



# Serbian post-crisis economic growth and development model 2011-2020.

## **Executive Summary**

Belgrade  
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## Foreword

Serbian Post-Crisis Economic Growth and Development Model 2011-2020 is a result of a joint work of the economists gathered around the publications „Macroeconomic trends and analyses“ published by the Economic Institute in Belgrade, and „Quarterly Monitor“ published by the Foundation for the Advancement of Economics at the Faculty of Economy in Belgrade. The intention of the authors is to emphasize that Serbia in the following decade has to make a thorough U-turn aiming at successful economic growth, since it has run out of all possibilities and presumptions which served as a basis for development in the previous decade. Even before the world’s economic crisis, which has only worsened the situation, especially in the real sector and in the area of employment, Serbia faced two fundamental macroeconomic imbalances. On one hand, too rapid growth of private and public consumption relative to GDP and, on the other hand, too much reliance on the growth non-exchangeable goods in the creation of GDP which increased foreign trade and current payments deficit of the country. Given the over-drying privatization revenues and limited possibilities of further over-borrowing in foreign countries, Serbia has to turn to a new model of economic growth and development, which is pro-investment and export-oriented.

The authors think that the projections until 2020 are optimistic, but also realistic and achievable. It is the only way to achieve dynamic economic growth which relies on increasing employment and productivity, which also provides internal and external macroeconomic stability and which opens the space to increase the living standard on the real basis.

The document includes the four basic parts, which basically boil down to two:

The first relates to the macroeconomic projections of economic growth, employment and productivity by 2020 showing in a consistent way how it is possible to achieve an average annual rate of real GDP growth of about 6%, increase in the number of employees for about 440,000, an increase of productivity which increases the international competitiveness of Serbian economy, doubles the share of exports in GDP, achieves high growth rates of investments, leads to the restructuring of the economy in the direction of exchangeable goods, maintaining the internal and external macroeconomic equilibrium. At the same time, through alternative scenarios, it warns about the dangers and risks if the lower growth rate is accepted, or due to social and political pressures, the “populist” model is accepted, which after a short time, will introduce Serbia into even deeper crisis.

The second part of the document shows what needs to be done to achieve the desired scenario of growth and development: maintaining appropriate fiscal and monetary policy with financial and public sector reform; employment policies, export orientation, with

the restructuring of the economy– reindustrialization, agriculture development, importance of telecommunications and information society development- more even regional development and an emphasis on infrastructure modernization. It is about transitional, reform-oriented and structural processes which create the surrounding for investments and economic activity that leads to achieving the desired goals of growth and development. At the end of the study a Matrix of Activities is provided, which defines the concrete measures and activities as well as institutions in charge of their implementation.

The authors believe that the proposed model is not only a correct development orientation, but also that the proposed development path of Serbia, with respect to all characteristics of our country, is in accordance with the recently adopted strategy “Europe 2020” as a long-term response of the EU to the world economic crisis. Therefore, we expect that the Serbian government consider this document and to accept it as a basis for the development of a comprehensive development strategy of Serbia until 2020.

We wish to thank for all the comments, critical remarks and suggestions which we received from the representatives of some ministries during our work, from the Chamber of Commerce, European Union, the leading representatives of international economic and financial organizations and institutions. Special thanks are due to the USAID which has supported the creation of this document under Serbian Economic Growth Activity.

*Jurij Bajec*

*Belgrade, August, 2010*

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## THE RESEARCH SUMMARY

### 1. MACROECONOMIC PROJECTION OF THE DEVELOPMENT IN SERBIA 2011-2020

#### INTRODUCTION

Even the first democratic Government of Serbia after the political changes of October 2000, when defining development priorities faced two economic, social and political demands. On the one hand, there were high expectations of citizens, completely impoverished during the 90s, for rapid improvement of living standards which is completely understandable if we know that in 2000 the GDP per capita was about 1,600 euros and average salaries were less than 50 euros. On the other hand, the “development gap”, that was created during the sanctions, wars, disintegration of the country and the market of the ex-Yugoslavia, should be filled as soon as possible. Due to the dramatic drop of the economic activity, Serbia in this period lost 150 billion of euros of the potential GDP, caught with obsolete technology and worn equipment, especially in industry, and with production which, by all standards, was lagging behind the demands of world market.

In the last decade, the economic growth and development were conducted in an attempt to achieve growth in both personal and public consumption and, on the other hand, through market reforms, privatization and inflow of foreign investments to create institutional and material conditions for stable development. However, if the results achieved in the period 2001-2008 are analyzed, it can be concluded that they were in the best case very moderate. The achieved average annual rate of real GDP growth of 5.4% seems solid, but was insufficient to compensate for a large development gap in the 90's. The other, bigger problem was the unfavorable structure of creation and use of the growing GDP, which led to increasing exports imbalance due to growing foreign trade and balance of payments deficit. The major components of the economic growth were services.

The main conclusion related to our foreign trade imbalance and future economic growth derives from the ratio of growth and participation of exchangeable and non-exchangeable goods in GDP. In 2001, the exchangeable goods (agriculture and manufacturing) participated in the formation of GDP with 32%, and in 2008 the share dropped to below 24%. As a structural phenomenon, this meant the reduced supply of goods for exports and increased demand for imported goods, even regardless of the fact that the internal demand (and consumption in its framework) grew faster than GDP - which required continuous expansion of the deficit in the balance of payment. This model can maintain until there is sufficient inflow of foreign capital which will, with the appropriate surplus in

the balance of financial and capital transactions, cover the current account deficit that is constantly growing wider due to the influence of the trade deficit. In short, the economic growth achieved, with its structure, did not provide the presumptions for future stable development.

The growth in domestic demand (7.5% per year) and consumption (7.3%), ending with 2008 when the global crisis erupted, was significantly faster than GDP growth (5.4% per year), thus, in 2007 and 2008 the value of domestic demand exceeded the value of the gross domestic product for over 23%. About 19% of the total domestic demand was covered with the excess of imports over exports, i.e. a deficit of goods and services, which grew by 10.9% per year.

Serbia is a leader in terms of share of expenses for pensions and expenses for employees related to overall share of public expenditure in GDP. The absolute amounts are small from the point of customer needs, but it is not due to the restrictive budgetary policy, but because of the low GDP per capita. According to this indicator, Serbia is lagging behind and will remain so if the spending policies remain subordinate to the needs of development.

The gross domestic investments were mainly financed from foreign savings. In the past three years, the ratio between the national and foreign savings in financing investment was between 1:2 and 1:3. Perspectives of capital inflows in the future imperatively demand for a change of this ratio – by increasing the domestic savings.

The main factors of the simultaneous coverage of the growing current account deficit and rising foreign exchange reserves have been foreign direct investment and private sector borrowing. The problems of rapid growth of indebtedness, especially private, arose in 2008 after the outbreak of the world crisis, but they would inevitably appear in the following years due to the exhaustion of resources for privatization by sale, the lack of conditions for the inflow of capital to be replaced by the greenfield investment and high rate of debt servicing.

The concept of economic policy should take into account several important changes in the environment. In the years to come: microeconomic and macroeconomic risks will be more pronounced, the regulatory requirements at national and international level will tighten, the current fiscal relaxation of most countries in the world which prevented the collapse of demand will not maintain for long, and the struggle with recession, the decline in exports, increased unemployment in the world, can encourage governments and central banks of some countries to perform (competitive) depreciation of national currency, which can lead to increased protectionism, trade wars and growing instability in international economic relations.

The economic policy of Serbia, in addition to these factors in the international context, will be determined by domestic inherited problems and future challenges as well. First, the inflation in Serbia, according to international standards, is likely to be relatively high. This conclusion stems from the fact that a deregulation of electrical power industry is awaiting, the market structure generates the final product prices increase, and the growth of regulated prices is unpredictable. Secondly, prospects of recovery of the real sector are uncertain. The increase in unemployment and decline in earnings may lead to wider social problems, political turmoil and orientation of the government in achieving short-term (populist) goals. Third, without reforming the public sector, the budget deficit and public debt would grow. Recovery of the economy and the introduction of the gray economy into the official framework would improve the picture on the revenue side of the budget, and the main challenges for economic policy makers remain on the expenditure side of budget. Fourth, external debt is growing and the debt servicing capacity represents a big threat to economic stability and growth.

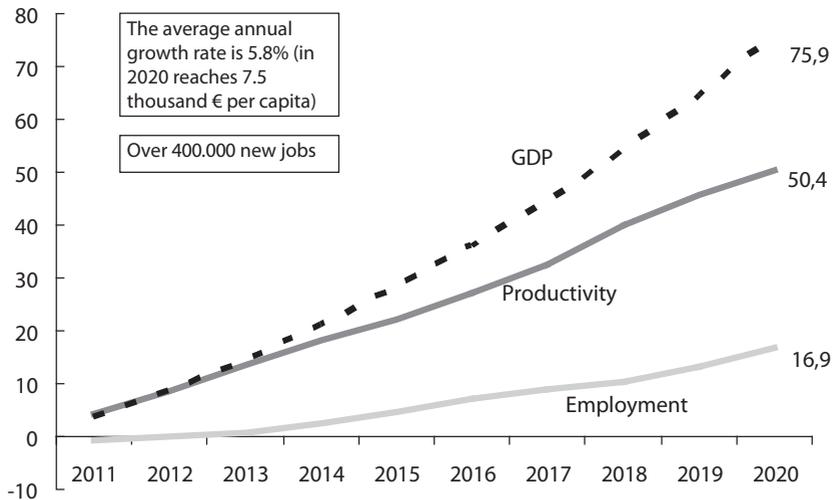
## THE BASIC GOALS AND PRESUMPTIONS FOR THE DYNAMIC ECONOMIC GROWTH UNTIL 2020

**1.1.** The world economic crisis has completely revealed that the previous model of economic growth and development of Serbia is not sustainable and must be thoroughly changed, if we are to avoid the fate of an undeveloped and over-indebted country. Namely, a model which involves considerably faster growth of domestic demand than GDP growth due to the growing share of current account deficit in GDP will function no longer. Given the over-drying privatization revenues and limited possibilities for further over-borrowing abroad, Serbia has to turn to a new model of economic growth and development that is pro-investment and export-oriented.

In this sense, the basic scenario of future development in the period 2011-2020 the dominance of growth of consumption is replaced by the dominance of investment growth. The basic scenario for the period until 2020 involves the award of the EU candidate country status, and finally the status of the EU member, as well as the use of economic benefits that this political development would bring.

The average annual real GDP growth would be 5.8%, and the growth of the domestic demand would be 4.7%. **The final internal demand - due to reduction of the share of the negative net exports, in order to ensure the sustainability of external debt - has to grow slower than GDP!** The value of GDP in 2020 would reach to 52.7 billion euros, or about 7.5 thousand euros per capita. Within this dynamics, by the end of the mentioned period, the productivity would be cumulatively increased by 50.4%, and employment by 16.9% (which corresponds to increasing the number of employees by about 440 thousand). Dynamically, the GDP growth is accelerating over time and is subject to the dynamics of investment.

**Graph 1: Cumulative growth of GDP, productivity and employment, 2010-2020 (in %)**



The projected average annual growth of Industry of 6.9% and construction of 9.7% or 5.5% of services, creates the conditions for changing the economic structure. The share of exchangeable products in GDP would increase from 30.7% in 2009 to 33.1% in 2020, despite the lower average rate and declining share of agriculture - from 9.6% in 2009 to 7.6% in 2020. Namely, the share of industry and construction, taken together, increases from 21.1% to 25.5% (in which the industry increases from 17.4% to 18.5% and construction from 3.7% to 6.9%); on the other side, the share of services drops from 55.3% to 52.9%.

