experience with the transition toward capitalism. Normally, the transition did not happen overnight, but it was much faster and far-reaching than in Serbia. Actually, it took 8-13 years to complete it. Open market-oriented economy and Trans-Atlantic integration\(^{10}\) (integration of CEE with the US and Canada via the EU) were key ideas in economics and geopolitics in the 1990s. Throughout the respective period, the EU and multilateral financial organizations like WB/IMF, EIB and EBRD as well as their values provided vital anchor points and a strong incentive for reforms. The process ended in 2004 when CEE countries on average reached their pre-transition levels of GDP, but this time with a completely renewed institutional setting and with a respectable level of macroeconomic stability. Because CEE economies became more compatible, more efficient, more competitive and more globalized, the transition process shifted toward economic catch-up and income convergence with developed economies and, finally, to political integration into the EU.

As a contrast to the CEE, Serbia has not completed transition yet. In its economic body, there are many bleeding points, primarily due to subsidy and loan extended from the government to the “list of 500+” companies as well as budget support to the pension fund as a consequence of the pay-as-you-go system. At the same time, the economy desperately needs new investments because it is still impotent and without adequate earning power, as well as without density of relevant players to provide necessary funds not only for sustainable development, but also for a normal functioning of the state.

Development is more than growth. Development is a prerequisite for sustainability and it is synonymous with improvements in people’s well-being. As a consequence, beyond the last wave of transition policymakers are looking for the answers to two key questions: Will fiscal consolidation in 2016 be sustainable? Will the last year’s growth be sufficient for sustainable employment? Answering these questions requires strategic audit of economic fact sheets.

**Strategic audit of Serbia’s economy fact sheet in 2016**

Serbia’s economic reality has some explanatory details. These elements, in causal and chronological order, are as follows:

---

\(^{10}\) Integration of CEE countries with the US and Canada via the EU
a. Transitional output gap
b. Deindustrialization
c. Financialization
d. Depopulation

a. **Transitional output gap.** The output gap is the difference of the cumulative effect of actual economic activities from its potential level. As far as the transitional output gap as concerned, it is the long-term effect of sustained disequilibrium between supply and demand for the period 1990-2016.

There are actually two output gaps, transitional and current. Transitional output gap is the level of output in the current year compared to the pre-transitional level of output (or the output in 1989) in constant prices. The output gap is a logical consequence of revolutionary more than evolutionary changes in early stages of transition. Namely, in the early stages of transition the regular consequence of radical reforms is GDP drop. In later stages, restructuring of the enterprises and banks, as well as development of investor friendly institutional settings usually contribute to acceleration of growth. The essence of recovery lies in the growth of productivity and output increase in the tradable sectors, as well as cost reduction in the non-tradable sectors, which, through a positive feedback loop, affects the competitive position of the tradable sector and creation of a new level playing field with larger density of relevant subjects attractive for new investments. When national economy reaches the pre-transitional level of output, transition comes to an end and catching up along with income convergence to developed economies starts.

A J-shaped curve portrays the transitional output gap. CEE economies have managed to reach pre-transitional GDP levels 8-13 years after the start of transition. Completion of transition of such economies was a prerequisite for political integration into the EU and, *via* the EU, in Trans-Atlantic integration. In addition to positive effects from economic integration, certain development incentives also emerge from the effects of the institutional convergence and political integration.

The EBRD-28\(^{11}\) group of transitional countries managed to break even in 2004 on average (see Figure 1-5). In the case of Serbia, after more than one quarter

---

\(^{11}\) Albania, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Montenegro, Estonia, Georgia, Croatia, Armenia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Hungary, Macedonia, Moldova, Mongolia, Poland, Romania, Russia, Slovakia, Slovenia, Serbia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
of a century, transition is not completed yet. Namely, the segment of curve that portrayed the recovery of GDP is a perverse multiple J-curve. It is, also, impotent curve which means two things at once. First, it portrays too slow improvement in the level of the output. Second, the curve never reaches its pre-transitional level of GDP. In 2016, transitional output gap still remains at a very high level in constant prices of around 25 % of GDP from 1989.

