



**Ivan Knezevic**  
*editor*

**The Current Status Quo and Prospects  
for Serbia's European Integration**

Analysis of Political and Economic Aspects

**Studies on International Issues B 07**

SLOVAK FOREIGN POLICY ASSOCIATION

Bratislava 2008





**European Movement**  
Serbia

This publication appears within the project *National Convention on the European Union in Serbia* implemented by the *Slovak Foreign Policy Association* and *European Movement in Serbia* in 2006 – 2008.

The project was supported by the Slovakia's Official Development Assistance program.



Editor  
Ivan Knezevic

Authors  
Dragan Djukanovic, Miladin Kovacevic, Ivan Nikolic

Translation and Proofreading  
Kate DeBuscherre-Nikolic, Marko Nikolic

© Slovak Foreign Policy Association, Bratislava 2008  
© Dragan Djukanovic, Miladin Kovacevic, Ivan Nikolic

**ISBN 978-80-89356-01-0**  
**EAN 9788089356010**

## **TABLE OF CONTENTS**

### **1. Introduction / 4**

### **2. Political Context of the European Integration Process in Serbia.**

#### **Analysis of the Most Important Political Issues / 6**

#### 2.1 Serbia and European Union: Membership Perspectives / 10

#### 2.2 Different Views of Serbia's Foreign Policy Priorities by the Leading Political Actors / 11

#### 2.3 Serbia and Multilateral and Bilateral Regional Cooperation in South East Europe / 13

#### 2.4 Preliminary Conclusions / 16

### **3. Macroeconomic Framework of the European Integration Process in Serbia / 18**

#### 3.1 Overview of the Main Macroeconomic Trends and Developments / 18

#### 3.2 Evaluation of Recent Structural Reforms in Serbia / 29

#### 3.3 Prospects of Future Economic Developments – Possible Scenarios Depending on the Political Circumstances in Serbia / 40

#### 3.4 Preliminary Conclusions / 43

### **4. Concluding Remarks / 46**

## 1. INTRODUCTION

Serbia has a crucial role to play in the Western Balkans, both for ensuring stability and as a motor for the economic development and prosperity of the region. The biggest country in the region, Serbia, could make rapid progress towards EU membership. However process of European Integration of Serbia has been burdened with many political barriers which have made the overall process complex and prolonged.

*Stabilization and Association Process (SAP)* of the Republic of Serbia began formally in 2001 establishing Joint Consultative Task Force as a mechanism for cooperation between Serbia and EU. The *EU Feasibility Report* of April 2005 confirmed that Serbia and Montenegro was ready to begin negotiations for a SAA (*Stabilization and Association Agreement*), with official SAA negotiations beginning in October 2005. Following the referendum on independence on May 23<sup>rd</sup>, 2006, Montenegro declared its independence on 3 June 2006. Subsequently, Serbia has confirmed itself as the successor state of Serbia and Montenegro, in line with the *Belgrade Agreement* of 2002. As a successor state Serbia could have continued negotiations with EU however these were called off in response to Belgrade's failure to locate the remaining *International Criminal Tribunal for the former Yugoslavia (ICTY)* indictees in May 2006.

During the suspension of the negotiations, the EU made efforts to ensure that the process of European integration in Serbia does not lose momentum. Therefore while the negotiations on SAA were called off the negotiations on visas were opened and after a year in September 2007 Serbia signed the agreements on visa facilitation and readmission between Serbia and the EU, which came into force on 1 January 2008. In February 2007, following parliamentary elections in Serbia, the EU agreed to restart negotiations once a new government was formed and in mid-2007 talks resumed. Negotiations were finalized in September 2007, with an SAA initialed in November 2007. Signature of it, however, remained conditioned on establishing full cooperation with the ICTY.

The start of 2008 foresaw a period of political instability for Serbia, which continued to hinder process of European Integration of Serbia. Relations with the EU and USA have deteriorated at an all-time low level over their recognition of Kosovo's unilateral declaration of independence. Prior to the unilateral declaration of independence of Kosovo relations between Serbia and the EU were progressing at a good pace though under pressure of joint issues of resolving Kosovo final status and cooperation with ICTY. However unilateral declaration of independence of Kosovo has created a strained situation in relations between Serbia and EU as well as perception among some Serbian politicians that the European perspective of Serbia conflicts with their national interest. Additionally, the governing coalition appeared to be weak and the government fell in March 2008, split over whether to pursue a nationalist or pro-European path. Nevertheless, push for further integration from both Brussels and Belgrade continued regardless of the seemingly difficult political environment which surrounded the issue of relations between Serbia and EU. Several EU states were favorable to signing a *Stabilization and Association Agreement* – in order to boost the country's pro-European forces ahead of the parliamentary elections, which has been seen as crucial for the country's future. As a result of these

efforts on April 29<sup>th</sup>, 2008 EU signed a SAA with Serbia, which has been seen as a key step towards future full membership. However signing of the SAA deeply divided Serbia's own political elite, considering it would mean abandoning Kosovo and recognizing its independence thus if nationalist forces won parliamentary elections European Integration of Serbia could come to a halt.

Nevertheless slow progress towards EU membership as well as inherent lack of political consensus over major priorities of the country accompanied with the frequent internal political instability created a climate of status quo in the European Integration process of Serbia. Additionally aforementioned factors caused the protracted transition of the Serbian economy which continuation depends upon the political success of the pro-European forces in the country. Furthermore the latest political developments created environment conducive to economic populism and significantly aggravated the economic situation in the country over the last period. What is more important if continues, uncertainty and country risk will lead to a further fall in foreign direct investment thus declining economic growth.

This paper gives an overview of overall political context of the European Integration process in Serbia and goes on to examine the key political barriers and challenges to further integration of Serbia into EU. Beside political context of the European integration of Serbia recent development in the Serbian economy as well as evaluation of the structural reforms has been analyzed extensively. The final section on prospects of future economic development encompasses possible scenarios depending on the political circumstances in Serbia.

## **2. POLITICAL CONTEXT OF THE EUROPEAN INTEGRATION PROCESS IN SERBIA. ANALYSIS OF THE MOST IMPORTANT POLITICAL ISSUES**

Following the end of several years of isolation of the Republic of Serbia (within the former Federal Republic of Yugoslavia) in 2000, caused by circumstances coming from the dissolution of the Socialist Federal Republic of Yugoslavia, a process of redefining the country's status with regards to the existing European and Euro-Atlantic integrations has begun. Earlier exclusive focus of Serbian political elites on the resolution of the status of ethnic Serbs in new states created in former Yugoslavia, most of all in Croatia and Bosnia and Herzegovina, was gradually replaced on the priority agenda by the ambition to initiate the accession process to the European Union, but also NATO.

Numerous problems, left as a "legacy" to the new government after the end of Slobodan Milosevic's rule, and undeniable domination of his Socialist Party of Serbia, burdened the process of European and Euro-Atlantic integrations. In the first place, it referred to the undefined final status of the southern Serbian province – *Kosovo*, which, following the military intervention of the North Atlantic Alliance in 1999 became a protectorate under the supervision of the United Nations. Even now, after Kosovo's unilateral declaration of independence (February 17th, 2008), a number of analysts think that new problems may occur in the relations between Serbia and the European Union regarding this entity. Kosovo was recognized as an independent state by twenty one of twenty seven European Union member states.<sup>1</sup> The second, not less important, issue was the regulation of the status of the *Republic of Montenegro* within the Federal Republic of Yugoslavia (2000-2003), and State Union Serbia and Montenegro (2003-2006). However, the solution of the problem came at the end of May 2006, after the referendum on the state and legal status was held in Montenegro in which the citizens of this former Yugoslav republic voted for independence. Another important issue influenced the country's dynamic in acceding to the European Union in the past eight years. It is the cooperation of former FR Yugoslavia, and then its legal successors – the State Union of Serbia and Montenegro and the Republic of Serbia – with the *International Criminal Tribunal for the Former Yugoslavia (ICTY)*. This cooperation entails both handing over the suspects to the Court, and providing relevant documents on crimes committed. The process of delivering persons suspected of crimes committed in the former Yugoslavia is unraveling very slowly, and Serbia still faces the issue of handing over three indicted persons who are suspected to be on its soil.<sup>2</sup>

Serbia's EU accession process is objectively characterized with an occasional lack of political will of the main political actors. This is particularly characteristic of the period between 2004 and 2007, but also in the months after Kosovo declared independence in

---

<sup>1</sup> Until July 1<sup>st</sup>, 2008, Kosovo independence was not recognized by following EU member states: Romania, Slovakia, Greece, Cyprus, Spain and Portugal.

<sup>2</sup> Those persons are Radovan Karadzic, Bosnian Serb was leader and the president of Republika Srpska (1992-1996), General Ratko Mladic, the commander of the former Army of Republika Srpska (1992-1995) and Goran Hadzic, former Serbian rebels leader in Croatia (1991-1995).

mid-February 2008, until the formation of the new government of the Republic of Serbia (July 3<sup>rd</sup>, 2008). Together with the above mentioned, constant rethinking of the foreign policy direction, and the lack of well established and defined foreign policy strategy of the country, influence the occasional slowing down of the process. After the democratic changes it was clear that the country is moving forward to membership in the European Union, but after the assassination of the Prime Minister, Dr. Zoran Djindjic, on March 12<sup>th</sup>, 2003, this process was significantly slowed down which was often done by the leading opposition party – the Serbian Radical Party, but by the ideologically close governing Democratic Party of Serbia as well.

Today it is clear that Serbia's accession process to the European Union is irreversible, i.e. that the possible domination of Eurosceptic (with the elements of anti-European) forces cannot essentially jeopardize the process despite the danger of slowing it down or even temporarily stopping it. With regards to that, it is important to point out the division in the Serbian society into *pro-Europeans* and *Eurosceptics* (with certain elements of anti-Europeanism). The results of the recent parliamentary elections in Serbia (May 11<sup>th</sup>, 2008 – See Table 1) show that this division in the society is almost half-half. On one hand, the coalition "For European Serbia" (*Democratic Party* – DS, *G17plus*, *League of Social Democrats of Vojvodina* – LSV and *Serbian Renewal Movement* – SPO), together with the minority parties and the *Liberal Democratic Party* – LDP (on whose list there were also *Social Democratic Union* – SDU and *Christian Democratic Party of Serbia* – DHSS) won 122 seats in the parliament, while the parties of the previous regime – coalition around the *Socialist Party of Serbia* – SPS, *United Pensioners Party of Serbia* – PUPS and *United Serbia* – JS) and the *Serbian Radical Party* – SRS, together with a far right *Democratic Party of Serbia* – SPS, on the other hand, won 128 seats. A gradual new orientation of the Socialist Party of Serbia as a modern European social democratic party, and the abandoning of hard nationalist and isolationist policies contributed to the formation of a new parliamentary majority with the aim of accelerating the country's European Union accession process.

**Table 1:** Parliamentary Elections in Serbia – May 11<sup>th</sup>, 2008

Election list		Electoral Commission (final results)	
		%	Mandates
1.	For European Serbia – Boris Tadic	38.40	102
2.	Liberal Democratic Party – Cedomir Jovanovic	5.24	13
3.	Democratic Party of Serbia-New Serbia – Vojislav Kostunica	11.61	30
4.	Serbian Radical Party – Vojislav Seselj	29.45	78
5.	Socialist Party of Serbia-PUPS-United Serbia	7.58	20
6.	Bosniak List for European Sandzak – Sulejman Ugljanin	0.92	2

Source: Center for Free Election and Democracy – CeSID, Belgrade, Internet: [www.cesid.org](http://www.cesid.org), July 15<sup>th</sup>, 2008.

If we want to view the reach of Serbia's accession to the European Union in a more objective manner, we cannot but to take a look at the same process unraveling in the countries of the former Yugoslavia, with the exception of Slovenia<sup>3</sup> (See Table 2). All the countries in the group are characterized by the transition process, post-conflict and democratic and economic consolidation which makes this comparison relevant. As it can be seen, the EU accession process was first started by the Republic of Macedonia and Bosnia and Herzegovina during 1998, and two years after them, following the change in government and coming of opposition political parties into power, this process was started by the Republic of Croatia and former Federal Republic of Yugoslavia. Until now, only the Republic of Croatia and the Republic of Macedonia secured candidate status for membership in the European Union, while Bosnia and Herzegovina and the Republic of Serbia remain at the bottom of the list due to numerous, mainly domestic, political problems. A considerable progress in the area of European integrations can be seen in the case of the Republic of Montenegro after gaining independence in 2006.

Regardless of the fact that in the accession process of the Western Balkan countries a so-called individual approach was dominant, i.e. individual evaluation of every country's successfulness, the Union did stress that all countries have a "European perspective". This was particularly emphasized by the administration in Brussels at the European Union Summit in Thessaloniki in June 2003.<sup>4</sup>

**Table 2:** *European Union Accession Dynamics of the Former Yugoslav Countries (July 2008)*

<b>Phase</b>	<b>Republic of Croatia</b>	<b>Republic of Macedonia</b>	<b>Bosnia and Herzegovina</b>	<b>Republic of Serbia</b>	<b>Republic of Montenegro</b>
Dialogue with the EU Commission representatives/ working groups	February 2000	January 1998 Cooperation Agreement with the EU	Consultative Working Group 1998.	Consultative Working Group (2001/2) & Enhanced permanent dialogue (2003/6)	Consultative Working Group (2001/2) & Enhanced permanent dialogue (2003/6)
Adoption of the Feasibility Study by the European Commission	May 24 <sup>th</sup> , 2000	June 16 <sup>th</sup> , 1999	November 18 <sup>th</sup> , 2003	April 25 <sup>th</sup> , 2005	April 25 <sup>th</sup> , 2005

<sup>3</sup> Republic of Slovenia is a European Union member state since May 1<sup>st</sup>, 2004.

<sup>4</sup> "The Thessaloniki Summit: a Milestone in the European Union's Relations With the Western Balkans", Brussels (June 18<sup>th</sup>, 2003).