The target parameters in the basic development scenario are:

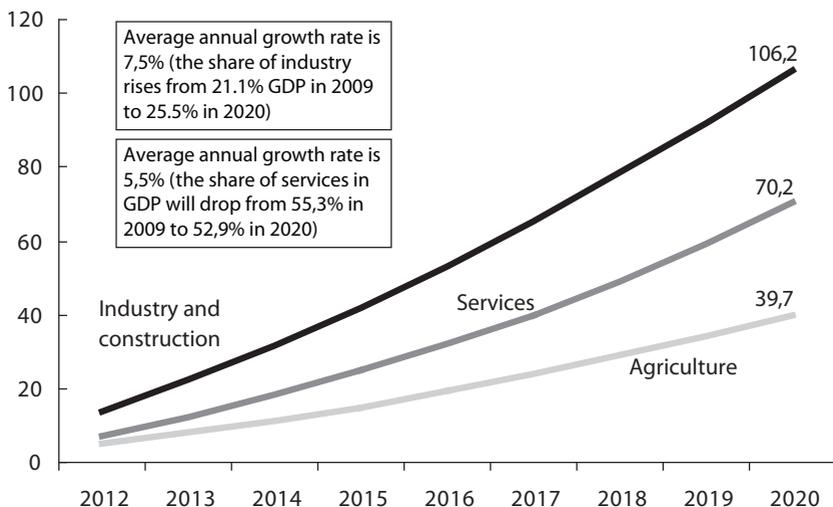
- raising the share of fixed investment to 25% in 2015 and to 28% in 2020 (with an average annual growth rate of 9.7%),
- reduction of the state expenditure share in the GDP from 20.5% in 2009 to 12.4% in 2020<sup>1</sup>,
- raising the share of exports of goods and services in GDP, from 27.6% in 2009 to 65% in 2020,
- significantly narrowing the current account deficit in balance of payments from 7.1% in 2010 to 3.3% of GDP in 2020.

Inflation in the period 2011-2012 is projected at 5%, at 4% in 2013 and 2014 and at 3% in all the years until 2020. The dinar exchange rate would depreciate about 2% per year

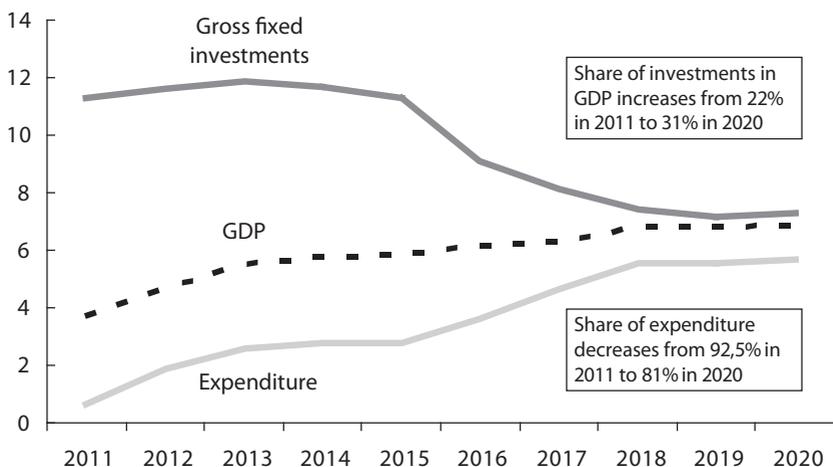
<sup>1</sup> For this purpose, the consumption of the state is a component of GDP usage according to SNA method. From the perspective of consolidated public expenditures it means their decrease from 42.5% GDP in 2010 to 38.5% GDP in 2020.

until 2015, after which it would be neutral (the growth of the euro would be equal to inflation growth in Serbia and the euro zone).

**Graph 2: The manufacturing structure of GDP, cumulative growth 2011-2020. (in %)**



**Graph 3: Inter-annual real growth of GDP, investments and consumption 2011-2020 (in %)**

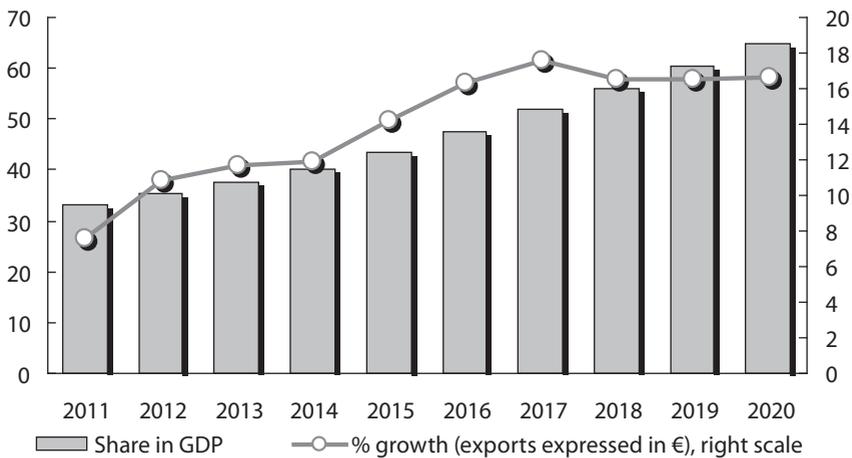


The targeted share of investment will be achieved if their average annual real growth was a 9.7% (for two-thirds faster than GDP growth). The value of these investments would in-

crease from 4.9 billion euros in 2009 (estimated) to about 9 billion euros in 2015 and to almost 15 billion euros in 2020. In addition, the share of gross domestic savings in gross investment would increase from 14% in 2009 to nearly 55% in 2015 and to 61% in 2020.

As for the balance of payments, the main target parameters are: raising the share of exports of goods and services in GDP, from 27.6% in 2009 to 65% in 2020 and reduction of limitation of coverage of imports of goods and services with foreign exchange reserves (from 11 months in 2009 to about 6 months at the end of the observed period). The construction is that in the period 2011-2020 the net inflow of foreign direct investment will bring 22.7 billion of euros (the cumulative amount of current account deficits during this period is about 17 billion euros; the potential grants that would alleviate the situation were not included in the calculation). On the other hand, the gross inflow of long-term loans for ten years would be 51.1 billion euros.

**Graph 4: Exports of goods and services 2011-2020**



Sustainability of the displayed models of development is based on three sets of assumptions that are mutually determined to a large extent.

First, adjustment in the economic system, macroeconomic policy and sector policies, the concept of accelerating economic growth based on replacement of consumer scenario with the pro-investment model of development and shifting the focus of investment towards the exchangeable goods. A special place in this sense is held by a public sector reform. Deviation from these assumptions, especially bearing in mind the upcoming election cycle, is one of the risks for achieving the presented scenario.

The second group consists of assumptions that allow the continuity and acceleration of the EU membership process. When it comes to the economic environment of the Serbian economy, this group of assumptions has another side - the time of recovery of the world economy, on which the projected growth of our exports and economic growth depend on.

Third, and perhaps the most important, is the risk associated with the issue of sustainability of external debt and external liquidity. Serbia in the next five years bears the risk of higher repayment burden of private debt, and its investment cycle needs to be based on foreign direct investments, public loans, and - significant increase of the share of domestic savings in financing investment. The main risk point in the financing the balance of payment is high debt servicing rate, which for the first five years is more or less already fixed and in 2015 it would still be 38% to 39% of the value of exports of goods and services. Hence there comes the imperative to reduce the share of trade deficit and current account deficit in balance of payments in the GDP.

**1.2.** Through alternative scenarios of economic growth there is a warning of dangers and risks in case a lower economic growth is projected for the future and, even worse, if the “populist” model that would introduce Serbia even to a deeper crisis was accepted as a result of social and political pressure.

In the first case, only a small reduction of average annual real GDP growth rate (4.9% instead of 5.8%) in the period until 2020 reduces the number of jobs for over 76,000 relative to the basic growth scenario, the productivity is cumulatively increased by 41% instead by over 50%. The possibilities to increase consumption would be confined to 2.5% instead of 3.5% per year while the investment are expected to grow about at the same pace as the increase in share of exports in GDP, and reform efforts would be approximately the same.

„The populist“ scenario is significantly more dangerous. The projected low average annual growth rate of 3% (with decreasing dynamics over the years), combined with the increase in the consumption of all forms along with subsidized employment in the first two years, would inevitably lead to rising inflation and depreciation of dinar. Such a scenario could not be feasible in the long run since as early as in 2013 there would be dramatic reduction in foreign currency reserves and external debt servicing would take away almost one fifth of the achieved GDP, that is, 60% of the exported goods and services value. **This scenario is not sustainable. Its actual result would be a balance of consumption through high inflation and strong real depreciation of dinar, and the spontaneous transition to the stabilization scenario already in the middle of the observed decade, with the annulment of real consumption growth!**

**1.3.** Unlike Serbia, which began its economic recovery only in 2001, the majority of other transitional countries began their transition to a market economy and supporting economic system reforms back in the early '90s, and accelerated that process in the past decade. Thus, it makes sense to compare Serbia to other transitional countries exactly in these time periods.

- The projected growth rates of gross domestic product and industry given in the scenario of development for Serbia in the period 2011-2020 are comparable with the dynamics of growth of a number of transitional countries in the period 2000-2008 (for example, our neighbors, Romania and Bulgaria).

- In terms of investment growth target the experience of Bulgaria is valuable, having in mind that it managed to raise share of gross fixed investment in GDP by 22.4 percentage points in just 10 years.

- The targeted goal is most challenging in the area of increasing the export competitiveness. International experience shows that achieving the targeted growth of the share of commodity exports in GDP would place Serbia at the top of the most successful countries in transition. However, even with such a fast recovery, the share of Serbian commodity exports in GDP in the end of 2020 would be only 47% due to low starting point, which is the average of countries in transition at the moment.

This brief comparative analysis of basic macroeconomic indicators with comparable countries confirms that the quantitative targets of the new model of economic growth and development of Serbia until 2020 are ambitious but realistically set. However, one should ask the question whether Serbia today, in 2010, from the perspective of the economic environment, implemented market reforms and European integration processes, has reached the level the successful transition countries reached in the previous decade, and on which they based their economic progress. If, in connection with this, we compare data on Serbia's progress according to the EBRD transition indicators, the ranking of Serbia in terms of international competitiveness (Economic Forum in Davos), the successfulness of business conditions (monitored by the World Bank), it should be noted that Serbia is lagging behind. This, among other things, means that Serbia based its economic growth in the period 2001-2008 less on reforms and more on a "consumer model" that was possible due to large privatization revenues and significant, primarily private, borrowing abroad.

Successful transition countries carried out their "first generation reforms" to a significant extent in the period 1990-2000 - privatization, macroeconomic stabilization, price liberalization and foreign economic liberalization. Simultaneously, the "second generation reforms" was implemented- the incentive environment for domestic and foreign

investors, full protection of property and contract, effective judiciary system, a modern tax system, reformed public sector, coordinated fiscal and monetary policies, an efficient banking system and the development of financial markets, developed private and public partnerships especially in the infrastructure sectors, regulated labor market and regulated relations between employees and employers, progress in reducing the grey economy and corruption, political stability - all of which increases the credibility of the country and reduce the risk of investment. In 2004 and 2007, ten countries crowned their success in the transition and acceptance of European standards and norms with membership in the EU, which provided additional momentum for economic development of those countries.

In its reform and transition processes, Serbia reached only half the way. Therefore, the new model of economic growth and development in the next decade requires, in fact, two inter-related u-turns. The first u-turn is related to transition from consumer to pro-investment and export-oriented economic growth. The second turn is needed in the area of accelerating the reform process and European integration and the appropriate macroeconomic and structural policies. It is about creating a lot more attractive economic environment without which the realization of the new model of growth and development would not be possible.