The first inflection point from bust to recovery on Serbia’s J-curve was in 1993 after the destructive effects of economic sanctions which the international community imposed in 1992. Sanctions got Serbia in economic depression (65% drop of output). In the following years the recovery of the economy from depression shock was actually at a slow angle. This period of slow recovery was interrupted more seriously with new inflection point, this time initiated by the NATO bombing campaign\(^{12}\). After the regime change in 2000, the growth accelerated relatively strongly. But again, recovery period was interrupted with the negative consequences of the Great Recession. In 2008, Serbia reached just 73% of pre-transitional GDP and GDP in 2009 dropped again, this time at the level of 69%. In the successive period until 2016 there were three recession sub-cycles in Serbia impacting the current output gap, too.

\(^{12}\) The government estimated that during 78 days of the military campaign total damage done to the industry and infrastructure was $ 100 billion.
Figure 1-6 shows the transitional output gap over the period 1990-2015, with the special focus on “a crisis within the crisis” during the Great Recession, or successive three current output gaps.

In 2015, the economy gradually strengthened, but the level of GDP, which was slightly below the pre-crisis level in 2008, indicated the current output gap. In 2016, the growth is continued and the level of GDP finally reaches the level from 2008.

In contrast to Serbia, the recovery segment on the J-curve in CEE was marked by rise at a sharp angle. A significant economic optimism contributed to relatively quick completion of the process. Lead indicator of such mood was the cost of capital. Sufficiently low interest rates allowed economic expansion (see Figure 1-7).

Also, the structure of investment followed proposition of sustainable growth. Namely, in low income developing economies, manufacturing along with commodities is the most important tradable sector. Manufacturing expansion is crucial for maintaining external liquidity in the short run, as well as for balancing current account in the long run. The structure of investment in CEE countries confirmed this proposition. In addition, the expansion of such tradable sector is aligned with investment multiplier.
In high income developed economies, relatively small share of manufacturing in GDP formation is not so problematic, because these economies have efficient manufacturing sector, strong service sector and high capital market attractiveness. In that case, the export of service-oriented businesses and capital inflow can help balancing current account deficits and keep the capital balance reasonably balanced.

Serbia does not have strong service sector and its capital market is thin and undergoing retardation. Also, the tradable sector is strongly hit by deindustrialization. In the following chapter we will see some specifics about that.

b. Deindustrialization. During the whole transition period Serbia was lagging behind CEE economies experiencing economic regression. The most dramatic decline was recorded in the real economy, especially in the segment of industrial production. According to [14, p. 21], the value of industrial production in the period 1990-2010 dropped by more than 60%, the share of industrial production in GDP fell from 31% to 15%, while the number of industrial workers declined from 1.03 million to 0.3 million.

These trends are in stark contrast not only to the trends in CEE, but also to the trends that were present in Serbia prior to transition period. Indeed, in the
period 1960-90, the industrial production in Serbia grew at an average compound rate of 8% and the economy manifested a solid degree of industrialization, given that all core industries figured in its structure (e.g. steel, automobiles, basic and fine chemistry, machinery, consumer electronics, military, food processing, etc.). What followed in the period after 1990 may freely be called deindustrialization. Figure 1-8 depicts two periods in the development of Serbian economy: the period of industrialization (1960-1990), and the period of deindustrialization (1990-2010).

Figure 1-9 presents the trends of industrial production in Serbia in comparison to the successful transition economies from the Visegrad Group. The figure shows that the transition process in this group of economies was characterized by an accelerated increase in industrial production, while in Serbia the trend was completely reversed.

The composition of FDI is, also, one of the causes of deindustrialization in Serbia and the further deepening of related structural imbalances. The structure of FDI in Serbia has been largely dominated by investments in financial intermediation (banks, insurance, etc.), real estate (primarily commercial), and retail. By contrast, in the countries from the Visegrad Group investments in manufacturing and infrastructure have prevailed (see Figure 1-10). Specifically, with a share of 40%, investments in manufacturing represent by far the largest component of FDI in this group of economies.

**Figure 1-8. Industrialization and deindustrialization in Serbia**

Source: [13, p. 21].
Financing of growth also matters. When the growth is significantly fueled by foreign credits, in case of demand contraction, high leverage could potentially increase the vulnerability of economy. Although the crisis in 2008 started with credit crunch, it continued with demand squeeze. Typical government response to the credit crunch was introduction of austerity measures. The response of the corporate sector consisted of implementation of deleverage strategy (i.e. debt reduction by decreasing assets). In other words, credit crunch and responses to that caused the contraction of production followed by a fall in revenue. General consequence of such crisis is that investors’ pessimistic feelings replaced previous optimistic feelings.