<b>Phase</b>	<b>Republic of Croatia</b>	<b>Republic of Macedonia</b>	<b>Bosnia and Herzegovina</b>	<b>Republic of Serbia</b>	<b>Republic of Montenegro</b>
European Commission gives recommendation to start negotiations	July 19 <sup>th</sup> , 2000	September 8 <sup>th</sup> , 1999.	October 21 <sup>st</sup> , 2005.	July 12 <sup>th</sup> , 2005.	July 12 <sup>th</sup> , 2005.
Council approves start of negotiations	November 20 <sup>th</sup> , 2000.	January 24 <sup>th</sup> , 2000.	November 21 <sup>st</sup> , 2005.	October 3 <sup>rd</sup> , 2005.	October 3 <sup>rd</sup> , 2005.
Commission initiates negotiations	November 24 <sup>th</sup> , 2000.	March 5 <sup>th</sup> , 2000.	November 25 <sup>th</sup> , 2005.	October 10 <sup>th</sup> , 2005.	October 10 <sup>th</sup> , 2005.
Initialing of SAA	May 14 <sup>th</sup> , 2001.	November 24 <sup>th</sup> , 2000.	December 4 <sup>th</sup> , 2007.	November 7 <sup>th</sup> , 2007.	March 15 <sup>th</sup> , 2007.
Signing the SAA and definition of application period	October 6 <sup>th</sup> , 2001. (six years)	April 9 <sup>th</sup> , 2001. (ten years)	June 16 <sup>th</sup> , 2008.	April 29 <sup>th</sup> , 2008.	October 15 <sup>th</sup> , 2007.
Temporary agreement comes into force	March 1 <sup>st</sup> , 2001.	June 1 <sup>st</sup> , 2001.			
Submitting membership application	February 21 <sup>st</sup> , 2003.	March 22 <sup>nd</sup> , 2005.			
Council awards candidate status	June 18 <sup>th</sup> , 2004.	December 17 <sup>th</sup> , 2005.			
SAA comes into force	February 1 <sup>st</sup> , 2005.	April 1 <sup>st</sup> , 2004.			
Initialization of membership negotiations	October 3 <sup>rd</sup> , 2005.	2008.?			

Source: "European Union Accession Dynamics of the Western Balkans Countries", *Evropski forum*, year IV, no. 3, 2006, p. 15. – Table completed by author, Dragan Dukanovic.

## 2.1 Serbia and European Union: Membership Perspectives

The signing of the Stabilization and Association Agreement<sup>5</sup> on April 29<sup>th</sup>, 2008, despite a number of conditions which will follow its ratification and implementation, is the most significant step in the eight years of relations between Serbia and the European Union. This is the first contractual agreement between Serbia and the European Union and contains an evolution clause which confirms the status of a potential candidate for membership. The signing of the Agreement was followed by numerous controversies surrounding article 135 which stipulates that the Agreement “shall not apply in Kosovo which is currently under international administration under Resolution 1244 of the United Nations Security Council from June 10<sup>th</sup>, 1999”. Such defined article in Agreement does not preclude the final status of Kosovo, and does not influence it in any way. Despite the explanation, representatives of the Democratic Party of Serbia and New Serbia, as well as representatives of the Serbian Radical Party, insisted that the Agreement be amended in this article stating that Kosovo is, in accordance with the Constitution of the Republic of Serbia, one of its provinces. However, this demand was, naturally, completely unreal and any attempt to realize them would mean turning back to the European Union.

After the successful completion of cooperation of the Republic of Serbia with the ICTY, one can expect the ratification of the Agreement in all Union member states, as well as in the European Parliament. Following the formation of a pro-European majority in Serbia’s National Assembly it can be expected that this document is ratified in a very short period. On the other hand, Serbian institutions must fully use their capacities in order to speed up the accession process. Therefore, in the above mentioned procedure, the National Assembly must occupy a special place because of the necessity to harmonize national legislature with the *acquis communautaire*, which implies the adoption of several hundreds of system laws.

Since the Irish citizens have rejected the *Lisbon Treaty*, which would institutionally redesign the European Union, in a referendum held on June 13<sup>th</sup>, 2008, a number of Brussels officials stated that such result may influence the further expansion of the Union to the Western Balkans. Similar discussion were held in the Union’s administrative circles during 2004 and 2005 on giving the status of “privileged partnership” to the countries of the region as a sort of substitute to full membership. Also, at the EU Council meeting held on March 11<sup>th</sup>, 2006 in Salzburg, it was pointed out that the Union must take care of its own “absorption” capacities, especially after the experience of a big enlargement from May 1<sup>st</sup>, 2004. Therefore, it can be concluded that after the procedural obstacles for the adoption of the *Lisbon Treaty* are removed, the countries of the Western Balkans will be given a chance to get closer to the Union faster. Of course, the Republic of Serbia should find its place in that context.

If one analyzes the accomplishments in the dynamics of Serbia’s accession to the EU until now, one can notice that, because of the lack of a basic social consensus in regards

---

<sup>5</sup> “Stabilization and Association Agreement between the Republic of Serbia and European Union“, [http://www.b92.net/info/dokumenti/index.php?nav\\_id=296490](http://www.b92.net/info/dokumenti/index.php?nav_id=296490).

to the country's foreign policy orientation, this process has been extremely slow in the past eight years. If the dynamics of Croatia's accession is compared with Serbia, one can see that it needed only twenty months between initiating dialogue with the representatives of the European Commission and signing the SAA (*See Table 2*). In Croatia, a wide consensus between leading political parties was reached at the beginning of this decade on joining the European Union.

Political stability is definitely one of the main factors which will influence the future intensity of Serbia's accession to the Union. If the newly formed Serbian government, in the next four years, succeeds in removing the obstacles in cooperation with the ICTY and at the same time secures the parliamentary majority to adopt reform laws harmonized with European Union legislation, the accession process can be finalized at the earliest by 2012. However, it is more realistic to expect that Serbia's accession to the European Union will take place in the second half of the next decade.

It has to be mentioned that the benefits for the Serbian citizens from the economic part of the *Stabilization and Association Agreement* will influence a higher degree of foreign investments. At the same time, easier access to European funds will improve the overall economic climate in Serbia and contribute to the completion of transition to market oriented economy. Simultaneously, the implementation of the Agreement will contribute to establishing tighter regional cooperation between the countries of the Western Balkans and, through the instrument of "political dialogue", additionally strengthen relations between Serbia and the Union.

## **2.2 Different Views of Serbia's Foreign Policy Priorities by the Leading Political Actors**

After the dissolution of the former Socialist Federal Republic of Yugoslavia at the beginning of the last decade, the Federal Republic of Yugoslavia and then State Union Serbia and Montenegro, did not have a well defined foreign policy strategy. One exception is the exposing of former Foreign Minister in the Federal Republic of Yugoslavia, Goran Svilanovic, presented in the Federal Parliament on October 24<sup>th</sup>, 2001.<sup>6</sup> In this expose, the four most important foreign policy directions of the two-members of Yugoslavia (Serbia and Montenegro) were emphasized:

- 1) determination of the country to join the European Union and the North Atlantic Alliance,
- 2) the strengthening of bilateral and multilateral means of cooperation with the countries of the Western Balkan region and South East Europe,
- 3) balancing of relations with great forces (before all with the United States of America, European Union and Russian Federation)
- 4) consolidation of relations and cooperation with the countries of the "third world".

After this expose, there was not a single strategic document which would entail a detailed analysis of foreign policy priorities of the country. Yet, there were no serious

---

<sup>6</sup> See "Expose of the Goran Svilanovic, Federal Minister for Foreign Affairs at the FRY Federal Parliament", (October 21<sup>st</sup>, 2001), [http://www.mfa.gov.yu/Srpski/spopol/Ministar/Govori/241001\\_s.html](http://www.mfa.gov.yu/Srpski/spopol/Ministar/Govori/241001_s.html).

attempts to question the above mentioned foreign policy priorities in the long term. Besides, Kosovo has, after negotiations on its final status at the end of 2005, changed from a leading domestic issue to a dominant issue in the formation and implementation of the country's foreign policy.

Domination of isolationist foreign policy in Serbia, which included the attempt of establishing a hegemonic position of the country in the Western Balkan region together with the permanent confrontation with the international community, was ended on October 5<sup>th</sup>, 2000. Today, however, one can talk about two completely different views of foreign policy priorities in Serbia, with mild varieties.

The first foreign policy concept, embodied in the *Democratic Party, G17 plus* and other partners from the coalition "For a European Serbia", undoubtedly is oriented towards faster integration of Serbia into the European Union and NATO. At the same time, all political parties advocate for intensification of all bilateral and multilateral means of cooperation among the Western Balkan countries and in the South East European region. Special attention is paid to overcoming numerous problems which burden the relations between the states which came out of the former Yugoslavia. This foreign political concept unquestionably is supported by the *Liberal Democratic Party* and *Social Democratic Union* together with the parties and coalition of national minorities.<sup>7</sup>

Even though the pre-election campaign rhetoric of the coalition around the *Socialist Party of Serbia* did not show that this alliance has the acceleration of the Serbia's European integration process as one of its priorities, but the post-election combinations regarding securing the parliamentary majority showed the opposite. Moreover, one of the priorities of the newly formed government will be accession to the European Union, according to the agreement between the two coalitions – "For a European Serbia" and SPS-PUPS-JS. Serious sociological and political analyses, on the other hand, show that the voters of SPS-PUPS-JS which only got 7.58% of votes or 20 seats in the parliament are closer to the Eurosceptic and anti-European sentiment. At the seventh party congress, held in December 2006, Socialist Party of Serbia adopted a Program Declaration which states that "NATO is a relic from the past and the days of the cold war, and that our road is neutrality..."<sup>8</sup>

The other foreign policy concept, an orientation towards European Union membership, but not NATO is characteristic for the coalition of the Democratic Party of Serbia and New Serbia. This concept became evident after October 28<sup>th</sup>, 2007, and the adoption of *Declaration of Neutrality* by the *Democratic Party of Serbia*.<sup>9</sup> Following the unilateral declaration of independence in the Kosovo parliament on February 17<sup>th</sup>, 2008 and its recognition by most of the European Union member states the position of the "people's coalition" drastically changed with regards to the country's future accession to the Euro-

---

<sup>7</sup> Those are the "Hungarian Coalition" – *The Alliance of Vojvodina Hungarians* (SVM), *Democratic Party of Vojvodina Hungarians* (DSVM) and *Democratic Fellowship of Vojvodina Hungarians* (DZVM), Bosniak List for European Sandzak gathered around *Party of Democratic Action of Sandzak* (SDA), as well as the *Albanian Party of Democratic Prosperity* (PDP).

<sup>8</sup> "Program Declaration from the Seventh Congress of the Socialist Party of Serbia", (December 3<sup>rd</sup>, 2006), p.9.

<sup>9</sup> "Declaration on Neutrality", *Democratic Party of Serbia*, (October 28<sup>th</sup>, 2007), *Evropski forum*, Vol. VI, No. 4, (2008), p. 2.

pean Union. This can be illustrated by the stubborn insisting of the DSS-NS coalition that the European Union institutions reaffirm territorial unity of the Republic of Serbia which included the southern province – Kosovo and Metohija. Moreover, the coalition conditioned the ratification of the SAA with the European Union clearly taking a position on the Kosovo status. According to the DSS-NS coalition the relationship between Serbia and the European Union would gradually change in the sense that the country's accession to this organization would no longer be a foreign policy priority. In this context, instead of tighter and balanced relations between Serbia and Brussels, Washington and Moscow, the country would turn to the Russian Federation and the People's Republic of China in the long term. The previous Serbian Prime Minister, Vojislav Kostunica, and his political party in the last four years also did not show interest in wider participation of the Republic of Serbia in the existing forms of regional multinational cooperation. As Serbia's foreign policy priority they exclusively set the resolution of Kosovo's final status. Moreover, elite party members in the circles around former Prime Minister Vojislav Kostunica, who de facto influenced the shaping of the foreign policy, often gave statements which could long term affect the bilateral relations among the countries in the region (for example, the statement of Aleksandar Simic, advisor to Prime Minister Kostunica, on Montenegro as a "quasi state" etc.).

Similar positions when it comes to foreign policy priorities has the *Serbian Radical Party*, the strongest opposition party in the Serbian parliament, which still calls for the solution of the Serbian national issue in the region of the Western Balkans – in Kosovo, Montenegro, Croatia and Bosnia and Herzegovina. In that context, SRS representatives often gave statements which were based on the attempts to revise current borders and create a grand Serbian ethno-national state. From time to time, *Serbian Radical Party* president and ideologist, Vojislav Seselj's, concept of the so-called Greater Serbia was revitalized.<sup>10</sup> Among the main guidelines of the foreign policy direction of the *Serbian Radical Party* there is no declaration for European integrations, although in the presidential and parliamentary elections campaign one could notice numerous speeches of party officials in which there were no drastic opposition to Serbia's accession to the Union (but only if Kosovo is treated as a province inside of Serbia). On the other hand, SRS is resolutely against a possible membership of the Republic of Serbia in the North Atlantic Alliance. At the same time, one can notice the part's disinterestedness in regional means of interstate cooperation, with the exception of cooperation with Serbs in former Yugoslav countries, Republika Srpska in Bosnia and Herzegovina and Serbian political parties in Montenegro.

### **2.3 Serbia and Multilateral and Bilateral Regional Cooperation in South East Europe**

Serbia undoubtedly has the interest that a more intensive interstate cooperation is established in the Western Balkan region and South East Europe through strengthening regional integrations and expanding their jurisdiction. However, with regards to that,

---

<sup>10</sup> See: Vojislav Seselj *Ideologija srpskog nacionalizma*. (Belgrade: Velika Srbija, 2002), pp. 997–9.

one can distinguish between two periods in Serbia's (earlier FR Yugoslavia and State Union Serbia and Montenegro) attitude towards multilateral forms of cooperation in the region. The first period is between 2001 and the second half of 2004 in which Serbia's role transforms from a completely passive one (during Milosevic's regime) to a leader in regional cooperation. The second phase starts in the second half of 2004 and it is characterized by focusing on the political elites on the so-called remaining national questions, primarily on the solution of the statehood of Montenegro. Because of that, in this period Serbia showed certain disinterestedness in deepening with regional cooperation.

As in most of the countries of the region, the sense of regional ownership of the means of multilateral cooperation in the Western Balkans is not strengthened in Serbia. The European Union still has a dominant role in the creation and support of regional cooperation in the southeast of Europe which can be seen in the example of the transformation of the *Stability Pact for South East Europe* into the *Regional Cooperation Council* during 2007 and 2008. Similar tendency was evident during the recent expansion of the *Central European Free Trade Area* to the countries of the Western Balkans and the Republic of Moldova (CEFTA 2006).