## 2. EMPLOYMENT PROJECTIONS AND TRENDS ON THE LABOR MARKET

The relatively rapid economic growth in the previous period was not accompanied by growth in employment due to transition and restructuring, unfavorable inherited situation, institutional and structural defects and limitations of economic policy. The world economic crisis annulled the first signs of recovery in the labor market that occurred in 2008, as in 2009 the employment rate dropped more significantly than economic activity, and such trend continues. In April 2010, the employment rate dropped to 47%. At the same time, the unemployment rate exceeded 20%.

Employment structure is characterized by a number of unfavorable features - the existence of dual labor markets, employment rate in the public sector is excessive; employment for salary in the private corporate sector is very small; informal and vulnerable employment rates are relatively high, agricultural employment rate of adult population in 2009 exceeded employment rate in the industry; the employment rate and activities of vulnerable groups are very low.

Education and skills have essential influence on the scope and quality of labor supply. Participation of university educated people in active population, aged 25-54, is less than

20%, and is less than the participation of people with no qualifications. In addition, the skills gap is growing and the problem will become more pronounced over the next decade.

Serbia is going to face a difficult and ambitious task in the next decade and it is a convergence with the European Union by cutting in half the current dramatic delay in the rate of employment as the main synthetic indicator of the labor market situation. Namely, the difference in key indicators of labor market between Serbia and the European Union, primarily in the employment rate of working-age population, which is currently 18 percentage points, is one of the most fundamental obstacles to Serbia's EU accession. For the convergence towards the goals set by Europe 2020, it will be necessary to achieve a faster average annual economic growth than the EU average, with simultaneous same or higher intensity of growth.

**Table 2 The Employment Rate in Serbia and EU in 2010 and 2020**

Goals	EU		Serbia		Difference	
	2010	2020	2010	2020	2010	2020
Employment rate (15-64 years of age)	66	73	48	65	-18	-8

Projections of trends of the main contingents in the labor market by 2020 were based on macroeconomic projections of growth of gross domestic product by economic sectors and the respective sector estimates of employment elasticity in relation to gross domestic product by approximately corresponding elasticity in the successful countries of Central and Eastern Europe, and for Serbia in the average it is 0.34 (industry 0.23; services 0.4).

According to projections, total employment will touch the bottom exactly in 2010, but will return to pre-crisis level not before 2013, and will begin to steadily grow at an average pace of over 50,000 persons per year. At the end of the period, total employment will be close to 3 million, which will be about 440,000 employees more than in 2010. Total unemployment, on the other hand, will reach its maximum this year, and will mildly decrease until 2013, which will be accelerated to the end of the projected period, so the number of unemployed in 2020 will be about 340 000.

Analysis of the projected changes in the structure of employment shows that they occur in the expected and desired direction, although their intensity is not going to be very strong. Industrial employment will increase by nearly 170,000 persons, that is, for nearly a quarter, and a share of employment in the industry in the total employment will rise from 24.2% in 2010 to 26.4% in 2020. On the other hand, employment in agriculture will mostly stagnate, which will cause decline in its share in total employment from 24.4% in 2010 to 21.6% in 2020. The relative share of employment in services in total employment will also

rise slightly, from 51.4% in 2010 to 52.1% in 2020, due to employment growth in services of nearly 250,000 people. Please note that this relatively slow growth of employment in the services share in total employment occurs due of the expected stagnation of employment in the public sector.

Detailed projections of trends in the labor market by 2020 show that solid but not spectacular results can be expected, although achieving the basic scenario would contribute to a more significant convergence towards the average indicators of the labor market of the European Union, but lagging behind the European Union would remain significant. Moreover, the unfavorable demographic trends will have a more significant influence on reducing the gap in basic indicators than only moderately positive trends in employment growth.

**Table 3 Structure of employment according to sectors, in thousands**

	2010	2015	2020	Increase	Growth in %
				2020-2009	2020/2009
<b>Employees</b>	<b>2.540,0</b>	<b>2.719,3</b>	<b>2.968,3</b>	<b>428,3</b>	<b>16,9</b>
<b>Agricultural activities</b>	<b>621,0</b>	<b>628,8</b>	<b>640,9</b>	<b>19,8</b>	<b>3,2</b>
<b>Industry</b>	<b>614,5</b>	<b>689,5</b>	<b>782,3</b>	<b>167,8</b>	<b>27,3</b>
Mining	27,3	30,5	34,5	7,2	26,4
Processing industry	422,1	450,8	497,1	75,0	17,8
Production of electricity, gas and water	45,8	46,4	47,2	1,4	3,0
Construction	119,3	161,8	203,6	84,3	70,6
<b>Services</b>	<b>1.304,5</b>	<b>1.401,0</b>	<b>1.545,1</b>	<b>240,6</b>	<b>18,4</b>
Whole sale and retail, repairs	347,2	403,1	498,0	150,8	43,5
Hotels and restaurants	76,4	79,2	82,4	6	7,9
Traffic, warehouses and connections	158,4	177	205,1	46,7	29,5
Other utility, social and personal services	119,1	123,4	128,4	9,4	7,9
Real estate business, renting	89,6	92,5	102,9	13,3	14,8
Financial agents	55,5	57,5	59,9	4,4	7,9
Administration, army, police, and other	128,2	130,3	130,3	2,1	1,7
Education	148,6	152,3	152,3	3,6	2,5
Health care and social protection	174,1	178,3	178,3	4,2	2,4
Other	7,4	7,4	7,4	0	0

In addition to defining the medium-term and strategic goals compatible with the convergence towards the society of higher levels of employment and less poverty, it is necessary to identify carriers of activities and key economic and social actors of the expected changes as well. In the domain of general economic policy, the transition to a new model of growth is expected to bring a radical change in incentives for economic actors, especially through the reform of income tax.

In the domain of institutions and labor market policies the further rationalization of passive measures, especially in terms of severance pay, will be needed. Also, the reform of the Labor Law is needed, in the direction of optimizing the relationship of security and flexibility in the labor market, adapting a widely accepted concept of safety and decent work to domestic circumstances. It is important to emphasize that the character of the optimization of two-way, i.e. that the review of the employment legislation means that some changes should be made in the direction of increased security, and some others in the direction of greater flexibility.

An important prerequisite for the implementation of these objectives and implementation of recommended changes is to achieve a social pact, which should provide additional conditions to increase the competitiveness of Serbian economy, along with the regulation of minimum wages and national coordination of trends in wages. In the early stages of implementation, its inevitable part will be the control of public sector wages. Also, an important goal of the social pact should be a gradual elimination of duality in the labor market, and equating terms and regulation of relations and business activities in different labor markets. In order to achieve these objectives, it is necessary to increase the share of active measures in the GDP in three years, from 0.1% to 0.4%, and then to stabilize that share at about 0.5% of GDP in the second half of next decade.

Demographic decline of the working age population that will accelerate over the next decade will require more efficient education system and increase of the average knowledge and skills of participants in the labor market, especially of the new comers. The more successful implementation of the new model, the higher the risk that the educational system, with its own relatively slow pace of adjustment, would become the bottleneck. This big challenge needs to be viewed through joint adjustment of employment, education and scientific and technological development strategies.

### **3. FISCAL AND MONETARY POLICY IN THE FUNCTION OF ECONOMIC GROWTH**

Macroeconomic policy should ensure a sustainable and credible medium-term economic stability in Serbia and thus create the environment for rapid economic growth. Credibility and sustainability of policies is significantly increased if they are regulated by rules which are legally binding.

### 3.1. FISCAL POLICY

#### FISCAL ADJUSTMENT AND ECONOMIC GROWTH IN SERBIA

Serbia should immediately begin with credible medium-term fiscal adjustment, i.e. reduction of the fiscal deficit, primarily (relative) reduction of the current public expenditure. This adjustment is one of the key levers that Government has at its disposal to ensure an acceptable level of medium-term growth.

The fiscal deficit of almost 5% of GDP in 2010 should be reduced to slightly above 1% in 2015. The main adjustment is to be achieved through the relative decrease (relative to GDP) in current public expenditure, restructuring at the same time the public expenditure. Expenditures for interest will be significantly increased due to growth of public debt. Also, the relative share of public investment must be increased significantly. It means that the current public spending must be cut more than the fiscal deficit. Since its main components are wages in the public sector (from the budget) and pensions, it makes this adjustment more difficult. Finally, the additional problem will be the relative reduction (as % of GDP) in tax revenues if tax rates remain unchanged. Future economic growth, to be sustainable, requires diverting the economy from imports and consumption towards exports and investment. This will lead to a reduction of the tax base, such as imports and consumption, which will result in the reduced revenues (customs fees and VAT) if the same rates are maintained. If the tax rate does not change, it implies is that the current public expenditure must be cut further in order to achieve this necessary fiscal adjustment.

The size of fiscal adjustment Serbia is going to face in the next five years is such that it requires the introduction of solid, legal rules that would ensure the adjustment. The legally introduced rules increase the credibility of the planned reduction of fiscal deficit and keep the public debt under control. Furthermore, the rules should help maintain the anti-cyclical fiscal policy, i.e. that country in good times creates a reserve (budget surplus), which will then be used in bad times; avoiding the pro-cyclical fiscal policy would be a significant result.

Finally, Serbia wants to join the EU. An important prerequisite for this is that the state should carry out the fiscal consolidation - reduce the deficit, limit the growth of public debt, achieve relatively reduced public spending by its restructuring followed by appropriate reforms, etc. Legally introduced fiscal rules should support this.

Serbia, in terms of fiscal policy and adjustments, is going to face the two different periods: first, the fiscal consolidation, i.e. significant reduction of the deficit and control of the public debt growth (until 2015), and then maintenance of the prudent fiscal position and policy. Thus, the two groups of rules are proposed, to match the challenges set: (a) transitional fiscal rules by 2015, and (b) permanent ones, afterwards.

The transitional fiscal rules that would apply until 2015 should provide for reduction of the current consolidated fiscal deficit of almost 5% GDP, at approximately 1% in 2015. In order to achieve this, the proposal is to reduce the deficit of 0.75% of GDP every year. The previous rule should not, however, threaten the ambitious plan of public investment and infrastructure construction. It is therefore proposed to allocate part of these investments from public expenditures when the fiscal deficit is determined to which the reduction applies. Taking into account the current size of public debt in Serbia: (about 35% of GDP), as well as the possible impact of the size of debt (debt intolerance) - public and external - on the potential crisis and economic growth, it seems that the upper limit of 45% of GDP is a good measure for Serbia. We should bear in mind that this amount is added to the still unknown future increase in debt on the basis of restitution.

As additional anchors for reduction of the deficit through the introduction of fiscal rules, we propose the control of wages and pensions so that they should grow more slowly than GDP. Control of wages and pensions through 2012 has already been agreed with the IMF. The period after the 2012 remained partly unregulated. As for pensions, the new draft law provides that after 2012 average pensions should be indexed according to inflation plus GDP growth over 4%. The growth of wages in the public sector after 2012 also should be limited to inflation plus half the GDP growth. The control of the public sector wages and pensions should be only a part of the broader public sector reforms and employment in it, as well as of the pension reform. In this sense, the size of targeted share of wages (8%) and pensions (10%) in GDP is often emphasized. We believe that the proposed transitional rules for wages and pensions should also apply after the 2015 i.e. while the shares for these two major components of current expenditure are reached.

The permanent fiscal rules that would apply after the expiration of the fiscal adjustment, i.e. after 2015, should limit the average (during the 'economic cycle') fiscal deficit to about 1% of GDP. This would, at relatively high rates of economic growth, provide stabilization of public debt to GDP, and probably its relative decline. On the other hand, the high share of public investment of about 5% of GDP would mean that the state saves enough, and that the anticipated small deficit, is primarily a result of large state capital investments. There would be a rule defined that would provide that in the years when economic activity falls well below the potential level the deficit should increase, and when it is above it should decrease and turn into the surplus.

The Fiscal Council, as an independent institution from government, is usually introduced along with the prescribing the fiscal rules, and it should be done in Serbia. It should provide an independent and credible assessment for the general population of the fiscal policy, control the implementation of legally defined fiscal rules, encourage public discussion on fiscal policy, thus raising knowledge and awareness of it.

