros and Steinherr, 2004: 68).

After the collapse of the Soviet Union, many countries saw an increase in input prices, i.e. oil and gas. Therefore, the importance of having some protection from foreign competition has

⁵ Markusen et al., (1995); Gross and Steinherr (2004); George and Kirkpatrick (2004)

proved to ensure the survival of many enterprises in Eastern Europe. Because of the structure of their economies (labour intensive production, mostly in the manufacture sector) a move to free trade would probably have led to a collapse by many firms who showed a negative value-added in the short run. Consequently, Eastern Europe would have experienced a dramatic rise in unemployment. Since unemployment or “the loss of a job is probably the most common proximate of household descending rapidly into poverty” (Winters, 2002: 1342), the governments were forced to keep some protection when opening up the economy. However, it is important to point out that trade barriers is only a temporary solution and not a permanent one. The negative effects of tariffs and other trade obstacles are numerous, e.g. trade distortions and a loss of welfare.⁶

Additional to the external liberalisation, questions emerge about the suitability of exchange rate regimes (and currency convertibility). To set an exchange rate regime that brings stability and confidence to the economy is crucial. Henceforth, the free-floating exchange rate regime drew modest support among reformers. In most transition countries, the choice of a fixed exchange rate regime raised limited support. Gros and Steinherr (2004: 74) suggest a dual exchange rate system, consisting of both a fixed and flexible exchange rate to be preferred by the transition country. The aim with such an exchange rate regime is to “limit the short term effects of a depreciation of the exchange rate on domestic prices while maintaining some degree of control over capital outflow and international reserves”(Kiguel and O’Connell, 1995: 22). The dual exchange system does not allow for net capital flow (unless the central bank allows for it), but it gives rise to stability. Since there cannot be any capital-flow, the current account is in equilibrium. This current account equilibrium insulates the economy from financial shocks from the outside, thus bringing stability to the macroeconomic environment.

2.6 Macroeconomic Stability and the Fiscal System

⁶See Markusen et al. (1995) for a theoretical approach.

When going from a plan to a market economy, the state continues to play an important role. Its role consists of supplying public-goods for the population. In assuring their production, the state is in need of revenues. These revenues originate above all from taxes. However, fiscal stability in transition is problematic. On the one hand, the need for revenues increases as transition moves forward. On the other hand, the ability to satisfy the increased demand is reduced, due to a lack of revenues. Governments exhorted to continue with liberalisation and privatisation of the economy, are doing so together with institutional reform in order to maintain fiscal balances.

When the transition countries can show price stability, i.e. where inflation is under control, investors will invest and hence create the basis for sustainable growth (Gros and Steinherr, 2004: 83).⁷ To take on inflation and halt its destructive force, the central bank in general and the state in particular should have fiscal balance, i.e. price stability. In the study conducted by Fischer et al. (1996: 57) the implication of inflation on growth in transition economies is comprehensive. They conclude that inflation and economic growth are negative correlates. Hyperinflation (inflation exceeding 50 %) was common in transition countries. Hyperinflation was due to a monetary overhang that took hold over many transition countries. A monetary overhang was in fact a result of years of capital accumulation together with the inability to spend their savings. When prices were liberalised, price levels increased and the general monetary overhang existing in East Europe further deteriorated inflation (Gros and Steinherr, 2004: 83). Another source identified as linked to inflation is the lack of control of the former state owned enterprises (SOE). Profit transfers from the SOEs declined substantially and a soft budget constraint was still common, fuelling instability and inflation pressure.

Another factor put forward by Gros and Steinherr (2004: 89) was the increasing demand for real wage compensation in the transition countries. Due to a problematic reform environment, the politicians saw no other way than to accept the wage demand by increasing the money supply, thus deteriorating the inflation even further. It can be noted that low saving rates represent an additional threat to fiscal balances. In addition, the introduction of a value added tax (VAT), works as an indirect tax. By taxing consumption as opposed to a tax on work that distorts savings, the VAT should augment the overall saving rate, which in turn would allow more room for further investment and improved public finances. Revenues are also generated

⁷ See also Fischer et al. (1996)

by increased profits in the private sector and from selling public assets in privatisation schemes.

2.7 Privatisations of the State Owned Enterprises

The aim of privatisation should first be to augment the efficiency in the economy, and as a result, create an incentive-based economy. Secondly, privatisation follows the line of democratic thinking, which the former communist countries never had experience. The creation of a democratic and a fair leadership was very important in keeping the public support for the reforms. Thirdly, privatisation is fundamentally about a change in ownership structure. It is perceived that private ownership employs harder budget constraints and is profit maximizing and therefore more efficient than state ownership (Djankov and Murrell, 2002: 741).

Kornai (1994: 39) describes the upheaval of the old communist society by highlighting two key factors of change: "going from a sellers to a buyers society (by price liberalisation)" and by "enforcing budget constraint (via privatisation)". The privatisation process- along with price liberalisation- installed a fundamental change in the post communist societies. The privatisation process also resulted in a "[...] mutation [...] that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one" (Schumpeter, 1954). It can be noted that creative destruction comes at a price: unemployment. The result of a more efficiently run enterprise removes the excess labour. Another effect of privatisation is the distorted income distribution. The history has shown that after the collapse of the Soviet Union, a few people acquired a large share of the private sector, which consequently enriched them. This does not only raises moral questions on the fairness of such a move, but also results in grave consequences for the continuing process of reforms (see Gros and Steinherr, 2004: 80; Mladen and Sekelj, 1997: 1060). The success of the privatisation is also a measurement of how well the overall transition is process is advancing. This process encompasses the overall reform and is therefore a proof of the success of the different elements in the transition process since it concerns the alterations in the ownership structure: the fundament of transition (Djankov and Murrell, 2002: 742).

There are theories of how to go about with privatisation. First is the mass privatisation strategy, where all eligible citizens receive one share of the privatised SOE. Voucher

privatisation is to set all the shares equal to the number of workers and then distribute the shares among the workers. These two approaches envisage citizens and workers to hold portfolios with many different shares, thus enabling the creation of an over-the-counter market (Gros and Steinherr, 2004: 81). The general idea with voucher/mass privatisation is to create an equal ownership structure on relative short time (Simoneti, 1993: 88).

The second way is to sell shares in SOEs to outsiders through auctions and tenders. Concerning tenders, interested parties submit an application where they state how they will finance the purchase and the production of the former SOE. By obtaining the ownership rights, the buyer could buy approximately 70-90 per cent of the total number of shares. This form of privatisation is common when privatising large SOEs. Auctions apply when the government privatises small and medium large SOEs. Again, 70-90 per cent of the shares are offered to the investors. However, in the auction it is the highest bidder who prevails. In both outsider privatisations, 10-30 per cent of the shares presents to the workers of the SOE.

