Insights from a Transition Economy: 
The Case of Serbia

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January 2011
Institute of Economic Growth
INSTITUTE OF ECONOMIC GROWTH

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This distinguished lecture by Professor Milica Uvalic is based on her recent book: *Serbia’s Transition—Towards a Better Future* (Palgrave/Macmillan 2010). Although the transition economies have been relatively little studied in India, the issues dealt with in this lecture are of substantial interest for understanding how the economic and the political interweave in determining economic outcomes. The lecture also presents a fascinating overview of a significant period of world history, after the fall of the Berlin Wall in November 1989, which officially marked the end of communist regimes in Eastern Europe, to the present. Through the experience of Serbia, the paper provides rich insights and lessons on the challenges involved in a transition as momentous as that from communism to capitalism.

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Milica Uvalic is Professor of Economics in the Department of Economics, Finance and Statistics, University of Perugia, Italy. She was educated at the Universities of Belgrade and Florence. She has served as consultant to several international organisations, including the Commission of the European Communities, the ILO, UNDP, UNESCO and GTZ. She has been President of the European Association for Comparative Economic Systems, Vice Minister for Foreign Economic Relations in the first post-Milosevic Federal Government of FR Yugoslavia, Research Fellow at the European University Institute, and a Public Policy Scholar at the Woodrow Wilson International Centre for Scholars, Washington, DC. She is currently also a member of the UN Committee for Development Policy.

Prof. Uvalic has written almost 150 papers and several books on central and southeast Europe relating to macroeconomic policies, privatisation, corporate governance, regional cooperation, trade liberalisation, R&D policies, EU enlargement and economic integration. Among her known books are: Investment and Property Rights in Yugoslavia (Cambridge University Press, 1992); Post-communist Transition to a Market Economy: Lessons and Challenges (co-edited, A. Longo Editore, 2003); Transition and Beyond (co-edited, Palgrave Macmillan, 2007); Globalization, Development and Integration (co-edited, Palgrave Macmillan, 2009), and her most recent Serbia’s Transition—Towards a Better Future (Palgrave Macmillan, 2010).
Insights from a Transition Economy: The Case of Serbia

Milica Uvalic

Abstract

In November 1989, with the fall of the Berlin Wall, communism officially ended in Eastern Europe. It marked the beginning of the transition from communism to capitalism throughout the region, involving systemic radical political and economic changes, with the aim of introducing multiparty democracy and a market economy. This paper is focused on one of these transition countries—Serbia—that was born from the break-up of socialist Yugoslavia. It will discuss twenty years of Serbia’s transition—from 1989 to 2009—explaining why a country which began with some of the best initial conditions for implementing the transition ended up lagging so substantially behind other transition economies. Although the emphasis in the paper is on economic transition, it is set against the wider context of major political and historical events. Starting from Serbia’s favorable initial conditions in 1989, when it was still part of socialist Yugoslavia, the paper proceeds to analyze the difficult 1990s characterized by high political and economic instability. The end of the Milosevic regime in October 2000 facilitated a radically new course. The changed political environment brought many economic achievements. Macroeconomic performance greatly improved and there was an acceleration of major institutional reforms, but there were also some significant policy failures. In the meantime, a substantial improvement took place in Serbia’s political relations with the European Union, leading to the signing of a Stabilization and Association Agreement in 2008 and Serbia’s recent application for EU candidate status. The 2008-09 global financial and economic crisis has had a severe impact on Serbia’s economy, raising many questions regarding its future prospects of growth.

Key words: Transition economy, Serbia, Macroeconomic policy, European Union

1 The paper is based on a lecture delivered in New Delhi on 25 November 2010 organized by the Institute of Economic Growth of the University of Delhi and the India International Center. The lecture and the present paper draw heavily on Milica Uvalic’s recent book Serbia’s Transition—Towards a Better Future (Uvalic, 2010). I am grateful to Radha Kumar, Charan Wadhwa and Bina Agarwal for their helpful comments.
Introduction

The fall of the Berlin Wall in November 1989 officially ended communism in Eastern Europe. With it began the transition from communism to capitalism throughout the region. This transition was an unprecedented experiment, since it implied a process of fundamental change in political and economic systems. In the political sphere, multiparty democracy replaced the one-party communist political system. In the economic sphere, a system based on private property and the market replaced the dominant state or social ownership of enterprises and non-market allocation of resources through centralized planning (or more decentralized forms of management as in Yugoslavia).

The transition to a market economy in Eastern Europe was meant to create capitalism by design as quickly as possible, and thus required the initiation of numerous radical measures simultaneously. The typical model followed the main prescriptions of the so-called “Washington consensus”, suggested by the major international financial institutions a decade earlier for the Latin American countries. This emphasized the benefits of economic liberalization, macroeconomic stabilization, and privatization (see Williamson 1990). Also in Eastern Europe in the early 1990s, the package of recommended economic reforms included several forms of liberalization: that of prices which under the old system were administratively determined; that of foreign trade through the reduction of tariffs and elimination of various trade barriers; and that of private economic activity which previously was restricted to small-scale crafts and sometimes, as in Poland and Yugoslavia, also to agriculture. It also emphasized the achievement of substantial macroeconomic stabilization through restrictive monetary and fiscal policies aimed at lowering inflation and fiscal deficits; and the privatization, as quickly as possible, of previously state or socially-owned enterprises.

Radical economic reforms were also coincident with many important institutional reforms, including the creation of new institutions of capital
and labour markets, both of which were practically non-existent in the previous economic system. These included fundamental reform of the banking system, creation of a stock exchange, diversification of financial instruments, and the setting up of non-banking financial institutions (such as investment funds), and key labour market institutions, such as a social safety net to protect the unemployed. The reforms were expected to provide incentives typical of a market economy, and so provide some of the main benefits of the market allocation of resources.

These changes are particularly well illustrated by the example of Serbia—one of the countries born from the break-up of the Socialist Federal Republic (SFR) of Yugoslavia, that over the past twenty years has officially changed its statehood five times. From being one of the six republics of SFR Yugoslavia during 1945-1991, soon after its break-up in mid-1991, Serbia together with Montenegro formed the Federal Republic (FR) of Yugoslavia in April 1992. The country changed its name in 2003 to the State Union of Serbia and Montenegro. Following the popular referendum in Montenegro in May 2006, when the majority of its citizens voted for independence, as of June 2006 Serbia and Montenegro have become two independent states. The last change occurred in February 2008, when Serbia lost its southern province of Kosovo, after Kosovo’s unilateral declaration of independence.

