

**BEYOND EXPANSIONARY AUSTERITY:
What Serbia's economy should do to transfigure fiscal stability into
sustainable growth?**

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INVITATION LETTER

The mission of this year's Kopaonik Business Forum (the KBF) under the title Beyond Expansionary Austerity is to provide evidence and theory-based answers to accelerate growth, this being the main economic challenge after the fiscal consolidation. Fiscal balance is a critical achievement of the latest round of reforms in the 2014-17 period. It is a prerequisite for recovery and dynamic growth. On the other hand, dynamic growth enables sustainability of the fiscal balance and credibility of the economy in the long run. Our intention is to discuss all relevant details about the drivers of growth both from macro and micro (or business) perspective, particularly regarding their interconnections.

Achievements of the latest round of reforms have redirected Serbia toward a strategic inflection point, from transitional recession to recovery. Hard budget constraints, both macro and micro, are prerequisites for structural reforms and recovery. They cannot be implemented independently from investment. Namely, when austerity prevails, the government does not make massive investments or finance risky ventures such as research and development. This approach neither offers the new generations little choice to follow the new normality and megatrends nor does it help the current generation to increase their income. Namely, austerity is a system that reinforces incremental behavior and, thus, the status quo for everyone. Settling for the status quo in terms of policy measures in a country lagging in economic development may be the greatest risk of all. It will also make us unable to adapt to meet the coming challenges, particularly technological entrepreneurship, as a principal challenge of the Industrial Revolution 4.0.

As always, at KBF there is no intention to offer isolated diagnosis on lacking policy targets and surviving challenges, or to repeat the arguments "for" or "against", but rather to consider the overall context and explanatory details from all relevant perspectives in order to set up the problem-solving platforms. Proceeding from the Government's vision of growth, through its macroeconomic policies (monetary and fiscal) articulation, we aim to come up with a program for sustainable growth based on industrial policies for the tradable sector. To accelerate growth, with fiscal stability maintained, the focus will be on industrial policy, both horizontal and vertical.

The present moment in global economy, characterized by the constant shifting of the balance of power, seems to be more challenging than ever. The new context calls for every national economy, large or small, developed or developing, mature or emerging, to be visionary, agile and proactive. Architects of the system and policymakers should not be afraid to step outside "the business as usual" comfort zone. One type of globalization (world as a market and/or factory) is dying out, while a new kind of globalization (world as a place of creation) is emerging. Shift from globalization "to the world" to globalization "from the world" positioned the local integration challenge, from geopolitics to economics, at the forefront. When Industry 4.0 speaks for itself, the economy (both global and local) is emergent, intangible and integrated. In such a world, breakthrough innovation is not an asset. It is information only. Local businesses are leveraging the world to compete at home. In geopolitics, the same principle exists: "The more the world is integrated, the local perspective matters more".

In such circumstances, the Government must change its mindset and be responsive to changes. To be responsive to the nexus of challenges, the Government must be responsible. In search for a solution, sustainability should be the criterion for a long-term vision. The Government should be striving for sustainability in all relevant aspects of its responsibilities (macroeconomic stability, openness, confident state including human capital development regarding healthcare, science and education, and political stability).

In the emerging world of interconnected multipolar geopolitical and conceptual regimes, for every national economy the ultimate goal is, again, growth, but this time growth that is sustainable and inclusive of the people, nature and national interests. In a new setting, to survive and prosper, again, every national economy needs to keep growing. Every government is looking for a new growth model and the related economic policy platform. It is not easy to make the right (re)positioning *vis-à-vis* the new normality and leading trends, or the strategy of global leaders. Change management (both macro and micro) is a way to respond to main challenges in an age when speed is becoming a currency.

In the modern world, scientific breakthroughs integrate the economy. The flows of ideas and information grow exponentially. Amalgams of virtual innovations from ICT and innovations from the physical and biological world have offered endless opportunities for amalgams of products and/or services, as well as innovative business models. Start-ups brought in the knowledge from the world on establishing innovative business models. When the world becomes more globalized in the abovementioned way, local integration is the most important. For example, in internet retailing, the leading companies are the local ones. In such circumstances, market niche is the norm. A start-up is, by definition, a global company because it positions itself as a platform for business development. In a globalized world, if you want to compete you need to be the best, no matter how large the niche market is or how strong the effect of agglomeration on niches from different geographies is.

Despite the current tendencies toward economic deglobalization inspired by Brexit and the Trump effect, in the long run, shifting back to local market protection will not prevail because it would work against two key forces of economic development – division of labor and diffusion of innovations. Also, despite the omnipresent crisis in the EU, there is a legitimate reason for hope that globalization of the world economy and harmonization inside the EU will ultimately prevail. With such optimism in the background, Serbia can make plans for the future.