2.8 Summary

The framework presented above provides the theoretical background of the transition program. The objective of the transformation process is to create an economy, which responds to demand and incentives. Efficient allocation of resources through private ownership will ultimately result in an efficiently administered economy. As I have outlined above, some reforms are of greater importance than others. Price and trade liberalisation creates efficiency gains, through competition in prices and products. Macroeconomic stability is prerequisite for a sustainable economic growth. A good macroeconomic environment enables economic agent to plan the future, and decisions become predictable. Privatisation of SOEs is an obstacle for the complete shift to a market economy. It reflects the process of all the former policies and is the receipt on how well or bad the performance of the transition process has been. Privatisation also encompasses the final shift from a central to a decentralized allocation system. Consequently, the ownership transformation is the most difficult part to succeed.

3. The Serbian Transition Mix

This chapter presents the Serbian transition program and discusses reforms initiated with focus on 5 sectors.

3.1 The Serbian Transition Program: A Background

The set up of the Serbian transition program followed the theoretical framework presented in chapter 2. The purported Washington consensus has been used by most of the transition countries in Eastern Europe in the 1990s. Ten years later the core issues needed in a transition program have not altered significantly. However, a post-Washington consensus gained momentum. The post-Washington consensus gave greater focus to the institutional set-up in the transition countries. Knowledge acquired from earlier transition experiences demonstrated that institutions matter more than was initially believed. In order to have a thriving private sector and international trade in a country, the state needs to be able to enforce and monitor these rules. Therefore, a legal framework and an institutional setting are key components of the transition. They embody the whole transition process and are integrated in each sector that will be described below.

Besides covering privatisation and liberalisation, emphasis was placed on institutional building. The new government in Serbia, together with the World Bank and IMF, set up three overall objectives for Serbia's transition program:

- 1) restoring macroeconomic stability and balances;
- 2) stimulating growth and creating a basis for sustainable supply response;
- 3) investing in improved governance and effective institutions (Breaking with The Past, 2001: 5; World Bank, 2004e: 6).

The objectives decided upon were a way to enhance living standards in Serbia by creating a market economy. The comprehensiveness of Serbia's reform program was substantial. The economic reform program (table 3.1.1, pp 19) covered a major part of the economic sphere. In order to gain access to international funds, Serbia had to agree on full-scale transition. Following the experience of its East European counterparts, Serbia intended to stabilise, liberalise and privatise the economy. The program had to be design after Serbia's initial conditions.

3.2 Initial Conditions

As Serbia embarked on its reform process, numerous obstacles occurred. In early 2000, Serbia had reduced the standard of living to 45 per cent of its 1989 level, which was already very low. GDP per capita in 2000 was merely US\$840-990. Serbia suffered from a lack of investment mainly in infrastructure, which in turn was a result of a decade of conflict and economic sanctions (World Bank, 2001a: 3)

Fiscal problems were inherited in the Serbian economy. Inflation posed the greatest threat to government. In 2000, inflation in Serbia reached a staggering 100 per cent. Consequently, focus was placed on policy to curb inflation. Better enforcement in customs collection should increase revenues for the government. The National Bank of Serbia (NBS) did not permit any credits to domestic enterprises; neither did the NBS allow financing of the national budget. The reform programme also acquired necessary assistance from the Paris Club who agreed to provide with financial aid by rescheduling Serbia's debt. Henceforth, inflation begun to decline and real structural stabilization reform could commence.

Serbia had already been through a transition programme in the mid 90s after the wars with Croatia and Bosnia. However, that transition program was never implemented because of continued armed conflicts. Therefore, the necessary transition reforms that Serbia set up was based on an entirely new reform programme, starting from 2000.

Following the former discussion, this study will describe the programme initiated in Serbia in 2001. It will emphasise on five different areas of reform, which Serbia has stressed as particular important: fiscal policy (3.3, pp 21), the new role of the state (3.4, pp 22), private sector reform (3.5, pp 23), trade and exchange rate policy (3.6, pp 24) and financial reform (3.7, pp 25).

Table 3.1.1

Serbia's Main Transition Reforms

	Policy Area	Date of Introduction	Implementation
A	<i>Stabilisation Policy</i>		
	Fiscal Policy		
	Tax Reform	2001	Reducing main taxes from 250 to 6, unified at a rate of 17 %. In 2003, preparation for the introduction of the VAT.
	Public Expenditure	2003	Public expenditure control was set up. Expected to be 46, 7 per cent in 2006
	Monetary Policy		
	Money Supply	2001-3	Rapid increase in the beginning of the reform due to a high inflow of foreign currency
B	<i>Systematic Reform</i>		
	State Owned Enterprises (SOE)		
	Privatisation	2001	Privatisation Law introduced. Sales of SOE through auctions and public tenders
	Factor Markets		
	Foreign Investment	2001	Foreign Investment Law introduced. Privatisation and macroeconomic stability resulted in high FDI inflows.
	Labour Market	2001	The Labour Act, protects workers from discrimination.

	Banking and Financial Sector		
	Financial Liberalisation	2003	Privatisation in the financial sector commence.
	Price Liberalisation	2000	Abolishment of all administrative price control, only price controls on public monopolies and municipal services
	The New Role of the State		
	Constitutional Reform	2006	Montenegro abscond the union 2006. Constitutional change in 2007 projected, with the vote on Kosovo's final status.
	Legal Reform	2002	Commercial Law introduced that should be aligned with the EU regulation. Several judicial laws were introduced to restore public confidence in the judicial system
	Institutional Reform	2001	Local government law, decentralize rules to local governments. Law on public administration and civil service, a move to reduce corruption
	Competition Reform	2002	Procurement law, enhance competition and use of public funds
C	<i>Trade and Exchange Rate Policy</i>		
	Trade Liberalisation		
	Import Tariff	2000-1	Tariffs were initially reduced, but this

			process stopped due to political pressure
	Import and Export Licences	2001-3	Abolished
	Free Trade Agreement	2001	New FTA signed with Russia and FYROM
	Exchange Rate Policy		
	Flexible Exchange Rate	2001	Improved fiscal stability made it appreciate against the dollar
	Unification of the Exchange Rate	2000	Price liberalisation ended the dual price system

Source: World Bank (2001a,b;2004e,f;2006); IMF (2004; 2006) and OECD (2003)

3.3 Fiscal Policy

Years of economic sanctions and conflicts had left a mark on the Serbian economy. Some sectors in the economy had developed a barter economy where arrears were exchanged instead of money. Additional risk to fiscal stability was of concern. The government faced a difficult situation with an increasing foreign debt. Even though the Paris Club agreed to help Serbia with some of its foreign debt, this risk could not be ignored. An additional risk on the fiscal balance emerged, which was related to the government commitment to health and pension payment. Although this was a political rather than a judicial obligation, it posed a risk on the already strained national budget and the public's confidence on the reform programme. Other fiscal risks, identified as alarming were: civil service wage bill, the continued enterprise financing of arrears, and subsidised loans to loss making SOEs (Breaking with the Past, 2001: 14). The transition programme thus focused on increasing and facilitating the tax system in order to enhance revenues and create stability. Illustrated in table 3.1.1(pp 19), the amount of difference taxes was reduced from 250 to 6, and preparation for the introduction of a value added tax was initiated. Because the tax revenues account for 54 per cent of the total government revenue it was important to optimize tax collection and reduce corruption. At the same time, the program envisaged public spending to be contained to appropriate levels. The central government froze scheduled payments to local projects and the NBS stopped giving credit to SOEs (Breaking with the past, 2001: 20).

