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# **REQUIREMENTS FOR ECONOMIC DEVELOPMENT OF SERBIA<sup>1</sup>**

**Professor Mladenka Balaban PhD<sup>2</sup>**

Independent university Banja Luka

**Abstract:** The global economic crisis has pointed to the problems of the current market growth model. More points out that the crisis is an opportunity, especially for countries in transition and developing countries to start their own growth model based on the accumulation of domestic and industrial production, rather than on imports and foreign investment. In the recession of the global economy, the greater the damage sustained by the economy that had had a strong industry. With the intensification of the global economic crisis, the Serbian economy has entered a period of turbulence and critical stage of development. GDP growth is based on imports, high spending and borrowing abroad, that this encourages consumption and finance. The moment when flow of capital into Serbia stopped, and credit activity, private and public consumption decreased, the domestic economy has entered a deep crisis.

The crisis has clearly shown that the model of development of Serbia, based only on the service sector, high consumption, imports and growing external debt is not sustainable. The most important place in the model must have industry, agriculture, investment and exports. The work will be analyzed macro-economic indicators in Serbia, Serbian economic position in the region, the factors that influence the development as well as forecasts and opportunities for economic development in the coming period.

**Keywords:** *economic crisis, macroeconomic indicators, perspectives of development.*

## **INTRODACTION**

The global economic crisis by the end of 2013 indicated that the current model of economic growth and development of Serbia is not sustainable and must be fundamentally changed if it is to avoid the fate of undeveloped and heavily indebted countries. Namely, will not be able to function model which considerably faster growth of domestic demand in GDP growth made possible through, increasing the share of deficit current account

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<sup>2</sup> Professor, Independent university Banja Luka, Economic faculty, email: jovbalyu@yahoo.com

to GDP. Due to the significant reduction in privatization revenues and limited possibilities for further excessive borrowing abroad, Serbia has to turn to a new model of economic growth and development that is pro-investment and export-oriented.

The economic crisis could not leave out the former Yugoslavia. Industrial production dropped significantly, as well as budget revenues, while budget deficit and interest rates rose and the volume of trade and the value of stock market indexes have fallen. Unlike Serbia that its economic recovery begins only in 2001, most other countries in transition, the transition to a market economy and supporting the reform of the economic system started in early 90s in order to accelerate in the last decade. That's why it makes sense to compare Serbia to other countries in transition, just in the same time period.

### RECENT ECONOMIC DEVELOPMENTS IN CENTRAL EASTERN AND SOUTHEASTERN EUROPE

	Private Sector					Public Sector				External fundamentals	
	Stock		Flow			Stock		Flow		Exchange rate misalignment	Reserves buffers
	Domestic credit to private sector in FX or FK source (% of GDP, end-2013)	Private debt from less stable ratio (December 2013)	Loan to deposit ratio (December 2013)	Current account balance (% of GDP, 2014)	External debt falling due (% of GDP, 2014)	Public debt exposed to FX risk (% of GDP, end-2013)	Stock of public debt (% of GDP, 2013)	Fiscal financing needs (% of GDP, 2014)	Average CDS spreads, May 22, 2013 - March 31, 2014 1/		
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)	(viii)	(ix)	(x)		
Serbia	35	26	114	-5	16	51	66	19	374	Moderate	215%
Croatia	55	46	109	1	30	36	60	20	332	Moderate	97%
Hungary	24	21	102	3	26	33	79	20	279	None	152%
Slovenia	3	32	137	6	31	23	73	16	296	None	
Latvia	0	29	145	-2	61	28	32	8	124	None	
Bulgaria	41	32	96	0	33	12	18	4	122	None	133%
Belarus	20	21	150	-10	21	23	37	17	777	Significant	14%
Macedonia	24	23	91	-4	18	30	36	14	...	Moderate	103%
Turkey	18	17	110	-6	23	11	36	10	212	Moderate	116%
Bosnia and Herzegovina	37	19	125	-8	14	30	43	5	...	Moderate	120%
Estonia	1	38	150	-1	47	0	11	2	65	None	
Romania	21	19	108	-2	23	23	39	9	189	None	147%
Slovak Republic	0	13	90	3	31	7	55	10	85	None	
Lithuania	31	9	123	0	25	28	39	7	124	None	
Poland	14	13	114	-2	18	17	57	10	84	None	139%
Albania	23	10	53	-10	3	19	70	28	...	None	164%
Czech Republic	27	20	82	-1	20	19	48	10	59	None	
Russia	7	13	121	2	8	2	13	2	182	Moderate	147%
Threshold	29	30	110	-6	18	29	60	18	200	Significant	75%