## **IS THERE SPACE AND JUSTIFICATION IN FAVOR OF SHORT-TERM FISCAL INCENTIVE IN SERBIA?**

The currently highlighted dilemma of economic policy in Serbia is whether now, when the economic activity is significantly below its potential level, it should be stimulated by increase in public spending, or should we immediately start with the medium term reduction of public spending and deficit?

When considering the introduction of fiscal incentives to Serbia, the most important point is the volume of the quantitative effect of the increase of public expenditure on production volume, (i.e. what is the fiscal multiplier). The result, relevant for Serbia, is that developing countries relative to developed countries have multipliers that are lower and of shorter lifetime (less stable). Taking into account the overall effect of fiscal expansion at \$ 1, the GDP will increase by only \$ 0.79 in the developing countries, i.e. less than the increase in public spending. The resulting assessment suggest that a fiscal stimulus leads to squeezing the private sector out, and that part of the increased demand caused by fiscal stimulus would spill over to import and not to domestic production incentives.

Second, the effect of fiscal incentives in developing countries can be reduced if these countries have high (external) debt. Namely, the increase in public spending and the resulting deficit leads to an increase in the already significant external debt, which causes anxiety for lenders and therefore increases the financial cost of borrowing. Interest rates in turn affect the slowing-down of economic activity, thus reducing the effect of fiscal expansion to production increase. In developing countries with high external debt, with a relatively open and flexible exchange rate, increase in current public spending has a minimal effect on the growth of production. On the other hand, the increase in public investment can have a significant effect.

All this together significantly reduces the possibility of massive fiscal stimulus of medium developed countries with emerging markets, which is an important message for Serbia.

### **3.2. MONETARY POLICY AND EXCHANGE RATE**

Serbia needs to maintain current monetary regime, where the main goal is control of inflation, and consequently the exchange rate is flexible. The course should follow its trend while the NBS intervenes only to prevent excessive fluctuations. The monetary regime in Serbia during the crisis was often implicitly and explicitly questioned, primarily because of 'instability of exchange rate', which is a euphemism for depreciation of dinar during the crisis. A flexible exchange rate enabled Serbia, as well as a number of transition countries, to amortize the impact of the crisis by depreciation of the domestic currency and thus prevent the full impact being transferred to a drop in production.

The regime of inflation targeting and flexible exchange rate shows its advantages in getting out of crisis. Namely, in the first half of 2010 Serbia recorded a significant acceleration of exports (20% expressed in Euros, compared to the first half of 2009), while imports saw much more modest increase (4%). In total, the revival, albeit modest, of production in this period came from export growth. Depreciation of dinar over the course of the crisis a part of the economy disproportionately highly - this is the segment of economy which leaned on the overvalued dinar. That part of the economy is based on import and sale in the domestic market, and borrowing abroad and investing in the domestic non-exchangeable sector. Depreciation of dinar is only an external sign of that this growth model is no longer viable, and that restructuring of the economy from production of non-exchangeable to production of exchangeable goods is necessary. Previous restructuring of the economy requires a medium-term period, and the regime of inflation targeting and supporting flexible exchange rate is a good framework that allows turning the economy towards investment into exchangeable sector and its resulting growth. Namely, a flexible dinar exchange rate, through its real depreciation, allows the value of the dinar overvalued before the crisis to be reduced to an acceptable level. The fall of the value of RSD leads first to the reduction of real wages and incomes in general, although less than proportionally, and this leads to the reduction of consumption by the population. Although painful (hence the wide reaction to the depreciation), this reduction of consumption is a part of the inevitable (for future economic growth) adjustment of consumption towards savings and investments. Second, and perhaps more important, stabilizing dinar at a lower, reasonable value enables the medium term net exports to become much more important generator of growth in Serbia.

Targeting inflation, the NBS should continue with the proclaimed policy of gradually reducing inflation in Serbia to the level of advanced transition countries. Low and stable inflation is a stimulus to investment and economic growth. Also low and stable inflation is the crucial factor of de-euroisation or dinarisation of the economy, a process that would bring significant benefits to Serbia and should be supported.

In short term, the question of coordination of monetary and fiscal policies arises. Namely, a strong decline of domestic and foreign demand during the crisis has kept inflation in Serbia under control, despite the large depreciation of dinar. This in turn allowed for the NBS to be very lenient with its monetary policy in the period of crisis and thus provide necessary stimulus to economic activity. Now, in mid 2010, the demand is beginning to recover slowly, and the dinar has depreciated considerably during the first half of the year. If the propagated fiscal stimulus in the form of increase in current public spending was to be added to the above, the declining trend of inflation could easily be stopped or reversed. Then the NBS would have to tighten the monetary policy and raise interest rates in the economy, and thus hamper the recovery of the private sector. It follows that, in the coming period, a much better combination of policies would be as follows: a

looser monetary policy with the resulting lower interest rates which would stimulate the private sector, and the start of the fiscal adjustment through deficit reduction, but also increase in public investment.

#### 4. FINANCIAL SECTOR AND NEW GROWTH MODEL

The financial sector of Serbia after the restoration of the banking business is known for strong dominance of the indirect financing system. Similar property is exhibited by the financial sectors of neighboring countries. National financial system in the medium and long term will be strongly banking-oriented. A key strategic objective in this area is to maintain the stability of the banking system and increase its capacity and competitiveness, while reducing the cost of banking intermediation.

The main strategic goal of development of banking industry in Serbia during the next decade is to preserve the high potential of growth and stability of the banking sector. This means continuing the current strategy with the necessity to increase competitiveness within the sector and between different forms of financial intermediation.

Maintaining high growth potential of the banking sector needs to open up the possibility of its internal diversification. It is desirable to activate diversified form of banking - savings cooperatives in the deposit market and microfinance institutions in the credit markets. These forms of mediation should reduce the costs of financial intermediation in the increase of availability of financial resources.

The main problem between the banking and real sectors is the high cost of banking intermediation. Reducing the excessive range of domestic and foreign, deposit and loan interest rates remains one of the priorities of monetary and financial regulation. On the other hand, in circumstances where there is not enough domestic savings to finance rising investment, the strategy of importing foreign savings remains necessary and desirable. These goals are mutually conflicting. The solution of the conflict is in the strategy of reducing the risk of Serbia and the risk of each business entity in its territory.

Another set of problems is related to the insufficiency and unfavorable maturity structure of domestic savings. The policy of mandatory reserves should equal competitive domestic and foreign savings and discourage short-term bank borrowing abroad.

The changes over the next decade should lead to increased freedom of choice the owners of savings in terms of investment alternatives. Another basic goal of change is increasing the available domestic and foreign savings to finance investment. These

goals are mutually complementary: inclination toward savings and investment should increase with an increase in the number and types of alternatives. The costs of mediation should be reduced due to reducing the impact of implicit institutional monopoly of commercial banking.

In addition to banking an alternative systems of financial intermediation will be developed in the next decade with the aim to increase the supply of financial sources to the enterprise sector and public sector. This is a set of institutional mechanisms based on the development of debt securities of public and private sector. These solutions would enable the financing of investments and increase the available savings without adverse monetary consequences.

Setting up a national development bank (NDB)<sup>2</sup> should provide more efficient financing of infrastructure projects and developing private-public partnerships in these projects. The focus of activities of NDB are pre-defined areas of activity and even pre-defined customer groups. A particular legal definition of the NDB is preferable, as its profile, in almost all institutional solutions, is characterized by high risk and low yield. A separate question of the status definition of the NDB is to define its relationship with the national banking system and especially the central bank. In order to reduce costs and / or increase profitability, the NDB often enters into the domain of activities of central banks or threatens its supervisory authority. This relation is the location of the first possible area of conflict of the NDB and other institutions of the national financial system. That is why the law defines the NDB and standards and measures of its effectiveness. (Thus, for example, the price of public debt is taken as a minimum rate of return on its capital and its minimum value of ROE.) Another important problem to be solved by the NDB status definition is its relationship with the Government. Conflict of the institution with the Government occurs when it constantly seeks additional funds from the state for capital injection, with no reliable findings on the effects of previous investment. Consequently, NDB can become a source of "contagion" that can spread throughout the system by promoting soft budget limits and constant demand for grant funds. In order to reduce losses in such circumstances, the government tightens the administrative control over the NDB or begins to apply the same regulations and supervision which the central bank implements for the commercial banks.

Particularly important part of the evolution of the national financial system is government bond market. The development of this market began in the circumstances of the global economic crisis. In this initial phase of market development, it should be insisted on the issue of bonds with maturity of one to several years (1, 2, no longer than 3). With

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2 The term national development bank, in the text that follows is used to refer to the official definition of the UN or as a financial institution that is primarily oriented to offer long-term source of funding for projects that generate positive external effects, and that private creditors are not funding sufficiently. A typical case of a project with high external effects is an infrastructural project.

the stabilization of the market, the maturity of the instrument is gradually extended. An important factor in the selection of maturity and the type of instruments in this market is the level of current and expected inflation. In the presence of inflation, the increase in risk premium in the yield curve of debt instruments is inevitable. Another important effect of the presence of inflation is a relatively short maturity of instruments. Gradual extension of maturity of instruments issued could be tackled only with the creation of a high enough level of confidence in the new instruments and stabilization of macroeconomic conditions there. Issue of debt securities with medium term maturity horizon would provide investors with an alternative to investment in equity securities or deposit funds into banks.

Obtaining funding for long term investment could be done more intensively on the Eurodollar market. With the development of local debt instruments markets, it would gradually be possible to increase both their maturity and credit rating. Preconditions that must be created locally to approach the international capital markets more seriously, include: several years of good economic performance and good macroeconomic forecasts for the future period, the sustainability of total public debt management strategies, steady economic growth, inflation which is controlled and smooth financing of deficit of the current portion of balance of payments, structural reforms, good information as well as political stability. Then the process would likely be supported by the IMF.

## 5. REFORM OF THE PUBLIC SECTOR

Directions for reform of the public sector are many and varied. One of the most important is to improve investment and business environment in order to reduce costs and risks of doing business in Serbia. Key activities are to improve the regulatory functions of the state and the modernization and construction of transport, energy, utilities and telecommunications infrastructure. Another direction of reforms is the reduction of public spending to about 40% of the GDP and fiscal deficit to about 1% of the GDP in the medium term. The third direction of reform is the change in the structure of public expenditure and the structure of the tax system in the direction of stimulating investment, employment and growth. In the case of public spending that means increasing the share of public investment, and reducing the current consumption, while in the case of taxes, it means reducing the tax burden of labor and increase of tax on consumption. The fourth direction of reforms is the improvement of efficiency of all segments of the public sector: education, health, justice, customs and tax administration, local administration etc. Finally, improving the efficiency of the republic, local and provincial public enterprises, the continued liberalization of infrastructure and utilities, as well as the partial privatization of public enterprises are an important component of public sector reform.

Regulatory function of the state can be significantly improved by simplifying administrative procedures, reducing corruption, improving competition policy, strengthening of financial discipline and regulation of property rights.

Administrative barriers that are manifested in the form of complex, non-transparent and unnecessary procedures increase cost of doing business in Serbia. Filling in the unnecessary and complicated forms, the obligation of obtaining a large number of permits for conducting activity, long period in which companies are waiting for permits, opinions and interpretations of regulations – all these directly increase the cost of doing business. The removal of administrative barriers in Serbia began by the so-called guillotine of regulations, but failed to simplify or terminate regulations that hamper the operations of the economy most. Therefore, in the future focus should be placed on regulations that effectively restrict business. Regulatory guillotine should be a permanent activity of the state, which would represent a counterweight to the permanent tendency of the state to promulgate difficult, and occasionally unnecessary regulations.