It was also recognized that the non-payment cycle needed to be bunged immediately. Consequently, the enforcement mechanism is of utter importance. Therefore, the legal system had to be reviewed and reformed: soft budget constraints needed to become hard. Concerning the bank sector, insolvent banks needed to be closed, and the lending by connection needed to halt (Breaking with the past, 2001: 23; World Bank 2001a: 8).

3.4 The New role of the State

Governance reform was interlinked with the much-needed fiscal discipline in Serbia. Fiscal decentralisation envisaged to make local government work under a harder budget constraint. It is thought that a decentralized state can coordinate and implement reforms by adapting to the local conditions better than a central state (Montinola et al, 1996: 51). The fact that the shift towards a market economy brought change in the relationship between state and business, facilitated the introduction of laws aiming to halt the increasing problem with corruption. De-regulation and decentralisation reform was important step towards a corruption free society. Corruption has poisoned the Serbian system for a long time. As a result, the Serbian bureaucracy is widely distrusted among its citizens.

Public administration reform visualized a reduction of the number of employees in the administration. Consequently, the Government law enacted in early 2001 reduced the number of government ministers from 34 to 17. The reform envisaged to increase the level of professionalized bureaucrats and make the public administration more efficient (Breaking with the past, 2001: 22).

The judicial system also needed thorough reform. Its staff lacked proper education and courts were overloaded with work. The legal system was biased the state and judgements were highly politicised. The overall problems with law enforcement further deteriorated the already modest support for the existing judicial system (Breaking with the Past, 2001: 71). Legal reform (table 3.1.1, p 20) aimed to meet the demands from the EU. Harmonizing the Serbian legal system with that of the EU was thought to increase the chances of an eventual membership.

North (1990: 58) stresses the importance of a well functioning legal system to set the new 'rules of the game'. Under an uncertain environment, the legal system plays an important role in supervision and enforcement of these laws. The low trust on formal institutions will eventually lead to an increased informal system. Here, the players will be protected from expropriation and guaranteed safe economic exchange. In Serbia, an informal economy has emerged after a decade of conflicts. The trust on government and administration's officials to provide for public goods has deteriorated, and the informal economy has become vital, especially for the rural population (Wallace and Latcheva, 2006: 90). Table 3.1.1 illustrates that politicians were aware of this problem. Consequently, reform enacted was aimed to improve the overall trust on public institutions.

3.5 Private Sector Reform

As can be observed in table 3.1.1 (p. 19) privatisation was early adopted (2001) in the reform process. According to Bourdet (1995: 32), an early privatisation scheme hardens the budget constraint on former SOE and thus helps reduce the inflation. However, Roland (2001: 36) stresses that without appropriate matching, the privatisation process could lead to insider privatisation. Consequently, this could give a lot of control to small groups, making future reforms more difficult. The Privatisation law introduced in 2001, stipulated the sale of several state owned enterprises (SOE) through auctions to "[...] clearly defined and dominant owners" (World Bank, 2001a: 8).

Harder budget constraint reappears when discussing about reform in the entire economy. In this process, the banking sector played a vital part in realizing this objective. Credit to loss-making enterprises had to terminate immediately. Bankruptcy- and liquidation laws envisaged to be implemented.⁸ However, as the overall owner structure was closely linked to the state, access to capital continued to be given to the important SOEs and not to capital scarce private enterprises (Breaking with the Past, 2001: 27).⁹ The SOEs were loss making and inefficient but due to contacts within the administration they could continue their production.¹⁰ During the initial stages of reform, the SOEs were a large employer of labour. Therefore, the new government could not allow for a swift liquidation of these enterprises because then the whole

⁸ Poland proved to be a good model to follow. They had successfully transferred excess assets from failing enterprises to productive use in well functioning enterprises (Breaking With the Past, 2001)

⁹ Prior to the macroeconomic stability reform which halted credit even to SOEs

¹⁰ Even though they operated 5 to 30 percent of its capacity (Breaking with the past, 2001)

transition programme could then be in danger. The transition programme had to be implemented gradually so that the private sector could absorb the excess labour from the privatised SOEs.

However, the Serbian entrepreneur encountered many difficulties in starting their own business. Numerous governmental regulations made market entry difficult and costly. Access to capital was limited and private entrepreneurs had to rely on friends and family in order to raise the necessary working capital. Therefore, reforms focused on improving the business environment and eliminate tax distortion in the private sector (Breaking with the past, 2001: 82; World Bank, 2001a: 4).

3.6 Trade and Exchange Rate Policy

In order to stimulate growth, Serbia focused early on removing trade obstacles for the export/import enterprises. In 2001, Serbia signed a free trade agreement with Russia and FYROM. Serbia also tended to harmonize its trade with CEFTA, which would substantially enhance Serbia's market access to this region. The European Union is supporting the Serbian trade liberalisation and is an important trade partner, since the beginning of the reforms. In fact, reforms to be eligible to participate in trade with the EU (in the future also the WTO) have served Serbia well. Important trade liberalisation has proceeded and increased access to the European market followed. Tariffs substituted quotas as trade barriers, facilitating customs' procedures. The opening up of the Serbian economy was prerequisite after a decade of economic sanctions. Old trade relations had to be re-established, and technological advancement had to be absorbed by the Serbian enterprises in order to compete on the world markets (Breaking with the Past, 2001: 48).

The unification of the exchange rate in 2001 (table 3.1.1, p 20) expected to bring some stability and sustainability to the export markets. Along with current account convertibility, the economy instigated the opening up process. Consequently, the trade reforms interlinked with the development of the private sector (see 3.5) with considerable potential for increased exports.

Reform of the foreign direct investment (FDI) laws was needed for the private sector to grow. Regulations that stipulated that a foreigner could only hold no more than 49 percent in the enterprise were to be abolished. According to this law, FDI originated from joint ventures, when in fact, they were mostly derived from privatisations and mergers. Therefore, adjustment of the law to the new conditions of the market economy was imperative. A law calling for reciprocity in foreign investment was also to be scrapped as it distorted investment away from Serbia (Breaking with the Past, 2001: 20).

3.7 Financial Sector Reform

The financial sector reform in Serbia initially focused on the bank sector. Absence of clear creditor rights and biased lending (to the SOEs) led to an increased distrust towards the Serbian banks. Six state owned banks dominated the sector in early 2001. Together, they held a majority of the bank assets in Serbia. Even though the private bank sector complied with regulation better than the state-owned banks, the initial development of private banks was slow. The state-owned banks were used as governmental tools to promote and protect key industries for the state such as telecommunications and utility companies. By controlling the price mechanism, these banks could provide low prices on e.g. energy and agriculture products. The objective of reform in the financial market was principally aimed to break the state dominance and introduce competition through privatisations and de-regulations.

