THE INFLUENCES IN CHANGES IN MACROECONOMIC REGIME AND POLICY ON THE DEVELOPMENT OF THE FOREIGN TRADE OF SERBIA

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INTRODUCTION: THREE BURNING AND THREE STRATEGIC PROBLEMS IN FOREIGN TRADE OF SERBIA

***Summary**. Both before and after the UN trade embargo (1992-1995), the foreign trade policy of FR Jugoslavija has been highly autarchic. Until the disingegraditon of 'SFRY this resulted in a significant underperformance of the foreign trade sector, while later this turned out to (almost) a complete halt in regular foreign trading. The key for boosting foreign trade lies in implementing institutional reforms and liberalization of foreign trade, even prior to the start of a credible mass privatization. This would be the only way to avoid creation of unproductive private monopolies and might present a way out of permanent recession of the Serbian economy.*

The three burning problems: *large foreign trade deficit, exchange rate misalignment and gray economy*

Problem No. 1. Deficit with constant drops of exports. . In the last five years, Yugoslav annual foreign trade deficit has been no smaller than $1.5 - 2.5 billion (Ch. II), which amounts to no less then 12—15% GDP, thus being well above the theoretically critical share of 3-5% GDP. Microeconomic reasons prevail; the outer wall of the sanctions provoked serious misalignment in domestic economic policy, no reforms have been implemented, which resulted in the drop in output, rising gray economy and corruption. Domestic products could hardly remain competitive, but domestic output also failed, despite overprotectionistic legislation. The lack of domestic production triggered imports, halted exports and thus lowered hard currency inflow and practically halted growth perspectives.

The Solution. Simplifying import and export regulations. Although there can be no fast solution to the problem of rising deficit, new legislation of import regulations would restore the official foreign trade flows. The existing export licensing also acts as an obstacle to exporting even the most profitable products (leather, berries, wheat, and some raw materials). Still, no fundamental boosting of exports can be expected prior to institutional, legislative and economic (both micro and macro) reforms. Lifting sanctions would prove to be an insurmountable obstacle to this, since Yugoslavia is not allowed to operate in the international payment system.

Problem No. 2. Gray economy. The unofficial estimates are that the share of the gray economy is no less than 30% GDP. Most profitable foreign trade transactions are practically all in gray zone.

***Three solutions for Problem No. 2*:**

1. ***Simplification of tax legislation and lowering taxes*** Argumentation is the same as described above.

2. ***Simplification and introduction of transparency in the foreign trade regulation.*** Foreign trading in Serbia requires significant expert knowledge of a highly non-transparent legislation. The customs regulation is defined by the federal parliament, but the actual foreign trade policy is run by federal government, which leaves room for ad hoc changes in actual policy, with no transparent documents, which would announce their implementation or withdrawal. Republican government also grants export and import licenses and agreements for most profitable export and import products.

3. ***Anti-monopoly regulation.*** At present, the most prominent monopolists act as members of all important institutions in this country. Thus if any changes are to be expected, an independent anti- monopoly regulator would be inevitable.

Problem No. 3. Exchange rate misalignment. Since the official exchange rate (6 DIN per 1 Deutsche Mark) lags six times behind the black-market price (35:1), price and output distortions are almost spectacular.

Solution. Introducing a crawling band exchange rate regime. A standard set of solutions is required. This would also diminish the share of gray economy.

THREE STRATEGIC PROBLEMS: the lack of strategy, large indebtedness and the outer wall of sanctions

Problem No. 1. Yugoslavia has no foreign trade strategy, even the wrong one. All measures, acts and legislation change several times a year, once leading to increasing liberalization, and the next time (due to the very powerful import lobby) they reverse to even more protectionist legislation then before any of 'liberalization attacks' which emerged 1995-2000.

Solution: New institutional arrangements are required. A careful Liberalization Program is required. With no mass privatization plan, this solution does seem feasible at present.

Problem No. 2. Foreign debt. Yugoslav foreign debt amounts to $14 billion. After lifting of the outer wall of sanctions the existing export returns would not allow any serious debt repayment service.

Solution. Intensify informal negotiations with foreign creditors, in order to announce reprogramming and enabling the inflow of new credit lines for immediate repayments. Foreign consultants who are in regular conta4cts with the creditors should be immediately hired. All informal arrangements must be unconditionally fulfilled, since the country rating is very low.

Problem No. 3. The outer wall of the sanctions. This is one of the insurmountable obstacles for any domestic reform. The greatest problem today is the overall centralization of economic and political power in several hands. No mass reforms can be implemented in these circumstances.

Solution. The pragmatism in dealing this matter virtually presents a priority obligation for any responsible government.

THE INFLUENCES IN CHANGES IN MACROECONOMIC REGIME AND POLICY ON THE DEVELOPMENT OF THE FOREIGN TRADE OF SERBIA

I MACROECONOMIC DEVELOPMENTS, 1995-2000.

Summary. Until 20 days ago, the overall underperformace of the Yugoslav economy was not likely to be ended. Two basic reasons had determined this outcome: (i) the

whole set of sanctions and trade barriers had been imposed by Western counties, and (ii) the inconsistent and anti-reform domestic government behavior, which was frequently named as “the inner wall of sanctions”, which affected domestic enterprises almost as badly as the outer wall of sanctions did. The two have been inspiring each other: most anti-reform moves by local government have been punished by re-inforcing sanctions, which gave an excellent alibi to domestic government to inforce even stronger centralization of the economy. The catastrophic effect of both can be easily traced on the graph depicted GDP movements in the Yugoslav economy, 1989-1999.