Serbia is an interesting case of a transition economy for several reasons. Like other Eastern European countries, Serbia started its transition to a market economy and multiparty democracy in the late 1980s, while it was still part of former Yugoslavia. But the country’s twenty year transition has been more complex than in many other parts of the former communist world, and in many ways unique. The multiple political events that afflicted Serbia in the 1990s had very negative implications for its economy, and greatly delayed its process of transition. While the political events in the Balkans have attracted considerable attention, relatively little is known even today about the Serbian economy. There are also a number of controversial issues. There is no agreement among
scholars when the transition in Serbia actually began—whether in 1989 while it was still part of Yugoslavia, or in late 2000 after the end of the Milosevic regime. There is even less agreement about the achievements and failures of the post-2000 economic reforms in Serbia, since the assessments have been divergent. There are also different views on why Serbia has encountered difficulties in implementing its transition.

There is no doubt that the main reasons for the delays in Serbia’s transition are primarily internal. The re-emergence of nationalism in the second half of the 1980s, the negative consequences of the break-up of the Yugoslav federation, the non-democratic political regime that prevailed throughout the 1990s, and the country’s involvement in several military conflicts—in Croatia (1991), in Bosnia and Herzegovina (1992-95), and in Kosovo (1998-99)—determined, for a whole decade, a clear priority of political over economic objectives. Hence fundamental reforms of the economic system were postponed. Along with these primary causes, however, external factors additionally contributed to delays in Serbia’s transition, including the very harsh international sanctions against FR Yugoslavia during 1992-95 which were renewed in 1998-99, the severe consequences of the 1999 NATO bombing, and the hesitant or inadequate policies of the European Union (EU) and the wider international community. Some of the international measures that were applied to Serbia/FR Yugoslavia were ineffective or counterproductive, contributing to even greater delays in carrying forward its transition to a market economy.

This paper discusses these complex dimensions of Serbia’s economic history during the last twenty years, from 1989 to 2009. It looks at why a country that had among the best initial conditions in 1989 for implementing transition-related economic reforms ended up lagging behind many other countries of the former communist world. Although the emphasis is on the economic transition, this is examined within a wider context of major political and historical events. Since during 1992–2008 Serbia and Montenegro were one state, some issues
will necessarily have to be addressed from the perspective of the whole country, but it should be borne in mind that Serbia represented by far the largest part of the post-1992 FR Yugoslavia in terms of territory, population and economic weight. Section 2 below briefly recalls the historical events in 1989 that marked the beginning of the transition to a market economy and multiparty democracy in Eastern Europe, and the initial conditions that prevailed in Serbia when it was still part of socialist Yugoslavia. Section 3 then discusses the difficult 1990s in Serbia/FR Yugoslavia, and explains the main reasons behind the high political and economic instability. Next, section 4 analyzes the new phase of Serbia’s economic history after the fall of Milosevic’s regime in October 2000, marked by important achievements as well as some policy failures. In Section 5, Serbia’s relations with the EU are also briefly analyzed, given that EU membership has become Serbia’s main foreign policy objective. In the concluding Section 6, Serbia’s current challenges are stressed.

2. Serbia on the eve of transition in Eastern Europe

When the transition to a market economy and multiparty democracy was starting in 1989 in Eastern Europe, Serbia was still a constituent part of the SFR Yugoslavia, a federation composed of six republics: Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia with its two autonomous provinces Kosovo and Vojvodina, and Slovenia, with populations representing various nations, national minorities and ethnicities (see Figure 1).

Although socialist Yugoslavia also started its transition in 1988-89, the process was interrupted by its break-up in June 1991. Five independent states were created on its territory, mainly according to the geographical borders of the republics that existed within Yugoslavia—this was the case with four of the five successor states of Yugoslavia (Bosnia and Herzegovina, Croatia, Macedonia and Slovenia), the only exception being the Federal Republic of Yugoslavia that was created by two of the former Yugoslav republics, Serbia and Montenegro.
At the time of the break-up, the initial conditions in SFR Yugoslavia and its successor states were somewhat different to those in other countries in Eastern Europe, primarily due to a longer tradition in market-oriented economic reforms, and specific international relations. SFR Yugoslavia started introducing some elements of the market mechanism rather early, soon after the Tito-Stalin conflict and the break with the Communist Information Bureau (Cominform) in 1948. One of the main novelties of the reforms in the 1950s was the introduction of a system of workers’ self-management in enterprises, aimed at giving workers some say in decision-making, along with the transformation of enterprise ownership from the traditional form of state property into social property, intended as property of the whole society. During the decades that followed, a number of economic reforms were implemented, aimed at decentralization
of the economic system and greater reliance on the market mechanism, including the liberalization of most prices, a multi-tier banking system, a more liberal system of foreign trade (Yugoslavia became member of GATT in 1966), and legislation on joint ventures to attract foreign investment. Yugoslavia’s unique economic system of “market socialism” stimulated considerable academic interest from the 1950s to the 1980s, as an example of a potential ‘third way’ between capitalism and socialism (Estrin and Uvalic 2008). Still, the beneficial effects of market-oriented reforms remained limited by the unchanged nature of the political system in Yugoslavia, which remained essentially communist. As a result, the Yugoslav economy continued to be characterized by some features typical of communist economic systems as described by Kornai (1980), including the dominance of non-private property, “soft” budget constraints through the coverage of enterprise losses, and state paternalism, namely continuous state intervention in enterprise affairs (Uvalic 1992). Despite these limitations, undoubtedly Yugoslavia’s extensive economic reforms brought many advantages relative to the traditional economic system that dominated the rest of Eastern Europe. Moreover, although Yugoslavia remained a communist country, in some areas there were more personal freedoms than elsewhere in Eastern Europe. For instance, after 1965, its citizens could travel abroad freely.