The high level of corruption increases the cost and risks of doing business and violates the equality of market competition and is a serious obstacle to investment and doing business in Serbia. According to the corruption perception index, Serbia is in the 83rd place in the world and it is much worse placed than most countries in Central and South-eastern Europe. Doing away with unnecessary and complicated regulations, improvement of judicial authorities, tightening penalties for corrupt officials all are the key measures to reduce corruption in Serbia.

Effective functioning of product markets in Serbia is an important requirement for long-term sustainable economic growth, including improving the existing legal framework for competition policy. In the coming period, the biggest improvement should occur in the area of improving the professional capacity of the Commission for the Protection of Competition, as well as in the segment of the sanctions that punish entities that abuse a dominant market position. In addition, the liberalization of some infrastructure services (power generation, rail transportation, natural gas distribution, etc.) would contribute to increase the efficiency of their work.

The successful functioning of the economy requires the existence of market financial discipline, which means that all market participants settle their obligations in accordance with the contract and the law. In Serbia, ten years after the beginning of the transition, there is still widespread financial indiscipline, obligations are settled with a lag or not at all. Key measures for improvement of financial discipline are to improve the efficiency of enforced collection, shorten deadlines and reduce cost of bankruptcy procedures and prevention of the abuse of monopoly position of the big supermarket chains. Resolving the fate of the companies undergoing restructuring would also contribute to the strengthening of financial discipline.

Effective functioning of a market economy requires clearly defined property rights. The process of privatization of socially owned enterprises has significantly contributed to the definition of property rights in Serbia. However, some segments of the property rights are still not clearly defined and therefore generate operational risks in the economy. It is therefore necessary as soon as possible to resolve issues of restitution, undertake the privatization of urban construction land, as well as to delineate property rights between the various levels of government.

Current state of infrastructure in Serbia is poor. Building a modern transportation, utilities, energy and telecommunications infrastructure directly contributes to reducing the cost of doing business in Serbia.

Parts of public sector reform includes the harmonization of the level and structure of public spending and tax revenues to the level of development of the country and long-term target growth rate. Maintaining macroeconomic stability, which is one of the preconditions for economic growth, requires that the fiscal deficit be reduced to a level that ensures that the public debt relative to the GDP remains on a long-term sustainable level. The general balance sheet framework for the consolidated government sector is defined by the Draft Law on fiscal responsibility which has already been discussed. If the current tax rates remain unchanged or if revenue-neutral tax reform is implemented, the share of consolidated public revenues in the GDP will stabilize at around 39% that the fiscal deficit of 1% of the GDP puts the consolidated public expenditure at the level of 40% of the GDP.

**Table 4 Projection of Consolidated Public Expenditures, as % of the GDP**

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Expenditures	42,5	42,2	42,1	41,8	41,1	40,6	40,1	39,7	39,1	38,8	38,5
Current expenditures	38,2	37,2	36,4	35,8	35,1	34,6	34,1	33,7	33,1	32,8	32,5
Salaries	9,8	9,6	9,3	9,1	8,9	8,7	8,5	8,3	8,1	8,1	8,2
Goods and Services	6,8	6,3	6,1	6,0	5,9	5,8	5,8	5,8	5,8	5,8	5,8
Interests	1,2	1,5	1,6	1,8	1,9	1,8	1,8	1,8	1,8	1,7	1,6
Subsidies	2,2	2,0	1,8	1,8	1,8	1,8	1,8	1,8	1,8	1,8	1,8
Transfers	18,2	17,8	17,6	17,1	16,7	16,4	16,2	16,0	15,7	15,5	15,2
Pensions	12,6	12,4	12,3	11,9	11,6	11,3	11,0	10,8	10,5	10,3	10,0
Other transfers	5,6	5,4	5,3	5,2	5,1	5,1	5,2	5,2	5,2	5,2	5,2
Capital expenditures	3,5	4,3	5,0	5,5	5,5	5,5	5,5	5,5	5,5	5,5	5,5
Budgetary loans, net	0,8	0,7	0,7	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,5

Reducing overall public spending and cutting the share of current public expenditure in total consumption (in addition to limiting the growth of salaries and pensions) requires that other components of current expenditure, such as expenditures for goods and services, subsidies, budgetary loans exhibit slower growth than the GDP. The condition

for the reduction of subsidies and budget loans share in the GDP is the transition from policy of attracting investment by subsidies, to attracting investors by favorable environment. In addition, for subsidy reduction it is necessary to raise the price of utilities and complete the restructuring of socially owned enterprises. Reducing costs for purchasing goods and services can be achieved by reforms of the sector of major consumers of goods and services, and by general improvement of public procurement procedures.

**Table 5. Fiscal deficit, deficit financing and public debt, % of the GDP**

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Fiscal deficit	-4,6	-4,3	-3,8	-3,2	-2,3	-1,8	-1,3	-0,9	-0,3	0,0	0,3
Primary fiscal deficit*	-3,4	-2,8	-2,2	-1,4	-0,5	0,1	0,5	0,9	1,5	1,6	1,8
Financing of fiscal deficit	-4,6	-4,3	-3,8	-3,2	-2,3	-1,8	-1,3	-0,9	-0,3	0,0	0,3
Net borrowings	-4,4	-2,6	-2,3	-2,2	-1,8	-1,3	-1,3	-0,9	-0,3	0,0	0,3
Public debt	37,0	38,3	38,9	39,0	38,6	37,6	36,7	35,4	33,3	31,1	28,7

Note: \* the primary fiscal deficit is the fiscal deficit corrected for the amount of net interest.

The reform of the tax system in the direction of reducing taxes on labor and increasing taxes on consumption would contribute to creating favorable conditions for employment, investment and exports while consumption and imports would not be stimulated. These objectives in the case of Serbia could be achieved by reducing the rate of social security contributions and increasing VAT. Low Corporate income tax rate makes the existing generous tax breaks seem superfluous, and their elimination is justified. Property tax reform would be achieved through: better capturing of property, tax base harmonization with market value of the property, replacing the percentage expressed tax credits by fixed amounts, etc. The expected result of the reform of property taxation is a more fair taxation but reforms would probably bring additional tax revenues as well. Balance sustainability of the overall tax reform implies them to be revenue neutral, but it is estimated that the increase of tax revenues by 0.5 to 1% of the GDP would not exacerbate the competitiveness of the Serbian economy.

In addition to changes in the structure of public expenditure towards growth in the share of public investment, what is required is the reform of the largest public sector income consumers: pension system, education, health care and social assistance.

The main objectives of the reform of pension systems in the medium term the reduction of spending on pensions in the GDP, increased redistribution from richer to poorer pensioners and the introduction of social pensions. Key measure to reduce the net expenditure for pensions from about 12.5% to about 10% of the GDP is the application of appropriate rule of indexation of pensions. The rules contained in the drafts of pension law

and the law on fiscal responsibility, along with other pension reforms, would reduce the expenditures for pensions to the specified level during the second half of the next decade. Certain savings in the medium term can be achieved by raising the minimum age limit, by reconsidering the entitlement to reduced service years, etc. Significant savings in the long run can be achieved by a gradual equalization of retirement age for women and men. The current level of redistribution from richer to poorer pensioners in Serbia is very low, it is necessary in the future to increase the degree of redistribution. Savings in the expenditure for retirement, that would be achieved through these reforms, would create the conditions for introducing a social pension for all elderly persons in the next decade (e.g. over the age of 70), who have no other sources of income.

Reform of the health care system and education system should contribute to improving the quality of their services, which is essential for the growth of human capital - one of the main determinants of economic growth.

On the basis of technological, demographic and other trends it is unlikely to expect the reduction of public expenditure on health in the GDP of Serbia in the future. Therefore, the main goal of reforms is to ensure higher quality and better access to health services by reallocation of existing expenditures. Increasing the efficiency of health services requires a transition from the current way of financing the cost to financing the performance, but also a substantial rationalization of the health system (reducing the number of non-medical staff, reducing the number of beds in hospitals etc.) to release the funds for its modernization.

Share of expenditures for education in Serbia is at the level of the regional average, but its results are weaker, from which it can be concluded that there is significant scope for increasing the efficiency of the education system. Rationalization of the network of primary, and to a lesser extent, secondary schools and moving to a per-student funding can achieve significant savings. In accordance with tendencies in highly developed and rapidly growing economies, it is necessary to introduce compulsory secondary school education over the next decade – as it is only after finishing secondary school that a student is trained for active participation in the labor market. The introduction of compulsory secondary education would probably not require significant additional resources, regarding the extra space and teachers in secondary schools. An important part of education reform is also improving the quality of university education, both public and private. In the case of public education, the key measures are the systematic quality improvement of curriculum and teachers, while in the case of private education the role of the state is primarily regulatory.

Public expenditure on social protection in Serbia is significantly lower than in neighboring countries, and prevalent expenses in its structure are not dependent on the financial

situation of the beneficiary. The reform of the social security system means increasing the amount of social support, reduction of administrative barriers to getting help, and reducing regressive nature of some forms of social assistance. Improving access and increasing the amount of social assistance would contribute to a relocation of social functions from enterprises.

Public enterprises (Republican, local and provincial) are an important part of the Serbian economy. They employ over 140 thousand workers, which is just over 7% of the registered employment. Since many of the public companies operate in capital intensive industries, their importance for the social wealth they engage is even higher. Although significant reforms in public companies were implemented during the last decade there are still major reform challenges before them, such as the continued restructuring, defining the strategy of privatization and liberalization of the activities in which public enterprises operate.

The common element in the restructuring of public enterprises is to improve the management of enterprises by the state because large-scale public investment will be realized through them in the coming years. In the majority of public companies it is necessary to further reduce employment through the restructuring process, while in some of the public companies there is need for further price increases as well as organizational changes, which would separate activities that have the character of the natural monopolies from the activities where competition is possible.

Privatization of public enterprises and liberalization of the activities in which public companies operate is one of the most important areas of economic reform in the next few years in Serbia. Liberalization of infrastructure and utilities as well as solving their property and other relations with the state or other public companies should precede privatization of public enterprises. However, liberalization of infrastructure and public utilities, except for natural monopolies, is desirable even if the state does not intend to privatize the public enterprise that operates in the said sectors. Further progress in the liberalization of infrastructure and municipal utility services requires improvement of the regulatory bodies. Effective functioning of regulatory bodies is a necessary condition as a state monopoly would not be replaced by a private one.

## 6. REINDUSTRIALIZATION

Industry of Serbia has not made a significant contribution to the transitional economic growth. Industrial production in 2009 was just 2.9% higher than in 2001, and industry participation in the creation of gross domestic product during this period fell from 21.7%

to 17.4%. Lack of intensive investments in the modernization of equipment and technology to improve manufacturing processes, on one hand, the unfinished privatization and restructuring of remaining large SOEs in the processing industry, large public enterprises and infrastructure services, lack of an effective process of liquidation or bankruptcy, and insufficient encouragement for post-privatization restructuring, on the other hand, represent key constraints to the efficient creation of a new economic structure.

According to the assumptions of the new model of growth and development, the average annual increase in industrial production in the period 2011-2020 is projected to 6.9%, and, in the total industry, the processing industry should be increased annually by an average rate of 7.3%. This movement would lead to an increase in share of industrial production in the GDP from 17.6% in 2011 to 19.1% years in 2020, and the processing industry from 13.0% to 14.7%.

Reindustrialization should imply a relatively greater increase in areas that, firstly in the transition period had a relatively large gap, and secondly, areas that bring greater added value. Targeted sectors are medium-and high-tech industrial production. More specifically, the following industrial fields: chemical industry, manufacturing machinery and equipment, transport equipment manufacturing and electronic industry. This group should include the food industry, given the results so far and possible expansion of this industrial area.