1. Output and final demand

It has been almost 10 years (starting in 1990) since Yugoslav economy has been recording poor economic performance. Starting with the disintegration of former Yugoslavia, followed by wars in Croatia and Bosnia and Hercegovina, greatest fall (-27.3%) was registered in 1993, accompanied by huge hyperinflation, which ended at monthly rate of 313.000.000% (recorded in January 1993). The drastic fall of economic activity had reduced GDP to only 41% of its 1989 level. Per capita GDP dropped from USD 2,800 in 1989 to USD 920 in 1993. After introducing a stabilization program in 1994, only a moderate recovery emerged. There were two principal reasons for that. First of all, a severe trade embargo had endured until 1995, which prohibited all trade with Yugoslavia. The second reason was that no major reforms had ever been introduced to accompany the stabilization program. In effect, apart from "monetary reconstruction" which consisted of introducing a very week type of a currency board, nothing else had been done.

Table 1

GDP at market prices

	1995	1996	1997	1998	1999	2000^{e}
GDP						
GDP, mil. USD	11114	13500	14500	14900	12024	12800
Growth rate (%)	6.2	5.8	7.4	2.7	-19.3	6.8
GDP p.c. , USD	1053.7	1277.3	1368.3	1400.3	1125.5	1200
GDP p.c., PPP**	2616	2828	3108	3261	2561	2753
Origin of GDP						
Agriculture/GDP	22.3	22.6	21.3	19	25.1	24
Industry/GDP	44.7	42.0	40.5	39.7	38.2	40
Services/GDP	33.0	35.4	38.2	41.3	36.7	36
Trade balance	-7.6	-9.8	-10.7	-9.4	-10.5	…

*estimate
** EIU estimate

Modest recovery lasted until 1998, when GDP per capita reached USD 1400. After a 20% fall in 1999, GDP p.c. amounted to only USD 1,120. Primarily due to severe price controls (food and utilities), per capita GDP in 1999 at the purchasing power parity was much higher, and almost reached USD 2,800.

Despite extremely inadequate macroeconomic policies (Ch . III: MACROECONOMIC REGIME AND POLICIES), the main obstacle to growth remains at the structural level.

Namely, the disintegration of the Yugoslav economy led to opening numerous problems, one of the greatest being a necessity to shift from interrepublican to international trade arrangements. It is indisputable that inter-republican trade in the former Yugoslavia was artificially high, due to the wrong economic policies (import substitution strategy, protectionism, soft budget constraints) and involvement of the political factor.

There is almost a consensus among domestic economists that such a high share of inter-republican trade created adverse consequences to the economic growth of the country, its economic modernization and restructuring, foreign trade balance and external financial position.

Table 2

Trade share*) in GDP

	Actual trade in 1989		Trade shares (% GDP) in small open economies	Actual Trade shares (total**))	
	For-eign	inter-repub-lican			
Import content	19	29	40-60	27	27
Export share	17	25	40-60	15	12

**) comprises goods and non-factor services*
***) including trade with former Yugoslav republics; figures are comparable with the sum of first two columns of the Table.*

Still, even if we sum-up the shares of interrepublican and international trade, the actual 1989. figures indicate that overall Yugoslav (Serbia and Montenegro) trade share in GDP lagged very much behind comparable data for small open European economies, thus being fundamentally unprepared for world trade competition.

At the moment of disintegration of Yugoslavia, domestic policy-makers should have shifted to a small-open-economy pattern of at least 40% export and import shares. Still, both sanctions and wrong economic policies lead to even worse position of Yugoslavia on international market than the situation was in 1989.

Thus the drop of export share from 42% in 1989. to 12% GDP in 1999, virtually presents the key summary indicator of the destruction of the Yugoslav economy.

Capacity utilization also fell drastically. As compared to the utilization level of 72% in the mid 1980s, the lowest rate had been recorded in 1993 when only 27% of all capacities were in use. Still, the recovery did not meet even half of the mid-1980s' level.

Table 3

Capacity utilization in FRY, 1995-2000.

	1995	1996	1997	1998	1999
Capacity utilization (%)	37,6	40,3	44,2	45,0*	37,0*

2. Inflation and exchange rate

After curbing hyperinflation in 1994, annual inflation rates varied from 18-93%, Despite severe price controls, parts of fiscal and quasi-fiscal deficits were constantly monetized which resulted in rising inflation. Thus there could be no exchange rate stability whatsoever.

Throughout 1995-2000, no exchange rate stabilization occurred. Despite some efforts to stabilize the black market exchange rate, in six years the Dinar depreciated app. 400% in real terms.