SFR Yugoslavia also benefited from specific international relations, since during the Cold War it was seen as lying between the Western and Eastern blocs. Unlike the Soviet Union and the six satellite East European countries, Yugoslavia was not a member of the Council for Mutual Economic Assistance (CMEA) or of the Warsaw Pact, but together with India and Egypt created the Nonalignment Movement in 1961. Yugoslavia was also one of the founding members of the International Monetary Fund and the World Bank and had privileged relations with the European Economic Community (EEC). Yugoslavia concluded several trade agreements with the EEC in the 1970s and a broad-based trade and economic cooperation agreement in 1980, which greatly facilitated its trade with Western Europe.
Such features of SFR Yugoslavia brought concrete advantages, in one way or another, to all its republics, including Serbia. Within the Yugoslav federation, Serbia had had a rather significant role by several important indicators (see Figure 2). In the late 1980s, it represented the largest part of the Yugoslav territory (34.5 per cent) as well as its population (41.5 per cent). It was the only Yugoslav republic to have two “autonomous provinces”—Vojvodina in the north and Kosovo in the south—set up primarily by the need to incorporate the sizeable national minorities of Albanians and Hungarians. Although the Yugoslav republic, constituted of Bosnia and Herzegovina, was the most multiethnic, Serbia also had large groups of other nations and national minorities. According to the 1991 census, only 66 per cent of Serbia’s inhabitants were Serbs. At the same time, there were many Serbs living outside Serbia: out of the total of 8.5 million declared to be Serbs in 1991, only 6.4 million actually lived in Serbia, while 1.4 million lived in Bosnia and Herzegovina, 580,000 in Croatia, 57,000 in Montenegro and 44,000 in Macedonia (Crnobrnja 1994, p. 30).

Serbia was also the republic that contributed the highest share of Gross Social Product (GSP) 2 (38 per cent), investment (38 per cent), and employment (38 per cent). Almost half of Yugoslavia’s agricultural output and over a third of its industrial output was produced in Serbia. Although Serbia was less export-oriented than Slovenia or Croatia, being the economically largest republic in 1990, it accounted for the highest share of Yugoslavia’s exports (30 per cent) and imports (33 per cent). In 1990, 57 per cent of Serbia’s exports were to the OECD countries and 60 per cent of its imports were from these countries. Serbia had an important role in Yugoslavia’s foreign economic relations

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2 Gross Social Product or Social Product in Yugoslav terminology corresponds to Gross Material Product: it is the value added of “productive” sectors of the economy, thus excluding most “non-productive” sectors such as education, health, defense, banking and other services. In this sense it is very similar to the concept of Net Material Product that for years was used in other socialist countries, but differs from such a concept because it is gross of depreciation.
also because many international contacts were established in Belgrade which, at that time, was the capital of both SFR Yugoslavia and Serbia. In 1989, Serbia had signed 33 per cent of all international cooperation agreements (on acquisition of technology, long term production, foreign investment, technical assistance), although the value of foreign capital invested in joint ventures in Serbia was relatively less significant (21 per cent), constituting only one third of foreign investment in Slovenia 65 per cent; see Uvalic 2010, p. 33).

Figure 2: Main indicators of republics of SFR Yugoslavia, 1991

![Figure 2: Main indicators of republics of SFR Yugoslavia, 1991](image)


Serbia was by no means a developed republic. In 1989 its GSP per capita was only 88 per cent of the Yugoslav average. However, there were large variations within Serbia, between the north and the south. Serbia proper—the central part without the two autonomous provinces—had a GSP per capita equal to the Yugoslav average, while Vojvodina was 18 per cent higher, and Kosovo only at 24 per cent of the Yugoslav average. In 1989, estimates of the London-based Economist Intelligence Unit indicated that the joint GDP per head (at Purchasing Power Parity) of Serbia and Montenegro (that would create FR Yugoslavia a few years later) was US$ 4,731, which
was around half of GDP per head of the most developed Yugoslav republic, Slovenia (Kekic 1996, p. 15).

At the eve of transition, therefore, Serbia inherited relatively favourable conditions from Yugoslavia, primarily due to a long period of market-oriented reforms and good political relations with the West. There were also some disadvantages shared by all the Yugoslav republics. The most serious was the ongoing political (and economic) crisis which started in the early 1980s, a few years after the death of President Tito. The crisis gradually developed through the 1980s, and after unsuccessful attempts to find a compromise solution acceptable to all the constituent republics of the federation, led effectively to the break-up of the Yugoslav federation in mid-1991. Second, all of Yugoslav republics inherited an ambiguous system of property rights. As mentioned earlier, enterprises in Yugoslavia were social property defined as property of the whole society, and hence of everyone and no-one. This feature rendered privatization more complicated than in other countries in Eastern Europe (where enterprises were usually owned by the state), since it was not clear who was to initiate the process of privatization and to whom the proceeds would go. Finally, in Serbia/Yugoslavia there was a greater resistance to radical systemic changes, since the regime enjoyed a higher degree of popular support, not only because of the specific features of the Yugoslav model, but also because unlike in other East European countries, communism was not imposed from the outside but emerged through grass-roots revolution during World War II. Despite these disadvantages, on the eve of transition Serbia and the other Yugoslav republics had relatively good starting conditions, compared to most of Eastern Europe.

3. Serbia’s interrupted transition in the 1990s

Serbia began its transition in the late 1980s, while still part of former Yugoslavia. It benefited from the more radical economic reforms launched by the last Yugoslav government in 1988-90 aimed at economic liberalization, macroeconomic stabilization and privatization of
socially-owned enterprises. Along with transition-related economic reforms, Serbia also held its first multiparty elections in December 1990, which saw the victory of Slobodan Milosevic and his Socialist Party of Serbia (SPS). Since the SPS was born from a marginally reformed League of Communists of Serbia, there was ideological continuity with the previous communist party. Moreover, despite parliamentary democracy with a number of parties represented in the Serbian parliament, the political system was effectively dominated by one party, Milosevic’s SPS, and had many features of an undemocratic regime. Since Milosevic’s SPS remained the dominant party throughout the decade, the democratization of the political system in Serbia was greatly delayed.

The economic transition was soon interrupted by three groups of external shocks. Though “external”, they were the direct or indirect outcomes of the political choices made by the Serbian/Yugoslav government. The government frequently blamed these shocks for the progressive worsening of the country’s overall situation, and was not willing to accept responsibility for dragging Serbia into a deep political, economic, and social crisis.