Chapter 1 – Exchange rate movements in the countries of CESEE in 2014

Source: Bloomberg, IMF

Analysis and projections of many international financial institutions, in their analysis pointed to two completely opposite movements in the euro, on the one hand side expected economic growth in most of Central, Eastern and Southeastern Europe (CESE) in line with the recovery in the Eurozone, but the other by region faces very specific risks. According to the International Monetary Fund (IMF) for the CESEE (excluding's largest economy, Russia and Turkey) is projected to grow by 2.3% in 2015, which represents a significant acceleration from last year, which amounted to 1.2%.

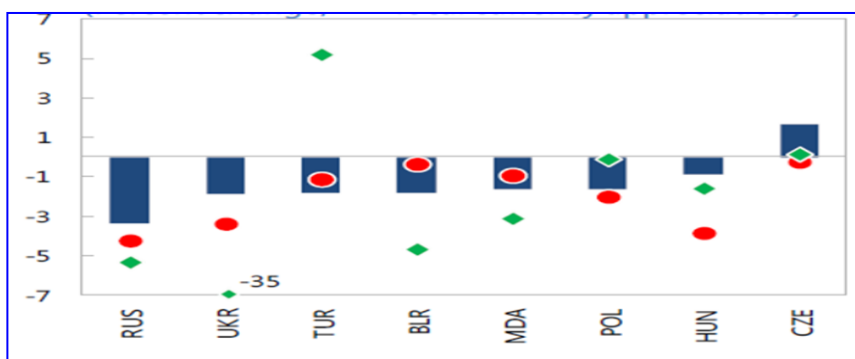
However, external financing conditions have become more volatile since mid-2013. In addition to reducing the pay of foreign banks, portfolio investment in CESEE, went negative in 2013 through the third quarter, for the first time since 2009. Although this indicator has increased at the end of 2013, the decline in investment may be due to a potential escalation of geopolitical tensions in the region, which certainly may adversely affect the recovery

expected in the euro area. The sensitivity of the region to external shocks funding comes mainly from the relatively high amount of foreign debt, large refinancing needs, and substantial foreign debt. While many CESEE countries have considerably improved their position in the current account in the last few years, vulnerability to external shocks are precisely the consequence of the external debt is high, where are therefore exposed to foreign exchange risk.<sup>3</sup>

Factors that contributed to the country CESEE sensitive to changes in the global environment are certainly:

- Increased participation of foreign investors in the purchase of government bonds.
- Increased role of foreign institutional investors.
- Reliance on relatively few common creditors. A large part of the funds which the economy borrows from banks relating to the assets of banks that come Eurozone.

*Table 1- Summary of countries that are exposed to changes influenced by external economic shocks*



Source: [www.imf.com](http://www.imf.com)

However, overall growth in CESEE was lower than that expected by 1.9% in 2014. Table 1 provides an overview of the combs that are violently react to economic shocks that occur in the environment because of the large public, long, high indebtedness of the country and their dependence on external financing. Based on the analysis of the IMF (International Monetary Fund), the following conclusions:

The private sector and the public sector are also compromised. The private sector is vulnerable, whether because of the high debt that bears foreign exchange risk or financial risk, while the public sector is at risk due to the high balance of payments deficit and high external debt. This especially applies to Croatia, Serbia and Hungary to which the negative external shock especially adversely affected.

<sup>3</sup> Arslanalp, S., and T. Tsuda, (2014), "Tracking Global Demand for Emerging Market Sovereign Debt," IMF Working Paper 14/39 (Washington: International Monetary Fund) p.33

Foreign trade misbalance leads to disruption of the exchange rate, where the country CESE mainly manage to provide stabilization of the exchange rate by using foreign exchange reserves, only Belarus has problems with these external shocks.

If we look at all the impact that can come from external environment only four countries show vulnerability on multiple fronts: Belarus, Croatia, Hungary and Serbia. Turkey can have a negative impact due to the fact that the high current account deficit is financed mainly by issuing short-term securities, while Estonia and Slovenia, can react to shocks owing to the fact that their private sector significantly indebted to foreign banks.