Due to expansive monetary and fiscal policies, nothing has changed – neither after peg -

Table 4

Prices and exchange rate, 1995-2000

	1995	1996	1997	1998	1999	2000**
Inflation rate (%, period average)	74,1	93,1	18,5	29,8	43,8*	62
Inflation rate (%, end of period)	120,2	58,7	9,3	44,3	58,6*	71
Dinar:DEM exchange rate (black market, period average)	2,43	3,51	3,91	6,32	12,50	17.5
Dinar:DEM exchange rate (black market, end of period)	3,4	3,9	5,0	8,15	21,00	26.7
Dinar:DEM exchange rate (official)	3,3	3,3	3,3	6,0	6,0	6.0/ 20.0

* Corrected data

** **A**ugust 2000

ging the Dinar to the Deutsche Mark (6:1) in 1998, nor after semi-official devaluation from June 2000, when the "Dinar stimulation of +14 Din/DEM has been introduced. Multiple exchange rates thus make the economic scene completely untransparent.

The list of stimulations by currency

Curency	Unit	Dinar Stimulation
AUD	1	17,0444
ATS	1	1,9899
BEF	100	67,8774
CAD	1	19,9111
DKK	1	3,6701
FIM	1	4,6053
FRF	1	4,1743
DEM	1	14,0000
GRD	100	8,1177
IEP	1	34,7676
ITL	100	1,4142
JPY	100	27,8059
KWD	1	96,9914
NLG	1	12,4252
NOK	1	3,3067
PTE	100	13,6579
ESP	100	16,4568
CHF	1	17,5114
GBP	1	44,1360
USD	1	29,9025
EUR	1	27,3817

Source: Zakon o deviznom poslovanju, maj 2000.

3. Employment and labor market

The most obvious sings of decay of the Yugoslav economy can be traced in the area of employment and labor market .

All data concerning employment, wages and living standard show enormous decay. The number of employees fell and the rate of unemployment has drastically risen, and the rest of the employees faced decreasing salaries.

Still, there are three facts that slightly improve this picture. First of all, due to a very large sector of gray economy, not all wages have been registered at all. Hence the official average monthly wages amount to less then a half of total family receipts (pensions and gray economy thus filling most of this "gap"). Second, due to a severe taxes on wages, most firms opt for tax evasion and pay only minimum wages, and than choose some other option (e.g. transport refunding, holiday reimbursements (regres) or some other form which stands for regular wage, except that it is not eligible for taxing). The

Table 5

Unemployment and labor market, 1995-2000.

	1995	1996	1997	1998	1999	2000*
Number of employees (000)	2.379	2.367	2.332	2.289	2.076	2021
Unemployment rate (%)	24,6	25,8	25,9	26,8	25,9	36.8
Average monthly wages (Din)	307	545	803	1063	1300	2375
Average monthly wages (DEM)	126	128	183	162	96	94

* August 2000

third fact is that the purchasing parity of the Deutsche Mark has been constantly higher in Yugoslavia then in other countries, primarily due to severe price controls in energy, food and transport. Despite the fact that the situation in the field of employment and wages is virtually cathastrophical, the data comparisons with neighboring economies might give somewhat biased picture.

4. The budget deficit

One of the lessons that Yugoslav economy forcefully learned is that monetization of fiscal deficit cannot bring anything but high inflation. After reaching 32% GMP (app. 27% GDP) in 1993, the firm monetary stance has been announced, which actually meant that the government will try not to monetize the expenidtures, due which exceed actual fiscal revenues. As far as the cash deficit is concerned, the situation is as follows.

A very ineffective fiscal system, along with a high share of gray economy and evasion brought a vast discrepancy between the cash and the due budget deficit. Thus, despite the enormous share of fiscal revenues in GDP, delays in payments and rising due deficit became the long-run characteristics of the domestic fiscal sector. However, the rising rate of inflation and severe depreciation of domestic currency suggest that monetization has been a powerful tool of populistic economic policy led so far. Hence the origins of rising inflation can be easily traced by following the data on fiscal deficit.

It goes without saying that the share of gray economy prevented tax-collectors to do the job more effectively. Still, having in mind that most of large tax-evaders are either actual members of the government or are closely related to it, there can be no clear-cut

Table 6.

Public consumption and fiscal revenues, 1995-1999

- % GDP

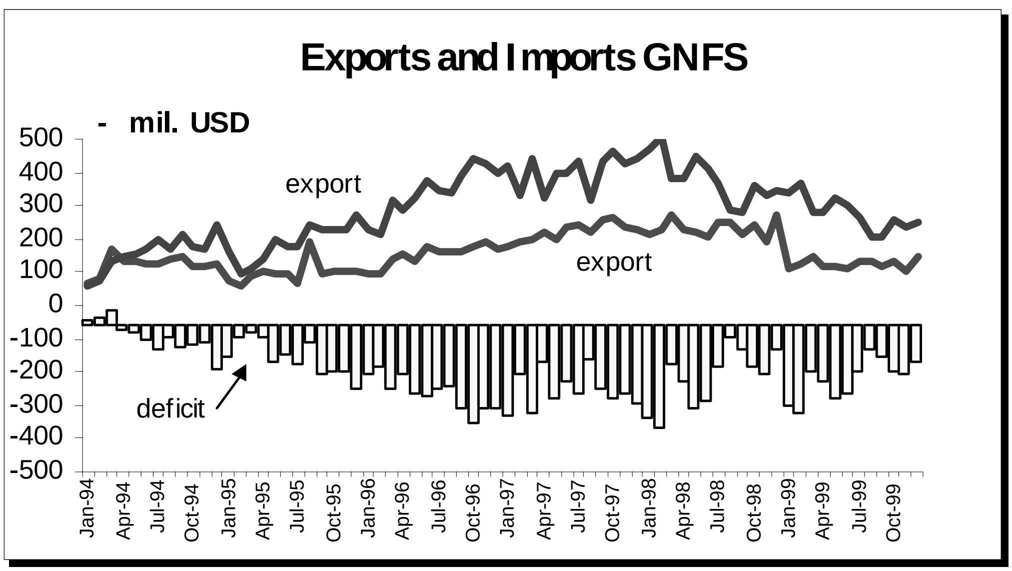
	Fiscal revenues	Public consumption	Deficit
1995	40.7	43.8	-3.1
1996	44.8	50.5	-5.7
1997	42.5	43	-0.5
1998	45	46	-1.0
1999	46	48.5	-2