The first external shock was the disintegration of SFR Yugoslavia in mid-1991, which brought extreme political and economic instability to the whole Balkan region, particularly Serbia, and Bosnia and Herzegovina. The second group of shocks were the military conflicts of the early 1990s in which FR Yugoslavia was directly or indirectly involved—in Croatia in 1991 and in Bosnia and Herzegovina during 1992-95—which had direct implications for economic policies of those times. The third external shock was the sanctions imposed by the United Nations and the European Union against FR Yugoslavia, because of its involvement in

3 Milosevic did not hesitate to use force. He sent tanks and special police forces against citizens in mass demonstrations, as happened for the first time in the centre of Belgrade in March 1991. There were numerous cases of imprisonment, beating up of demonstrators and key opposition leaders, continuous harassment of the opposition mass media, censorships, and arbitrary arrests. During the 1990s, street demonstrations became a favorite method of popular protest against the political regime in Serbia.
armed conflicts. From 1992 onwards, the UN adopted several resolutions which introduced severe and widely-based international sanctions against FR Yugoslavia. This included not only an economic embargo on trade and other business transactions with Yugoslav firms and banks, on foreign direct investment, and on access to international financial markets; it also included restrictions on cultural, scientific and sports contacts with the outside world, and on air traffic over Yugoslavia, so that Belgrade airport remained closed for several years. In the meantime, FR Yugoslavia also had an unregulated status in the most important international organizations, since the Yugoslav government insisted on recognising the “continuity” between FR Yugoslavia and SFR Yugoslavia, hoping that this would provide FR Yugoslavia the right to the former country’s assets and membership in international organizations.

These political events had profound economic consequences for Serbia. The end of the Yugoslav federation led to the break-up of its economic and monetary union. This implied the loss of a protected market for Serbian products in other parts of the former country, directly contributing to its deep recession of the early 1990s. The military conflicts of the early 1990s heavily burdened the Serbian/Yugoslav government through war-related expenditure, contributing to extreme macroeconomic instability in 1992-93. The highly expansionary monetary and fiscal policies necessary to finance the wars in FR Yugoslavia led to one of the worst hyperinflations in world history: in 1993 the inflation rate was 116.5 trillion percent. It peaked in January 1994, when prices rose by 60 per cent per day, making the Yugoslav inflation the second highest recorded inflation after the Hungarian hyperinflation of 1945-6, (and the third highest of the current, Zimbabwe’s hyperinflation in 2008, see Figure 3). The hyperinflation in FR Yugoslavia lasted 24 months, the second longest in world history, after the Russian hyperinflation in the 1920s. Extreme monetary instability was additionally fuelled by inappropriate exchange rate policies, as the official fixed exchange rate of the dinar was only sporadically adjusted to the continuously increasing black market rate.
During this period FR Yugoslavia also experienced an economic recession of unprecedented dimensions. Indeed, all countries in Eastern Europe went through a deep recession in the early 1990s, often referred to as the “transformational recession”, caused by different factors—the economic/trade disintegration (of the CMEA, USSR, or federations, such as the CSSR or Yugoslavia), a systemic vacuum due to the passage from a centralized administrative system to new market institutions, and erroneous economic policies. However, FR Yugoslavia’s recession was one of the most profound. Over 1990-93, FR Yugoslavia registered a cumulative decline in GDP of around 80 percentage points. During these years of extreme economic instability, there were frequent shortages of basic products, a flourishing informal economy, rapid currency depreciation, and a high degree of “marketization”, namely the effective disappearance of the national currency (the dinar) as a means of payment and its replacement with the German mark. Along with the rapid fall in GDP, industrial production declined even more, contributing to marked deindustrialization.

Figure 3: Monthly rate of inflation in Serbia and Montenegro (FR Yugoslavia), January 1992– February 1994

The exceptional conditions that prevailed in FR Yugoslavia in the early 1990s also substantially delayed economic reforms. Those started in Serbia in 1989-90 were effectively suspended or reversed. Due to the deteriorating economic situation after 1992, the government introduced various emergency packages based on a series of administrative measures—general or selective price freezes, wages limits or controls, and rationing of the most essential products. The international trade embargo effectively reversed the trade liberalization measures implemented in 1990-91. For social reasons a government decree prohibited the lay-off of workers in the period of international sanctions. During this period, key Serbian firms, considered of strategic importance for the economy, were nationalized, in order to enforce government control. In the meantime, the economic situation further deteriorated due to the economic embargo imposed by the UN sanctions, which effectively blocked trade, and economic and political relations with the outside world.

Following this period of extreme monetary and economic instability, a stabilization programme was implemented in January 1994 by the newly-appointed governor of the Yugoslav National Bank, Dragoslav Avramovic. The program was based on radical monetary reform that introduced a currency board: a fixed exchange rate and monetary emission strictly limited by the availability of foreign reserves. These measures were initially very successful as they eliminated hyperinflation virtually overnight and brought about economic recovery. However, the results were short-lived since already in mid-1994 the tight monetary policy was relaxed and the currency board was thus abandoned. Moreover, the government was unwilling to implement fiscal reforms, or make any fundamental changes in the economic system. Although a new privatization law was adopted in 1992, further legal amendments in 1994, which introduced an inappropriate revaluation of enterprise assets, practically cancelled most of the privatization.

After the signing of the Dayton Peace Accords in December 1995 which officially ended the war in Bosnia and Herzegovina, the
expectations were that the general conditions in FR Yugoslavia would quickly change for the better. Contrary to expectations, however, this period brought continuity of government policies implemented in the past, rather than radical changes of the political and economic system, and further isolation of FR Yugoslavia, rather than the normalization of the country’s relations with the international community. International sanctions against FR Yugoslavia were officially lifted, but since the political regime in Serbia had not changed, what remained thereafter was the so-called “outer wall” of sanctions which prevented the re-entry of the country into major international organizations, the unfreezing of Serbian firms’ foreign accounts abroad, access to international financial markets and the arrival of much needed foreign direct investment.