In the general public and among the politicians there are two completely opposite views of the future of regional cooperation. One is based on the fact that all regional initiatives were formed under the pressure from the European Union, and that after the countries join the European Union they will lose its purpose. The other, entirely opposite view, is based on the "maximalist" understanding of regional initiatives. In accordance with it, the future *Regional Cooperation Council* (together with the Cooperation Process in South East Europe) would be an important part in strengthening the southeastern dimension of the future European Union which would include the Western Balkans.

Today, the leading and most important means of multilateral cooperation between the states in the Western Balkans and South East Europe are the following:

- South-East European Cooperation Process;
- Regional Cooperation Council (transformed Stability pact for South East Europe);
- South-East European Cooperation Initiative;
- Central European Free Trade Area;
- Black Sea Economic Cooperation;
- Adriatic-Ionian Initiative;
- Danube Cooperation;
- Central European Initiative and
- South-East European Energy Community.<sup>11</sup>

The Western Balkan Region, still burdened by the bad legacy of the conflicts in the

---

<sup>11</sup> On the development of means of multilateral cooperation in South East Europe see: Dusko Lopandic *Regionalne inicijative u Jugoistočnoj Evropi: institucionalni oblici i programi multilateralne saradnje na Balkanu*. (Belgrade: Institute for International Politics and Economics and European Movement in Serbia, 2001), pp. 19–191; and Jelica Minic and Jasminka Kronja. *Regionalna saradnja za razvoj i evropsku integraciju*, (Belgrade, Tirana, Skopje, Podgorica, Sarajevo, Yagreb, Pristine: European Movement in Serbia, Albanian Institute for International Studies, Center for Institutional Development, European Movement in Montenegro, Helsinki Committee for Human Rights in Bosnia and Herzegovina, Institute for International Relations, Kosovo institute for Political Research and Development, 2007), pp. 5–56.

last decade (1991-1999), has, however, managed to make a step forward in the last several years and to create new forms and means of interstate cooperation. That is why one should not underestimate the results of the regional initiatives. Of course, a number of unsolved interstate problems and an objective lack of political will still prevent a more intensive development of cooperation in the region.

The official relations between Ljubljana and Belgrade have particularly been jeopardized in the first half of Slovenia's presidency over the European Union. The reactions of the part of the Serbian public to Slovenia's recognition of the independence of Kosovo were very pronounced in February this year culminating in the attack of the embassy of this country and shopping malls in Belgrade and Novi Sad.

The relations between Serbia and the Republic of Croatia are, despite numerous problems, improving over the past several years. Even though the return of people of Serbian nationality who fled Croatia in May and August 1995 was not successful, Belgrade and Zagreb concluded a series of bilateral agreements on economy, social issues and culture.<sup>12</sup> The reactions to the Croatian recognition of Kosovo's independence were a lot milder compared to the Slovenian one. The *Independent Democratic Serbian Party* (SSDS), which is the strongest Serbian political party in Croatia, did not leave the government of this country despite the threats it will do so if Croatia recognized Kosovo's independence. This prevented the fall of the government formed by the *Croatian Democratic Union* and *Croatian Peasant Party*.

In the period after 2000, the relations between Serbia and Bosnia and Herzegovina moved forward with the establishment of the *Interstate Cooperation Council*, which however lost on importance over the last few years. On the other hand, several statements by Serbian state officials regarding the status of Republika Srpska within Bosnia and Herzegovina and, as they claimed, its right to self-determination stirred the Bosnian public. However, these statements did not jeopardize long term good relations between the two states.<sup>13</sup> Bosnia and Herzegovina did not recognize the independence, nor were there any serious attempts of public debate on the issue.

Following the proclamation of independence of the Republic of Montenegro and the referendum on the statehood of this former Yugoslav republic on May 21<sup>st</sup>, 2006, the relations with Serbia were brought to a very low level. That is illustrated by the fact that the newly appointed Serbian ambassador to Montenegro began his duty at the beginning of 2008. The unsolved status of ethnic Serbs in Montenegro additionally complicates relations between Belgrade and Podgorica.<sup>14</sup> In that sense, it is interesting to note that some government officials have created close relations with pro-Serbian parties in Montenegro without trying to form such relations at the level of governments. Possible recognition of Kosovo as a sovereign state still is not a part of the public discourse in Montenegro, but some circles in the ruling *Democratic Party of Socialists* left some room that it could happen, as they said, in a foreseeable future.<sup>15</sup> However, it is not rare to hear

---

<sup>12</sup> List of Agreements available at: <http://www.mfa.gov.yu/Srpski/Foreinframe.htm>.

<sup>13</sup> "Koštunica da drži prste dalje od BiH", *Blic*, (October 25<sup>th</sup>, 2007), p. 3.

<sup>14</sup> See: Dragan Djukanović, "Položaj Srba u postjugoslovenskim državama", *New Serbian Political Thought* No. 3/2007.



analysts saying that such a decision of the Montenegrin government could jeopardize current “co-existence” between the pro-Serbian and dominant Montenegrin part of the population and that it could affect security in the country.

The Republic of Macedonia and the Republic of Serbia managed to overcome certain bilateral problems over the past decade. This, however, still does not include the solution of a dispute between the *Serbian Orthodox Church* and the *Macedonian Orthodox Church* which culminated in 2005 when the Macedonian state started a trial against bishop Jovan, the *Serbian Orthodox Church* representative in Macedonia. However, one can conclude that the two states have established successful economic cooperation, but also cooperation in areas of culture, social issues etc.

#### **2.4 Preliminary Conclusions**

During the eight years since the beginning of a true process of democratization and transition, Serbia faced constant reexamination of its own international and geo-strategic position. Even though the changes in political and economic circumstances brought the necessity that the country joins European and Euro-Atlantic structures, it is often that some very influential political actors try to slow down or completely stop the above mentioned processes. However, after the recent parliamentary elections in Serbia (May 11<sup>th</sup>, 2008,) a pro-European majority was successfully formed in the National Assembly by the representatives of a coalition “For European Serbia” and the coalition of the *Socialist Party of Serbia*, *United Pensioners Party of Serbia* and *United Serbia*. The resolution of the final Kosovo status could have, due to the strengthening of Serbian nationalism after the unilateral declaration of independence in this entity, jeopardized the integration of the Republic of Serbia into the European Union and encouraged the sense of self sufficiency among the citizens. However, that did not happen after the May elections. It is clear that in the upcoming period Serbia will move towards membership in the Union at a slower or faster pace depending on the efficiency of the new government and reaching a wider social consensus.

Together with Bosnia and Herzegovina and the Republic of Montenegro, republic of Serbia is at the bottom of the list of regional countries according to the intensity and successfulness of European integrations. Yet, numerous examples of support from the European Union after Kosovo’s declaration of independence give basis for optimism that the country will move faster towards full membership in the Union once it finalizes cooperation with the ICTY.

Deep division in Serbian society with regards to European integration was successfully overcome with the formation of the new government. This division is shown through the existence of two different views of foreign policy priorities and lack of clearly defined and established strategic goals of the country. On one hand, the parties gathered around the coalition “For a European Serbia”, the *Liberal Democratic Party* and the parties of

---

<sup>15</sup> See: Novica Djurić, “Milo će o Kosovu kada dode vreme“, *Politika*, (March 1<sup>st</sup>, 2008), <http://www.politika.co.yu/rubrike/Svet/Milo-ce-o-Kosovu-kada-za-to-dodje-vreme.lt.html>.



national minorities are advocating for faster integration into the EU and NATO, while on the other hand, the parities of the so-called people's coalition – *Democratic Party of Serbia* and *New Serbia* are in favor of joining the EU, but under the condition of recognition of Serbia's territorial integrity and preservation of Kosovo within its borders according to the *United Nations Security Council Resolution 1244*. At the same time DSS and NS are opposing entering the North Atlantic Alliance and are calling for Serbia's military neutrality. Socialist Party of Serbia and its coalition partners are also for joining the European Union without explicit conditions, but not the North Atlantic Alliance. The leading opposition party, the Serbian Radical Party, is not essentially interested in acceding to the European Union, but at the same time, it is resolutely against NATO membership. It is still burdened by ideas of its founder and ideologist, Vojislav Seselj, about forming a unitary Serbian state in the Balkans, i.e. *Greater Serbia*.

In the light of different foreign policy priorities, Serbia has, since the beginning of the process for determining Kosovo's final status at the end of 2005, had a passive role in the existing means of interstate cooperation. Also, its relations with neighboring states were determined to great extent with their relation towards a unilaterally proclaimed independence of Kosovo. However, the author concludes that the bilateral relations between Serbia with its new neighbors (the states which came out of former Yugoslavia) are improving, but they are often hampered by inadequate regulation of the status of the Serbian ethnic minority in those states.

### **3. MACROECONOMIC FRAMEWORK OF THE EUROPEAN INTEGRATION PROCESS IN SERBIA**

#### **3.1 Overview of the Main Macroeconomic Trends and Developments**

The Serbian economy is on a transition path. If that path is shown as a u-curve which represents employment and the first half is the decrease in employment to a minimum from which the line rises to the point of saturation, Serbia is obviously in the first half of the curve, i.e. it did not pass the minimum, or it is not even close to the minimum. The transition between 2001 and 2007 enabled a partial re-industrialization from 2003, which formed a basis for stronger export dynamics since 2004. The growth in production and employment in the private sector, which significantly made up for the loss of jobs in the public property sector, is a result of monetary stability reached between 2001 and 2003, privatizations completed in that period, resolution of the foreign debt problem and the gaining of credibility for the inflow of foreign capital as well as the reforms and progress made in the financial and monetary sector. However, wider structural reforms were lacking, most of all a comprehensive reform of the public sector, so the reach of economic policies (fiscal and monetary) remained short.

*Gross Domestic Product* – The growth of gross domestic product in 2007, especially in the first half of the year, was impressive, 7.3% in the whole year, and 8% in the first six months. Nevertheless, in November 2007, this growth was seen as unbalanced<sup>16</sup> by the *International Monetary Fund's* (IMF) Mission. The IMF Statement said that it reflected high growth of domestic demand spurred by rising salaries, credit growth and expansive fiscal policy in the previous year. The most dynamic growth in the previous years was recorded in trade, construction, traffic and telecommunications, and in the financial and state sectors. For example, in 2007, retail turnover jumped around 23% compared to 2006, the volume of telecommunication services expanded by 39.7%, while construction works grew 19.1%.

Since 2000, the private sector recorded the most dynamic growth, most of all as a result of started structural reforms, a faster privatization process and a number of stimulation measures and activities undertaken by the local and state administrations, but also thanks to the advantages that characterize private property.

In the first five or six years of transition (2001-2006) the share of active companies rose from around 85% in 2001, to over 90% in 2006. In five years, the share in total employment grew from 17% to over 55%, and the share in forming gross added value of companies jumped from 18% to 58%. It is the private sector that accounts for five sixths of the growth in added value between 2001 and 2005. There is no dilemma that the companies from the private sector (together with the entrepreneur sector) represent the main absorption outlet for the redundant workers from social and mixed property companies.

---

<sup>16</sup> "Concluding Statement of the Mission", (November 6, 2007).

**Table 3:** Growth Rates, Changes Relative to Previous Year

	<b>Gross domestic Product</b>	<b>Fixed assets Investm.</b>	<b>Gross Value Added, Industry, total</b>	<b>Gross Value Added, Manufactured</b>	<b>Physical volume of production Industry total</b>	<b>Physical volume of production Manufactured</b>	<b>Productivity Industry</b>
2001	4,8	-4,2	-3,2	-3,3	0,1	0,7	4,1
2002	4,2	-0,8	-2,5	-2,9	1,8	2,7	12,7
2003	2,5	3,1	-3,8	-6,0	-3,0	T	10,9
2004	8,4	15,9	6,7	8,7	7,1	9,6	12,5
2005	6,2	5,9	1,0	-0,1	0,8	-0,7	9,0
2006	5,7	9,2	5,0	5,6	4,7	5,3	14,2
2007	7,5	19,6	4,7	5,4	4,6	5,4	14,3

1) Note: Data on GDP, GVA and investments for 2006 are preliminary.

2) Note: Data for 2007 are estimated.

The private property sector also appears superior with regards to lower cost of labor and higher productivity. It is only in this sector that the labor costs are lower than 50% of added value. Industrial labor productivity grew in 2005 and 2006, which lasted until the beginning of 2007, when it started its slowdown. Between January 2003 and October 2007, the productivity trend reached 89.7%, while the salaries in industry grew 69.7%.

*Industrial production* – The stabile growth trend in the industrial production, together with exports, started in mid-2005. This corresponded with the growth in demand that

**Table 4:** Share in GDP, %

	<b>Gross Domestic Product</b>	<b>Investments in fixed assets</b>	<b>Gross Value Added, Industry, total</b>	<b>Gross Value Added, Manufacturing</b>
2001	100,0	10,4	21,6	19,4
2002	100,0	11,8	20,2	15,8
2003	100,0	16,1	18,9	14,0
2004	100,0	17,7	19,7	14,4
2005	100,0	17,3	18,6	13,7
2006 <sup>1)</sup>	100,0	17,9	18,2	13,6
2007	100,0	18,0		

1) Note: Data for 2006 and 2007 are estimated.

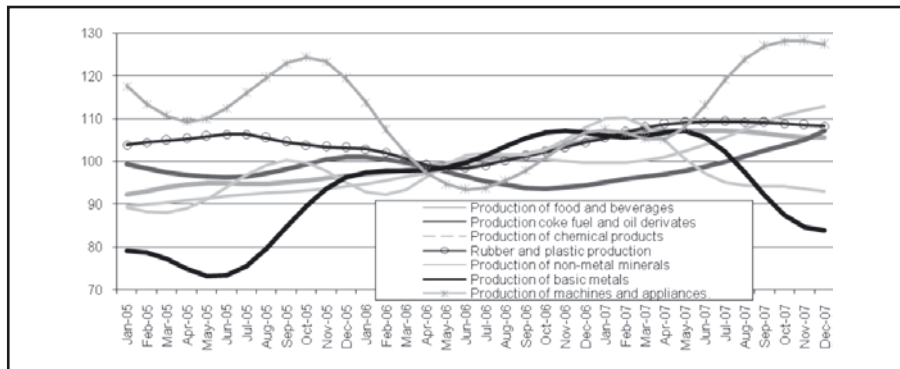
**Graph. 1** Trends of Productivity and Real-Term Salaries and Wages in Industry

year owing to the beginning of credit expansion activities of the private banking sector. Salaries, as the second most important component of demand, were under control that year because of the extended IMF STAND-BY arrangement, which was successfully completed by the beginning of 2006.