view as to how much did tax evasion hurt the system. Namely, in "hard times" most of these firms were forced to give "grants" to the government, thus repaying their debts in a highly irregular but still in a very efficient manner.

5. Foreign trade deficit and external debt

A vicious combination of two factors: (i) a whole range of sanctions against Yugoslavia imposed by the US, the UN, and the EU and (ii) a complete maladjustment of domestic economic policy, resulted in a whole range of underperformaces in the Yugoslav economy, one of the greatest being a huge foreign trade deficit.

The rise in both imports and exports essentially began in December 1995, with the lifting of the UN Security Council embargo (enacted in May 1992). During the sanctions, monthly



exports fell from $400 to $100 million, while imports fell less: from $500 to below $200 million. Since the suspension of the trade embargo December 1995, imports and exports have followed highly unbalanced growth paths, thus creating a $2.2 billion trade deficit by the end of 1996. Having been partly compensated by the surplus in both factor and non-factor services account, the overall current account deficit practically remained the same as before. Still, until these days, the outer wall of sanctions, imposed by the UN, prohibits

Yugoslavia from membership in the IMF and the UN, as well from accessing international payments system. Thus the foreign trade flows have been rather suppressed from its “natural” level.

Table 7.

Current account and trade deficit, 1995-2000

- % GDP

	1995	1996	1997	1998	1999	2000
Current account (%GDP)	8.19	8.39	8.75	7.95	8.84	12.50
Trade balance (%GDP)	8.20	14.46	12.14	13.48	13.04	14.20

There is no transparency in financing of the deficit. On the one hand, no regular sources of covering the deficit can be traced. On the other hand, Yugoslavia has been subject to economic and financial sanctions and has no ties with international financing organizations since 1992. Thus the deficit was partly financed by domestic private savings (both citizens and firms), including almost all earning from the sale of Telekom Serbia (which amounted to USD 900 million). The money from this sale was also used for financing imports, either via direct loans to companies which used the money for imports, or via increasing wages and salaries which were also used for buying foreign goods, since domestic supply of both durables and undurables is extremely poor. Part of the deficit was presumably financed by loans granted by Russia and China.

Yugoslavia's total foreign debt is estimated at app. $14 billion. There is practically no net borrowing, but the debt will continue to grow each year because of the build-up interest arrears. The debt/GDP ratio thus approaches 100%, ant the debt/export ratio stands well over 350%.

In addition, foreign-exchange reserves have constantly been held at minimum, covering no more then half-month import requirements. Numerous reasons for such a striking underperformace are elaborated more in following chapters.

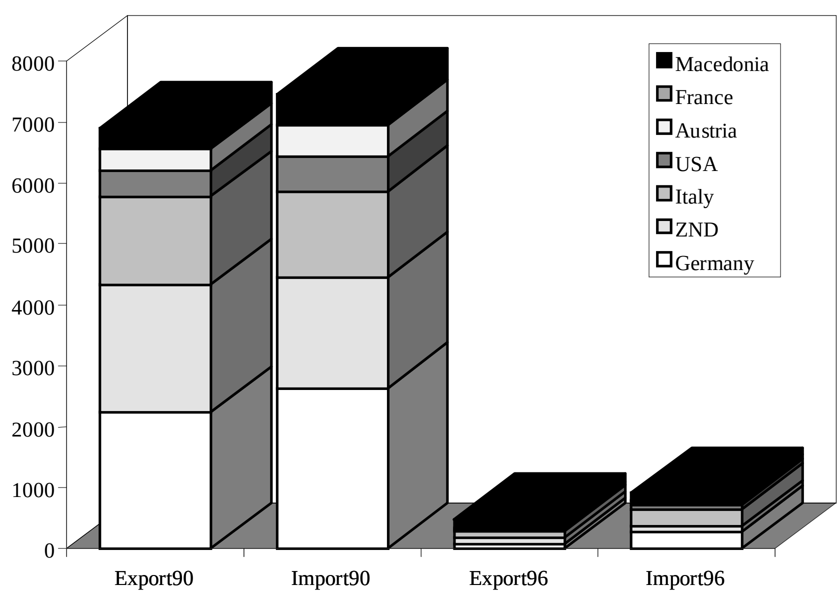
Foreign trade by country.

Apart from the drop in the volume of trade, no substantial change in foreign trade partners can be traced. Before the embargo, the European Union comprised 46% of exports and 43% of Yugoslav (Serbian and Montenegrin) imports.