### **NEW GEOPOLITICAL RISK IN EUROPE**

The escalation of the political crisis in Ukraine has introduced new risks for the region. Market bonds and foreign exchange markets in Ukraine, Russia, and to a lesser extent, Belarus and Moldova came under new pressure in February and March 2014 concerns about sanctions against Russia after the referendum in the Crimea, the negative effects are reflected in investment and growth, which will further lead to regional spillover.

A further escalation of geopolitical tensions could affect significantly the European countries through trade and financial channels. Several countries-including the United States, European Union, Canada, Japan and Russia-imposed sanctions. Intensifying sanctions and cons of sanctions can lead to major spillover and affect the real sector (trade, remittances) and financial (assets valuation, banking) sector. Moreover, an extended period of geopolitical tensions could affect negatively not only on the countries of Central and Southeast Europe, but also on the economies of developed countries of Western Europe.

For much of Europe, the real economic ties with Russia and Ukraine are mainly related to the energy sector. Neighboring countries, Moldova, Belarus and the Baltics, may have seriously undermined macroeconomic indicators with a decrease in trade and remittances coming from Russia. The economies of Central Europe (Hungary, Slovenia, the Czech Republic and Slovakia, and Poland), Finland, and some countries of Southeast Europe (eg, Serbia, and Bulgaria) have moderate exposure to export to Russia and Ukraine (2-5 percent of GDP). Among the larger Eurozone countries, Russia has the strongest by the international economic relationship with Germany and the Netherlands.

When it comes to foreign direct investment goods these sanctions will be most affected neighboring countries, such as Moldova and Belarus, and some countries in Southeast Europe, Bulgaria and Montenegro. Financial centers such as Cyprus and Luxembourg, also report high two-way FDI flows with Russia.<sup>4</sup>

Europe's dependence on Russian gas supplies to a substantial portion of which passes through Ukraine in the region will lead to a large increase in energy prices in case of disruption of the oil and gas. About 40 percent of Europe's consumption of natural gas is supplied by Russia, with indicators higher in most of Central and Southeast Europe. Russia also supplies Europe

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<sup>4</sup> Heinz F.H., and Y. Sun, (2014), "Sovereign CDS Spreads in Europe—The Role of Global Risk Aversion, Economic Fundamentals, Liquidity, and Spillovers," IMF Working Paper 14/17 (Washington: International Monetary Fund).

with about one-third of the consumption of crude oil. Most CESEE countries are very reliant on Russian oil and gas to meet their energy needs (with the participation of Russian supplies in the total gas consumption of between 40 and 100 per cent), but also Germany, Austria, Finland.

Most European countries have limited direct financial linkages with Russia and Ukraine, but due to current events decreases trust and bond with common investors. Cyprus, Austria and Hungary are the most exposed to the risk that comes from the banking risk, with assets of 4-13 per cent of national GDP, mainly through their banks, ie. local affiliates. Fortunately exposure is not big enough to jeopardize the parent bank. However, the significant impact this crisis will have on the profitability of their banks. In contrast, Switzerland and some of the countries in the euro area can benefit from the so-called "capital flight" from Russia and Ukraine. The overall risks are more prone to bad side, which reflects the possibility of a long period of weak growth in the Eurozone, the instability of the financial markets, rising interest rates.

### **ECONOMIC DEVELOPMENTS IN SERBIA**

After economic growth in 2013, this was one of the highest in the region, in 2014, GDP declined by 1.8% primarily due to the floods that had caused significant damage to the mining and energy sectors. However, negative trends were stopped in T4 where the GDP recorded a growth of 0.5% driven by good performance of manufacturing industry and the partial recovery of the sector affected by the floods. Positive trends have continued at the beginning of this year, which is indicated by the January industrial production increased by 6.5% assuming a contraction of final consumption due to fiscal consolidation measures in 2015 is expected to decline in GDP of about 0.5%. However, trends from the beginning of the year and a faster recovery in the euro zone suggest the possible favorable outcome.

After falling in the third quarter of 2014 (6.8%), as a result of falling demand in the euro zone and floods, exports in the fourth quarter recorded growth of 4.4%, thanks to strong growth in exports of agricultural products, metals and tobacco. Suppressed imports due to weak domestic demand caused by fiscal consolidation measures, as well as falling oil prices. At the end of 2014, export was at 55.7% above pre-crisis levels, while imports were 6.5% below that level. The coverage of imports by exports was 72.4% (12-month moving average). Current account deficit in 2014 was reduced to 6.0% of GDP despite the negative effects of floods on the export and import of energy. In the coming period the current account deficit will be fully covered by foreign direct investment.