During 2006 and 2007, the stable growth trend continued, but based on the latest data and analyses, one can conclude that the trend was interrupted at the end of the year. In September and October, the reduced speed in the growth of industrial production was possible to explain by the sharp fall in production of basic metals due to the overhaul at US Steel plant in Smederevo and the fall in production of non-metal minerals (cement); once these factors are excluded from the index of total industrial production, there is no decrease in the deseasonal series. But, in November, such result changed; basic metals production was reduced by 27% compared to the same month in 2006, cement production moved upwards, but other areas, which pulled the growth before, started showing decreasing tendencies. This mainly refers to the food industry which has the biggest share in industrial production 22%, and processing industry 29%. Other more important areas that had a considerable share in growth are: production coke fuel and oil derivatives, chemical production, rubber and plastic production, non-metal minerals, basic metals and the production of machines and appliances (*See Graph 2*).

Food production recorded the most stable growth since the beginning of 2005, and it represented the basis for stable growth of production in general. In November, one can notice a sharp fall of deseasonal value, by over 7%, which caused the fall in year-on-year physical volume of production by 5.5%. An important factor in this negative result was

**Graph 2.** *The Largest Areas of Processing Industry in Serbia 2005-2007. Trend Cycle, Indexes (average 2006=100)*

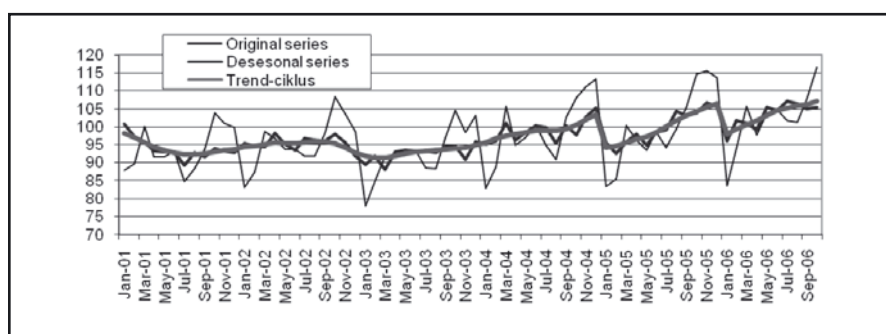


the drought in 2007, which had the character of environmental disaster, and significant rise in prices of food in the second half of the year. However, in December, there was a relative recovery of about 3% compared to November in the original series, or around 9% in deseasonal series. The completion of the overhaul at US Steel brought about a significant recovery in the field of basic metals. The chemical industry was recording an upward trend, so these three areas, which account for 39% of total industrial production have, in the short term, slowed down the fall in industrial production.

The total industrial production in 2007 did not exceed 4%, with growth stopping at 3.7%, which makes the statistical estimate of 4.6% growth from the December statement too optimistic. Even though it is not likely that in the first half of 2008 we return to a stable growing trend, some important fields give cause for optimism; it is likely that the recovery of basic metals production will continue, non-metal industry is on the rise, as well as chemical production, rubber industry and the production of machines and appliances. All this promises a reasonable stagnation in industrial production, if not even growth in the first half of 2008, under the assumption that there is no sharp fall in demand due to risks which can imply a radical ebb in foreign capital inflow that covers a big part of imports, including the imports of intermediary goods.

Significant improvement in industry, compared to the level from the beginning of the period, still does not allow the conclusion that there has been a trend of re-industrialization which could be compared to success stories of the transition process, or the industrial level before the 1990s. That is the main reason for the absence of dynamic employment, especially in the corporate sector. A relatively small decrease of employment in the period in question can be attributed in part to the low intensity of structural reforms and an unreformed public sector. Such state of industry significantly conditions the structure of the total offer, i.e. expansion and high import levels, small coverage with exports and foreign trade imbalance.

*Unemployment* – The current situation with regards to employment (*Table 5.*) is such that at the end of 2007, or at the beginning of 2008, we still have a significant number of

**Graph 3:** Industrial Production in Serbia 2001-2007. Indexes (average 2006=100)

employees in the public and mixed property sector, even though that number rapidly decreased over the last years. A look at the unemployment rate does not show a considerable decrease in 2006, but, according to the data from the National Employment Service, 2007 brought a decrease of at least two percentage points, from 26.6% in 2006 to 24.4% in 2007.

**Table 5:** Number of Employment (thousands)

Sector	September 2001	September 2007	Index 2007/2001
Budget sector	321,6	317,6	98,8%
Public state enterprises	134,9	100,1	74,2%
Public local enterprises	52,3	58,4	111,5%
Public sector – total	508,9	476,1	93,6%
Social ownership	643,7	201,4	31,3%
Mixed ownership	377,0	271,5	72,0%
Private ownership	1258,2	1553,5	123,5%
<b>Total</b>	<b>2787,8</b>	<b>2502,5</b>	<b>89,8%</b>

Note: Security and defense (army and police) not covered.

This figure reaches around 470,000 taking into consideration that slightly under 1,000 big and medium socially or mixed owned companies expect privatization, restructuring or liquidation, and that public and public-communal enterprises still need to undergo the process of corporatization and privatization. On the other hand, the entrepreneur sector (self-employed professions, shops, etc.) which was the most propulsive in the increase of jobs between 2001 and 2006, with a total number of jobs rising from around 214,200 to 572,100 in 2006, in 2007 reached stagnation and saturation. In the same period, the num-

ber of farmers fell significantly from 691,700 in 2001, to 501,900 in 2007, but it managed to stop the trend.

Companies, institutions and organizations which have the biggest overall number of employees recorded a fall as a group from 1,738,200 in 2001, to 1,427,600 in 2007, but the number of employees in the private sector grew from 208,500 in 2001, to 478,500 in 2007, which is not only the result of employment in new companies and creation of jobs, but also the privatization of the existing companies. Moreover some of them still have not gone through structural transformation.

It can be said that in the whole period between 2001 and 2007, the number of newly created jobs did not exceed 200,000 and this number mostly refers to jobs in small enterprises or institutions and organizations. It is very unlikely that there will be a doubling of the number of workers in this sector in the next five to six years which would compensate for the fall which is before us in the process of transformation of the public sector and social property.

*Trade flows* – The basic characteristic of foreign exchange of the Republic of Serbia in the period between 2001 and 2007 was a continuously high deficit in goods and services which amounts to an average of 23.3% per year share in the GDP. The greatest deficit in this period was recorded in 2004 due to the introduction of VAT, while the deficit in goods and services in 2007 is at the level of 21.5%. The real deficit in 2007 reached EUR 6.9 billion. The table below shows import and export levels in the period 2001-2007.

**Table 6:** *Serbian Export and Import in mil. EUR*

	<b>Exports</b>	<b>Imports</b>	<b>Balance</b>	<b>E + I</b>	<b>E / I (%)</b>	<b>GDP</b>	<b>Deficit in GDP(%)</b>
2001	1896.0	4757.9	-2861.8	6653.9	39.9	13186.2	-21.7
2002	2192.0	5919.0	-3727.0	8111.0	37.0	16811.8	-22.2
2003	2442.4	6589.3	-4146.9	9031.7	37.1	18008.7	-23.0
2004	2831.6	8623.3	-5791.7	11454.9	32.8	19723.5	-29.4
2005	3608.3	8439.2	-4831.0	12047.5	42.8	21113.4	-22.9
2006	5102.5	10462.6	-5360.1	15565.0	48.8	25249.5	-21.2
2007	6432.2	13358.7	-6926.4	19790.9	48.2	30581	-22.7

*Note: From 2003 we apply new methodology with larger coverage in data processing (included returned goods, financial lease and re-exports);*

*GDP in 2006: estimate by Statistical Office of Serbia;*

*GDP in 2007: estimate by Ministry of finance.*

Until mid-2005, the exports grew moderately, while the imports grew explosively by mid-2004. Growth of exports started to pick up in the second part of 2005 as a result of production growth after restructuring and privatization in the previous years. Import growth until mid-2004 was spurred by the expanding domestic demand. There was a correlation between growth in salaries lead by an uncontrolled growth of salaries in the

public sector and growth in imports, mainly of consumer goods. Public sector salaries were put under control in mid-2004, after the government was formed and the arrival of the IMF Mission. In that way, the expansion of imports was stopped and foreign trade deficit was put under control. It remained like that until 2006.

The explosion of the foreign trade deficit after September 2006 was caused by the explosion in demand after the rise in public sector salaries following the budget rebalance in October 2006 showing up in the structure of imports as well. There was a continuous growth in imports of intermediary and consumer goods, as well as agricultural products due to poor yield in Serbia and high rise in prices of these products. Even though the import growth trend was slowed down in the last months of 2007, as well as the growth of exports, the rhythm of growing deficit did not slow down threatening to anticipate the risks of the upcoming financial and currency crisis when the inflow of capital that covers the deficit ebbs. In 2006 and 2007, the level of foreign capital, both credit and investment was at the level of USD 7 billion.

However, one should not forget the liberalization from 2002 as one of the factors in the increase of the deficit. Most of the quantitative limitations were abolished, and there was a drastic decrease in customs rates; Serbia started the procedure for the accession to

**Table 7: Serbian Payment Balance, 2001-2007 (% GDP)**

	2001	2002	2003	2004	2005	2006	2007
I. Current Operations	-2.4	-7.9	-7	-11.7	-8.5	-11.5	-16.46
1. Goods	-19.54	-20.37	-19.76	-26.39	-20.15	-19.67	-21.10
1.1. Exports f.o.b.	15.42	13.96	16.31	16.65	18.94	20.48	21.16
1.2. Imports f.o.b.	-34.96	-34.32	-36.07	-43.04	-39.09	-40.16	-42.27
2. Services	2.07	0.82	0.99	0.71	-0.02	-0.2	-0.04
2.1. Exports	5.2	4.73	5.11	6.02	6.23	6.65	7.03
2.1. Imports	-3.13	-3.91	-4.11	-5.31	-6.26	-6.85	-7.07
3. Goods and Services (1+2)	-17.48	-19.55	-18.77	-25.67	-20.18	-19.87	-21.14
3.1. Exports	20.62	18.68	21.42	22.68	25.17	27.14	28.19
3.1. Imports	-38.1	-38.23	-40.19	-48.35	-45.35	-47.01	-49.33
4. Current transfers	10.01	9.01	10.12	12.91	11.68	8.85	5.66
4.1. Receipts	13.18	11.34	12.28	15.36	14.87	13.75	9.74
4.2. Expenditures	-3.17	-2.33	-2.16	-2.45	-3.18	-4.9	-4.08
5. Official transfers (donations)	5	3.13	2.34	1.94	1.25	0.72	0.66
II. Capital and Financial Transactions	6.7	12.9	12.4	12.6	18	29.6	20.00

*Note: Data taken over for National Bank of Serbia, USD, mil, and converted in EUR Coefficients  
USD into EUR      1.1166    1.0607    0.8851    0.8046    0.8044    0.7974    0.7307.*



the *World Trade Organization* (WTO), and it became a part of the *Stabilization and Association Process* which implied further adjustment of foreign trade policies: lowering quantitative limitations in exports and imports, tariffication of non-customs measures and transferring of the protection measures to policies for the protection of the environment, regional development and prevention of disloyal competition. Also, high dependency on the import of energy, as well as copper and iron ore used in the production of basic and other metals, which have a high price on the global market<sup>17</sup> cause the deficit to rise. Importing of equipment and repro materials followed the increase in activities of privatized companies. Credit expansion added to the growth in imports of durable consumer goods, which is also one of the reasons for the high deficit.<sup>18</sup>

Export expansion, as already mentioned, happened mainly due to privatization, investments and renewal of production in privatized companies. In addition to that, there were certain stimulants such as:

- 1) signed and ratified free trade agreements with the countries of the Stability Pact which are now unified in a single CEFTA agreement<sup>19</sup>;
- 2) export of the surplus of agricultural goods;
- 3) getting a preferential status in the exchange with the EU for a certain number of products (textile, agriculture);
- 4) favorable prices of metal and metal products in the global market.

The limiting factor for a stronger reindustrialization and further export expansion is the insufficient amount of greenfield investments. The reasons for that are in what one may call country risk which includes political instability, macroeconomic risks of the collapse of monetary and price stability, an unreformed and expansive public sector, unregulated management and use of construction land, corruption in obtaining necessary permits etc. The slowdown and reversal in the growth trend, and the fall in exports from September 2007 can be temporary due to three incidental factors: ban on exporting crops, decrease in metal production and increase in the sugar stock. However, in 2008, the export growth trend which was present until mid-2007 is not likely to return.

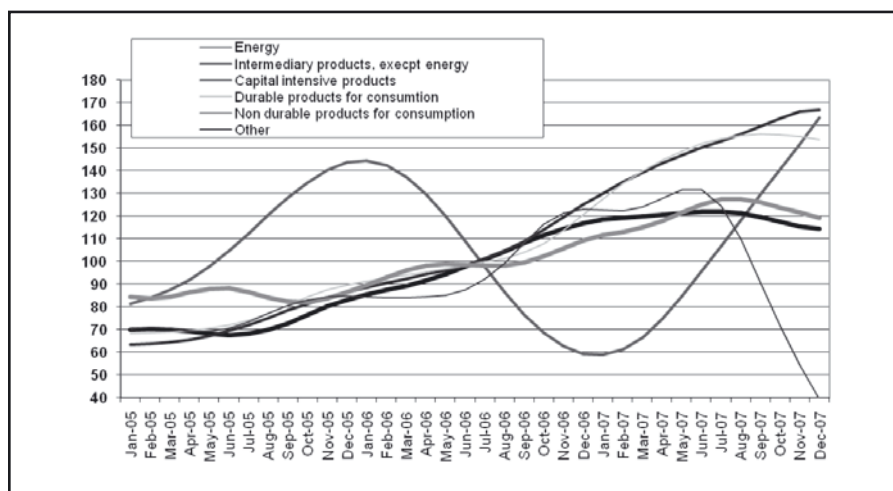
The structure of exports in the period between 2001 and 2007 did not change significantly – Serbia mostly exported intermediary goods (50% of total exports), followed by non-durable consumer goods (25% of total exports). That structure is unfavorable because products that make for more than half of the exports are mainly products for reproduction and basic metals semi-products which contain less newly added value, and cost less in the global market. A structure like this is, in the long term, inadequate and that is connected with raising the level and dynamics of greenfield investments. During 2007, there was a certain move forward in the structure of the exports because it recorded a growth rate in exporting capital goods (over 50%).