The adverse political conditions in FR Yugoslavia which also prevailed after 1995, continued to negatively affect economic performance. Although inflation never reached the dramatic rates registered in the first half of the 1990s, it remained high (close to 100 per cent) in 1996-97, declining to 20-30 per cent over the next few years. High growth rates during 1995-97, upto 10 per cent in 1997, were insufficient to compensate for the deep recession of the early 1990s. Despite the lifting of sanctions, there was only limited revival of foreign trade. The lack of normalization of FR Yugoslavia’s relations with international financial organizations impeded the inflow of badly needed loans as well as foreign direct investment (FDI). Due to high political risk, there was only one important foreign investment deal, in June 1997, with the privatization of 49 per cent of Serbia Telekom, sold to the Italian STET (29 per cent) and Greek OTE (20 per cent) for DM 1.57 billion.

Strong anti-reform forces remained influential within the government, preventing major changes in economic policy or more radical reforms. Instead of liberalization of economic activity, the Serbian government continued to implement administrative control over the economy. The foreign trade system remained protected through high tariffs and a number of non-tariff barriers. The dinar remained non-convertible, contributing to
the divergence of the official from the black market exchange rate. A new privatization law was adopted in 1997, but since it did not render privatization obligatory, its implementation assured only partial privatization of primarily small-scale enterprises. Many new laws adopted during this period contained provisions which indicated the lack of willingness by the Serbian/Yugoslav government to abandon pre-1989 institutions and practices.

The multiplicity of adverse developments in the 1990s had significant social consequences in Serbia. The UN economic embargo encouraged smuggling, war-related illegal activities, and corruption. There was growing social differentiation, poverty and inequality, as income was frequently redistributed in favour of the elite. There was also income redistribution in favour of the government through various channels, including the inflation tax, freezing of citizens’ foreign currency bank deposits, and various pyramid schemes which involved para-state banks, where many citizens lost all their savings once they declared bankruptcy. A close relationship was established between the political and economic elite, providing for the overlapping of economic and political competences. By the late 1990s, the directors of the thirty most important enterprises were also the key politicians, members of the Serbian parliament, ministers in the Yugoslav government, and the closest political collaborators of President Milosevic.

In the meantime, the country was facing rising political and social unrest. After the official non-recognition of the election victory of the opposition parties at local elections in 1996, mass demonstrations were organized throughout Serbia, particularly in Belgrade in the winter of 1996-97. Although the pretext for the mass uprising was the theft of election votes, it was in fact a protest against Milosevic’s political regime. The theft of election votes was formally acknowledged only in early 1997, after the intervention of an international mission of the Organization for Security and Cooperation in Europe (the OSCE).
In the meantime, there was a progressive worsening of the political situation in Kosovo. After the adoption of the new Serbian constitution in 1990 which centralized Serbia’s power over the province of Kosovo, the confrontation between the Serb and the Albanian community became more extreme. In early 1996, after the creation of the Kosovo Liberation Army (KLA), the first violent clashes took place between the Yugoslav National Army and the KLA. The attempts to find a peaceful solution to the crisis in Kosovo through the Serbian–Albanian dialogue proved unsuccessful. As a reaction to Serbian policies in Kosovo, a new package of UN sanctions was imposed against FR Yugoslavia in May 1998, reinforced in March 1999. In early 1999, after the failure of international negotiations with representatives of the Milosevic regime in Rambouillet, the NATO 78-days military intervention in FR Yugoslavia started. Despite the lack of authorization from the UN Security Council (essentially due to veto by Russia and China), a number of countries—including the United States, United Kingdom, France, Canada and Italy—considered it necessary to use force for preventing a “humanitarian catastrophe” (Cassese and Gaeta 2008, p. 44). The absence of the UN Security Council approval as a legal basis for the intervention led other countries including China, Cuba, India, Namibia, Ukraine and Russia—to strongly condemn the NATO intervention, arguing that it was against the UN Charter and international law. Although the NATO intervention was supposed to prevent ethnic cleansing by the Serbian authorities in Kosovo, the bombing first prompted the regime to accelerate ethnic cleansing, then it succeeded in reversing it with Serbian army withdrawal and some Kosovo Liberation Army cleansing of Serbs. The economic costs of the war were enormous, with estimates ranging from USD 30 to 100 billion. The military intervention destroyed basic infrastructure, several bridges and a number of important factories, causing a drastic deterioration of the economy in 1999, with a 19 per cent drop in GDP and a 50 per cent decline in exports.
4. Serbia after 2000: Embarking on transition for a second time

In the elections of 24 September 2000 Vojislav Kostunica, the candidate for President of FR Yugoslavia of the Democratic Opposition of Serbia (DOS), won. Radical political changes took place after 5 October 2000. Milosevic’s failure to recognize the election results of September 2000 led to a general uprising of the Serbian population. After two days of continuous demonstrations, Milosevic had to give in and recognize the results, and Kostunica became the new president of FR Yugoslavia. In January 2001, Zoran Djindjic became the new Serbian Prime Minister.

At that time, there were many complex political issues calling for resolution. After a decade of international sanctions and isolation, FR Yugoslavia had to regulate its status in the main international organizations, including its membership in the UN, the IMF and the World Bank. The complex relationship between Serbia and Montenegro also needed to be resolved, because within the Federal government Montenegro was represented by its main opposition party SNP (Socialist Peoples’ Party) that for years had been a loyal collaborator of Milosevic. The country was subject to strict political conditionality related to war crimes, but within the government there was no consensus on the imprisonment and delivery of Slobodan Milosevic to the International Criminal Tribunal for former Yugoslavia in the Hague. Milosevic was put in jail only at the end of March 2001 and was delivered to the Hague Tribunal much later, on 27 June 2001, the evening before the donors conference for FR Yugoslavia. The arrival of international financial assistance was extremely important at that time, but the promised aid would not have been secured had Milosevic not been transported to the Hague the previous day.

Despite these problems, the end of the Milosevic regime facilitated a radically new course in economic reforms. After late 2000, the renewed transition to a market economy brought many economic achievements. One of the most important was macroeconomic stabilization. After 2001, average inflation declined from over 90 per cent in 2001 to around 10 per
cent in 2008, sustained by prudent monetary and exchange rate policy. During 2001–08, GDP grew close to at or over 5 per cent (Figure 4); the only exception being 2003, the year when Prime Minister Djindjic was assassinated.