**Table 6. Designed share of sectors and industries in the GVA and growth rates**

Sectors	Share in the GDP		Growth rates
	2008.	2020.	2008-2020.
<b>Low-tech</b>	<b>50,7</b>	<b>43</b>	<b>6%</b>
Food production	29,9	24	4,1%
Textile	4,9	5,2	8%
<b>Medium-low-tech</b>	<b>25,4</b>	<b>22</b>	<b>6%</b>
Coke and petroleum derivatives	0,3	0,4	8%
Rubber and plastic	6,0	5,5	5%
Other minerals	6,0	5,6	6%
Metal	13,1	10,5	5%
<b>Medium-high-tech</b>	<b>16,4</b>	<b>23</b>	<b>10%</b>
Chemical	7,7	10	10%
Machines and equipment	5,0	7	8%
Means of transport	3,8	6	11%
<b>High-tech</b>	<b>7,5</b>	<b>12</b>	<b>12%</b>
Electronics	7,5	12	12%

Growth in production will support the massive investment provided that the share of processing industry in total FDI inflow in the next decade increases to about 40% from the current 30%. The total inflow of FDI in the processing industry in the observed period would have to exceed 9 billion euros.

Activities that may encourage reindustrialization and which can achieve the stated goals are classified into three groups: improving the business environment, direct and indirect state measures.

The basis of industrial policy is structural reforms and infrastructure investments. The main task of the state administration should be the review and removal of restrictions on the development of entrepreneurship. This reduces operating costs, shortens the time required for administrative tasks, improves the environment for investment and improves the position of Serbia on the relevant rankings of international competitiveness, which contributes to lower borrowing costs for the state and the economy.

Indirect measures are guarantees and insurance, technical assistance, specific organizational forms of support operations, innovative mobilization of financial resources. The state would guarantee the obligations of the companies on the basis of: investment programs, contracted export business and contractual liability of companies in targeted industry sectors and devastated regions. Technical assistance to companies is preferred in two areas. The first is the support to the development projects and other field is training. Specific organizational forms of business support include support to the development of business incubators, clusters, technology parks, free industrial zones and export zones. Ways of state support to development of venture capital funds can be different: the establishment of state venture capital fund, state investing in private venture capital funds, state financing of private venture capital fund, the establishment of joint public-private venture capital fund (public-private partnership), the financing of business incubators, giving guarantees to investors investing in private venture capital funds, tax incentives for operation of venture capital funds.

Direct measures include lending to the economy according to clearly set principles. In institutional terms, it is necessary to translate dispersed development activities of the state into one institution. State loans to industrial producers need to have several components: loans for start-ups in all sectors, loans for start-ups in the targeted sectors, loans for small and medium enterprises in all areas, loans for small and medium enterprises in targeted sectors, loans for regional development, loans for investment, export credits, loans for innovators.

In institutional terms, the centralized concept of the institutional framework implies transitioning of all desirable development activities of the state into one institution. Apart

from development bank and business in the domain of this institution, the centralized development institution of Serbia would include other proposed measures of industrialization. The advantages of such a solution would be multiple:

- A stronger coordination and more complementary implementation of economic policy measures;
- Apparent overlap of some activities and the lack of other development activities, and thus creation of preconditions for more efficient and cheaper public services work;
- The development institution would have a better view of actual and necessary measures of industrial policy, and the bottlenecks in the state support the development would be more noticeable;
- Government assistance programs would be recognizable to the public, and the effect of attracting industry and involvement in development projects would be significantly higher compared with the current concept;
- The prerequisites would be met for a deeper and more comprehensive communication between the state and the economy and, hence, adjustment of industrial policy for the real needs of companies;
- Clients (companies) would get the optimal assistance, it would be possible to assess whether they are eligible for a business incubator, a cluster, the credit for innovation, credit for small and medium enterprises, or some other solution;
- The company could be supported in several stages, from innovation financing to help the export of products;
- The foreign programs, and links to international and regional institutions would be achieved in a more efficient way, so the utilization of foreign funds would be higher;
- The construction of a new economic structure requires attributing greater importance to investment in innovation, business incubators, technology parks, together with universities and research institutions, and greater attention to these activities could be given in a centralized institution;
- Various components of state intervention would be more effective: an analytical device to assess customer risk, high transparency of the supported projects, monitoring results and informing the public.

The dynamics and structure of budget expenditures for industrial policy should keep the total costs for industrial policy at about 1% of the GDP and to provide change in the structure of current expenditure in accordance with the (new) principles of reindustrialization.

The main risk for the successful implementation of reindustrialization and achieving the projected growth rates is the absence of preconditions for reduction of consumption in the GDP and for the increase of investment in the GDP, according to the implications of the new model of development. The risk is in the slow recovery of the global and, in particular, the European economy as well, as high growth rates of production and exports

are conditioned by increased absorption of Serbian products abroad. What is necessary is to improve the business environment continuously and effectively. Finally, it is necessary to foresee and allocate necessary budget funds for industrial policy - about 1% of the GDP or about 302 million euros in 2011 and about 527 million euros in 2020 - and that it be used in the thought out manner and in accordance with the guidelines of the (new) industrial policy.

## 7. AGRICULTURAL DEVELOPMENT POTENTIAL

Production and economic effects of agriculture in Serbia are not at the level provided for by the rich natural resources, and are lagging behind competing countries in the region. The growth rate of net agricultural production over the past decade amounted to an average of 1.3%, while the gross value was 1.9%, which are lower values compared to the 1980s period. The reasons for the slow growth can be found in: (a) Technical and technological backwardness arising from insufficient investments in technical equipment, transfer of knowledge and new technologies, which has been present for the second decade already; (b) Slow change of agricultural structure dominated by small farms with irregular and modest surpluses and non-standard quality products; (c) Poorly conducted privatization process, resulting in the desintegrated production chain in food production; (d) Slow adjustment to the demands of the international market in terms of standards and procedures related to the food health safety; (e) Unstable support system, which has dynamically varied both in the volume of placed assets and in their allocation and structure of potential users.

The agriculture in Serbia needs urgent and radical intervention, in order to readily welcome the upcoming liberalization of the most vulnerable sectors and provide greater contribution to the growth of national economy. Projected optimistic growth model anticipates an average growth rate of 3,4 % in agriculture, over the next ten years. Bearing in mind the structure of agricultural production in Serbia, the available resources and the achieved level of productivity, it was determined that changes must take place primarily in the direction of:

- Productivity growth, yield stabilization and production structure changes in crop production - Primarily production of grain (wheat and maize), vegetables and fruits (certain sorts) has large space for growth in yield. Production results achieved in the industrial plants production is at the level of developed European countries and there is not much space left for the growth in yield. On the other hand, there is a potential for industrial plants area growth (oleaginous plants, energy crops), which would significantly contribute to the growth of agricultural production value, but also to the necessary change in its structure. Only potato, of all vegetable crops, has

a significant impact on the growth of agricultural production value, but its yields are far below the objective capacities. By increasing the crop yield, expanding the product range and production of vegetables indoors, this group of crops would provide a more significant contribution to the growth of agricultural production. Production effects of fruit (most types) and grape production are significantly lagging behind the developed countries and are modestly participating in the agriculture value. Growth opportunities are limited due to the lack of the labor force and large funds therefore required. Development of these activities must be directed towards new technologies and quality standards.

- Achieving greater representation of livestock in the agricultural production value by stopping the negative trends of livestock and meat production of all kinds, as well as through the growth of milk production. The participation of livestock in the value of agricultural production dropped to about 30-35%, which is a very low value and an indicator of under-developed agriculture. Without the development of livestock, Serbian agriculture will remain exporter of cheap raw materials, which is an unacceptable solution from the aspect of the food industry development. Growth of production value would benefit mostly from the improvement of cattle and pig breeding. Both sectors are facing the problem of an unorganized market, expensive stock - feed (as consequence of field crop yield fluctuation), slow implementation of standards and the gray economy. Pig and cattle breeding, due to its sensitivity, shall be among the last to be affected by market liberalization, which leaves room for the negative trends to be stopped in the next mid-term (3-5 years) period and start the growth phase.

In order to accomplish such an ambitious plan, it is necessary to accelerate, intensify and provide adequate financial support for the activities in the area of:

- Building a stable and sustainable agricultural sector, which will be competitive in the domestic and international markets and contribute to the growth of GDP and exports;
- Structural improvement of the sector which is set as a long-term goal, and whose realization will largely depend on employment growth and the speed of restructuring of the other parts of the economy;
- Establishment of an efficient legal and institutional framework, harmonized with international standards and integration process requirements. This is the primary goal, whose achievement requires: complete and radical reform of the agricultural policy, faster harmonization of national legislation with EU requirements, recruitment and strengthening of human resources in the area of administration, establishment of new and reform of the existing institutions ready to meet the complex requirements of the sector transformation and to ensure successful withdrawal of EU pre-accession funds.

The proposed measures, whose realization dynamics and implementation actors are listed in the activity matrix, are sublimated as:

1. Increase in total support to the manufacturers and expansion of list of potential beneficiaries;
2. Introduction of direct payment system in livestock production;
3. Support to investments in machinery, equipment and facilities, better adapted to real needs of farms throughout the territory of Serbia;
4. Opening of microcredit organizations that deal with the financing of agriculture;
5. Investments in land infrastructure (protection of land from the negative effects of water and other forms of degradation);
6. Development of an efficient system of transfer of knowledge and new technologies and its implementation in production practice (advisory sector development);
7. Stabilization of the market and reduction of the gray economy (more rigorous control, financial and market one, and more efficient sanctioning of business entities that operate in agricultural products trade);
8. Support to cooperatives and associations of producers;
9. Introduction of standards HACCP, ISO 22000, ISO 14000, Global GAP, GHOST, and certification of products in food production according to religious standards (“Kosher” and “Halal”):
  - Accreditation of national laboratory system for food control and certification in the food safety chain; training of the inspection services staff,
  - Full and effective implementation of the integrated border management system;
10. Activation of the land market, strengthening of land rental and trade market;
11. Complete reform of agricultural policy and support systems:
  - Accredite the Administration for Agricultural Payments, establish Management Authority and the Inter-ministerial Group, as well as other structures and bodies;
  - Continuous education of personnel, especially in the field of EU integration requirements;
  - Regulation of cadastral records, register of farms, FADN (Farm Accountancy Data Network), implementation of the Agriculture Census.

## 8. ELECTRONIC COMMUNICATIONS AND INFORMATION SOCIETY

For the economy, electronic communications represent means to modernize and increase competitiveness, and for the citizens they are means for better access to information and improvement of the quality of life. According to OECD research, increasing investments in electronic communications for 8% affect the increase in GDP by 1%. Application and more intensive use of information and communication technologies in all areas of life and work of people lead to the formation of the modern “information

society". Development of information society will affect the increase in employment, economic development and improvement of standard of life. In the period 2001-2009, transport, storage and communication gross value added (GVA) growth increased in Serbia by the high annual average rate of 14,9%. This was mainly contributed by the telecommunications (and postal activities), whose GVA is involved with about 44% in total GVA of the transport, storage and communication sector.

**Electronic communications** sector includes construction, maintenance, use, and lease of public communication networks and equipment, as well as providing electronic communication services. Major shift in the market of *fixed telecommunication* services has been made by issuing the license (in February 2010) to the second operator for the fixed telephony, Telenor company. In this way the first step towards the factual abolition of monopoly and fixed telecommunication network market liberalization was made, providing access to competition and new investments in the fixed telephony sector. *Mobile telephony* faces expansive growth and it is the most profitable part of telecommunications. Market entry of the third operator of mobile telephony has raised the level of the competition and furthered market liberalization. There is a fight for the market among the competitors, accompanied by reduction of prices of services, improvement of service quality and introduction of new technologies. The number of mobile phone users in 2009 reached 9.912 million, and total generated traffic amounted to 8.2 billion minutes, which is 39% more than in 2008. Penetration is 132,2%. Signal coverage of the territory and the population is high, but still not complete. Internet services market is constantly expanding. Growth of service providers and users has been recorded. Total number of fixed Internet connections in late 2008 amounted to 865.9 thousand. It is expected that by 2014 there will be 1.9 million broadband connections in Serbia.