The evident principal agent problem that occurs with a state ownership is multi-faceted. Primarily, the soft budget constraint implies that the banks are not profit maximizers. A soft budget constraint makes them less effective in choosing the investment project that is the most optimal. Instead, the decision is made on political variables and thus becomes inefficient. Creditor rights are not respected and the loss of proper property rights will result in reduced savings. Savings in Serbia are further discouraged by the negative real interest rate (Breaking with the Past, 2001: 111; Claessens and Fan, 2002: 79).

Initial reform primarily focused on the restructuring of the banking sector. As table 3.1.1 (p.20) indicates, reform in the financial sector was slow. The Real shift in the ownership structure first began in 2003 (see table 3.1.1, p. 19).

3.8 Summary

The reform program of Serbia was comprehensive. The reforms envisaged the creation of a market economy and aimed at increasing living standards. In order to succeed with this aim, Serbia initiated a reform program that entailed the whole economy. Fiscal reforms envisaged an increase of governmental revenues. Consequently, the tax system should be improved by reducing the number of taxes. In addition, limitation on subsidies given by the state to SOEs was expected to reduce public expenditure. Institutional, i.e. legal- and private sector reforms, aimed to create a healthy institutional infrastructure necessary for economic growth.

The authoritarian rule in Serbia was ended in 2000. The newly elected government initiated reforms in 2001, supported by the World Bank and IMF. The majority in Serbia welcomed the transition initiated in 2001. A decade of wars and isolation had made the population long for economic and political change. The political condition for a transition existed. Concerning the economy, its initial condition was less encouraging. An overall inefficient business environment together with soaring inflation made sequencing of reform focus on stabilisation.

Serbia started reform by a comprehensive liberalisation of the economy. Prices were liberalised in 2000 and trade liberalisation followed in 2001. As a result, inflation reached high levels. Therefore, a thorough stabilisation process followed. While the economy was adjusting to the new condition, privatisation was held back. However, as the economy began to stabilise and the private sector gained momentum, privatisation of SOEs commenced. Sequencing of reform followed the pattern of previous transition countries: liberalisation and stabilisation, followed by privatisation.

4. Transitional Developments: The Outcome on Serbia

The outcome of the first 4-5 years in transition is presented. The progress is based on the theoretical tools presented in chapter 2.

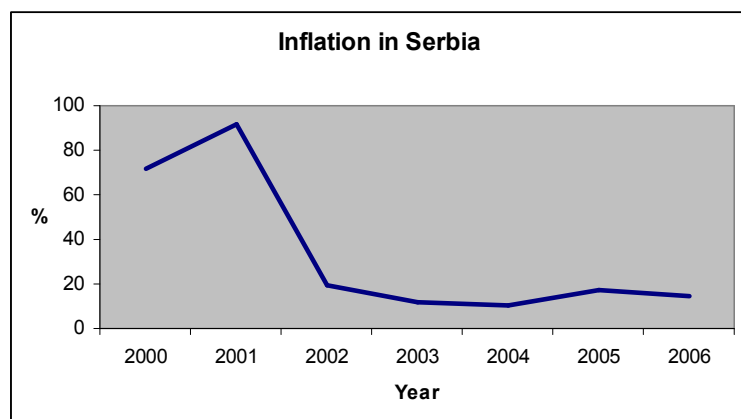
4.1 Introduction

In the early chapters, I have shown that fiscal stabilisation is a precondition for economic growth. Consequently, I will focus on the fiscal stabilisation process. The economic growth is a good indicator of how the economy has performed during the last year in transition. Trade and international integration has become vital for small economies. Therefore, trade and international integration plays an important role for the future of Serbia's economic development. Private sector development and privatisation will explain at which degree the shift to a market economy is proceeding. Since the beginning of the reform, access to capital had been problematic for private entrepreneurs. As we will see, the bank sector entails both the potentials and obstacles to the Serbian economy.

4.2 Macroeconomic progress

By embarking on the path of reform, inflation gained momentum again. As mentioned in the earlier chapters, there is an imperative to implement price liberalisation, but this has a side effect: increased inflation. Therefore, after the introduction of price liberalisation in 2000, Serbia introduced a flexible exchange rate and convertibility on current transaction. As illustrated by Figure 1 (p. 28), inflation increased even further. The inflation was disturbingly high in 2000 (111.9 per cent), forcing the Serbian government to take action against inflation. The sharp drop came as the government increased revenues and reduced expenditure. After three years into transition (Figure 1, p. 28), inflation eventually reached a reasonable level of 7.8 per cent in 2004 (World Bank, 2001a: 6; IMF, 2004: 5). It can be assumed that inflation had taken its toll on the Serbian economy. Living standards, according to the IMF, were lower than its 1989 standards. Due to the introduction of a value added tax (VAT) and high-energy prices on the world markets, inflation stabilised but at a high level (IMF, 2004: 66; World Bank, 2003d: 8 and 2004e: 4).

Figure 1.



Source: IMF (2004), World Bank (2001); (2004); (2006)

To regain its position as a leading country of the Balkans, Serbia had to go through additional structural reforms. The stabilisation of inflation was only a prerequisite for economic growth. The advice the IFI gave to Serbia was to slash public expenditure due to an increasingly and troublesome current account deficit. The actual soaring account deficit present in Serbia reveals one important thing about the Serbian macroeconomic environment. It emphasizes on the current structural competitiveness problems due to a malfunctioning export market, which is a result of the appreciation of the Dinar (World Bank, 2004: 11).

Table 4.2.1 <i>Current Account in Serbia, percent of GDP</i>	
2000	-3,9
2001	-4,6
2002	-9,5
2003	-9,3
2004	-12,5
2005	-9,6

Source: IMF (2006)

In order to reduce the current account deficit while increasing investment, it is recommendable that national savings augment. National saving is the difference between the income and outlays by households and enterprises. Thus, in order to stimulate more saving from enterprises, Serbia needs to ameliorate the business climate and reform its bank sector,

increasing private sector revenues. Concerning the households, there is an evident need to moderate consumption in order to enhance own savings in the country.

To maintain control of the economy of the country, the Serbian government needs to secure revenues to finance public projects as health care and law enforcement. The Serbian tax system worked rather well from the beginning of the reform process and raised a considerable amount of revenues for the state. Therefore, the aim has mainly been to promote a tax system that does not distort work efforts or investment, and induces a low administrative cost. In an effort to harmonize the tax system and thus lowering the administration costs, Serbia reduced the number of main taxes from 230 in 2000 to 6 in 2003. An additional tax reform was to shift taxation from income to consumption. This led to the introduction of a sales tax of 20 per cent in 2001. Besides bringing in revenues to the state, the tax was a preparation for another source of revenue: the VAT, introduced in 2005.