Serbia also attracted a substantial amount of Foreign Direct Investment (FDI)—a cumulative total of $15 billion by the end of 2008. Increasing capital inflows have also been secured through emigrants’ remittances which presumably have been even higher than the FDI (no accurate statistics are presently available), and financial assistance from various international organizations, the European Union and other western countries. Foreign capital has played an important role in helping Serbia’s development, since internal savings, although growing, have been rather low.

Figure 4: Real GDP growth and inflation in Serbia, 2001-08


Serbia has also experienced an acceleration of institutional reforms. For evaluating progress in this area, it is useful to consider the transition indicators developed by the European Bank for Reconstruction and Development (EBRD), which measure progress in eight main areas of transition-related economic reforms in the
Figure 5: Foreign Direct Investment in transition countries and Serbia, 2001-08 (net inflows, in million US dollars)


Bank’s 29 country clients in Eastern Europe, through scores that go from 1 (implying no reform) to 4+ (comparable to a developed market economy). From the recent assessment of the EBRD in 2009, we can see that Serbia has moved a long way towards the “ideal” model of a market economy (Figure 6). In some areas of reform Serbia has already reached, or is quite close to the level of a developed market economy. The liberalization of prices and of the foreign trade system were implemented in early 2001, while small-scale privatisation was carried further with the new law adopted in mid-2001. Major financial sector reforms were also undertaken with the closing down of four large banks in 2001-02 and the privatization of most banks to form multinational European banks after 2003, so that today 80 per cent of banking assets are foreign owned. The setbacks were primarily in four areas of reform: large-scale privatization, enterprise restructuring
and corporate governance, competition policy, and the securities markets and non-financial institutions, where Serbia still has a below-average score of 2 or 2+.

There have been some additional policy failures, not measured by the EBRD transition indicators, in particular “jobless” growth. Despite relatively strong GDP growth during 2001-08, employment declined until 2006, while unemployment, whether measured by the official or the labour force survey rate, continuously increased (see Figure 7). Only in 2007 did the labour market indicators improve, although the trend discontinued with the outbreak of the global economic crisis in late 2008.

Figure 6: Transition indicators of the European Bank for Reconstruction and Development: Scores for Serbia and average scores for all EBRD client countries, 2009

Source: Uvalic (2010), p. 256, based on information of the EBRD.
Another major long-term problem is the slow economic recovery. By 2008, Serbia’s real GDP has reached only 72 per cent of its 1989 level, which is the most unfavourable position among all Balkan countries (see Figure 8). The slow economic recovery is due to both the deep recession of the early 1990s, deeper than in most other transition countries, and the GDP fall of 19 per cent in 1999 due to NATO bombing. The relatively high GDP growth rate after 2001 has been insufficient to compensate for the extreme loss of output in the 1990s. Moreover, there was a further setback in 2009 when Serbia, strongly affected by the global economic crisis, registered a negative GDP growth of around 3 per cent, so that by the end of 2010 Serbia was at only 70% of its 1989 GDP level (EBRD 2010).

Figure 7: Serbia’s labour market indicators, 2000-08

Serbia has also been facing increasing external imbalances. Although foreign trade has recovered remarkably from 2001 onwards, the value of its imports has regularly been double that of its exports, determining a rising trade deficit. The high foreign trade imbalance is the primary cause
of the just as rapid increase in the current account deficit, which at the end of 2008 approached 18 per cent of Serbia’s GDP (see Figure 9).

Figure 8: Real GDP in Serbia and other Balkan countries, 1990-2008 (1989=100)

![Real GDP graph]

Source: Uvalic (2010), p. 258, based on data of the EBRD.

At the basis of these failures—insufficient new employment, limited economic recovery, increasing external imbalances—are structural weaknesses in the real sector of the Serbian economy. The transition strategy adopted in 2001 in Serbia was very much in line with the priorities set by the “Washington consensus”—liberalization, macroeconomic stabilization, and privatization (see Williamson 1990), measures which were recommended also to other East European countries in the early 1990s. The emphasis was on macroeconomic policies, while a number of important microeconomic reforms, except for privatization, were neglected. Yet it is precisely these microeconomic reforms that proved to be fundamental in much of Eastern Europe, as their delayed implementation caused setbacks even in some of the most successful transition countries, like the Czech Republic (see Svejnar and Uvalic 2008). The lessons of the so-called “post-Washington consensus”,
that emerged in the second half of the 1990s, stressed the importance of both privatization and easing the entry of new private firms; of both transfer of ownership and effective corporate governance; of increasing competition, which is just as important as privatization; and of both markets and active government policies (see Kolodko and Nuti 1997).

Serbia did not learn sufficiently from the rich experience of the Central East European countries. It neglected or postponed a number of complementary reforms, which are just as important for improving enterprise efficiency. Enterprise restructuring was expected simply as a by-product of liberalization, stabilization and privatization. It was assumed that, once privatized, enterprises would quickly and efficiently undergo economic restructuring. Such expectations were
not fulfilled, due to policy failures in several inter-related areas: insufficient microeconomic restructuring of Serbian enterprises under the new privatization model, overly optimistic expectations regarding foreign direct investment, and the postponement of restructuring of public enterprises. Insufficient restructuring was also due to the slow pace of other accompanying reforms, such as improvements in the business environment, competition policy, hardening of budget constraints, changes in corporate governance and employment policy. Both types of issues deserve to be explained further.

Regarding the privatization strategy, the new privatization law adopted in 2001, based on the method of sales to strategic investors of over 2,000 enterprises through tenders and auctions, encountered serious delays in its implementation. Although the initial deadline was end-2005, by May 2009 there were still some 535 firms that had not been sold, or 23 per cent of the total planned for privatization. Moreover, there have been some 420 broken contracts since 2001, mainly due to the non-respect of obligations by the new owner, such as the illegal sale of assets and non-payment of wages and social security contributions. Firms sold to foreign companies have mainly been restructured, but in those sold to domestic owners, which represent the large majority of cases, little restructuring has taken place. Privatization proceeds, for the most, have not been used for investment or restructuring.