In 2014, net FDI inflow of 1.2 billion euros. The largest inflows were recorded in the financial sector, manufacturing industry and trade. In the first quarter of 2014, the highest gross inflow of foreign investment was directed at the financial sector (32.3%), due to the conversion of bank debt into capital, and in the processing industry (27.9%). Net inflow in 2015 will amount to 1.3 billion euros, of which the largest part will be directed to the processing industry and trade.

In 2014, the overall fiscal deficit was 6.7% of GDP due to high interest payments (3.0% of GDP), as well as due to flooding. Mandatory expenses (salaries and pensions) were reduced in 2014 in nominal amount and will be frozen in the medium term. Additional savings from 2015 on state aid (incl. Subsidies) state-owned enterprises and public procurement. Measures rationalization of general government (5% each year, of which one-half of the natural outflow), and restructuring state-owned enterprises, agreed with the

IMF, are included in the fiscal strategy for 2015-17. Public debt at the end of January 2015 amounted to 23.2 billion. Euros (74.0% of estimated GDP). Growth in the share of public debt in GDP since the mid-2014 largely is due to the appreciation of the dollar.

Bank loans in December recorded a growth rate of 2.1% as a result of the temporary recovery of loans to the economy by the positive impulses from subsidized loans as well as the growth of loans to households. Real growth rate of bank loans to the economy by the end of 2014 amounted to 1.5%. In 2015, the projected slight decline in lending activities due to the completion of the program of subsidized loans in December 2014, slow economic recovery, and due to continued strict credit conditions.

*Table 2 - Movement of macroeconomic indicators in Serbia for the period 2008-2014*

SERBIA	2008	2009	2010	2011	2012	2013	2014
Real GDP, %	5,4	-3,1	0,6	1,4	-1	2,6	-1,8
Consumption, %	6,1	-0,2	-0,5	0,9	-2	-0,6	-1,3
Investment %	14,6	-23,7	-7,9	7,3	14,3	-7,7	-4,8
Government %	-0,4	-4,4	0,1	-0,5	2,8	-6,4	1,5
Export %	9,4	-6,9	15	5	0,8	21,3	3,9
Import %	12	-19,6	4,4	7,9	1,4	5	3,3
Unemployment Rate %	13,6	16,1	19,3	23	23,9	22,1	18,9
Real Wages %	5,6	0,8	1	0,2	1,1	-1,5	-1,5
Current Account Deficit %	21,2	6,6	6,8	10,9	11,6	6	6
CPI %	8,6	-4,4	10,3	7	12,2	2,2	1,7

Source: Statistic NBS, [www.nbs.rs](http://www.nbs.rs)

Determinant of development and structure of problem loans represent legal entities from the processing industry, trade and construction, as well as persons in bankruptcy (in the category of other sectors). The share of problematic loans in the population is below the average (10.3% in November 2014). NBS adopted measures to reduce problem loans, but the economic recovery of the economy and efficiency of the legal system are equally significant. Despite the downward trend since the beginning of the crisis, the coverage of gross NPLs regulatory provision is at a satisfactory level (115.9% in November 2014). Allowances of total loans (made in accordance with IFRS) covering more than half of gross NPLs (56.7% in November 2014). The ratio of net problem loans and balance sheet capital of the banking sector stood at 33.7% in November 2014.

### **IMF ARRANGEMENT IN SUPPORT OF DEVELOPMENT**

The Executive Board of the IMF approved a three-year precautionary arrangement worth 1.2 billion programs is based on three pillars:

1. The recovery of public finance: consolidation measures based on the reduction of mandatory expenditures (salaries and pensions), state aid to enterprises and better collection of taxes will lead to the sustainability of public debt in 2017 and increase the scope for monetary policy relaxation.
2. Stability of the financial sector: The solution for the problem loans (court and out of court settlements, market development problematic

- debt), to improve the framework for resolving the problem banks, strengthening the supervisory framework for the implementation of specific diagnostic tests.
3. Structural reforms: Reducing fiscal cost of privatization or bankruptcy for over 500 companies in the portfolio of the Privatization Agency. Corporate restructuring and liquidity support for the abolition of large systems (railways, roads, EPS, Srbijagas).<sup>5</sup>

### **Economic trends in Serbia in the coming period**

The current model of economic growth and development of Serbia is not sustainable and must be fundamentally changed if we are to avoid the fate of undeveloped and heavily indebted countries. In fact, there no longer could be able to function model which considerably faster growth of domestic demand in GDP growth possible through increasing the share of current account deficit to GDP ratio. Given the over-drying privatization revenues limited possibilities of further excessive borrowing abroad, Serbia has to turn to a new model of economic growth and development that is pro-investment and export-oriented.