Table 4.2.2

<i>Fiscal Revenue and Expenditure (% of GDP)</i>			2001	2002	2003	2004	2005
Revenue			38,9	43,1	42,3	41,5	40,7
Expenditure			40,3	46,9	45,8	44,8	43,8
Overall Balance			-1,4	-3,8	-3,5	-3,3	-3,1

Source: IMF (2006), World Bank (2006) and World Bank (2004)

4.3 Economic Growth

The Serbian economy grew at annual rate of 5 percent during the first year of transition. Serbia never experienced the same contraction in production (J-curve effect) as other transition countries experienced in 1990s. A large inflow of capital helped to mitigate the expected output decline. In addition, the early growth experienced in 2000 was much due to a recovery from the Kosovo war in 1999. Consumption was a driving force behind the economic growth in the initial stages of transition. This is evidenced in the period 2001-2003, when private consumption grew at an average rate of 8,8 percent (World Bank, 2006: 11).

Figure 2 illustrates the Serbian growth during transition. With a growth reaching 9 per cent in 2005, Serbia is actually regaining its momentum on the macroeconomic scene. Investment is

increasing, due to a high inflow of FDI to Serbia. Since national savings are negative, FDI is becoming more important to the macroeconomic outlook. To enjoy further investment, Serbia needs to strengthen its legal framework, through the enforcement of contracts and protection of property rights.

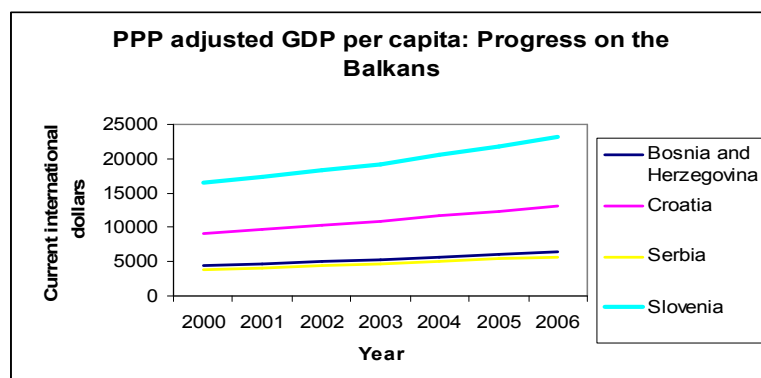
Figure 2



Source: IMF World Outlook Data 2006

Concerning per capita development, Serbia has experienced a slow progress during the first year of transition. Compared to its neighbouring countries, Serbia lags behind the leading countries, together with another war-torn country Bosnia Herzegovina (see Figure 3.). Reform has set Serbia on a steady course towards enhanced living standard. The steady growth rate that Serbia has experienced indicates that reform has proven well for Serbia's per capita development. World Bank (2006: 8) concludes that the average living standard has significantly risen and that absolute poverty has substantially fallen in the first two years of transition. This is an acknowledgement of the positive progress made by the reform program.

Figure 3.

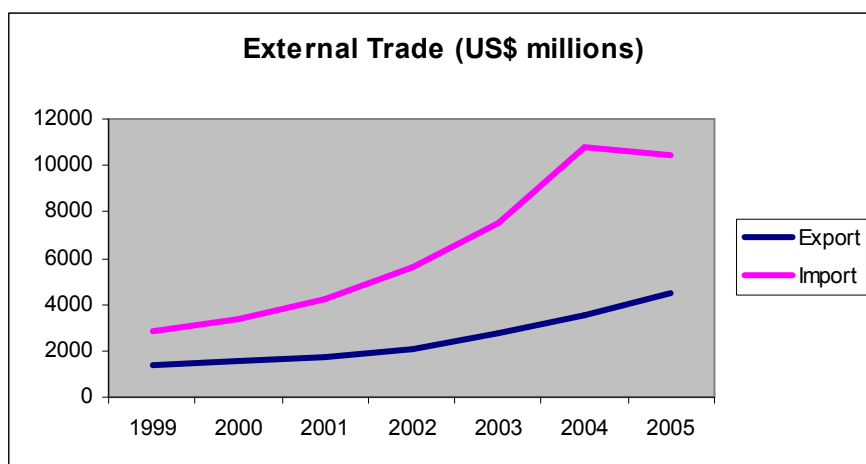


Source: IMF World Outlook Data 2006

4.4 Trade and International Integration

After ten years of absence from international and regional trade, Serbia gained early access to the EU market through the Stabilization and Association process (SAp). This opportunity was not fully embraced by the Serbian export sector that only grew by 4,2 percent (in Euro terms) during 2001-2003. During the same period imports grew by 18,9 percent (also in Euro terms) (World Bank, 2006: 33). The liberalisation of the Serbian economy and the removal of trade obstacles led to a surge in imports, mainly from the EU. Therefore, the current account deficits rose (see 4.1) during the initial stage of trade liberalisation.

Figure 4.



Source: Statistical Office of the Republic of Serbia

Foreign producers met the increased demand from the domestic market. Moreover, the Serbian exporters had not adjusted to the new realities of a market economy. This is due to a decade of war and international isolation, which forced firms in the trade sector to rebuild their old trade relationships. This process delayed the adjustment to the new conditions of the market further. An additional reason to the large current account deficit is the real appreciation in the Dinar against the Euro, which made the Serbian export sector less competitive. Another explanation to the uneven trade growth is traced back to the structure of trade. Serbia's export was primarily in low skilled labour-intensive production. This type of exports helped to cushion the unemployment and the expected production fall at the start of the reform process. However, Serbia has become ensnared in a level of low capital-intensive production and low value-added exports. The Serbian experience differs with reference to the SEE-countries, in that these countries experienced a shift from labour-intensive production to a more capital-intensive production through the course of transition (see table 4.4.1, p 32). An explanation for that could be the slow growth in the private sector. Lack of access to capital, proper protection of property rights and enforcement of contracts makes private business in

Serbia complicated. At the micro level, enterprises face a shortage in skilled production factors and at the macro level an uncertain environment; which consequently results in insufficient investment, making international integration complicated.

Table 4.4.1

<i>Factor Intensity</i>	Serbia	Serbia	Serbia	Serbia	Hungary	Hungary	Hungary	Hungary
	1997	2000	2001	2002	1990	1993	1997	2002
		Composition of Export to the EU (%)						
Unskilled Labor	22,6	22,7	24,1	22,6	21,5	27	16,2	12,2
Capital Intensive	14,6	10,9	12,2	9,7	21,3	25,6	43,3	50,7
Skilled Labor	18,9	19,4	18,6	15,4	14,5	15,4	22,4	26,6

Source: UNCOMTRADE Databases reported by the EU (World Bank , 2004g: 38)

Serbia's major trade partner is the EU. On average about 43 percent of Serbia's export share goes to the EU and 40 percent of Serbia's imports' share originates from the EU. However, Serbia has not taken advantage of its proximity to the EU markets and is still trapped producing low value goods. Although the EU is important to the Serbian economy, the integration process between Serbia and the EU has stagnated since 2003. Serbia has not yet obtained a formal invitation of pre-entry talks with the EU. The "EU factor" that was so vital for the East European economic development has not proven as effective to Serbia. Firstly, Serbia has had internal political disputes that have stalled economic reform.¹¹ Secondly, the reluctance from the EU to accept further member states has led Serbia to postpone further trade liberalizing reform. Initially, Serbia reformed the trade sector in order to obtain access to the EU markets. While this has supported the Serbian economy to grow initially, further trade reforms depend on the political assessment of future gains from increased integration and trade with international markets.