In the import structure for the period between 2001 and 2007, there are no significant changes: most imported are reproduction products and consumer goods. The consumer

<sup>17</sup> Energy imports accounts for around 20% of total imports

<sup>18</sup> The import of vehicles in the last several years revolved around 7% of total imports.

<sup>19</sup> Exchange is customs free for the majority of products making Serbian goods competitive in the exchange with these countries.

**Graph 4:** Serbian Exports, by Use 2005-2007 EUR Value Trends (average 2006=100)

goods group is dominated by non-durable products, which is, together with the fact that the equipment accounts for less than 20% of total imports, unfavorable for a transition country such as Serbia, although there was an improvement in the import of equipment, and in particular in the first half of 2007.<sup>20</sup> Data for the year 2007 show that the import structure was dominated by the reproduction products with 60.8% (USD 11,160.7 million), then consumer goods with 21.7% (USD 3,989.7 million) and equipment with 17.4% (USD 3,200.1 million).

*Monetary policy* – Strict monetary policy prevented inflation shocks despite the shocks that came from the outside in terms of higher gasoline and other regulated prices. The National Bank of Serbia's (NBS) target core inflation was lowered from 14% in 2005, to 6% in 2006 and 5.4% in 2007. In 2007, the target band for core inflation was set right (between 4% and 6%), but the total inflation surpassed the plan and reached 10.1%. Total inflation gained on speed in 2007 (from 1.2% in the first quarter to 3% in the fourth) due to faster growth in both base and regulated prices. It is important to point out two very significant groups of products which pushed the inflation. Those products are agricultural goods and gasoline. Gasoline prices are adjusted to the price of crude oil, but its price influences, to an extent, the prices of other products. Increase in prices of agricultural products (total of 15%) presented a shock that was not anticipated. Its background was formed by the drought in the vegetative period and, even more, conditions on the

<sup>20</sup> The investment impulse in the first half of 2007 was spurred by the funds from the *National Investment Plan* approved at the end of 2006 and beginning of 2007. The Serbian Government has adopted the *National Investment Plan* (NIP) to engage the surplus income from privatization in the most effective way possible, and, at the same time, to stimulate employment, infrastructure modernization and economic growth.

market. Prices of some important foodstuffs rose over the prices in the surrounding countries. Milk and dairy products, oil and meat products are the most characteristic examples.

Thanks to monetary restrictiveness, especially in the first half of the year, the expansion of demand, spurred through two main channels, salaries and loans, did not cause inflation to get out of hand, or to jeopardize price and monetary stability. The effects of the restrictive monetary policy in the first half of the year were visible all the way until the end of the year, regardless of the fact that the key policy rate, two week repo rate, was lowered from around 14% to 9% already in August. However, in September, there were considerable movements in the core inflation showing that the main instrument of monetary policy, interest on repo papers, was not as effective as in the beginning of the year. Still the “emergency brake” was the exchange rate which, due to the dinar’s appreciation in the conditions of dynamic capital inflow from abroad, represented the main anchor, no longer as a tool of monetary policy, since the exchange rate was formed freely on the currency market, but as a basic parameter (“price in the system”) with a significant transfer to the prices.

In a two-currency system, such is present in Serbia<sup>21</sup> the repo rate occasionally appears as an ineffective and even ambivalent instrument in regulating liquidity. The increase of the repo rate to National Bank of Serbia papers further fuels lending abroad which then comes to the currency market strengthening the relative value of the dinar and stimulating the offer of foreign currency from domestic savings. Looking back, now we know that in the first half of 2005, the liquidity came more from domestic savings, and that in the second half of 2005, the expansion of lending abroad through the banking sector started with the lending component becoming the main source of liquidity.

The inflow of capital and the control of dinar liquidity inevitably caused appreciation of the domestic currency regardless whether that appreciation was compensated by the growth of productivity. For example, in 2006, the real appreciation within the year amounted to 16.5%, and in 2007, the real appreciation reached 10.4%. Based on the available data on industrial productivity for 2006, the index was 116%, while in 2007, it was around 107.5%. Judging by industry, in 2006, the appreciation was compensated by the growth in productivity, while in 2007, it compensated it only in part.

*Public finances* – The IMF’s Mission, in November 2007, on the basis of the “Memorandum on the Budget and Economic and Fiscal policies in 2008, stated its opinion that despite efforts to control discretionary spending, there is a growing deficit that does not allow curbing of the domestic demand. They pointed out high salaries in the public sector as a result of increases in 2006 and 2007, and the continuation of high expenditures of the *National Investment Plan* (NIP) which could prompt a further widening of extreme imbalance. In order to reverse the extreme imbalance, the IMF recommended fiscal restrictions in a foreseeable period when the structural reforms would yield full effects. It is necessary to have a fiscal surplus of between 2% and 3% of GDP, and already in 2008, it should be 1% of the GDP. The experience of the Eastern European countries shows that such adjustment is possible. Another recommendation is to focus on fiscal consolidation and control of spending, i.e. fiscal discipline. The budget of the Republic of Serbia envisages

---

<sup>21</sup> As a legacy from the past, underdeveloped financial system and embedded distrust for the national currency.

a formal deficit of RSD 14.8 billion (1/2% of the GDP) as a result of the increase of regular revenues by 15% and the increase of regular spending by 9.9%. State spending in the GDP usage balance judged against these parameters shows that the 2008 usage will remain at the same level as in 2007, of 24.4% of the GDP, which is considered to be over inflated.

An issue that is more important than the formal deficit or surplus in public spending is the dynamics and structure of the expenditures. Since the capital expenditures, i.e. outlays for the NIP, were reduced it was possible to make the regular spending which roll into consumer spending more expansive. In that way, regular spending grows 12.1%, with salary spending growing 15.6%, donations and transfers 14.5%, subsidies 11.4, etc. The proclaimed policy for salary growth of budget beneficiaries was to follow the inflation index, but through some collective agreements certain concessions were made anticipating real growth. If expenditures for the repaying of the principal debt and obtaining of financial property are added to the formal deficit, as well as the envisaged loans, the negative sum climbs to RSD 89 billion, which is covered by borrowing and privatization revenues.

Fiscal policy must be characterized as particularly pro-cyclic. That means that instead of using it to cool the overheating demand, or at least not to add to the growth of demand and consumption in the phase of big capital inflow, fiscal policy represents the main factor in the growth and redistribution of income and in that way accumulates risks for a future "hard landing" at the time when the capital inflow stops, while in the meantime, leaving out the possible effects of raising competitiveness, productivity and output in the sector of exchanged goods.

However, the current fiscal realism is understandable; on one hand, 2008 is the year of important political and state decisions, especially in the context of continuing and expediting the process of joining the European Union (EU), and on the other hand, the inherited obligations and dimensions of public spending cannot be significantly reduced without accelerating the whole reform of the public sector. It is often talked about monetary policy being in a quagmire, but at the same time it is forgotten that fiscal policy is too left without maneuvering space in the absence of structural reforms in the public sector.

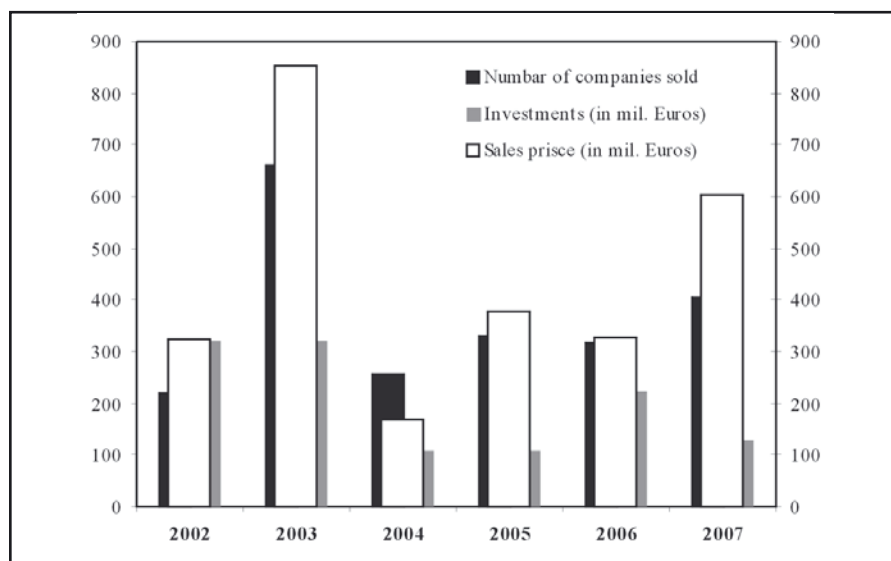
It is obvious that we are approaching a point in time when we need a u-turn. The Memorandum projects that the real growth rate in the following years (2008-2010) reaches the level of 6% to 6.5%, with the scenario of economic policies according to which the dynamics of state spending is radically slowing down in real terms from 16.1% in 2007, to only 2.1% in 2010. The evident goal is to have de-accumulation of risks from the financial crisis at the side of foreign trade and payment imbalance so that the foreign trade sum is brought down from 21.5% (in 2007) to 14.7% in 2010, and to retain individual spending real growth (in 2008 and 2009) lower than real GDP growth (at the level of 4% to 5%) and that the sustainability of future development is based on double figures of foreign investments (20% in 2008 and around 14% in 2009 and 2010).

So, the aims are a pro-investment turn together with curbing the foreign trade deficit and preservation of social acceptability and reaching a comfortable level of state spending. However, it appears as though all of the three above mentioned goals (prevention of financial crisis, social acceptability and investment propulsion) have a higher price from the one envisaged by the Memorandum. The goals cannot be accomplished without a sharp cut in the aggregate state spending, i.e. without a turnaround in one of the following years which implies negative real levels of state spending.

### 3.2 Evaluation of Recent Structural Reforms in Serbia

In 2007, 405 socially owned companies were privatized with 283 sold at auctions, 16 through tender procedure and 106 at the capital market. Total revenues from privatization of these companies amounted to EUR 603.1 million, and agreed investments add up to EUR 125.8 million.

**Graph 5:** Privatization Results from 2002 until the End of 2007



In the period between 2002 and 2007, 1,200 share packages were sold from the Share Fund portfolio bringing in EUR 613 million in revenues. During 2007, the Share Fund sold minority stakes in 420 companies and recorded revenues of EUR 162.8 million. For the first time, minority stakes of 348 companies were sold in the capital market.

The following table shows the results of the privatization process which was based on the Privatization Law.

The *Privatization Agency* estimates that there are 750 socially owned companies left to be privatized. With the amendments to the *Privatization Law* a deadline was set for the remaining socially owned companies to be sold (December 31<sup>st</sup>, 2008). The companies that do not find a buyer before this deadline will either go in receivership or be taken over by the Share Fund<sup>22</sup>, or their shares will be disbursed for free through privatization register to all citizens over the age of eighteen.

<sup>22</sup> The Share Fund sells shares left over from the previous privatization procedure, based on the earlier *Privatization Law* and other acts which arranged property transformation.

**Table 8:** Privatization Results (from 2002 until the End of January 2008, in thousands Euros)

Method	Number of companies bid	Number of companies sold	Percent of effectiveness	Number of employees	Sales price	Investments	Social program
Tender	185	90	49%	82,458	1,126,902	985,897	276,689
Auction	2,073	15,544	75%	145,318	998,269	219,694	-
Capital market	722	567	79%	113,284	553,803	5,902	-
Sum	2,980	2,201	68%	341,060	2,678,974	1,211,493	276,689

In privatization so far, around 10% of tender sales were cancelled, while with auction sales that percentage is somewhat higher, around 14%. The contracts were broken off and cancelled in cases of:

- 1) failure to meet the conditions from the investment program according to the previously agreed dynamics;
- 2) closing of business premises and putting them out of function, change in purpose, renting them long term below real market value;
- 3) selling of objects-property above the allowed percentage of capital value stipulated in the contract;
- 4) failure to meet the requirements from the social program and cutting short the deadline to announce surplus in labor force;
- 5) bad management, wrong business decisions and personnel moves with serious consequences;
- 6) unawareness of domestic rules, general conditions of doing business, market, operation of particular business subject;
- 7) drastic fall in the value of small shareholders' shares (as a consequence of all the above). These problems are not the only ones, but they are characteristic and point to the reasons which lead to decreasing the positive effects of privatization.

It should be pointed out that in the privatization process until now some of the key issues remained open, and without adequately solving them it is not possible to complete the transition process within the deadlines envisaged by the law or to set in motion the full effects of changes in the economic, social and political balance in the society. Those issues are:

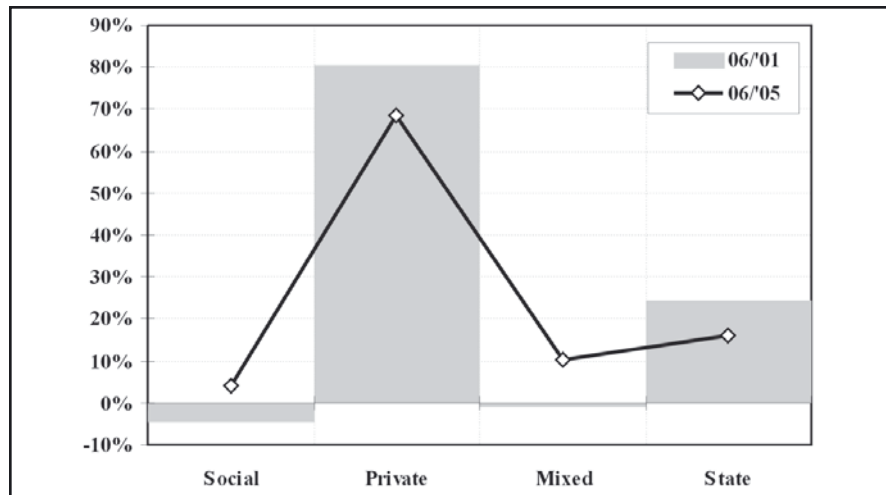
- *Distribution of free shares to the citizens* (at the end of 2007, the Serbian government adopted a bill on free distribution of shares of public companies to be given to some four million citizens left out of the privatization process until now);
- *Privatization of the public (state) sector* – Extreme importance of this sector to national economy comes from the fact that vast state capital was invested in this it, employs a lot of workers, with particularly high external effects on society and economy, nature of their activities now is mainly monopolistic with a significant effect to the standard of living and general economic and political stability;

- *Privatization of city development and agricultural land* – Current status of state ownership over development land and its leasing to investors and the complexity of relations between owners of buildings on state or nationalized land creates confusion and misunderstanding with the investors and greatly hinders and limits their interest. Such exotic state of “ownership” over development land has, as a result, low investments, big losses in revenues for the state and negative effects to the level and growth of GDP;

- *Denationalization* – There is still no clear concept for returning property that was nationalized after World War II, and the main problem is that a good part of it has already been privatized with subsidies or for free and future tax payers are left with servicing the burden of nationalization, despite numerous foreign and domestic debts.