Foreign Trade by Destination & Origin

	Exports	Imports	Deficit
Germany	146	524	-378
Italy	181	435	-254
USA	33	119	-86
France	55	134	-79
Russia	156	225	-69
Ukraine	15	55	-40
China	11	48	-37
Belarus	3	9	-6
FYRM	212	213	-1
Slovenia	29	56	-27
Republic Srpska	380	229	151

MOST IMPORTANT EXPORT MARKETS



Regarding trade by country, Germany, Italy and Russia remain the most important partners. Still, estimates are that in the near future, along with overall growth and the re-establishment of trade with other former Yugoslav republics, the EU will still remain Yugoslavia's most important trade partner..

Foreign trade by commodity

As for the composition of merchandise imports and exports, a substantial change has been registered in export flows. Before the embargo, 70% of total exports consisted of machines, parts, transport equipment and various finished goods. In the period January-August 2000, their share fell to 23% of total exports. The share of primary commodities consequently rose, especially due to exports of food (grain, fruit and vegetables) and live animals. Regarding imports, the share of fuels, machines and transport equipment fell due to poor domestic investments. On the other hand, the imports of food and crude materials rose.

Table 8

Foreign Trade by Commodity

% of total imports/exports

Imports	%	Exports	%
Crude petroleum	11.5	Non-ferrous metals	14.0
Yarn and fabrics	5.7	Vegetable and fruits	8.6
Vehicles	4.5	Wheat	7.8
Mineral ore	4.4	Iron and steel	5.0
Iron and steel	4.1	Electrical machines, apparatus	4.0

Table 9
Structure of Exports from the Western Balkans to the EU (1998) as % of Total

	Albania	Bosnia and Herzegovina	Croatia	FR Yugo-slavia	Mace-donia
Agriculture	9,9	2,1	3,2	13,5	9,4
Textile	35,2	33,7	27,9	17,5	39,3
Footwear	29,6	16,3	8,5	4,0	3,7
Iron and Steel	5,6	3,7	0,7	19,2	23,5
Wood	3,5	16,4	9,1	4,2	1,5
Total of the above	83,8	72,2	49,3	58,4	77,4
Other	16,2	27,8	50,7	41,6	22,6

Source: Adapted from: The Road to Stability and Prosperity in South Eastern Europe – A Regional Strategy Paper, The

World Bank, (Washington DC: March 2000)

The faster rise in imports and the lagging of export receipts resulted in a $1.2 billion deficit on the foreign trade account. Unlike the pre-embargo period, there are neither remittances, nor tourism and transport hard currency earnings which could substantially lessen the current account deficit. Thus, with approximately $14 billion in foreign debt, the overall Yugoslav performance on the international capital market is quite unfavorable.

The situation wold only substantially improve when arrangements with the IMF and the World Bank are settled. But, according to the current state of affairs, agreements could hardly be reached in less then 6 months. Approximately the same period lies ahead for the London and Paris club arrangements, thus leaving Yugoslavia with the following debt service indicators.

Table 10

Debt service indicators

	1999	Severely indebted
debt service to exports	141%	30%
debt to exports	252%	275%
interest to exports	43%	20%
debt do GDP	68%	50%

EIU, own estimates

according to which the international debt position seems rather gloomy. Hence, the urge remains to reduce recession by initiating fresh capital inflow, leaving privatization as one of the feasible ways to achieve this goal.

Balance of payments.

According to official information, average annual current balance of payment deficit in the 1996-99 period amounted to USD 1.4 billion (USD 5.5 billion cumulatively), i.e. about 12 of GDP.

Table 11.

Current Balance of Payment

- million USD

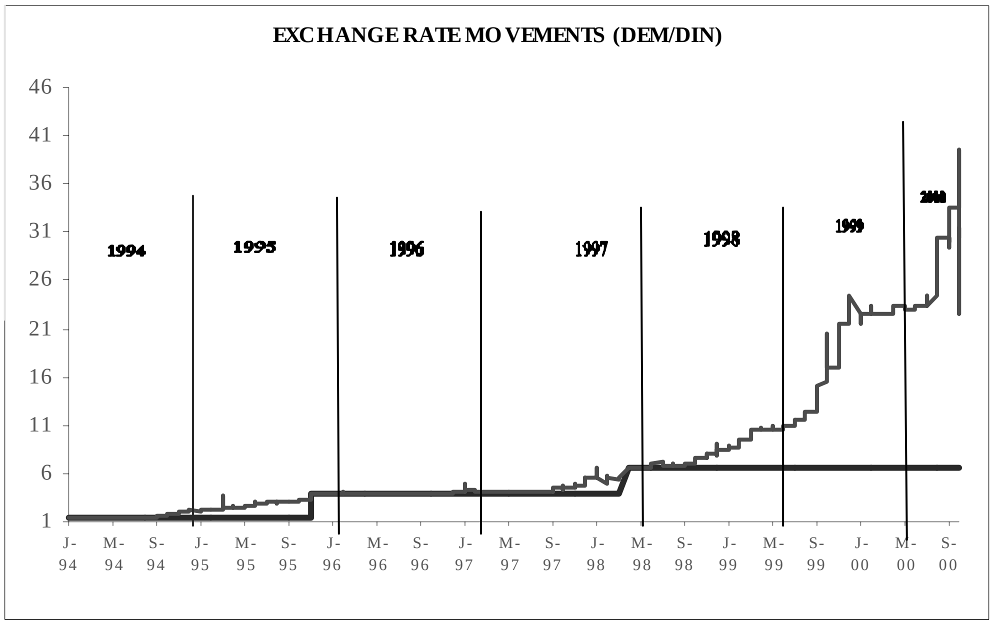
	1996	1997	1998	1999*
I TOTAL INCOME	3,371	4,019	4,275	2,440
1. Export of goods	1,842	2,677	2,750	1,560
2. Export of non-factor services	688	818	850	400
3. Money transfer- Remitence	442	457	540	450
4. Interest	46	59	75	10
5. Purchase and sale of foreign currency	353	8	60	20
II TOTAL EXPENDITURES	4,688	5,574	5,670	3,660
6. Import of goods	4,102	4,826	4,870	3,300
7. Import of non-factor services	277	362	390	200
8. Drawn currency from individual foreign current accounts	286	352	360	150
9. Serviced interests	23	34	50	10
A) Balance of goods (1-6)	-2,260	-2,149	-2,120	-1,740
B) Balance of services (2-7)	411	456	460	200
C) Foreign trade balance (A+B)	-1,849	-1,693	-1,660	-1,540
D) Balance of trans. other than trade (3+4+5-8-9)	532	138	265	320
III Current balance of payment - net (I-II) or (C+D)	-1,317	-1,555	-1,395	-1,220