The regional integration has developed slowly. It appears that the plethora of FTA agreements with the SEE-8 countries has distorted the Serbian trade pattern. Different agreements with different countries have led to promotion and demotion of certain sectors. Since 2003, Serbia enjoys an 84 per cent access for its exports to the SEE-8markets (World Bank, 2006: 29).¹² However, since there is a lack of harmonization among the SEE-8 in trade regimes, trade

¹¹ The murder of Prime Minister Djinic in 2003 and the constitutional vote projected in December 2006 have slowed the transition process in Serbia.

¹² The SEE- 8 countries consist of; Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYROM, Moldova, Romania and Serbia.

would be more effective if agreements were harmonized and trade barriers were indeed removed. Individual FTAs distorts trade patterns and ultimately reduces Serbia's opportunities of an effective integration into the world trade system.

Even though trade has been a disappointment to Serbia, FDI has become an important source of new technology and foreign capital. FDI has also balanced the low saving rate in Serbia, thus ameliorating the overall economic growth perspectives (Brada et al., 2006: 677). Situated between the EU, Eastern Europe, Turkey and the Middle East, Serbia's geographical location entails expectations of a large FDI inflow. It should be noted that the FDI flow conceded with the start of the second wave of privatisation in Serbia.¹³ As the privatisation process slowed in 2003, FDI became an indicator of how much confidence the foreign investors have on the Serbian economy. Table 4.4.2 illustrates the decline in FDI after privatisation was stalled 2003.

Table 4.4.2

<i>Net FDI Inflow (millions of EUR)</i>							
	1998	1999	2000	2001	2002	2003	2004
Serbia	81	105	27	160	475	1204	716

Source: Serbian Privatisation Agency

World Bank (2006: 50) and Brada et al. (2006: 650) acknowledge the importance of political stability and a proper functioning legal framework. Consequently, the lack of both the former and the latter has resulted in less FDI for Serbia than it was initially projected (see Table 4.4.2). The reduction in FDI is also due to the overall business environment in Serbia, which is characterised by corruption and crime, which distort investment projects.

4.5 Private Sector Development and Privatisation

The first round of privatisation reform in Serbia took place in the mid 90's with unfortunately dire results. "Insider" managers took control of the enterprises without restructuring or

¹³ The first wave, initiated in the mid 90s, came to halt due to conflict.

preparing them to the condition of the market economy. As the second round of privatisation took place in 2001, lessons had been learned from Central Europe's privatisation process a few years earlier and from Serbia's own privatisation process in the 90s. Three different models of privatisation were employed in the second round of privatisation. First, tender schemes were applied mainly when medium and large SOEs are privatized. This meant that 70 per cent of the total share goes to strategic investors whereas the last 30 per cent are sold to the employees of the enterprise. The second form refers to auctions, used on relative small state owned enterprises. Consequently, before the privatisation, 10-30 per cent of the firm's shares are distributed to the employees. Then the 70 to 90 per cent left is sold to local or foreign investors (Republic of Serbia, 2005: 14). A third type of privatisation was also introduced: reconstruction. Here, the SOEs to be privatized are given technical and organizational assistance because they could not be sold in their current financial state. After reconstruction, they are to be sold in one of the aforementioned privatisation scheme.

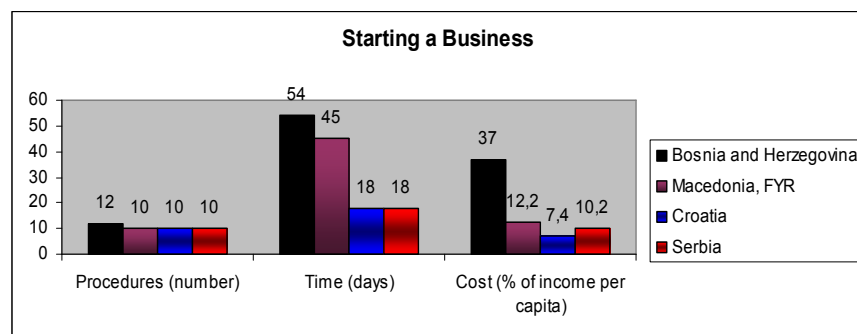
These initiatives resulted in a new ownership structure for a large number of SOEs. The privatisation process was successful after 2001. According to Goldberg et al. (2003: 8), the privately owned firms obtained a higher level of total factor productivity (TFP) than the state owned firms. Lokshin and Jovanovic (2003: 488), explain that workers in private sector in Serbia are younger and better educated than the SOE workers. From that, the wage difference between private firms and SOEs is likely to expand even further in the future. Although productivity was higher in the private firms compared to state owned firms, a lack of exclusive property rights still make entrepreneurship in Serbia uncertain. Serbia is the least performing country in the region to enforce contracts according to table 4.5.1. Consequently, entrepreneurs are reluctant to use the formal system to enforce contracts; instead, informal channels are being used to protect their properties.

Table 4.5.1 <i>Indicator of Contract Enforcement</i>				
		Number of procedures	Duration (days)	Cost (% of debt)
Bulgaria		34	440	14
Croatia		22	415	10
Macedonia		27	509	32,8
Serbia		36	1028	23
Source: Cost of Doing Business 2004				

The privatisation process from 2001 to 2003 resulted in an increase of the share of private firms in the Serbian economy. In 2005, 65 % of all enterprises were privately owned (World Bank, 2006: 23). The EBRD (2005), reports that these enterprises accounted for 50 percent of Serbia's GDP. However, compared to Hungary (80 %), Bulgaria and Poland (70%), the private sector share of GDP in Serbia is trailing behind these countries and reform is still required.

To start up a business today, Serbian entrepreneurs still have to go through costly and time-consuming procedures. However, compared to its regional neighbours, Serbia is one of the business friendliest countries in the region (see figure 5). Even though reform has not been entirely smooth, reform is moving in the right direction.

Figure 5



Source: Doing Business 2006, World Bank

One major lesson that Serbia drew from earlier privatisation in East Europe was that ownership in itself is not sufficient to improve the performance problems encountered by firms in transition. A thorough reform of the institutions in Serbia must concede with the privatisation process in order to create a good business environment. A better institutional framework also lowers transaction cost that consequently ameliorates the firm's productivity. Up to today, it can be acknowledged that the overall legal restructuring process has been sluggish due to political uncertainties.

4.6 Bank Sector Progress

The financial sector went through a similar transformation process as the private sector. The number of banks operating in Serbia diminished. From 2001 to 2004, 37 banks either dissolved or merged, leaving the total number of banks to 46 in Serbia. However, the creative

destruction process, i.e. privatisation, halted in 2003 due to political uncertainty (World Bank, 2006: 81).

Five years on, the state banks still dominate the banking sector in Serbia. By controlling 44 per cent of total assets, we can assume that these banks have a classic principal agent problem. It also seems logical to suggest that the state dictates the allocation of capital, making it difficult to obtain access to working capital for private entrepreneurs. In this context, they find it difficult to produce efficiently. Investment is financed through internal funds, which impedes the efficient allocation of resources (World Bank, 2006: 80).