The positive effects of privatization in Serbia so far can be best seen in the analysis of financial results of companies and entrepreneurs between 2001 and 2006 which shows that the private sector recorded the most dynamic growth mainly as a result of initiated structural reforms, faster privatization process and institution of incentives offered by both the local and state level, but also thanks to the advantages that characterize private property *per se*. In the period between 2001 and 2006, the private sector increased its share in the total number of active companies which submitted final reports (from 85.5% in 2001 to 91.5% in 2006), in total employment (from 17.4 to 55.4% respectively), in forming gross value added – GVA (from 18% to 59.5% respectively), and it accounts for four fifths of GVA growth in the period between 2001 and 2006.

**Graph 6:** Contribution of Ownership Types to Gross Value Added (GVA) in Serbia



<sup>25</sup> Labor cost is defined as a quotient which represents the relations between gross income and value added – VA, and as a measure of productivity is gross added value in basic prices per employee.

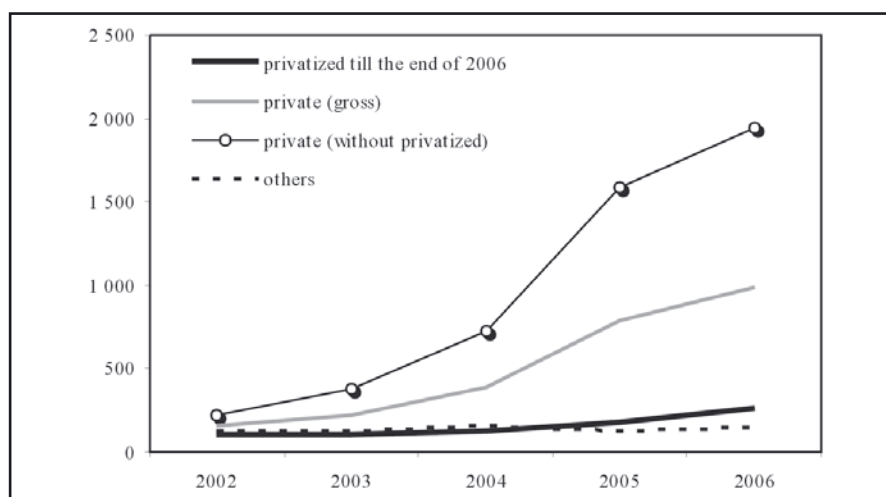
The private property sector proves to be superior in respect to low labor cost and high productivity<sup>23</sup> too. Labor cost in this sector is 0.5 lower (in 2006 they amount to 0.49 which means that gross salaries burden GVA with 49%). There is no dilemma that the high productivity growth significantly compensates for the effect of real appreciation of the domestic currency, so the growth in exports in the last several years does not represent as big of a paradox as it may seem at first – growth in productivity also shows the weakness of the relation: higher dinar depreciation = higher exports.

One other finding needs to be pointed out too. If we would take out companies privatized since 2000 from the group of private companies, we would clearly see that their business result is satisfactory, even though it is far from the potential of the “original” private sector. It turns out that more time than anyone could have anticipated is needed to further increase efficiency and transformation of these companies into competitive producers through recapitalization, business expansion, reorganization, strengthening of discipline and introduction of new entrepreneurship.

It is obvious that, on average, all companies which are privatized need a period of at least two years to show effects of privatization on productivity, while the effects of restructuring and increased productivity on GVA growth show even later. As it can be seen from the next chart, between 2001 and 2006 the cumulative growth of private sector GVA, from which the privatized companies were left out, reached an impressive 1,841%, i.e. it grew almost 18.5 times which is far more than the VA growth in privatized companies. For comparison, GVA growth in the rest of the sectors combined (social, mixed and state) amounted to only 47% in this period.

Institutional reforms started in 2001 had the aim of establishing a stabile and efficient market system, but most of all, competitive economy. However, the dynamics of institutional reforms did not develop at a preferred speed. The Serbian economy in 2008 is still in the process of building a market system of doing business and establishing systematic presump-

**Graph 7:** Index of GVA Change in Private and Privatized Enterprises (2001=100)





tions for its unhindered functioning, all with the goal of realizing the adopted strategic development priorities – reaching higher economic growth rates on which macroeconomic and social stability can be built. Simultaneously, the processes of adjusting the economic and legal systems are unraveling, as well as the processes of adjusting infrastructure to EU standards.

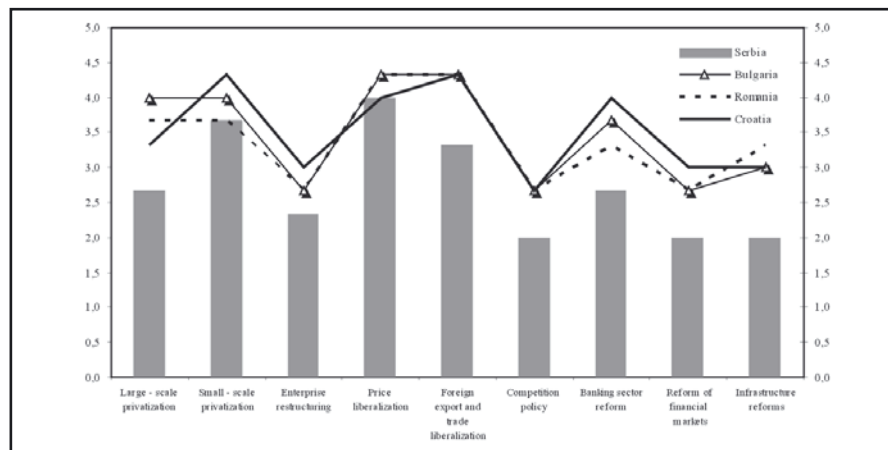
In the previous period of economic transition, Serbia completed the first phase of reforms with establishing macroeconomic stability and laying the ground for the second phase in reforms which will focus on economic growth and structural changes. Legal security of businesses is increased and the conditions for doing business are improved, which is very important for investors from abroad. The average annual transition index was raised from 1.6 in 2000 to 2.7 in 2007. An a lot harder reform phase is ahead of Serbia and it refers to the restructuring and modernization of companies, efficient competition policy and infrastructural reforms.

The latest report from the *European Bank for Reconstruction and Development* (EBRD) for 2007, which analyzes the progress in structural and institutional reforms, Serbia still lags considerably behind other transition countries. With an average grade of 2.7 for the annual transition index (nonpondered arithmetic average of 9 indicators) Serbia dropped from being number 17 among transition economies to between 23 and 24.

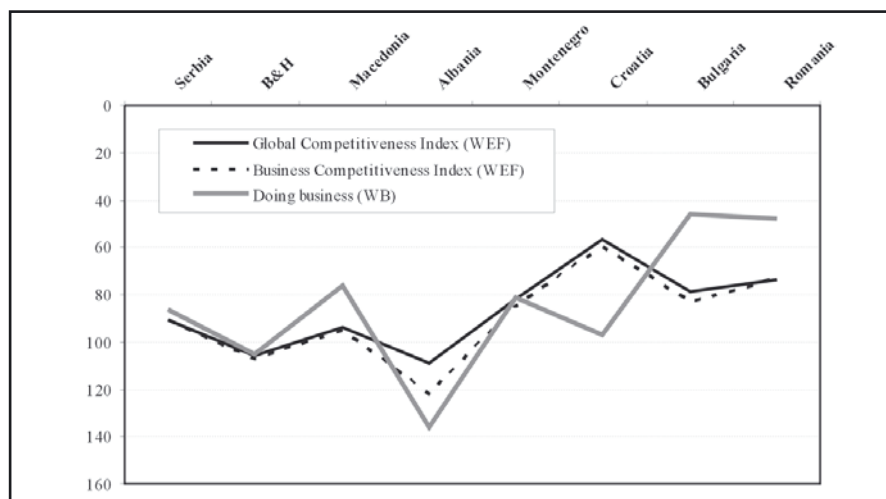
With the highest index value (4) Hungary is the closest to the level of the developed market economies from all of Serbia's neighboring countries. Next to it, more advanced transition economies include Estonia, Czech Republic, Slovakia, Poland and Lithuania. In the SEE region, Bulgaria and Croatia have the best score (3.5), with Romania behind (3.4), followed by Macedonia and Albania (3.1 and 3 respectively) and Montenegro (2.8). Serbia and Bosnia and Herzegovina occupy the last two spots with 2.7.

The results so far warn about several important things. First, Serbia has a low average index value of 2.7. Second, it is evident that in the period between 2006 and 2007 there was no significant move forward (in 2006, the average index value was 2.6). Third, it is easy to notice even the smallest progress: competition policy, financial market development, privatization of public companies. Forth, in terms of reforms, Serbia is not only

**Graph 8:** *The EBRD Transition Indicators for 2007*



**Graph 9: Rank of SEE Countries in Terms of Competitiveness Indexes<sup>24</sup> and Doing Business in 2007/2008**



lagging behind the countries that joined the EU in 2004, but it also trails its main competitors in the region, Bulgaria, Romania and Croatia. Second major structural problem expresses itself in low competitiveness of the Serbian economy. The latest analysis from the *World Economic Forum* (WEF) points to two things. First, in 2007, compared to a group of 131 countries, Serbia is at a very low 91<sup>st</sup> place compared to its main competitors (Croatia 57, Romania 74, Bulgaria 79) and second, Serbia practically stagnated and even worsened its position compared to the previous period (85<sup>th</sup> in 2005, 87<sup>th</sup> in 2006). A part of the blame for the fall can be placed on the methodology of measuring indicators, and the bigger number of countries (for example, in 2007 the analysis was expanded to three more countries compared to 2006, so Serbia was pushed down due to the better ranking of the newly introduced countries).

Analysis of certain factors of low competitiveness warns to low efficiency of market institutions, underdeveloped infrastructure and macroeconomic instability. When it comes to business environment, political instability, lack of work ethics, inefficient bureaucracy, difficult access to financial means and corruption make up for 60% of all factors which hindered doing business.

<sup>24</sup> Global Competitiveness Index is a synthetic index which comprises three sub-indexes: (a) sub-index which includes basic development factors – institutions, infrastructure, macroeconomic environment, health and primary education; (b) sub-index which gathers factors of efficiency increase; (c) sub-index which gathers factors of sophistication and innovation.

Every year, the World Economic Forum also measures the business competitiveness index which marks the level of micro-competitiveness, i.e. the concrete capabilities of companies from certain countries. In general, there is a high correlation between the two indexes. The business competitiveness index has two sub-indexes: (a) sub-index that measures the sophistication of companies' business operations; and (b) sub-index which measures business environment in which a company realizes its activities.

**Table 9: SEE Countries Rankings According World Bank-IFC Doing Business in 2008**

	<b>Doing Business Index</b>	<b>Starting a business</b>	<b>Dealing with Licenses</b>	<b>Employing Workers</b>	<b>Registering Property</b>	<b>Getting Credit</b>
1	46 (BUL)	21 (MAC)	76 (MAC)	57 (BUL)	46 (MOL)	13 (B&H)
2	48 (ROM)	26 (ROM)	90 (ROM)	93 (MOL)	62 (BUL)	13 (BUL)
3	75 (MAC)	81 (MOL)	103 (BUL)	98 (MON)	82 (ALB)	13 (ROM)
4	81 (MON)	<b>90 (SRB)</b>	113 (MON)	109 (ALB)	91 (MAC)	<b>13 (SRB)</b>
5	<b>86 (SRB)</b>	93 (CRO)	<b>149 (SRB)</b>	<b>110 (SRB)</b>	99 (CRO)	48 (ALB)
6	92 (MOL)	98 (MON)	150 (B&H)	114 (B&H)	103 (MON)	48 (CRO)
7	97 (CRO)	100 (BUL)	153 (MOL)	128 (MAC)	<b>115 (SRB)</b>	48 (MAC)
8	105 (B&H)	123 (ALB)	162 (CRO)	139 (CRO)	123 (ROM)	84 (MON)
9	136 (ALB)	150 (B&H)	168 (ALB)	145 (ROM)	144 (B&H)	97 (MOL)
		<b>Protecting Investors</b>	<b>Paying Taxes</b>	<b>Trading Across Borders</b>	<b>Enforcing Contracts</b>	<b>Closing a Business</b>
1		19 (MON)	43 (CRO)	38 (ROM)	17 (MOL)	41 (MON)
2		33 (BUL)	88 (BUL)	53 (B&H)	37 (ROM)	61 (B&H)
3		33 (ROM)	99 (MAC)	<b>58 (SRB)</b>	45 (CRO)	72 (BUL)
4		<b>64 (SRB)</b>	111 (MOL)	70 (ALB)	74 (ALB)	78 (CRO)
5		83 (B&H)	118 (ALB)	72 (MAC)	84 (MAC)	81 (ROM)
6		83 (MAC)	<b>121 (SRB)</b>	89 (BUL)	90 (BUL)	82 (MOL)
7		98 (MOL)	129 (MON)	96 (CRO)	<b>101 (SRB)</b>	<b>103 (SRB)</b>
8		122 (CRO)	134 (ROM)	113 (MON)	126 (B&H)	127 (MAC)
9		165 (ALB)	142 (B&H)	122 (MOL)	131 (MON)	178 (ALB)

Source: *Doing Business in 2008*, IFC-World Bank (the number next to the country's name signifies the place country occupies on the list of 178 countries that were subject of the research).

Even though macroeconomic policy is undoubtedly important, it is agreed that the most important determinant of prosperity and welfare is the quality of institutions and business regulations. Yet, there are very few researches that deal with specific aspects of regulation and analysis of its influence on the economic results such as productivity, investments, grey economy, corruption, unemployment and poverty. The lack of systematic knowledge objectively prevent the creators of economic policies to estimate precisely how good the legal-regulatory system is, and in that way accurately locate what should be reformed and to what extent.