The 2001 strategy also envisaged the exclusion from privatization of some 550 public/state-owned strategic firms that were nationalized in the 1990s. The process of corporatization, restructuring and privatization of these state enterprises was effectively postponed to after 2006, when the new Serbian constitution was adopted. The new constitution finally removed some ambiguities regarding the property status of these public/state firms, thus opening the door for their restructuring and privatization.
Another key element of the new privatization strategy was reliance on FDI. When the new privatization law was adopted in 2001, there were overly optimistic expectations regarding the arrival of badly needed foreign capital. The radical political changes of late 2000 were insufficient to immediately decrease the country’s political and economic risk and attract large amounts of FDI. During the whole 2001-08 period, as already illustrated, total FDI stock was not high. Almost all FDI has been privatization-related, and there have been few greenfield investments. Moreover, two thirds of the FDIs have been in services—banking, telecommunications, real estate, trade—namely in non-tradables which do not contribute much to Serbian exports. Many industrial firms have not been modernized or restructured, although the manufacturing industry represents by far the largest part (over 90 per cent) of Serbian exports.

In addition to Serbia’s weak privatization strategy, the accompanying reforms were unjustly postponed. Serbia has done a lot to improve the business environment, but not in all areas. Entry barriers for firms have been removed too gradually, and there are still areas, like registering property or obtaining building permits, where conditions remain highly unsatisfactory, even in 2010. A new bankruptcy law was adopted only in 2004, while the procedure for the write-off of enterprise debt was clarified only in 2006. As a result, contrary to aspirations, there has actually been a slowdown in net firm entry: for every closed enterprise, 8 new firms were created in 2006, but only 4 in 2008.

Thus the general situation regarding market competition is unsatisfactory. A law on the Protection of Competition was adopted by the Serbian government only in 2005, while the Anti-trust Commission was set up in 2006. Since the Commission was given insufficient competences, another reform is presently in course to ensure more effective policies in this important area. A related area is the hardening of enterprise budget constraints, which have been implemented in a selective way. Government subsidies remain important in several sectors,
including mining, transport, metallurgy, textiles, chemicals, construction, and wood. Some of the largest firms in the mentioned sectors have been incurring substantial losses, but the government has not undertaken timely measures to restructure them.

As to corporate governance, Serbia has adopted new legislation introducing the OECD principles of corporate governance, but these principles often remain unimplemented. The reasons vary, from an insufficient ability of the new domestic owners to control the managers, to the lack of awareness of the new legislative framework or its deliberate non-implementation.

An ineffective employment policy has also contributed to limited microeconomic restructuring in Serbia. Reasons for the poor results include the very low expenditure, of only 0.1 per cent of GDP for active labour market policies, in recent years. Even more important is an inadequate labour taxation, which has greatly contributed to a large informal labour market persisting even today. The process of job creation in the new private sector has also been very slow (see Arandarenko 2009). Limited microeconomic restructuring in Serbia has had two major macroeconomic consequences, as it has directly contributed to the relatively slow growth of the private sector, and inadequate capacity restructuring.

The private sector in Serbia has grown slowly: from 2001 to 2010, it increased its share from 40 to 60 per cent of GDP. Among all 29 client countries of the EBRD, only six have done as poorly. Bosnia and Ukraine, like Serbia today, have 60 per cent share of the private sector in the GDP, while Belorussia, Tagikistan, Turkmenistan and Uzbekistan have even lower shares. Somewhat paradoxically, Serbia’s private sector expanded faster during the difficult 1990s than after 2001, since it increased from only around 10 per cent of GDP in 1991 to 40 per cent of GDP in late 2000. Employment in the private sector has growth much faster, where currently over 70 per cent of the labour force earns a living (see Figure 10).
Structural changes that have taken place in Serbia have favoured the fast expansion primarily of services. By 2008, services were already contributing 64 per cent of gross value added. By contrast, industry not only underwent a strong process of deindustrialization in the early 1990s, but there was a further relative decline after 2001. Consequently, by 2008, Serbia’s industrial sector had reached only 52 per cent of its 1989 production. The share of agriculture in GDP also declined from 2001 onwards. The overall consequence of these changes is that Serbia has seen its tradable goods sector fall from 41 per cent of GDP in 2000 to 24.6 per cent in 2007 (see Stamenkovic et al. 2009), in this way strongly contributing to the rising trade deficit.

5. Serbia’s relations with the European Union

Serbia’s transition to a market economy was also delayed by the exceptionally unfavorable international environment in the Balkan region, during the last 20 years. Apart from internal conflicts and extreme political
instability, severe measures taken by the international community against FR Yugoslavia in the 1990s, and more recent EU policies of strict political conditionality, have delayed Serbia’s transition and slowed its integration with the rest of Europe. After the political changes in the late 2000, Serbia’s relations with the EU have assumed increasing importance, so today joining the EU has become Serbia’s main foreign policy objective.

The European Union has played an important role in shaping the direction of political and economic changes in the Balkan region, but primarily after 2000. Due to Yugoslavia’s disintegration and the military conflicts that accompanied it, in 1990-91 the EU did not elaborate a consistent and long-term strategy for the Balkan region, which may have prevented some of the tragic consequences of Yugoslavia’s break-up. In the 1990s, EU policies towards the Balkan countries were mostly ad hoc, and so very different than those applied to the Central East European countries which, already in the early 1990s, were receiving substantial financial assistance and association agreements from the EU.

It is only after the end of the Kosovo war in mid-1999 that the EU launched its Stabilization and Association Process (SAP), a new approach aimed at facilitating the integration of the Western Balkan countries—Albania, Bosnia and Herzegovina, Croatia, Macedonia, and FR Yugoslavia—with the EU. The SAP consists of various measures to facilitate EU-Balkan integration: substantial trade liberalization, financial assistance through new programmes specifically set up for the Western Balkans (the CARDS and the more recent IPA programme), contractual relations through the signing of Stabilization and Association Agreements, and most importantly, prospects of EU membership.

This new framework enabled the renewal of EU’s political and economic relations also with FR Yugoslavia (Serbia and Montenegro) in late 2000. Since the official launch of the SAP for FR Yugoslavia in 2001, there has been substantial trade liberalization and steady progress toward legal harmonization. During 2000-06, the EU helped the ongoing
economic, political, and legal reforms in Serbia and Montenegro through its CARDS programme with some € 2.6 billion (out of a total of € 5.1 billion allocated for the region), and continues to support Serbia through its new IPA programme. Visa-free travel to Schengen countries for Serbian citizens was also finally granted and started being implemented from 1 January 2010.