Overall, the banking sector remains overpopulated, limiting healthy competition between banks. However, the growing number of foreign owned banks operating in Serbia show evidence of the business potential in the country. According to one bank consultant in Serbia, the market will '[...] grow by 20 percent annually for the next five years' (Saywell, 2006: 2). Because of the perceived growth potential, more banks will find their way to Serbia. Increased competition is the key to put more strains on the regulatory power, and to draft appropriate competition laws, which will deregulate the entry and exit procedures.

4.7 Summary

Overall, the Serbian transition process got a good start. Inflation initially proved to be a difficult obstacle to overcome. Price and external liberalisation aggravated inflation further. However, as the government increased its revenues and reduced its expenditure, inflation was brought down to a sound level. Alike, living standards in Serbia in the initial stages of transition proved to be lower than its 1989 levels. However, the data presented suggest a steady improvement in living standards.

Serbia experienced healthy growth figures during the first year of transition. Growth figures at around 5 per cent annually, had much to do with Serbia's recovery from the last decade of war and international isolation. Consumption was also a driving force behind the initial growth figures. The effects on per capita growth have been limited though. Compared with its neighbouring countries, Serbia is lagging behind.

The external liberalisation reform enacted by the government had several effects on trade balances. Firstly, the removal of trade obstacles led to a surge in imports. As the export firms had not adjusted to the new conditions, the external balance deteriorated substantially. Secondly, international integration was made complicated by the uncertain environment in Serbia and by the fact that firms in general faced shortages in production factors. However, FDI became important for Serbia's aspiration to reintegrate in to the world market. As a result of privatization sales to foreign investors, FDI increased considerably during the first year of transition. However, as the privatization process lost its initial momentum, FDI declined, mainly due to a deficient legal framework and unclear property rights.

Recently privatised enterprises have experienced a better TFP growth than the SOEs. The private sector attracted younger and more skilled workers to its enterprises. From that, access to working capital has been improving as the banking sector becomes more competitive. However, the lack of clear property rights, together with timely procedures in setting up a business, has made the life as a private entrepreneur in Serbia difficult and costly.

Overall, the reform process progressed satisfactory during the first three years. However, after various political events in 2003, reform lost its initial momentum. The political support for the reform programme has declined. As a consequence, the government has been forced to postpone important reforms focusing on institutional reform.

5. Conclusions

In 2005, Serbia's economy grew by 9 per cent, indicating that the economy is experiencing positive results after 5 years of transition. One of the main issues with transition was to improve the living standard for the Serbian population. During the first two years of transition, absolute poverty fell and standard of living rose. Continued economic growth is key to ensure a steady improvement of per capita income. Moreover, in order to favour a

continued economic growth and increased per capita income, privatisation and private sector development are projected as a valuable response for Serbia's future growth.

The development of the bank sector has proceeded with force and is attracting foreign banks to the Serbian market. Here, the ameliorating confidence of the overall bank market contributes to the fact that banks are starting to experience healthy competition. This is largely due to the liberalisation and privatisation of the financial market. From that, the spillover effects on the private sector are major: access to capital is becoming straightforward with increased competition and overall privatisation. Today, it should be noted that loan decisions are made on economic parameters rather than on political connections. Therefore, more working capital is accessible to private entrepreneurs. However, this phase in transition has been initiated only recently and we can only speculate in the future outcome for the private sector in general.

Private sector development has improved since the transition started but is not gaining enough momentum to dominate the economy. Private sector development has been hampered by the arbitrary legal system and the initial lack of access to working capital. As a result, the private sector has moved towards the informal sector, where working capital is easier to acquire and where contract enforcement is overseen by the own group and not the state. The reluctance of private firms to participate in the formal economy is damaging the Serbian economy as a whole. Reforms to reintegrate them into the formal economy are imperative if Serbia wants to experience a positive future transition.

Privatisation intended to ameliorate effectiveness of the Serbian economy. Five years on, the privatisation process has slowed down due to political uncertainties. Today, the enterprises already privatised demonstrate a higher productivity and a faster economic growth than the SOEs. However, privatisation as a mirror of overall progress towards a market economy is ambiguous. On the one hand, progress has been made by the Serbian authority in adjusting the economy to the new conditions of the market. On the other hand, the ex ante expectations about the economic gains was not satisfied ex post. Consequently, the overall support for a break with the past has lost its initial momentum. To regain this lost momentum, Serbia needs to resolve key political issues, i.e. the final status of Kosovo. Until this problem has been solved, conducting economic reforms will not be as efficient as intended. Political focus on economic transition is prerequisite for further structural reform in the Serbian economy.

The major difficulties encountered by Serbia along its transition process have so far been identified as the deficient legal system and the lack of an effective enforcement mechanism. Besides the damaging effects on civil society, the lack of a proper legal system has distorted the development of the private sector. High costs, timely procedures and an uncertain environment further complicate entrepreneurship in Serbia. The major challenge of the near future is to reintegrate the private sector within the formal economy. A reform of the institutional setting will generate a pro business environment, which will possibly promote exports and private sector development.

The difference between the transition countries of the 1990s and Serbia's transition relies on the fact that the latter avoided the output contraction. The reluctance to privatise the most important industries together with a gradual implementation of market reforms bypassed the expected initial output contraction. The weak response of the private sector from the reform programme is of concern. Compared to its counterparts in East Europe, Serbia is lagging behind in private sector share of GDP. From that, the reforms facilitating the entry and exit of enterprises should be emphasised in Serbia's transition program. This is subjected to an ambiguous economic progress, which could be traced back to political disagreement.

Post conflict reactions gave a clear support for a break with the past, shared among the majority of the Serbian population. However, unresolved issues concerning the war have hampered the Serbian transition.¹⁴ Transition in a post conflict context does not change the fundamentals in creating a market economy. A complete restructuring of the economy is still prerequisite for further reform and international integration. The Serbian experience helps for a deeper understanding of the importance of political factors in the reform process. Transition in a political context, characterised by uncertainties makes structural reforms and privatisation especially problematic. A social consensus on the path towards a market economy must be put above political disagreement in order for the transition to carry on.

¹⁴ E.g. the final status of Kosovo and the extradition of war criminals to the war tribunal in The Hague.