* Estimate

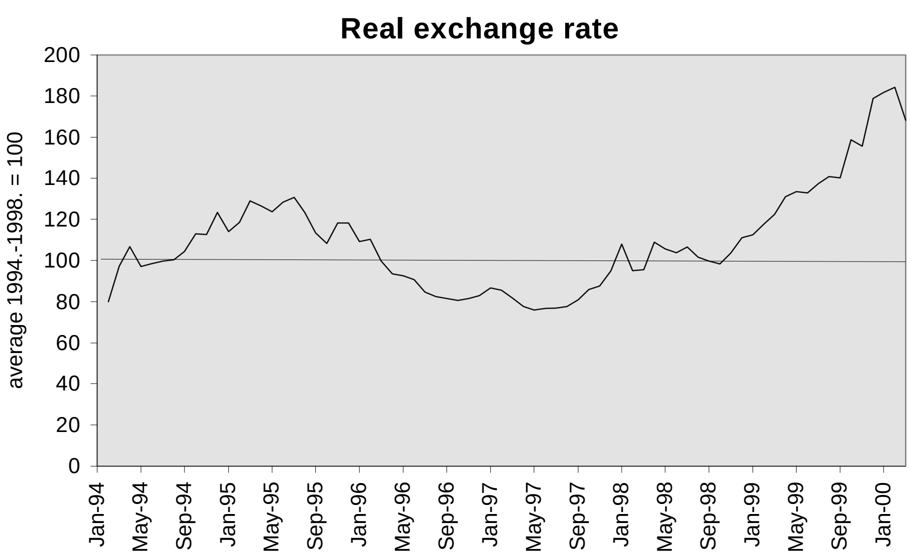
III MACROECONOMIC REGIME AND POLICIES

1. Monetary and Exchange Rate Policy

Throughout 1995-2000, two main triggers have been augmenting money supply. Firstly, the Central Bank has been issuing credits to improve the liquidity stance of commercial banks and of insolvent firms. Secondly, a costant monetization of accumulated fiscal deficit has been detected. Since the deficit predominantly consists of arrears in pensions and wages, aggregate demand has been rising, inducing almost an immediate rise in the black market exchange rate. The final shock to expansionary monetary policy was introduced in May 2000, when the Government announced a Dinar-based repayment of frozen hard currency savings, which was followed by announcing the election campaign in June this year. This led to a rise in black market exchange rate from approximately 20:1 to almost 43 DIN:1 DEM by late September this year.



Due to price controls, domestic prices rose slower then the nominal black market exchange rate. Demand for foreign currency by firms and households also affected real exchange rate developments.



Despite announcing a tight monetary policy and exchange rate stability, no monetary robustness has ever been registered. On the contrary, most transactions fled to the gray market, no remonetization occurred, thus leaving Yugoslavia far behind all transition economies, even the most underdeveloped ones.

Since the share of M1 in GDP in 2000. amounted to only 5-6 , remonetization has not started . In the mid-80ies, the share of M1 in SFR Yugoslavia amounted to 20 , which could be labeled an acceptable remonetization level for FR Yugoslavia. The reccomendations on 30 share of money supply in GDP [Gomulka, 2000] might not be fulfilled for quite a while. In all republics of former Yugoslavia, this share is still below 10 .

At present, there is obviously no room for a further rise in base money. Neither fiscal nor financial discipline have been established, and under present contitions the inflow of foreign capital is far from feasible.