In the new global economy, complementarity between national economies is important. However, connectivity is crucial. It is more important to whom you are connected than who you are. Serbia, as a microscopic economy on the European soil, late developer with a delay in transition, import and debt-dependent economy located on the global economy periphery and, consequently, an economy with limited impact on global economy and politics, must adopt the perception that the EU is a reality (economically and geopolitically), and position itself clearly toward it.

Where is Serbia in the new context? The lessons in economic history teach us that a country that achieves proper geopolitical positioning and technology change can grow its way out from certain disadvantages from the past, including the poverty trap and great indebtedness. Of course, technological determinism as a consequence of Industry 4.0 euphoria and technological *deus ex machina* could not yield results without an adequate growth model and economic policy platform. In each country, a new model of growth and economic policy platform for Industry 4.0 will influence the change in the mindset of society – the way it lives, the way it grows and the way it makes choices.

Unfortunately, Serbia's economy is burdened with many traps (middle income, transitional, poverty, etc.). The most telling indicator of vulnerability of an economy is perhaps the poverty trap. Economic theory teaches us that at the low level of development the marginal product of capital is high. However, if there are certain diminishing returns to scale due to structural imbalances, complementarities and particularly the inadequate level of human capital (both basic and advanced), this combination of

factors could tone down the previous proposition and lead to a low level of the marginal return on capital. In the event of small increase in capital yield due to very low return, economy stays in the poverty trap.

More seriously, since it does not allocate funds for investments, households do not save and economy remains in a stationary state. Large-scale capital, both public and private, particularly human, is necessary if an economy wants to break free from the previously mentioned trap, initiate income convergence with the developed economies and move away from the periphery to the core of global economy. This is why some scholars supported acceleration of the accession process because they expected that the necessary capital for recovery and catching up would come primarily from the neighboring EU.

Accession to the EU should be a priority for Serbia, at least because geography speaks for itself. Besides political will, there is a strong economic rationale for accession. The so-called “near to market argument” makes the EU the largest trade partner, investor and creditor. However, Serbia’s accession aspirations depend significantly on the compatibility argument, or on the speed of reforms in the country.

Most, if not all relevant studies, emphasized the existence of sizable divergence between Serbia and EU, both in the macroeconomic performance and the structural elements. As a consequence, Serbia’s economy suffers asymmetric shocks typical of countries that are in different stages of the business cycle due to domestic shocks and/or because common shocks from the EU could have a different impact. The problem is more serious if the asymmetric shocks affect an impotent economy with limited capacity to react, which is a reality in Serbia.

Previous documents of the Kopaonik Consensus pointed out that there are many challenges that Serbia must face in the years ahead in order to decrease the distance *vis-a-vis* the EU. Before defining structural reforms, we must address long tails of system failures and possible solutions if we intend to build a sustainable economy capable of EU accession.

First, Serbia’s economy must restructure itself because it is not sustainable. By fixing structural imbalances from the past, Serbia should avoid the inherited weaknesses due to competitive disadvantage relative to near competitors. New industrialization should build on its unquestionable strengths in tradable sectors and extend the existing competitive advantages into the future. Naturally, we cannot take the current strengths for granted. If near competitors invest more in infrastructure, education, science and R&D, and we do not, then we cannot expect to maintain our strong sides.

Second, in order to be effective, each national economy should close the gap between best-performing regions, industries and companies within the country and those that are less productive. When the majority of the business-relevant subjects fall behind the leading entities concentrated in the big cities, the challenge for any government is to close the gaps and to ensure that every region meets its potential. The skill gap is one of the major barriers in doing that. We must remember that the primary issue in systemic transition is to remove the skill gap, rather than the capital gap. However, the dominant orientation toward the soft skills in the field of ICT (information and communication technologies) and STEM (science, technology, engineering and mathematics) leads to the paradox that university graduates do not possess numeracy and networking skills they need not only to command a good wage, but also to be able to find any employment.

Third, to be efficient, Serbia must become a competitive place to start and to grow a new business. Mistakes and overestimations from the past share the same element – focus on rejuvenation of existing industries and companies, particularly the biggest and most politically sensitive among them. The so-called “old economy” and strategizing about incumbent businesses were two focal points of policymakers to make proposals for expansion and/or for restructuring (from privatization to financial

consolidation and rightsizing). Following the “too-big-to-fail” doctrine, policymakers ignored the newcomers. Many new industries and a great majority of today’s global business leaders, particularly from the ICT field, did not exist at the time when systemic transition in Serbia started. The new industrial policy must focus not only on creating the right conditions that enable the incumbents to prosper, but also on setting up the rules for the new economy development.