With the aim of overcoming the above mentioned problems the *International Financial Corporation*<sup>25</sup> (IFC) of the World Bank traditionally publishes its annual report which refers to regulations, procedures and expenses connected with one company's operations

<sup>25</sup> A part of *World Bank Group* which provides loans to the private sector.

in its entire life cycle, from the establishment to closing down. The full title of this year's report is *Doing Business in 2008*, and it analyzes the following indicators of business environment: starting a new company, obtaining permits, hiring and letting workers go, registering property, possibility of obtaining loans, protection of investors, paying taxes, cross-border trade, fulfilling contractual obligations and closing down of the company. The research encompassed 178 countries.

As the previous table shows, according to the ease of doing business in 2008 Serbia, at number 86, is in the middle among the countries of the region. From the SEE countries, Bulgaria is ranked best at 46, then Romania and Macedonia, while the lowest ranking have Bosnia and Herzegovina and Albania at 105<sup>th</sup> and 136<sup>th</sup> place respectively. It is interesting that Croatia was named best reformer in the region even though it is ranked very low (97). Croatia conducted reforms in four out of ten areas being analyzed in the publication *Doing Business*. Out of ten indicators, compared to last year, Serbia advanced only in two. The procedure of starting business was relaxed, as well as to close it down, while other indicators more or less remained at the same level as the year before.

**Table 10:** *Some Indicators of Doing Business in SEE Countries in 2008*

	Indicators	ALB	B&H	BUL	CRO	MAC	ROM	SRB	Serbia (in '03)
	GNI per capita (US\$)	2.960	2.980	3.990	9,330	3.060	4,850	<b>3.910</b>	1910
	Population (in mil)	3,1	3,9	7,7	4,4	2,0	21,5	<b>7,4</b>	7,4
	<i>GNI is gross national income</i>								
<b>Starting a business</b>	Procedures (number)	10	12	9	8	9	6	<b>11</b>	11
	Duration (days)	36	54	32	40	15	14	<b>23</b>	51
	Cost (% GNI per capita)	20,9	30,1	8,4	11,7	6,6	4,7	<b>8,9</b>	9,5
	Paid in Min. Capital (% GNI p.c.)	34,3	43	56,3	18,4	0	1,5	<b>8</b>	120,3
<b>Employing Workers</b>	Difficulty of Hiring Index	44	67	17	61	61	78	<b>67</b>	28
	Difficulty of Firing Index	20	30	10	50	30	40	<b>30</b>	40
	Firing costs (weeks of wages)	56	31	9	39	26	8	<b>25</b>	21
	<i>Each index assigns values between 0 and 100, with higher values representing more rigid regulations.</i>								

	Indicators	ALB	B&H	BUL	CRO	MAC	ROM	SRB	Serbia (in '03)
<b>Enforcing Contracts</b>	Procedures (number)	39	38	40	38	39	32	<b>36</b>	36
	Duration (days)	390	595	564	561	385	537	<b>635</b>	1.028
	Cost (% of claim)	31,8	38,4	22,2	13,8	33,1	19,9	<b>28,4</b>	23
<b>Trading Across Borders</b>	Documents for export (number)	7	6	5	7	7	5	<b>6</b>	-
	Time for export (days)	21	19	23	22	19	12	<b>12</b>	-
	Cost to export (US\$ per container)	745	1.030	1.329	1.200	1.130	1.075	<b>1.240</b>	-
	Documents for import (number)	9	7	7	8	7	6	<b>6</b>	-
	Time for import (days)	22	18	21	16	17	13	<b>14</b>	-
	Cost to import (US\$ per container)	750	985	1.377	1.200	1.130	1.075	<b>1.440</b>	-
<b>Registering Property</b>	Procedures (number)	7	7	9	5	6	8	<b>6</b>	6
	Duration (days)	47	331	19	174	98	150	<b>111</b>	186
	Cost (% of property value)	3,5	5	2,3	5	3,5	2,8	<b>5,4</b>	5,5
<b>Closing a Business</b>	Time (years)	-	3,3	3,3	3,1	3,7	3,3	<b>2,7</b>	2,6
	Cost (% of estate)	-	9	9	15	28	9	<b>23</b>	23
	Recovery rate (cent on the dollar)	-	35	32,4	30,2	15,8	28,9	<b>23,1</b>	20,8

Source: *Doing Business in 2008*, IFC-WB. ((-) means that this indicator does not exist or that is not comparable to the last year's one due to changes in methodology).

Here, we will list some of the reforms which were undertaken in SEE countries in the past year, with a special focus on Serbia:

- Serbia transferred company registration from the jurisdiction of courts under exclusive jurisdiction of Business Registers Agency. Businessmen can also register their companies electronically and the company can start operations within 23 days, down from previous 51 days. On the other hand, Serbia lowered the founding capital from EUR 5,000 to EUR 500, which resulted in 40% increase in the number of newly founded companies compared to 2003;

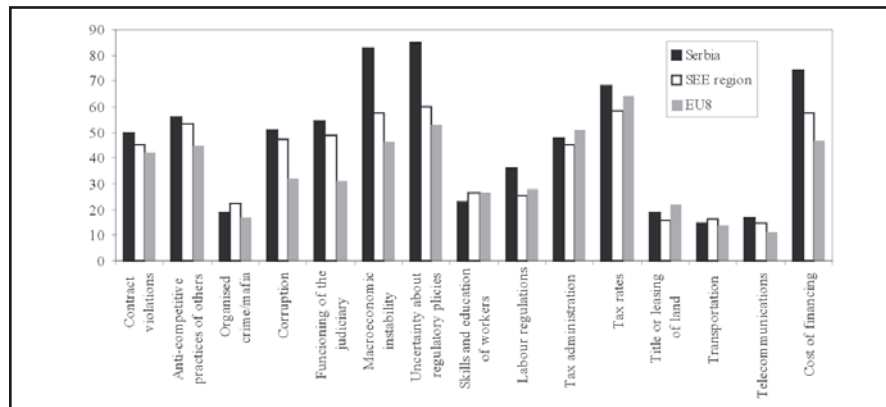
- Serbia and Macedonia adopted new labor laws making the regulations more flexible, easing employment to companies and enabling them to employ workers on fixed term contracts. Macedonia, additionally, sped up the process of obtaining construction permits, lowered the profit tax for companies to 12% (with another decrease to 10% planned for 2008);
- Two years ago, in order to register property 956 days were needed, which is now brought down to 174 days. Starting a business is also facilitated and all the procedures for starting a business are unified in a “one-stop-shop” agency, while the registration of pension and health insurance is done electronically. Also, obtaining loans is easier;
- New credit bureaus are opened in Romania which simplifies the procedure of credit worthiness inspection of potential clients;
- Bulgaria’s Public Credit Registry introduced a system of electronic operations which shortened the information retrieval from three days to only a few seconds. The lower loan limit was abolished at the Registry which increased the credit coverage nine fold. In addition, it introduced private court officials to improve efficiency depending on court orders;
- In Bosnia and Herzegovina, Croatia, Romania and Serbia it is now easier to sign and enforce financial agreements with collateral security;
- Romania introduced a uniform general tax rate of 16% and lowered salary taxes (including contributions towards social and health insurance, as well as for unemployment). Albania and Bulgaria lowered corporate taxes. Progress in the reform of the tax system in Serbia is illustrated by the introduction of value added tax instead of the sales tax.
- Serbia shortened the time necessary for solving contractual disputes from 1,028 days to 635 days thanks to the introduction of new procedures in the area of civil law. With the amendments of the law on receivership new demands were introduced concerning receivership managers, and the deadlines for conducting the receivership procedures were shortened.

At the end, we will briefly look into the quality of state administration in Serbia. In the past seven years, during the implementation of economic reforms in Serbia, the “bottleneck” that appeared was the lack of capacities from the state administration, whose capacities were not built to the extent that would match the growing demand in the economic sphere, becoming more of a barrier than incentive for a faster development of the private sector. The reform of state administration was the longest and slowest in other transition countries too, but Serbia, having in mind that it started its reform the last, has the imperative of fast reform implementation. This is particularly with the realization of a Free Trade Area in SEE project to form a market of 57 million people which would potentially be attractive for investors and in which the countries of the region would compete to attract more FDI in the upcoming period.

The importance the investors give to the criterion of good public administration when they choose the investment destination can be viewed in the results presented in the publication *BEEPS*<sup>26</sup> (*The Business Environment and Enterprise Performance Survey*), which is prepared jointly by the *European Bank for Reconstruction and Development* (EBRD) and the World Bank. The research is being conducted with the aim of identifying

main obstacles for doing business in the countries of Central and Eastern Europe and the former Soviet Union. At the same time, the results of the report should assist in removing the degree in which the companies and businessmen influence shaping of the laws and their application according to their own interests. It is also used to confirm the degree of the “entrapped state“ phenomenon which is one of the most important forms of the so-called big corruption where the private sector bribes high state officials, “buys“ laws, regulations and the position of state supplier.

**Graph 10:** Problems Doing Business – Across Regions (% of Firms Indicating a Problem)



Source: EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS).

The results of the research shown in the chart refer to Serbia, the countries of South Eastern Europe and a group of 8 to 10 transition countries which joined the EU first in 2004. As it could have been expected, different factors have dominant influence on forming a business environment in these countries. Yet, it is clear that in the transition countries, a group of indicators which represents the quality of state administration (corruption, bureaucracy, political stability and the predictability of politics) is dominant compared to another group of indicators which are the traditional measure of macroeconomic stability (inflation and exchange rate policy). Even though the group of indicators which includes the sources of financing, labor legislature, and availability of work force, tax system and infrastructure represents an important factor in the formation of business environment, this influence still lags behind the public administration indicators.

The results of the survey of Serbian businessmen confirm the previous finding even more convincingly. Uncertainty in terms of regulatory policies is the main obstacle which

<sup>26</sup> For the needs of *Business Environment and Enterprise Performance Survey (BEEPS)* only entrepreneurs are being interviewed and their number depends on the sized of the polled countries and it ranges from 200 for small countries to 600 for Russia, for example. That is the main difference from *Doing Business* publication where conclusions are based on the answers of lawyers and accountants, i.e. professional which are not directly responsible for company's activities.

tops even the effects of macroeconomic instability. In accordance with that, the transformation of a politicized, controlled, slow and inefficient administration to an efficient and service oriented one must become one of the priorities in the reform, which also includes the reform of institutions, procedures and personnel with the goal of better policy formation and meeting the demands of the clients.

The analysis of the World Bank has shown that despite visible progress compared to the time of Milosevic's regime, Serbia still considerably lags behind not only EU member states, but the also the average of the South Eastern European region. At the same time, this can be a good answer as to why Serbia is not more attractive to foreign greenfield investors, why were the initial successes in establishing a macroeconomic stability are on "thin ice" this year, and why it is not possible to create a favorable business environment in long term which would stimulate the growth and development of the domestic economy.

### **3.3 Prospects of Future Economic Developments – Possible Scenarios Depending on the Political Circumstances in Serbia**

Two different margin scenarios can be seen depending on the alternative political options in the Republic of Serbia and their influence on international economic relations in the widest sense – openness and non-discrimination in terms of flow of goods and capital on one hand, and (mutually) discriminatory consequences on these flows in case of lowering political relations with some countries on the other. Both start from the current slowdown in investment activities and capital inflow in the expectation of the outcome of the latest general elections in Serbia and negotiations on the new government.

The optimistic margin scenario is based on the assumption that the mentioned slowdown is temporary and that after the elections there will be a reestablishment of interest for placing investments and credits to Serbia, together with a dynamic growth, job creation and rise in the standard of living. The pessimistic margin scenario stems from the assumption that the capital inflow will be insufficient to secure balance in payments, that there will be no growth in investments, that the economic growth will be considerably slowed down compared to the current one, and that this will significantly lower or stop the real growth in consumption, with a probable strong depreciation and inflation.

The economic situation in Serbia, viewed through the lens of current political turbulences, increasingly contributes to drawing a conclusion where the problem of inflation will be of secondary importance for economic processes in the upcoming short term period. Reluctance and caution of the foreign investors to invest in Serbia, together with the more expensive loans on the international financial market, contributes to the reduction of foreign currency offer directly influencing the rate of the dinar, as well as stock exchange indexes. However, the decrease in the net inflow of foreign capital narrows the space for financing imports or real capital (investment equipment) and in that way reduces the possibilities for economic growth and the increase of exports in the future.

The optimistic margin scenario is based on the assumption that during the second half of this year at least the same openness of our economy will be established when it comes to foreign trade affairs and capital transfer, not only in terms of systematic solutions, but also in terms of performance of economic policies, which have to be non-dis-



criminary and predictable in the following years – in real solutions and good intentions of stakeholders in economic policy, and before all, in the perception of foreign investors and creditors. GDP growth of 71% until 2015 would create space for raising the level of household spending further 65% and, depending on the structure of investments, for creating up to 300,000 new jobs, with increased competitiveness and the perspective for further stable growth.<sup>27</sup> The problem would occur with a notably dwindling capital inflow, lower than what is necessary to support these processes.

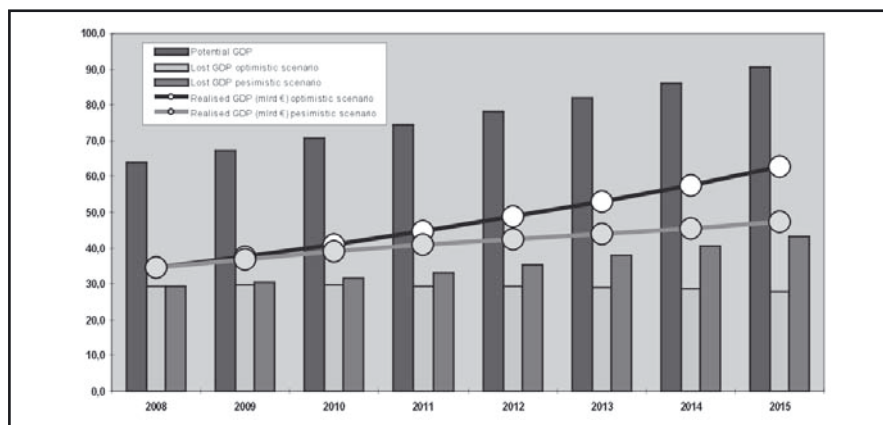
The other, pessimistic margin scenario starts from the premise that the capital inflow will not be sufficient. Significant decrease of funds from abroad, through credit and investment channels and through the money orders can be a consequence of political decisions to cooperate selectively with, for example, only those countries which would not recognize Kosovo's independence. The more radical alternative of this strategy could be economic self-isolation. The other group of causes could be sizeable increases in the basic risks in a country which can occur by stopping institutional reforms or radicalization of political instability. This group of factors would influence any capital, regardless of the country of origin. The argument that the reduction of capital inflow, from the EU for example, could be compensated by capital from other sources is not a valid one. This "other" capital too will arrive in continuity only if it is possible to invest it in a profitable manner and with a tolerable amount of risk in an economy which will further increase the competitiveness of its exports to the EU; various one-time aids and arrangements, no matter how welcome, do not solve the problem. The main problems of the state the Serbian economy would find itself in five to eight years are connected to its key structural and export parameters.