During the crisis there were serious problems with investment in finance, real estate, and service sector as a direct effect of destructive character of speculative bubbles on value. In the context dominated by “fear of fear”, investments are the segment of economy that suffers the most. Reduced level of investments particularly affects the economies with a high level of public debt, because in new circumstances it is difficult to maintain a fiscal balance and service large debt. Interestingly, in the last crisis real economy (manufacturing + agriculture) in Visegrad Group showed the greatest vitality and resilience against new stressors inspired by financial meltdown. The cause for that is structure of investment in the
pre-crisis period characterized by the dominance of investment in manufacturing and infrastructure.

According to [6], economies in transition that demonstrated the greatest convergence of GDP per capita, above all, and the greatest resistance to the Great Recession, are actually the countries from the Visegrad Group that based their growth on investment in tradable sectors in the pre-crisis period.

In contrast, the tradable sector is one of the biggest weaknesses of Serbian economy. This has become especially obvious during the period of the Great Recession when the need for the foreign currency inflow based on export and substitution of import has become particularly emphasized under the pressure to reduce indebtedness (deleverage effect) and maintain external liquidity. However, in the case of Serbia, during the Great Recession export was growing at nearly the same rate at which the import was declining (see Figure 1-11). It is in contrast with the countries from the Visegrad Group where there was a simultaneous increase in both export and import. Although at the first glance this fact sounds like good news for Serbia, we have to take into account that the previous trend was happening in the conditions when the industrial production was contracting more strongly than GDP, which points to the continuation of deindustrialization. Furthermore, this situation leads to lower fiscal revenue and fiscal balance problem.
c. Financialization. In the global economy there is a strong tendency for willing financialization as the most important factor causing vulnerability. The level of financialization in Serbia is not in the danger zone, because the share of debt in GDP (77.8%) is below the safety level (80-100%), which is the threshold for the counterproductive character of the financial system.

Also, the level of financialization is significantly below the comparative level in the global economy and Europe. Yet, from Table 1-5 we can draw other valuable conclusions.

It is expected for the capital markets to be worth less than the debt market, much less when compared to total bank assets. However, in Serbia, market capitalization accounts for only 10% of GDP, compared to 83% and 75% of GDP in the world and Europe, respectively. Too thin for the country that hopes to achieve above-average rates of growth. The dangerous outcome is that, in an economy with barely breathing capital markets, the financial system becomes bank-centric and the economy can only pray that the cost of capital which is elevated for investment financing would be fair and economically acceptable. Something that was so far hardly seen in Serbia.

To put words in numbers, when comparing crude ratios, the disproportion becomes obvious at first glance. It is virtually 4-fold larger in Serbia than in
the global economy, and more than 2-fold larger in comparison to Europe. In a country with a significant level of household savings (21% of GDP), it is yet another contradiction of the system.

*d. Depopulation.* In middle-income countries demographic risk is strongly correlated with low economic performances. During transition, Serbia lost more than 1 million of people. The output gap is connected with unemployment and emigration.

Virtually during the entire period after 2000, which is usually erroneously labeled as „real transition”, with the exception of the last two years, the rebound in employment has typically lagged compared to the rebound in GDP. Jobless recovery made the poor macroeconomic performance caused by the output gap even worse and chances for demographic recovery smaller.

From the economic perspective, the structure of the population is unfavorable for economic development (see Figure 1-12). A substantial part of population body pertains to inactive segment (around 60%). The inactive segment consists of unemployed, pensioners, and the “rest”. The private sector is almost the same size as public and informal sector together. The ratio between economically inactive and active population is 1.53, which means that one employed person supports 1.53 inactive persons. Such population structure is not compatible with sustainability proposal. Due to over-employment in the public sector, the strategic goal in the new industrialization should be private sector expansion.