Table 12

Money supply and dollarization in FRY and sellected countries, 1995-2000

- GDP

	1995	1996	1997	1998	1999	2000
M1/GDP						
FRY	5.8	5.3	6.4	6.1	6.5	6.1
Ukraine	…	6.6	8.5	8.8	9.5	…
Bulgaria	…	7.4	6.5	10.2	11.5	…
Romania	…	7.3	5.0	4.7	4.2	…
Russian federation	…	8.0	9.5	10.3	9.1	…
Dollarization						
(hard currency in broad money)						
FRY	80.2	79.4	72.1	75.3	77.4	78.1
Ukraine	…	18.6	14.3	18.5	22.9	…
Bulgaria	…	34.8	49.8	40.7	38.2	…
Romania	…	23.0	32.0	29.7	37.5	…
Russian federation	…	19.5	17.9	21.7	28.0	…

Source: Economic survey of Europe, 2000 No. 1 and NBYdata for FR Yugoslavia

The effects on foreign trade. Due to the rising gap between the official and black market exchange rate, numerous distortions emerged. Thus most earnings in exports come from the certainty that the black market exchange rate would rise in the meantime. One of the profitable businesses is to buy domestic products using the existing black market exchange rate, perform exports and sell earnings at a higher black market rate (which had risen due to rise in M1). Thus exporters of competitive products (raw materials, wood, berries etc) earn even more then importers. Practically, these earnings come from the wrong monetary policy, rather then from the prosperity of the businesses themselves.

Having this in mind, some government regulations seem less absurd. Namely, in the country with such low exports, every export license is heavily taxed, numerous licenses are charged, export earnings are subject to 20 "retention quota"[1], etc. Not to mention the request that registration of foreign trade firm is not allowed if the owner operates in premises less then $30\ m^2$, etc.

Thus the government is trying to retain some of the consequences of the monetary policy maladjustment. Further damaging of the system is quite evident.

As of early 1997, the National bank has not been selling hard currency to medium and small importers, which turned most of hard currency operations to a gray market. On the other hand, the profit margin in importing is much larger, since domestic supply of many products is simply marginalized. Huge earnings are heavily taxed ever since the phase of reporting imports. Reporting costs 5 of the transaction, 20 deposits are required. The money can be withdrawn in Dinars only (official exchange rate is used), etc. The profitability of importing remains high, due to a marginalized domestic production. Still, importers have to run their books using the official exchange rate, the price differential between the imported and domestic prices becomes huge and is subject to 14 tax on price differentials. Since no price control is imposed on imported commodities, this is one of the ways to "repurchase" the dinars they issued in ordeer to finance the fiscal deficit.

[1] 20% of export earnings is thus instantly "sold" to the Central bank using the official exchange rate.

Price and wage policy

Price policy. As of 1995, almost 95 of prices in Yugoslavia are under control. There are two basic reasons for implementing price controls.: protection of the living standard of the population and lowering the official rate of inflation. Since 'price and exchange rate stability' has became a commonplace in political retorics, one of the ways to converge to this claim is to 'miscalculate' the actual data.

The whole set of price controls is highly untransparent. Federal legislation is limited to cases of price margins in retailing, while republican legislation consists of direct, indirect and various forms of informal control.

Direct price control is usually implemented in order to 'protect' the living standard: food, electricity, oil, pharmaceuticals, utilities and transport, amount almost to a half of retail trade. The key change emerged on March 9th in 1995, with the enactment of the Anti-monopoly Statement ***(uredba).*** Changes in almost all prices are approved only after Republican authorities granted agreement (***saglasnost).*** In 2000, almost 90 of all prices (100 in retailing) are under control.

Thus the only 'mechanism of survival' for prosperous Serbian firms has been to to join the ruling party and provide 'protection'. Two main mechanisms were used to 'by-pass' regulation. It was ether the 'donation to cover costs', which was used firms producing necessities, (the case of Tetrapak, which stopped the supply and provoked shortages of milk), or 'merging for enabling production' which was used to enable an effective rise in prices which would not affect the statistical data on inflation (the case of cement production). Small and medium firms could not implement such an evasion (the fine for unauthorized shift in prices is set to three years of prison).

This policy resulted in shortages of all products under direct control, excessive rise in prices on the gray market and further lowering the living standard. Remarkable price disparities and high losses of firms accompanied these regulations.

Impact on foreign trading. In 1999, rigorous price controls made many Serbian firms to shift significant part of their production to Montenegro, Macedonia, Bosnia and other countries. Thus shortages increased, provoked the government to halt regular foreign trading (both imports and exports) in products which are needed on domestic market. While the ban on exports seemed logical, neither importing of these products was allowed, since this would have increased prices and thus worsen the living standard and lead to the rise in CPI. These regulations were thoroughly implemented, leaving population with no sugar, oil, etc. The controls were much more severe than in cases of hard currency dealing, making citizens to enter a real adventure when buying one liter of oil, etc.

Wage policy. Due to a constant drop in real wages and excessive practice of forced leaves (as a substitute for lay-off), labor and wage protection policies are highly ineffective. One of the greatest burdens comes from the fact that most firms are obliged to pay some sort of compensation to workers. Fiscal burden on **wages** is relatively high: on one dinar of net wage, one dinar is paid for fiscal duties. This burden is the result of the following: (i) current taxes and social security contributions on wages, (ii) part of untaxed personal income (amounting to 20-30 of net wages) and (iii) “solidarity tax” levied on net wages (pensions) at progressive rates (from 3.85 to 23.08), introduced to cope with the consequences of the bombarding.

If the firm is unable to pay, two mechanisms are at hand: either the payment due becomes a part of the firms’ debt, or workers themselves agree that firms should just pay the wage taxes, which will leave them ‘employed’, waiting for better days to come. In either way, production costs rise and competitiveness fall under the possible level.