If foreign investments in the next several years would stay at the level projected for this year, of USD 2 billion, and if the inflow of new credit would keep between USD 5 and USD 6 billion a year, it would require a sharper reduction of negative net imports (deficit of goods and services). This strategy can be realized only through reduction of imports to a measure that equals its administrative restriction. This might cause possible reduction in GDP growth – both because of the import dependence of production and because of considerable reduction of services volume. This balance of payments would be balanced with the balance of GDP use in which GDP is reduced to an annual level of 2%.<sup>28</sup>

As it can be seen in Graph 11, in the optimistic scenario – with the average real GDP growth of 6% a year in the years after 2015 (to which a 2% rise in prices indexed in euros) – the annual amounts of loss in the potential GDP falls and in 2028 Serbia reaches its relative position from the 1990s. The cumulative amount of losses in the seven-year pe-

<sup>27</sup> This scenario may vary with lower GDP growth rates after 2012 (for example 5% to 6%) with adequate decrease of the necessary capital inflow. The period for reaching these results will be extended in a certain amount, but the basic direction is kept: economic growth, productive employment, rise in the standard of living and increase in economy's competitiveness.

<sup>28</sup> There is an example in our history. Following the closure of the capital market in SFRY in 1979 the deficit of current balance of payment had to be reduced first, and then, after the "explosion" of external liquidity of the country in 1982 move to surplus. The consequence was the fall in investments and decrease in GDP growth in the 1980s to an average of 0.6% a year, which was the population growth. GDP per capita literally stagnated for a whole decade.

**Graph 11: Potential and Realized Domestic Product 2000 - 2007 (in bilion EUR)**

riod between 2009 and 2015, compared to the potential GDP with a continuous growth of three percentage points, amounts to EUR 203.5 billion. As mentioned earlier, the 2015 GDP is higher than the GDP in 2007 by 71%. More than 300,000 new jobs would be created, with an increase of the share of investments in the GDP and the growth of an average salary to EUR 620 (real growth of 5% a year).<sup>29</sup>

In the pessimistic border scenario, the annual loss compared to potential GDP rises until 2015 and reaches EUR 43 billion in 2015, which cumulatively by EUR 50 billion more than in the optimistic scenario. The average salary – under the assumption that neither state spending nor investments record real growth – rise at the most 0.5% a year and in 2015 reach the monthly level of EUR 460. There are no new jobs created, except in the extensive i.e. fictitious employment. This raises labor costs and reduces productivity and competitiveness. Imports become subject to administrative restrictions. In order to overcome the crisis, a new structural adjustment is necessary.

Why are there fewer investments in the “pessimistic” non-European scenario? First, in case of discretionary relations towards economic partners – lowering political relations with countries which recognized Kosovo’s independence (including the possible refusal to ratify the Stabilization and Association Agreement, lawsuit to the International Court etc.) – it would mean abolition of preferences which our exports to those countries enjoy according to the general preferential scheme, which are timed, and the reduction of our exports because of it<sup>30</sup>.

Second, in case of investments coming from “friendly countries” the motive that the EU countries have to invest in Serbia will disappear: cheaper labor force – whether it is

<sup>29</sup> See: “Two Border Development Scenarios until 2015”, *MAT&KB* 3/08.

<sup>30</sup> Currently, around 55% of Serbia’s exports are going to the EU and its reduction cannot be compensated by monumental redirection to other destinations, which neither gives those preferences, nor have the identical structure of demand.

buying of the existing companies or greenfield investments – for the volume of production which would be directed at the EU market. The interest of the alternative investors is exactly the interest to export to the EU, and that is why the reduction of export growth and investment volume are in direct mutual connection. For now, the only existing interest is in the buying of the state oil company NIS with oil sources, pumps and monopoly, and all that for a very low price.

Third, the lack of greenfield and portfolio investments cannot be compensated by selling the existing companies – there is no such value that would fill the gap over a number of years! Therefore, the potential annual volume of investments of USD 3 billion to USD 4 billion will be reduced. In our projections, we took the amount envisaged for this year, of USD 2 billion, which was arbitrarily determined, but it says that the reduction of investment capital inflow would be between one third and one half.

Fourth, one of the sources to finance investments is also loans. Loans would get more expensive due to lower credit rating (increase in risk premium because of political relations). The *condition sine qua non* is, therefore, to decrease credit and investment risk for placements in Serbia. The EU accession process is not a necessary condition, but on its own it not only enables all these other presumptions, but strengthens them and brings additional material benefits.

Widening of economic relations – in terms of foreign trade and investments – especially their redirection to expanding economic giants such as Russia, China and India – will create a new field for fast economic growth in Serbia and that is why those relations should be nourished and improved. However, there should be no mention that a serious reduction of already developed relations with the countries of the EU – whether because of real activities or because of the perception in those countries of the increased risk for investing in Serbia – could be substituted by relations with new partners, especially not in one, even a whole, mandate of a government. Such reduction would lead into financial crisis and would cause a drop on the development scale, lower standard of living, fictitious employment, decrease in productivity and competitiveness.

### **3.4 Preliminary Conclusions**

In the previous period of economic transition, Serbia completed the first phase of reforms with establishing macroeconomic stability and laying the ground for the second phase in reforms which will focus on economic growth and structural changes. The growth of gross domestic product in 2007, especially in the first half of the year, was impressive, 7.3% in the whole year, and 8% in the first six months. The stabile growth trend in the industrial production, together with exports started in mid-2005. Significant improvement in industry, compared to the level from the beginning of the period, still does not allow the conclusion that there has been a trend of re-industrialization which could be compared to successful transition countries or to the industrial level before the 1990s. That is the main reason for the absence of dynamic employment, especially in the corporate sector.

The current situation with regards to employment is such that at the end of 2007, or at the beginning of 2008, a significant number of employees are still employed in the public and mixed property sector, even though that number rapidly decreased over the last years.

The basic characteristic of foreign exchange of the Republic of Serbia in the period between 2001 and 2007 was a continuously high deficit in goods and services. The explosion of the foreign trade deficit after September 2006 was caused by the explosion in demand after the rise in public sector salaries following the budget rebalance in October 2006 showing up in the structure of imports as well. Even though the import growth trend was slowed down in the last months of 2007, as well as the growth of exports, the rhythm of growing deficit did not slow down threatening to anticipate the risks of the upcoming financial and currency crisis when the inflow of capital that covers the deficit ebbs. Thanks to monetary restrictiveness, especially in the first half of the year, the expansion of demand, spurred through two main channels salaries and loans, did not cause inflation to get out of hand, or to jeopardize price and monetary stability.

State spending in the GDP use shows that the 2008 usage will remain at the same level as in 2007, of 24.4% of the GDP, which is considered to be over inflated. In order to reverse the extreme imbalance, the IMF recommended fiscal restrictions in a foreseeable period when the structural reforms would yield full effects. It is necessary to have a fiscal surplus of between 2% and 3% of GDP, and already in 2008, it should be 1% of the GDP.

Institutional and structural reforms started in 2001 had the aim of establishing a stable and efficient market system and competitive economy. However, the dynamics of institutional reforms did not develop at a preferred speed. In addition a lot harder reform phase is ahead of Serbia and it refers to the restructuring and modernization of companies, efficient competition policy and infrastructural reforms.

Privatization process has been continued however some of the key issues remained open. Without adequately solving them it is not possible to complete the transition process within the deadlines envisaged by the law or to set in motion the full effects of changes in the economic, social and political balance in the society. Although that the conditions for doing business are improved the latest report from the *European Bank for Reconstruction and Development* (EBRD) for 2007, which analyzes the progress in structural and institutional reforms, showed that Serbia still lags considerably behind other transition countries. Second major structural problem expresses itself in low competitiveness of the Serbian economy. The latest analysis from the *World Economic Forum* pointed that in 2007, Serbia was at a very low 91<sup>st</sup> place compared to its main competitors Croatia 57, Romania 74, Bulgaria 79. In addition Serbia practically stagnated and even worsened its position compared to the previous period 85<sup>th</sup> in 2005, 87<sup>th</sup> in 2006.

Depending on the alternative political options which could form a government of Serbia and their influence on international economic relations of Serbia two margin scenarios has proved that level of foreign direct investment is crucial for further economic growth, job creation and standard of living. Results showed that in the optimistic scenario the 2015 GDP is higher than the GDP in 2007 by 71%. More than 300,000 new jobs would be created, with an increase of the share of investments in the GDP and the growth of an average salary to EUR 620 (real growth of 5% a year). Additionally, with the average real GDP growth of 6% a year in the years after 2015 in 2028 Serbia reaches its relative position from the 1990s.

In the pessimistic scenario the average salary – under the assumption that neither state spending nor investments record real growth – rise at the most 0.5% a year and in

2015 reach the monthly level of EUR 460. There are no new jobs created, except in the extensive i.e. fictitious employment. This raises labor costs and reduces productivity and competitiveness. Imports become subject to administrative restrictions. In order to overcome the crisis, a new structural adjustment is necessary.

The economic situation in Serbia, increasingly contributes to drawing a conclusion where the problem of inflation will be of secondary importance for economic processes in the upcoming short term period. Reluctance and caution of the foreign investors to invest in Serbia, together with the more expensive loans on the international financial market, contributes to the reduction of foreign currency offer directly influencing the rate of the dinar, as well as stock exchange indexes. However, the decrease in the net inflow of foreign capital narrows the space for financing imports or real capital and in that way reduces the possibilities for economic growth and the increase of exports in the future.

#### 4. CONCLUDING REMARKS

Since 2000 and the beginning of a true process of democratization and transition, Serbia's EU accession process faced constant reexamination of its own international and geo-strategic positions well as lack of political consensus of the main political actors. This is particularly characteristic of the period between 2004 and 2007, but especially in the months after Kosovo unilaterally declared independence in mid-February 2008. The Kosovo status deeply divides Serbian society with regards to European integration, and jeopardized the integration of the Republic of Serbia into the European Union encouraging the sense of self sufficiency among the citizens. As a result Serbia at the moment is at the bottom of the list of regional countries according to the intensity and successfulness of European integrations.

However, after the recent parliamentary elections in Serbia a pro-European majority was successfully formed in the National Assembly by the representatives of a coalition "For European Serbia" and the coalition of the *Socialist Party of Serbia*, *United Pensioners Party of Serbia* and *United Serbia*. Political stability is definitely one of the main factors which will influence the future intensity of Serbia's accession to the Union. If the newly formed Serbian government, in the next four years, succeeds in removing the obstacles in cooperation with the *Hague Tribunal* and at the same time secures the parliamentary majority to adopt reform laws harmonized with European Union legislation, the accession process can be finalized at the earliest by 2012. However, it is more realistic to expect that Serbia's accession to the European Union will take place in the second half of the next decade. It is clear that in the upcoming period Serbia will move towards membership in the Union at a slower or faster pace depending on the efficiency of the new government in the process as well as on reaching a wider social consensus.

From the other hand on the basis of current developments in economic transition in a wider sense, and especially the loss of control over public spending over the last year and a half, and strengthening of consumption and credit expansion, together with covering fiscal deficits with privatization revenues, a question arises – are there conditions for the development of currency or financial crisis?

The warning comes from the data on the movements of balance of payment aggregates. Since the last quarter of 2007, one could notice that the total surplus of balance of payments in 2007 lowered to one quarter, or one fifth by the end of 2007, compared to 2006 with a worsened structure of capital inflow to the detriment of the share of direct foreign investments, and in favor of credit and portfolio investments. The narrowing of the total balance for now is not implied by ebb in capital inflow. The problem is in the extreme expansion of current transactions deficit, which reached close to 16.5% of GDP in 2007. There is a tendency that – due to projected domestic demand, slowdown of exports, redirection of the monetary policy to the preservation of price stability, mainly through repo operations, i.e. possible increase in the key interest rate and appreciation as a consequence – in this year 2008, a 2007 level of the share of trade deficit and current balance deficit in the budget is kept. That implies high sensitivity to any sharpening of demotivational factors in capital inflow. The greatest threats, in these circumstances, are

political risks concentrated in one or two current issues: the start of the EU accession negotiations and solving the Kosovo problem.

Institutional and structural reforms which started in 2001 aimed to establish a stable and efficient market system and competitive economy did not develop at a preferred speed. The Serbian economy in 2008 is still in the process of building a market system of doing business and establishing systematic presumptions for its unhindered functioning. The analyses of the World Bank and the European Bank for Reconstruction and Development for 2007, has shown that despite visible progress Serbia still considerably lags behind not only EU member states, but the also the average of the South Eastern European region. Second major structural problem expresses itself in low competitiveness of the Serbian economy. Competitiveness of the Serbian economy deteriorated according the latest analysis from the World Economic Forum which will put additional pressure on the trade deficit. All of these analyses offered a good answer as to why Serbia is not more attractive to foreign greenfield investors and why it is not possible to create a favorable business environment in long term which would stimulate the growth and development of the domestic economy.

Additionally two development scenarios devised on the basis of the slowdown in investment activities and capital inflow in the expectation of the outcome of the latest general elections in Serbia proved that dynamic growth, job creation and rise in the standard of living highly depend on the level of foreign capital inflows which in turn depend on the alternative political options and their influence on international economic relations of Serbia.

Moreover if the above mentioned political risks are eliminated, there is a fact that the macroeconomic imbalance could become bigger implied by the consumer policies, opportunism in implementation of reforms, a de-stimulating system for labor intensive investments, corruption practices and criminal elements connecting public and private interests. The imperative of the complex reform in the public sector is in a horizon and cannot be left for the future. Unfortunately year 2008, as well as the previous one, is lost. Therefore a radical shift is ahead of Serbia in 2009. Without it, destabilization, if not financial crisis, is almost inevitable. However after signing of the SAA the perspectives are likely to be more optimistic. It is expected that owing to signed SAA reforms will be continued, stability maintained, capital inflow returned to recent year's level as well as investment risk reduced and favorable investment environment created.