The main purpose of the new wisdom in economic theory and policy is the annulation of fractures of the system from the past such as deindustrialization, output gap and over-proportional financialization, as well as the inadequate mix of macroeconomic fundamentals. Although growth in Serbia has been in the positive territory during the last three years, it is actually an incremental growth. It indicates that the economy is too sluggish to maintain the sustainability proposal. Such economy is in a stationary state.

An economy in a stationary state, even with some episodes of growth, had ceased to grow in a sustainable way. Such economy has four hallmarks. First, the output gap. Second, the economy is under threat of double macro deficits (current account and fiscal) and, consequently, growing indebtedness. Third, the regulations and institutions are degenerated to the point that rent-seeking activities strongly compete against the entrepreneurial ones. In such a system, a symbiosis of political and entrepreneurial elites could exploit the system to their own advantage. Forth, standard of living for the majority of people is miserably low, inspiring social imbalances, particularly economic emigration and brain drain.

In a stationary economy, policymakers who could be progress-prone in a dynamic economy become progress-resistant, including dangerous forms of social pathologies such as the red tape. As a consequence, public debt has become a way for the older generation to live at the expense of the young. During the previous transition ending with 2014, the Government created forms of debt that, by design, cannot be inflated away. As a result, the next generation will be saddled for life with liabilities incurred by their parents. In such a context, social groups relevant for structural reforms such as technocrats, researchers and academics luminaries are reduced to a mere no man’s land between foreign corporations and partocratic governance.

After fiscal consolidation, there has never been a time of greater promise for recovery. The trend is good, but the macroeconomic performance improvement is not good enough due to structural imbalances from the past and inadequate macroeconomic fundamentals. There are many bleeding points in Serbia’s economic body, primarily due to subsidies and loans extended to the state-owned-sector (SOS), as well as due to budget support to the pension fund and tertiary sector as a consequence of the pay-as-you-go system. In short, recent successes of the expansionary austerity policy could mask the deeply rooted fractures in the system. Paradoxically, people’s aspirations and expectations, particularly from groups not fully relevant for economic recovery, such as pensioners and employees in the public sector, have in the meantime been rising faster than the real growth.

Serbia’s economy desperately needs a new development impact. Development is a prerequisite for sustainability and it is synonymous with improvements in people’s well-being. Development is more than just growth. As a consequence, after the last round of transition, policymakers in Serbia are looking for the answers to two questions: Will fiscal consolidation achieved in the last three years be sustainable? and Will the last year’s growth be sufficient for the sustainability proposal? Answering these questions requires shifting from growth to development, more precisely from sclerotic growth to a more dynamic one.

For the dynamic growth to be achieved, breakthrough objectives are needed. For example, to double the GDP in the next 15 years. This radical proposition means 5-6% of the compound average growth rate in the following period. It is not an easy shift because political leaders are too often trapped in traditional linear thinking by ignoring exponential increases of opportunities. Being a hostage of “the mind-setting trap”, the political class usually does not understand that technology, as well as the disruption that

comes with it, is an exogenous force to which human beings respond by using adequate growth models and economic policy frameworks.

Considering our transition experience from the past, we also need to recognize that good economics cannot be divorced from good politics. This is a reason why this field is known as “political economy”. Also, we have to recognize that institutions have influence on the economy only as long as politics is reasonably well-balanced. Deep imbalances can create a political groundswell that can overpower any constraining institutions. No matter how well-developed their institutions are, economies suffer from structural imbalances if their politics become imbalanced.

Serbia is at a crossroads. In the age of overall discontinuity, brave politicians with a valuable and feasible vision, academic luminaries familiar with major trends and economics practitioners whose optimism is a result of previous achievements could help the national economy to survive and prosper. They should also examine the roadmaps of reforms, macroeconomic policy measures, industrial policy that matters and major geopolitical priorities.

Moreover, any reform journey should also address the more practical realities of today, reimagining core systems in network technologies and infrastructure, as well as restructuring of SOS, improving analytical capabilities in state authorities and building automatic platforms for start-ups, new venture financing and leading technology vendors, particularly from ICT. All of the abovementioned is by no means trivial.

The web of life in Serbia is a mingled yarn of threats and opportunities. Given that threats dominate over the opportunities, the mission of KBF is to define the vision that transforms threats into opportunities and capitalize on them by inspiring different forms of agility throughout society. This year’s convention is an attempt to find and test such a vision.

We kindly ask you to dedicate your time and will, and participate in this event.