The objectives are digitization of telecommunication infrastructure, reaching an average European level of development in the field of electronic communication, enabling the Internet to be accessible, fast, cheap and safe, encouraging the development of the web economy, increasing the participation of domestic industry, providing efficient access to information and knowledge, etc..

The area of electronic communication and information society will be regulated by the digital agenda of Serbia, comprising Electronic Communication Development Strategy in the Republic of Serbia from 2010 to 2020 and Information Society Development Strategy in the Republic of Serbia by 2020.

Development of electronic communications in the coming years will be directed towards the improvement of the existing state of infrastructure, development of services, introduction of new technologies in all areas, upgrading of electronic communication industrial equipment sector, environmental protection, etc.. The national network will

be formed after the model of open optical network and shall be based on the existing infrastructure of different operators. *The development of broadband access to the network* will influence the upgrading of economy through networking of economic regions in the country, increase of competitiveness, improvement of communications, etc.. World Bank research indicated that 10% increase of penetration of broadband connections in the world affected the increase in GDP by 1.3%. Development of a national broadband communication network will provide introduction of *services for public administration, health, education, justice and business sector*. To ensure the promotion and extend range of quality service offer to the users, it is necessary to stimulate competition between the network access operators. *Transition from analogue to digital broadcasting* will be based on: establishment of regulatory framework, design and implementation of distribution network MFN / SFN, adoption of the Allocation Plan for radio frequencies for the period after 2012, STB procurement and adoption of measures to encourage domestic manufacturers of the required equipment.

Development of **the information society** will be improved by: implementing information and communication technologies in public administration, health, justice, education, science and culture; encouraging the e-trade development, consumer protection and coordination of e-trade development; human resources development; development of innovative start-up companies; intellectual property protection for software and digital content and information security improvement. For the development of "information society" it is necessary to ensure the availability and accessibility of information and communication technology (ICT) to all. In order to achieve that, it is necessary to provide fast low-cost access to the Internet, primarily through telephone lines or cables, and through wireless technologies and satellite. Electronic network should be sufficiently secure (against hackers and viruses) in order to build customer confidence in electronic payments and secure the privacy of citizens.

In order to maintain competitiveness and monitoring of the dynamic development of information society and electronic communications, the investments of 5 billion Euros are estimated in the stated strategies. Funds for the implementation of the stated projects will be provided, besides SDI, by international organizations, donations and through public-private partnership

## 9. EXPORT GROWTH

Serbia has achieved relatively high annual growth rate of exports of goods and services in the period 2001-2008 (20.9%, in Euros). However, even such a high growth did not contribute to increase of the participation of commodity exports in GDP (22.2% in 2008,

which is the second weakest performance in Europe, after Albania). This has created a large foreign trade deficit (24.1% of GDP in 2008) that decisively influenced the record deficit in current foreign payments (18.7% of GDP in 2008). Coverage of commodity imports with exports amounted only to 47.9%. At the same time, the export structure - raw materials, processed material, food - clearly indicates that this is exports which is typical of less developed countries.

The main objectives of export-oriented growth by 2020 are as follows:

- Achieve an average annual growth rate of 13.5% for exports of goods and services, thus reaching a share of 65% in GDP (it implies increase in value of exports of goods and services from 8.5 billion euros in 2009 to 34.2 billion in 2020);
- Increase the share of tradable sectors in GDP formation by the export growth;
- Reduce foreign trade deficit from 15.5% in 2009, to 12% in 2020;
- Increase participation of tradable goods in the export structure with higher share of value added.

By 2020 significant changes in terms of export destinations should not be expected. The share of the EU and the CIS (Commonwealth of Independent States) should be slightly increased, while CEFTA countries share should be reduced. Serbia needs to strengthen economic relations with former Yugoslav republics and rebuild neglected traditionally good business relations and trade with the Near and Middle East countries and North Africa.

Structural changes in exports should move towards growth of share of middle technology products, accompanied by the decrease of share of products based on resources. That means growth of the share of machinery and transport equipment sector in total exports; almost stagnation in the beverages and tobacco sector, and a light fall in the share of other sectors.

Export growth will be possible only if, beside strengthening of small and medium enterprises sector, "well-known" transnational companies are attracted to *greenfield* invest, or technologically update still unprivatized large production companies. Those are companies in the field of: production of electrical and other products for households, furniture, medicines, trucks, boats, rotating electric machines, internal combustion piston engines.

Tourism is expected to offer largest contribution to the growth of revenues from export of services. In order to achieve a growth rate of about 13,6% per year, active role of the Ministry of Tourism and tourism organizations is required in promoting Serbia as an attractive destination for leisure and entertainment. Transport services will follow the dynamics of trade, and the fastest revenue growth is expected from IT and information services that had the fastest growth in the preceding period as well.

**Table 7: Realized and projected value of exports, in thousands of euros and growth rates in %**

	2008	2020	Growth rate 2008/2000, %	Growth rate 2020/2008
Total	7.428.355	24.821.000	26,2	10,6
Food and animals	1.015.745	2.400.000	24,6	7,4
Beverage and tobacco	169.082	550.083	41,6	10,3
Raw materials, except fuels	305.576	586.900	17,9	5,6
Mineral fuels and lubricants	253.864	631.600	74,4	7,9
Animal and vegetable oils and fats	99.752	185.382	31,3	5,3
Chemical products	751.427	2.216.359	29,0	9,4
Products classified by material	2.422.957	6.332.888	24,3	8,3
Machinery and transport equipment	1.293.547	7.990.501	31,3	16,4
Miscellaneous finished products	1.048.306	3.158.084	24,3	9,6
Products and transactions, unmentioned	68.099	769.202	14,0	22,4
<b>Structure of exports by technological intensity (in %)</b>				
	1990	2000	2008	2020
Based on resources	30,6	45,2	37,1	27,7
Low technologies	29,0	27,8	30,1	24,7
Middle technologies	29,2	16,2	20,6	33,1
High technologies	7,3	5,6	7,0	7,6

Note: author's estimation

**Table 8. Serbian exports of services, in millions of Euro**

	2002	2008	2020	Growth rate 08/02	Growth rate 20/08
'200 Total Services	691.1	2.581.7	9.415.0	24,6	11,4
'205 Traffic	199.5	651.7	2.300.0	21,8	11,1
'236 Tourism	89.6	573.2	2.635.0	36,3	13,6
'245 Communication services	71.8	87.3	150.0	3,3	4,6
'249 Construction services	70.9	245.2	800.0	23,0	10,4
'253 Insurance services	8.8	32.9	150.0	24,5	13,5
'260 Financial services	6.4	29.7	100.0	29,3	10,6
'262 Computer and IT services	3.0	96.0	1.000.0	77,8	21,6
'266 Licenses	16.2	19.8	30.0	3,4	3,5
'268 Other business services	186.3	717.8	1.800.0	25,2	8,0
'287 Personal, cultural and recreational services	6.3	109.1	350.0	60,9	10,2
'291 Government services	32.2	18.8	100.0	-8,6	14,9

Note: author's estimation

Achieving 65% share of exports of goods and services in GDP, from the current less than 30%, requires fundamental swerve in the macro-economic policy. Avoidance of strong

real appreciation of RSD is an important precondition for such a shift to occur. Postulates for reaching the goals of export-oriented economy are: continuation of European integration, intensification of economic cooperation in the CEFTA region, exploitation of full potential for exports to the Russian Federation, OPEC and Mediterranean countries, intensification of cooperation with the Diaspora, motivation of the inflow of export-oriented investments, growth of intra-industry trade with EU and CEFTA. Simplification of business conditions in Serbia as well as informational support to local producers about potential export markets also represent important requirements in terms of turning in the direction of the export based development.

## 10. REGIONAL ASPECTS OF THE NEW DEVELOPMENT STRATEGY

Research and empirical analysis of regional development in Serbia indicate that the key factors of regional imbalance and polarization in Serbia are: (a) continuous unfavorable demographic trends; (b) high regional unemployment, (c) permanent devastation of the industrial complex, (d) lack of infrastructure and (e) uncompleted and dysfunctional institutional framework.

Discrepancies in regional competitiveness are reflected in the concentration of economic activity of successful companies, high profits and employment in Belgrade and Južnobačka areas, while other regions face low economic activity, underdevelopment and high labor costs. Regional economies are not sufficiently restructured for the high demands of competitive foreign markets.

The primary objective of Serbian regional policy is to create economically strong, competitive regions that will achieve integration into global economic trends. The objectives of regional policy do not change, but the strategies to achieve them are being transformed. Traditional regional policy approach that was primarily based on redistribution of wealth between rich and poor regions and on mono-sectoral approach, is giving way to the principle of strengthening the regional indigenous and endogenous potentials and to the multi-sectoral approach.

The main reasons for the state involvement in this area are enormous intra-regional and inter-regional imbalance that impede the development and initiate migration flows. The State did not have any systemic regional response to numerous territorial deformations in order to cushion the transitional impacts and constraints faced by the affected areas, or contribute to their enabling for the auto-propulsive development. This applies in particular to support to the areas with special development problems, through investments and stimulation of capital inflows, with a view to compensate for structural weaknesses

of those regions. In order for the state support to be effective, it is necessary to ensure its continuity and long-term intensity.

**Areas with specific development problems.** Severity of regional disproportions differentiates three groups of areas with special development problems.

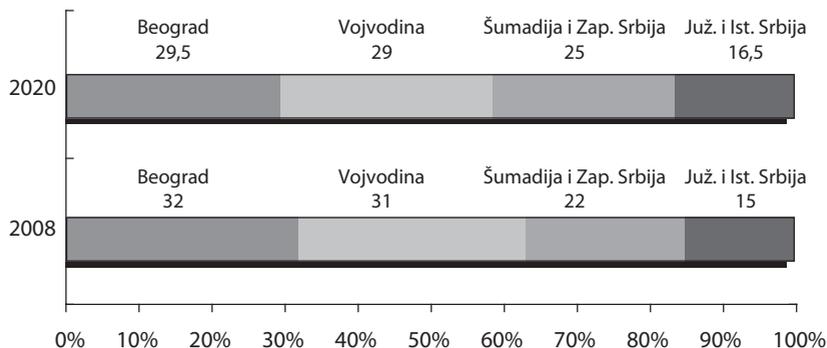
*Undeveloped area (UDA).* Traditionally under-developed area includes 40 municipalities distinctive for their exceptionally poor infrastructure, financial, economic and human resources.

*Industrially devastated area.* As a consequence of the economic distortion in the 1990s, and due to the process of transforming the economy into a market economy and the transitional adjustment, a new devastated area was formed. It comprises former industrial centers in 20 cities, which were bearers of regional economic development. With regard to the 1990s, they lost more than 40% of business revenues and more than 50% of employees in the processing industry.

*Serbian communities in the Autonomous Province of Kosovo and Metohija.* Serbian communities in Kosovo and Metohija include about 250 settlements with about 130,000 inhabitants. Economically impoverished people without employment, additionally faced with frequent ethnic conflicts, high unemployment rate, low social status, poor quality of education, unsustainable infrastructure and utilities' conditions and lack of economic prosperity.

**Scenario of regional economic growth by 2020.** represents the resultant projected key macroeconomic variables: (a) economic growth rates, (b) commodity export growth rates, (c) investment growth rates, and (d) processing industry growth rates.