In this sense, the basic scenario of the future development in the period of domination of consumption growth is replaced by the dominance of investment growth. As shown in one of the projects the group of economic experts in cooperation with USAID "Post-crisis development model Serbia..." it is necessary to provide adjustment in the economic system, macroeconomic policy and sectorial policies of the concept of accelerating economic growth based on the replacement of consumer and pro-investment scenario development by moving the center of gravity towards the tradable investments. A special place has a public sector reform.

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

Third and perhaps most importantly, is the risk associated with the issue of sustainability of external debt and external liquidity. Serbia in the next five years bear the risk of higher repayment burden of private debt and its necessary investment cycle should be based on foreign direct investments, public debt and substantial increase in the share of domestic savings to finance investment. The main risk point in the balance of payments financing, is the high rate of debt servicing.

### **CONCLUSION**

The socio-economic reality in Serbia for years, among other things: all the higher unemployment rate, as lower employment rate, high inflation rate, high percentage of the shadow economy, high illiquidity of economic entities, unfinished and accompanied by numerous weaknesses privatization, high foreign debt, high levels of corruption, a high percentage of the poor population, and more. Mentioned characteristics are largely negative effect on the material and social status of employees and their families.

The economic and social situation in Serbia best illustrated by the fact that it's gross domestic product to a level of about 65 percent that of 1986, the

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<sup>5</sup> [www.bep.org.rs](http://www.bep.org.rs)

number of unemployed around 760,000 and has almost a million citizens living below the absolute poverty line.

Economic crisis or economic depression in Serbia lasts for more than thirty years and it is not just a consequence of the global economic crisis, but for the most part the crisis, domestic production.

However, Serbia has not spared the negative impact of the global economic crisis. Despite the global economic crisis, and now the geopolitical risk due to the conflict between Russia and Ukraine have a negative affect the economic recovery of Serbia. Whether Serbia will be able to provide foreign direct investment, a sufficient number of jobs, with an increase in the volume of exports; increase the volume of industrial production; increase the purchasing power of the population with the growth of living standards of the population remains to be monitored in the future.

### **PREDUSLOVI ZA EKONOMSKI RAZVOJ SRBIJE**

**Prof. dr Mladenka Balaban**

**Apstrakt:** Globalna ekonomska kriza ukazala je na sve probleme aktuelnog tržišnog modela rasta. Sve više se ističe da je kriza prilika, posebno za zemlje u tranziciji i razvoju, da sopstveni model rasta počnu zasnovati na domaćoj akumulaciji i industrijskoj proizvodnji, umesto na uvozu i stranim investicijama. U recesiji globalne ekonomije, veće štete pretrpele su ekonomije koje nemaju snažnu industriju. Sa zaoštavanjem globalne ekonomske krize, srpska ekonomija ušla je u vrlo turbulentno razdoblje i kritičnu fazu razvoja. Rast BDP-a zasnovan je na uvozu, visokoj potrošnji i zaduživanju u inostranstvu, koje tu potrošnju podstiče i finansira. Onog trenutka kada je zaustavljen priliv kapitala u Srbiju, kada je došlo do pada kreditne aktivnosti i privatne i javne potrošnje, domaća ekonomija ušla je u duboku krizu.

Kriza je jasno pokazala da model razvoja Srbije, zasnovan samo na sektoru usluga, visokoj potrošnji, uvozu i rastu spoljnog duga, nije održiv. Najvažnije mesto u modelu treba da imaju industrija, poljoprivreda, investicije i izvoz. U radu, biće analizirani makroekonomski pokazatelji u Srbiji, ekonomska pozicija Srbije u regionu, faktori koji utiču na razvoj kao i prognoze i mogućnosti ekonomskog razvoja u narednom period.

**Ključne reči:** ekonomska kriza, makroekonomski pokazatelji, perspektiva razvoja.

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