Despite progress, it has taken more than seven years for Serbia to sign a Stabilization and Association Agreement (SAA). The SAA was signed only at the end of April 2008, mainly due to Serbia’s non-compliance with one of EU’s political conditions which requires full collaboration with the ICTY in The Hague. Serbia has recently applied for EU membership and hopes to become an EU candidate in 2011, which should lead to the opening of negotiations on membership. What is still blocking the granting of candidate status to Serbia is the non-delivery of general Ratko Mladic, responsible for war crimes in Bosnia and Herzegovina.

Serbia’s political integration with the EU is also complicated by the issue of Kosovo. Although in the UN Security Council Resolution 1244 adopted after the 1999 war, the province of Kosovo was declared to be part of Serbia, effectively it remained under the UN/EU administration. In February 2008, Kosovo unilaterally declared independence, but has not been recognized by Serbia or the five EU member states—Cyprus, Greece, Romania, Slovakia and Spain. There is still no clear indication how this delicate issue can be resolved. At the same time, it should be stressed that today around 70 per cent of the Serbian population is in favour of joining the EU.

There has been increasing economic integration of Serbia with the EU. Thanks to the changed political climate and EU trade preferences granted to Serbia in November 2000, there was a rapid revival of its trade with the EU. Over the past decade, the EU has become Serbia’s main trading partner, responsible for 54 per cent of its exports and 53
per cent of its imports in 2008. Serbia’s main exports to the EU consist of agricultural products (sugar, raspberries, corn), tires, iron, steel and machinery. In other words, it continues to be dominated by agricultural and low-processed manufacturing products. In contrast, the main imports from the EU are vehicles, diesel fuels and medicaments.

Serbian-EU economic integration has also taken place through incoming FDI from EU member states, and increasing integration of financial and capital markets, prompted especially by the privatization of the Serbian banking sector. By 2008, among the 11 largest banks in Serbia, 10 were private foreign banks, mainly owned by EU banks (including Banca Intesa, Raiffeisen, Eurobank, Hypo Alpe-Adria, Unicredit, Société Générale) (see Uvalic 2010, p. 166).

6. Present challenges

The transition to a market economy and multiparty democracy in Serbia has proved to be complex. Nevertheless, Serbia is now increasingly resembling other transition countries. Over the last decade, it has become a more open economy with dominant private ownership. It has liberalized its trade with the EU and with its non-EU neighbours. It has reformed many of its institutions. Its financial sector is dominated by foreign-owned banks, and there is an emerging stock exchange. After 2001, Serbia has been one of the fastest growing transition economies. It has reached substantial macroeconomic stabilization. It has had a stable or appreciating internally convertible domestic currency. It has accumulated foreign exchange reserves reducing the risk of external insolvency. And it has at last attracted foreign investors, and privatization opportunities abound. These features have characterized the Serbian economy during much of the post-2001 period.

The global financial and economic crisis, which began to be felt in Serbia in the last quarter of 2008, has interrupted the process of economic recovery and catching up (Cerovic 2009). Like many other countries in
Eastern Europe, Serbia was severely hit in late 2008 primarily through two channels—the greatly reduced capital inflows from abroad (FDI, remittances, loans) and the collapse of export demand, primarily in the EU (Nuti 2009). In 2009 the Serbian economy registered a 3.1 per cent drop in GDP and deterioration of other main macroeconomic indicators.

With the 2008-09 economic crisis, many accumulated problems have surfaced. This is why the Serbian government must urgently address the shortcomings of its post-2000 model of economic development. The growth model applied in Serbia, as in many other East European countries, has been one of fast integration into the global economy through increasing trade and financial flows. But it has also been a model driven by increasing indebtedness and credit-driven growth, which has created a high dependence on capital inflows from abroad. The global economic crisis hit Serbia at a moment when many economic problems were becoming unsustainable—consumption was much higher than production (financed by foreign savings and investment), a growing trade and current account deficit, huge and rising unemployment, limited enterprise restructuring, insufficient growth of the new private sector, mounting problems of many state-owned enterprises, and structural changes that have favoured primarily the fast expansion of services. This model is no longer viable and will require a serious rethinking of future policies. Among numerous challenges, the most important is to further increase the competitiveness of the Serbian economy in world markets through more substantial enterprise restructuring and modernization, and fast completion of all those reforms that were considered secondary in 2001, yet have proved to be fundamental. There are several policy measures that seem particularly important for strengthening the real sector of the Serbian economy. Serbia needs an active industrial policy to encourage investment, innovation, research and development, and quality standards. It needs a consistent package of horizontal measures for all enterprises that would facilitate their restructuring and in this way a diversification of its industrial base. Another related area is Research and Development, to guide greater investment in science, education and innovation, since human capital is essential for long-
term growth. Serbia also urgently needs a much more efficient employment policy, that would increase wage employment in the private sector. This will require more active labour market policies and a thorough reform of the taxation system, essential for lowering labour costs and increasing competitiveness.

All three areas are the direct responsibility of the government. Serbia needs to strengthen the role of the state, through more active and better coordinated government policies. It must improve the quality of government supportive institutions to undertake priority investments, enforce laws, collect taxes, supervise the financial sector, and fight corruption. Unless the functioning of government institutions improves, it is clear that many economic reforms will be implemented only half-way. Serbia needs to reconsider the role of the state in order to take full advantage of ongoing economic reforms and the return to normalcy of a country that has remained isolated from the rest of the world for too long.

The more difficult challenges are political. The first issue is Serbia’s relations with the EU. Given that its negotiations with the EU over the last decade have been a powerful engine of institutional change towards EU standards, Serbia needs political will to enable its entry into the EU as soon as possible. The Serbian government has applied for EU membership and hopes its application will be evaluated positively, since it has put in substantial effort to carry forward market-oriented reforms, introduce democratic institutions, implement European standards, and renew relations and build new bridges with its neighbours. It is now up to the EU to accept Serbia into the European family. The second and longstanding issue is Kosovo. Its declaration of Independence in February 2008, has further complicated the history and geography of the Balkans. Although no country voluntarily renounces a part of its territory, Kosovo is today de facto independent, so the Serbian government should forcefully and consistently implement its pro-reform and pro-Europe agenda, reconcile with its difficult past, and look primarily towards the future.
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