References

Bourdet Y., 1992, Reforming Laos Economic System, *Economic Systems*, 16 (1), pp 63-88

Bourdet, Y., 1995, An Economic Evaluation of the Laos Transition Mix, *MOCT-MOST*, 5 (1), pp 29-51

Brada J., A. Kutan and T. Yigit, 2006, The Effects on Transition and Political Stability on Foreign Direct Investment Inflows, *Economics of Transition*, 14 (4), pp 649-680

Campos N. and F. Coricelli, 2002, Growth in Transition: What We Know, What We Don't, and What We Should, *Journal of Economic Literature*, 40(3), pp 793-836

Claessens S and P.H Fan, 2002, Corporate Governance in Asia: A Survey, *International Review of Finance*, 3(2), pp 71-103

Djankov S. and P. Murrell, 2002, Enterprise Restructuring in Transition: A quantitative survey, *Journal of Economic Literature*, 40 (3), pp 739-792

EBRD, 1999, Transition Report, European Bank of Reconstruction, London
-, 2004, Transition Report, European Bank of reconstruction, London

Fischer, S., R. Sahay, C.A Végh, 1998, From Transition to Market: Evidence and Growth Prospects, *IMF Working paper* (WP/98/52)
-, 1996, Stabilization and Growth in Transition Economies: The Early Experience, *Journal of Economic Perspectives*

George C. and C. Kirkpatrick, 2004, Trade and Development: Assessing the Impact of Trade Liberalisation on Sustainable Development, *Journal of World Trade*, 38 (3), pp 441-469

Goldberg I., B. Radulovic and M. Schaffer, 2003, Productivity, Ownership and the Investment Climate: International Lessons for Priorities in Serbia, *World Bank Policy Research Working Paper* 3681

Gros D. and A. Steinherr, 2004, Economic Transition in Central and Eastern Europe: Planting the Seeds, Cambridge University Press

Gros D. and G. Vandille, 1997, Output decline and recovery in transition economies: causes and social consequences, *Economics of Transition*, 5 (1), pp 113-130

Havryshlyn O., I. Izvorski and R. van Rooden, 1998, Recovery and Growth in Transition Economies 1990-1997: A Stylized Regression, *IMF working paper* (WP/98/141)

Hernandez E., 1997, Liberalization and the Behaviour of Output During the Transition from Plan to Market, *IMF Working Paper* (WP/97/53)

IMF, 2001, First Review under the Stand-by Arrangement and Request for a waiver, IMF Washington

-, 2004, Serbia and Montenegro: Poverty Reduction Strategy Paper, Washington

-, 2005, Selected Issues and Statistical Appendix, Washington

-, 2006, Serbia and Montenegro: Poverty Reduction Strategy Paper- Progress Report, Washington

Jones, C.I., 2002, Introduction to Economic Growth, W.W Norton & Company Inc. New York

Kiguel M and S. O'Connell, 1995, Parallel exchange rates in developing countries, *The World Bank Research Observer*, 10 (1), pp 21-53

Kolodko W., 1999, Transition to a market economy and sustained growth. Implications for the post-Washington consensus, *Communist and Post-Communist Studies*, 32 (3), pp 233-261

Kornai J., 1992, The Post-socialist Transition and the State: Reflections in the Light of Hungarian Fiscal Problems, *The American Economic Review*, 82(2), pp 1-21

-, 1994, Transformational Recession: The Main Causes, *Journal of Comparative Economics*, 19 (1), pp 39-63

-, 2000, Ten Year After "The Road To a Free Economy": The Authors Selfevaluation, Paper for the World Bank "Annual Bank Conference on Development Economics-ABCDE", Washington

-, 2006, The Great Transformation of Central and Eastern Europe, *Economics of Transition*, 14 (2), pp 207-244

Lindbeck A., 1973, Ekonomiska system- ett mångdimensionellt fenomen, *Ekonomisk Debatt*, 1, pp 3-18

Lokshin M. and B. Jovanovic, 2003, Wage Differentials and State-Private Sector employment in Yugoslavia, *Economics of Transition*, 11 (3), pp 463-491

Marangos J., 2003, Price liberalization, monetary, and fiscal policies for transition economies: A Post Keynesian perspective, *Journal of Post Keynesian Economics*, 25 (3), pp 449-469

Markusen J., J. Melvin, W. Kaempfer and K. Maskus, 1995, International Trade: Theory and Evidence, McGraw-Hill International Edition,

Mladen L. and L. Sekelj, 1997, Privatization in Yugoslavia (Serbia and Montenegro), *Europe-Asia Studies*, 49 (6), pp 1057-1071

Motinola, G., Qian, Y., Weingast, B., 1996, Federalism, Chinese Style: The Political Basis for Economic Success, *World Politics*, 48 (1), pp 50-81

North D., 1990, Institutions, Institutional Change and Economic Performance, Cambridge University Press

North D. and R. Thomas, 1973, The Rise of the Western World: A New Economic History, Cambridge University Press

OECD, 2003, National Treatment of International Investment In South East European Countries: Measures Providing Exceptions, Paris

Qian Y., G. Roland and C. Xu, 1999, Why is China Different from Eastern Europe? Perspectives from Organization Theory, *European Economic Review*, 43(4-6), pp 1085-1094

Republic of Serbia, 2005, Impact Assessment of Privatisation in Serbia, *Privatisation Agency*, Belgrade

Roland G., 2001, Ten Years After... Transition and Economics, *IMF Staff Paper*, 48, pp 29-52

Sachs J. and D Lipton, 1990, Creating a Market Economy in Eastern Europe: The Case of Poland, *Brookings Papers on Economic Activity*, 1, pp 75-148

Saywell N., 2006, Serbian Banks Battle for Market Share, *Euromoney*, pp 1

Schumpeter J., 1954, *History of Economic Analysis*, Oxford University Press

Simoneti, M, 1993, A Comparative Review of Privatisation Strategies in Four Former Socialist Countries, *Europe-Asia Studies*, 45 (1), pp 79-102

Wallace C. and R. Latcheva, 2006, Economic Transformation Outside the Law: Corruption, Trust, in Public Institutions and the Informal Economy in Transition Countries of Central and Eastern Europe, *Europe-Asia Studies*, 58 (1), pp 81-102

Williamson J., 1990, What Washington means by Policy Reform. In: Williamson J., (Ed.), *Latin American Adjustment: How much has happened?* Institute for International Economics, Washington, DC.

Winters A., 2002, Trade Liberalization and Poverty: What are the Links?, *The World Economy*, 25 (9), pp 1339-1367

World Bank and the Government of the Federal Republic of Yugoslavia, 2001, *Breaking With the Past: The Path to Stability and Growth*, Volume 1 & 2

World Bank, 2001a, *Federal Republic of Yugoslavia Transitional Support Strategy*, Washington D.C

-, 2001b, *Federal Republic of Yugoslavia Legal and Judicial Diagnostic*

-, 2003c, *Serbia and Montenegro: Public Expenditure and Institutional Review*, Washington D.C

-, 2003d, *Serbia and Montenegro Recent Progress on Structural Reform*, Washington D.C

-, 2004e, *Republic of Serbia: An Agenda for Economic Growth and Employment*, Washington D.C.

-, 2004f, *Memorandum of the President of the International Development Association to the Executive Directors on a Transitional Support Strategy Update for Serbia and Montenegro*

- , 2004g, Country Assistance Strategy For Serbia and Montenegro, Washington
- , 2006, Poverty Reduction Strategy Progress Reports, Washington

Data

IMF Economic Outlook Data:

<http://www.imf.org/external/pubs/ft/weo/2006/02/data/index.aspx>

World Bank, Doing Business: <http://www.doingbusiness.org/>

Serbian Statistical Office: <http://webrzs.statserb.sr.gov.yu/axd/index.php>