Previous analysis leads to the conclusion that Serbia’s economy is not only deindustrialized, but also out of tune. Therefore, structural reforms toward new industrialization and the strengthening of tradable sectors are urgently needed

<table>
<thead>
<tr>
<th>Year: 2013</th>
<th>GDP, in $Bil.</th>
<th>Stock market cap. in $Bil. (1)</th>
<th>Debt market in $Bil. (2)</th>
<th>Bank Assets in $Bil. (3)</th>
<th>Debt as a % of GDP</th>
<th>Debt + Bank Assets, in % of GDP, (2+3)/GDP</th>
<th>Financial sector % of GDP (1)+(2)+(3)/GDP</th>
<th>Crude Ratio % (2+3)/(1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>75,500</td>
<td>62,600</td>
<td>97,300</td>
<td>126,700</td>
<td>128.87%</td>
<td>296.69%</td>
<td>379.60%</td>
<td>357.83%</td>
</tr>
<tr>
<td>Europe</td>
<td>16,700</td>
<td>12,600</td>
<td>30,000</td>
<td>48,700</td>
<td>179.64%</td>
<td>471.26%</td>
<td>546.71%</td>
<td>624.60%</td>
</tr>
<tr>
<td>Serbia</td>
<td>46</td>
<td>5</td>
<td>26</td>
<td>46</td>
<td>56.52%</td>
<td>156.52%</td>
<td>167.39%</td>
<td>1440.00%</td>
</tr>
</tbody>
</table>
to invigorate current anemic growth potential. Also, new macroeconomic policy regime is needed to eliminate hidden fractures of the financial system.

The final result of all analyzed and interrelated fault lines is that the system is stuck because the key institutions which are supposed to lubricate economic growth and have been key tenets of transition no longer do so. Actually, capital market is undergoing retardation and banks behavior is undermining corporate sector. In bank-centric financial system commercial banks, in particular, are unenthusiastic about extending loans to the corporate sector. If there is no circulation of fund flows and credit release is reduced to retail lines, capital cannot flow to where it is needed, and growth suffers. Banks are at the heart of any financial system. However, Serbia’s financial system is suffering from a failure of the heart which is unable to perform its basic function, financing of growth.

If Serbia intends to accelerate its growth, it must be capable to define adequate solutions for all the addressed challenges. Concerning the annulation of certain failures from the past, particularly in the segment of privatization of the state-owned companies, in the last transition wave we have observed some causes for optimism. The fact that after recent privatization of JAT (airline services) and Železara Smederevo (steel plant), the state-owned giants in the commercial sector such as Galenika (pharmacy), Petrohemija (petrochemical industry), Resavica (mining) and RTB Bor (mining and smelting combine) are waiting for restructuring. But, there is plenty of work to be done in the segment of loss-making
state-owned commercial enterprises from the so-called the “list 500+”. This is an extremely sensitive political problem, because privatization and rightsizing are usually connected with job cuts and the rising pressure on budget (for example, voluntary leave program). For the loss-makers in the commercial sector of the state-owned portfolio, many renowned economists are advocating bankruptcy as a solution. A soft budget constraint on microeconomic level jeopardizes the hard budget constraint on the macroeconomic level. Successful restructuring of these companies will relieve the state budget by the amounts of subsidies and increase room for larger investments in infrastructure and tradable sector.

Network technologies and natural monopolies need different approach. A relatively easy way for quick annulation of the past failures in the segment of the state-owned sector is its emancipation. However, this requires two things at once, smart investment and full implementation of corporate governance.

**Demographic risk: Missing aspect of transition**

As explained before, transitional shock in a form of economic activity fall in Serbia happened in truly unique circumstances of systemic transition during the country disintegration. Transition in Serbia demonstrated that the gravity law applies to the economy as well: altitude is easier to be lost than to be reached again.

In strategizing about a national economy, the output, usually explained with GDP, is a starting point. But, key performance of the economy cannot be realistically assessed if population is not included. For a deeper understanding of the performance of the economy, its sustainability and potential to flourish, we must combine output with population. In macroeconomic performance measure like GDP per capita, “per capita” is equally important as GDP. Also, they are mutually interdependent variables.

During the serial conflicts for heritage of former Yugoslavia in the 1990s, Serbia lost economic base upon which replacement fertility breeds. The net effect of population change was influenced by significant refugee influx, but in the second wave of transition, as the economy remained impotent. Unfortunately, well-educated youngsters of refugee population left the country, leaving behind pensioners, socially endangered and low-educated people.

Sixty years ago, an average Serb had a bit more than 29 years. In 2016, he is 14 years older, standing forth in the line of the oldest nations in the world. The aging