**Graph 5: Regional GVA contributions**



- As part of the basic model of economic growth, regional growth model for the regional level NSTJ-2 was designed. For regions of Šumadija and Western Serbia and the Southern and Eastern Serbia more dynamic growth rates were designed for processing industry in the period 2011-2020. The average projected growth rate for processing industry in Belgrade and the region of Vojvodina is 6,5%, while for the region of Šumadija and Western Serbia and the region of Southern and Eastern Serbia it is 8,8%;
- Regional model included changes in regional structures in all regions. Developed regions are to reduce their participation, the biggest changes in the structure of processing industry are located in the region of Šumadija and Western Serbia, in the sub-sector of Medium-low-tech group.

**Strategic priorities.** After the adoption of the *Regional Development Strategy (2007)*, by adopting the *Law on Regional Development (July 2009, and the amendments in May 2010)*, the process of establishing a unique Serbian regional development management system has begun. The main features of the new model of regional development management are:

- promoting national and European regional development principles, which are in conformity with EU cohesion policy, but which also reflect the specifics of Serbia;
- clear institutional structure and mechanisms for regional development policy management;
- effective mechanisms of cooperation between regional and municipal authorities;
- clear concept and terminology;
- flexibility: regulating general issues and creating basis for passing the by- laws;
- legal basis for monitoring and evaluation.

The positive regional experience of EU countries and good results in the field of regional policy can be achieved if the following seven preconditions are met:

*Political support.* Continuous, clear and unambiguous political support to the process; continuous allocation of significant resources for regional development; application of all measures of the Government containing the principle of regional redistribution and the principle of encouraging competition and implementation of the laws relating to regional development;

*Flexibility and innovation* in order to adjust measures and instruments of regional policy to the new trends, international crises and global developments;

*Macroeconomic stability,* price stability and sound fiscal policy stimulate investments, productivity increase and job creation in the regions;

*Strong institutions.* High quality and efficient administrative capacity at all levels, strengthening of institutions and human resources are the basis for sustainable development;

*Expertise and analytical-statistical basis.* Well-designed regional development policy is required. Investments in infrastructure and people must be focused, well-designed and created based on the comparative advantages of the regions, in order to achieve the maximum effect;

*Partnership.* Efficient regional policy is increasingly oriented towards the principle of good governance with multiple levels of administration, where each level of administration contributes to the creation and implementation of regional policy within its jurisdiction;

*"The adequate measure" of decentralization.* There is a positive correlation between political decentralization and efficiency in developed countries, but the effect is much weaker when it comes to decentralization in the undeveloped countries.

## 11. ENERGY SECTOR

The Energy sector of the Republic of Serbia is characterized by numerous problems which may be a limiting factor for further economic development: unfavorable volume and structure of energy resources, high level of energy import dependence with a tendency of further growth, the main energy indicators not only exceed the EU standards but are worse than in most countries in the region, the condition of the infrastructure capacities is inadequate, the level of operational efficiency of energy businesses is unsatisfactory.

By reviewing the current state of the energy sector, in terms of the implications it may have on future economic development of Serbia, the following strategic objectives were defined:

- attracting investments in construction of the new and upgrading of the existing electric power capacities in the value of about 9 billion Euros and about 4 billion Euros investment in the gas sector,
- diversification of energy resources and promotion of the wider use of renewable energy resources and
- improvement of energy efficiency in all sectors of energy production and consumption.

The main reasons for starting an intensive investment cycle in **the electric power industry** are growing electricity consumption, the necessity of replacing old, inefficient plants and compliance with environmental regulations. The EPS (Electric Power Industry of Serbia) Development Strategy, adopted in 2008, envisages that 9 billion Euros should be invested by 2015 in the investment projects, of which: 3.4 billion Euros from EPS funds,

3.8 billion Euros from credit lines and 1.8 billion Euros on the basis of strategic partnerships with foreign investors. Bearing in mind that this is a capital-intensive activity and that the period of construction of energy facilities is in average 5-7 years, the time frame for implementation of the defined projects should be considered provisory.

**Table 9. Estimated investments in new production capacities in the electric power industry, in millions of Euros**

Project	Estimated value of investment
Completion of construction of Thermal Power Plant (TE) Kolubara B in Lazarevac	550
Construction of a new block TENT B3 in Obrenovac	870
Construction of a new co-generative block TE-T0 (Thermal Power Plant and Heating Plant) Novi Sad	280
Construction of HE (Hydroelectric power Plant) Gornja Drina	435
„Kostolac B projects“	1.100
Projects under the Agreement with SECI ENERGIA	1.500
<b>Total</b>	<b>4.735</b>

**Table 10. Estimated value of investment projects in the gas sector, mil. of Euros**

Project	Estimated value of investment
South Stream	1.200
Gas storage - Banatski Dvor (Phase 2)	50
Gas storage - Itebej (Phase 1)	70
Interconnection - The Republic of Srpska	35
Interconnection - Romania	6
Interconnection - Bulgaria*	60
Interconnection - Croatia	32
Interconnection - Macedonia	21
Interconnection - Montenegro*	18
Rehabilitation of the gas pipeline system	5
Development of gas pipeline transmission network***	440
Development of local distribution network***	670
LNG Terminal****	150
Gas pipeline in Pancevo	32
Thermal Power Plants****	1300
<b>Total</b>	<b>4.089</b>

Note: \* Estimation of the PC Srbijagas, based on the European Commission intention, \*\* Method of implementation and time frame of this project are not known at this time, \*\*\* Appraisal of PC Srbijagas - linear (depending on funding), \*\*\*\* No planning documents.

Besides the construction of new production capacities, the investments are also required for rehabilitation and modernization of existing production capacities, which include

not only the increase of the nominal power and increase of the efficiency of work, but also the reconstruction of transportation and disposal of ash and slag, installation of electric filters and equipment for desulphurization of exhaust gases, facilities for waste water treatment, etc. Based on available data, the estimated resources amount to 4.1 billion Euros.

In the **gas industry**, several capital investment projects are planned for the forthcoming period. The following table provides an estimate of necessary funds for their implementation.

In the **oil industry** investment priorities are the product pipeline construction, oil pipeline, storage systems and pumping stations.

In order to realize these priorities it is necessary to undertake a series of measures and activities, among which the following ones stand out for their importance: removal of price disparities between the energy-generating products and the introduction of protection of socially vulnerable energy consumers component, reorganization and corporatization of energy entities, adoption of the new Energy Law and the Law on the rational use of energy, removal of administrative barriers and adoption of incentives on the system level to stimulate investment in energy projects, especially those based on renewable energy resources, etc.

## 12. TRAFFIC

Favorable natural and geographical, as well as traffic position of Serbia is a comparative advantage and good basis for the development of all forms of transport and to attract transit of commodities. Poorly developed infrastructure, outdated transportation capacities, inadequate organization of traffic, safety and environmental protection represent major obstacle to economic growth, increase of productivity and competitiveness. The goal is to establish a transport system that would be able to compete with the traffic in European countries, by its new organization, improved infrastructure and transportation means.

During the development of Serbian traffic the security level and quality of service will constantly increase, comparative advantages of each form of transport will be valorized and negative impact of traffic on the environment will be reduced. During the improvement of the situation and the modernization of road, railway and inland waterways infrastructure, the Pan-European Corridors X and VII shall have priority.

To achieve the basic model of economic growth by 2020, in **railway traffic**, it is necessary to continue the process of modernization of PC "Železnice Srbije" (Serbian Railways) infrastructure. Current state imposes the need to restore the railway infrastructure to the projected state, in the first phase, and then in the next phase to perform gradual modernization. The modernization will include electrification and construction of double tracks through the entire Corridor X railway, in order to increase the passenger traffic speed to 160 km/h, and freight traffic speed to 120 km/h. In addition, it is necessary to rehabilitate the railroads connecting Serbia with the neighboring countries (Belgrade-Vrbnica (Bar), Belgrade-Vrsac, Valjevo-Loznica), and to rehabilitate and construct railway lines of national importance (Belgrade-Airport "Nikola Tesla" - Batajnica, rehabilitation of regional railways). It is also necessary to implement the following projects: Digitization of telecommunication infrastructure and introduction of railway mobile radio equipment, Digitization of control systems and maintaining the appropriate level of traffic on the Corridor X railways; Project for reduction of delay of trains on the railway border crossings of Trans-European Corridors and Project for procurement of machinery for infrastructure maintenance. Needed funds for modernization of infrastructure are estimated at about 5.2 billion Euros.

The priority in the construction of **road infrastructure** is the completion of Corridor X by 2012, which has economic, developmental and strategic importance. The construction of the highway that connects Vrsac - Pancevo - Belgrade - Cacak - Pozega with the highway through Montenegro to the Bar, would intensify the transit flows and attract commodities on the road between Bari - Bar - Belgrade - Bucharest and from Belgrade to Budapest and Vienna. The network of Serbian highways should be supplemented by the construction of the road with east-west direction: highway Pojate - Preljina, which will link two major Corridor X transit directions and the South Adriatic route; Požega - Uzice - Kotroman (border with Bosnia and Herzegovina); Paraćin - Zaječar - Bulgarian border, connecting the eastern parts of Serbia with Corridor X. For the purpose of completing the national road network, it is necessary to build routes Novi Sad - Ruma - Šabac - Loznica, Hungary border - Kikinda - Zrenjanin - Pancevo - Kovin, highway Kragujevac - Batočina that is the link to Corridor X and semi-highway Pozarevac - Kučevo - Majdanpek - Negotin. City beltways, II class State Roads, etc.. The dynamics of the implementation of these projects depends on the provided funding. Required resources are estimated at about 7.5 billion Euros.

By improving transport infrastructure and organization, River Danube, i.e. Corridor VII, will act as the driver of regional and economic development. Secure voyage by modern inland vessels, development of harbour activities, implementation of intermodality with the support of logistics systems, will lead to an increase in transport volume and the increasing importance of **water traffic**. Development of water traffic can be achieved through the implementation of projects within the three groups of the improvement

program. The first program will include works on upgrading the inland waterways state, which should be implemented continuously until 2020. The second program of activities is aimed at improving waterway transport services. Modernization and completion of information and communication systems in the port authorities, equipping of navigation supervision services and modernization of ports and docks will provide safer and more efficient service delivery. The third program will include activities to improve the infrastructure of inland waterways. According to the evaluation of the Ministry of Infrastructure, it is necessary to allocate 350 million Euros for the implementation of these projects, and they will be implemented through the budget funds, international financial institutions, pre-accession funds and loans.

**Airport infrastructure** will be improved by including various forms of private investments through full and partial rental of airport facilities and services. In order to attract goods and passengers, it is necessary to connect airports with adequate railways and roads. The construction of railway passenger and freight station will allow expansion of the Airport "Nikola Tesla" in Belgrade, which would include hotel complex, bus terminal and multi-storey car park. It is also necessary to improve the infrastructure for commodity traffic by building a cargo terminal, platform and runway for cargo planes. In this way, the Airport "Nikola Tesla" will become an important regional, transit, passenger and cargo hub. Airport "Konstantin Veliki" in Niš will serve for the reception of tourist aircrafts, and as an alternative airport for the "Nikola Tesla" airport. Therefore its modernization is needed. Necessary funds for implementation of these projects amount to 150 million Euros.

It is necessary to develop studies and projects to identify needs and requirements for the development of **intermodal transport services**. In order to define the location of logistic centers, it is necessary to perform the Feasibility Study for freight traffic flows that will be integrated into the EU mainstreams. This study, based on the concentration of demand for transport, should confirm the adequacy of development of at least three logistic centers (terminals) of different sizes and characteristics, in the area of Belgrade, Novi Sad and Niš. Construction of the terminal would have a major impact on the development of the overall traffic system and overall economy, especially the less developed areas. Construction of new terminals should be realized on the basis of cooperation between public and private sector.

Financial resources will be provided from the budget, loans from international financial institutions, the EU pre-accession funds, private equity funds and companies. The possibility of implementation of contemporary financial models (BOT, PPP and other arrangements) will be considered as well. Particular attention should be paid to institutional and legislative compatibility with European standards.