Gross Wages and Competitiveness of Yugoslav economy

Country	Gross wages	GDP per worker (monthly)
FRY	170	527
1. Czech Republic	420	747
2. Hungary	430	919
3. Poland	456	692
4. Slovak Republic	347	620
5. Bulgaria	187	231
6. Romania	141	291
7. Russia	240	543

Source: *Transition Report*, 1999, estimates for FRY.

At the same time, due to the fall in employment, labor productivity slightly rose, thus improving our foreign trade position.

Impact on foreign trading. Upon lifting the outer wall of sanctions, Serbia cannot count on hihger competitiveness due to lower unit labor costs etc. Once the sound fiscal system is implemented, the room will be narrowed for evading wage taxes, non-reporting employees in small firms etc. Large social safety net has to be introduced in order to revitalize labor market. Thus one cannot count that the existing productivity level can prove advantageous once the overall reform processes are implemented.

Fiscal policy. The existing tax system is **non-transparent**: it consists of a considerable number of various tax instruments, the calculation of which requires high expert skills. Thus one of the mechanisms for implementing such a system was to proscribe a lump-sum tax for small firms: otherwise, a self-employment private owner should need at least two or three full-time accountants which would study and implement tax legislation.

Tax rates, the tax basis and the calculation procedures for taxing wages, social security contributions, and excises have changed a number of times. Just for illustration purposes, we will list only most relevant tax legislation changes, 1994-1999: 1. 7. 1994, 28.12.1995, 28.5. 1996, 17.12.1996, 31.12.1996, 18.1.1997, 30.12.1997, 18.11.1998, 20.4.1999, 16.7.1999, 16.11.1999, 22.12.1999, 17.7.2000. Still, no strategy can be traced whatsoever, neither widening nor narrowing of tax base can be identified; neither expansive nor restrictive fiscal policy crystallized.

The treatment of taxpayers is highly discriminatory; there is a large number of exemptions and special regimes, which significantly reduces tax basis. Thus low tax burden of privileged taxpayers is possible only because the unprivileged have paid both for themselves and for the privileged ones. Also, while some service their duties as lump sum, others do not pay according to their actual economic situation.

Republics are in charge of the tax system, while on federal level only the basic principles are set, i.e. the definition of basis, tax payers etc. Inter-republic legal conflicts related to taxes, contributions and other duties are taken care of on federal level. Tax system is entirely **centralized**: municipalities, cities and autonomous provinces participate in the Budget of the Republic of Serbia. They collect their belonging revenues (taxes) through the Republic budget.

Weighted cumulative ***turnover tax rate*** amounts to 21 . Cumulative rate is the result of basic turnover tax rate (9, 10 and 20) increased for additional 3 (surtax earmarked for financing railways), 3 (special tax on sails of goods and services carried out on the territory of the city of Belgrade), and for 0.6-4 (for defense and rebuilding). The dispersion of turnover tax rates is also high. Thus, there are seven different turnover tax rates for the city of Belgrade (30 , 20 , 19 , 17 , 11 , 4 and 0.6) and seven different turnover tax rates used for the areas other than Belgrade (27 , 17 , 16 , 14 , 11 , 4 and 0.6).

Excises vary 3-5 for cigarettes and alcoholic beverages (beer excluded), 10 for beer, 20 for luxury products, 30 for coffee and 50-60 for oil derivatives. If other proscribed consumption taxes were added to the excises, their share in prices would still not be large in comparison to those in other countries. This can be illustrated by the example of oil derivatives, coffee and cigarettes: the share of excises in retail prices of oil derivatives, coffee and luxury cigarettes amounts to 15 , and in the price of alcoholic beverages to 20 . By adding other consumption duties, the share would increase to maximum about 50 (for oil derivatives), which is lower than the standard rate on international scale.

Although nominal **import tariff rates** fluctuate within the broad interval of 0   to 40 (plus 1   for the expenses of customs records), the weighted proscribed customs rate amounts to 16 , and the effective one between 7-8 of the value of the imported goods, which cannot be considered high.

There are various forms of discretionary tax exemption. First, the government either openly exempts specific branches of industry and separate companies, but also tolerates or partially writes-off unserviced tax liabilities of particular companies, which is an instrument of discrimination; second, companies themselves find ways for doing this (an indication of this is an insignificantly low profit tax).

A considerable part of transactions are performed in gray channels. Tax evasion is primarily a consequence of economic crises, as well as certain high tax rates (tax and contributions on wages, the highest turnover tax rate etc.). The level of economic activity is very low, so that any burden is considered as high and attempts are made to avoid it. On the other hand, terms of trade have deteriorated, which increases the operating expenses, leaving little room for servicing public revenues regardless of their amount.

As a consequence of carrying out a significant part of trade outside the regular market, **revenues from turnover tax and excises** are relatively low in FRY in comparison with most countries. The conservative estimate of shadow economy sector share amounts to 30   of GDP. Shadow economy is particularly present in the trade of food products, clothes, cosmetics and other chemical products. However, extreme proportions of gray economy have been registered in trade of excised products.

Foreign trade policy.

Federal ad republican legislation require the companies to obtain an enormous number of various certificates and licenses. In addition, a 5-10 charge on every transaction additinally slows down the procedure, since most firms choose not to declare the annual, but only the minimum volume of transactions. Not to mention the flee to the gray market in order to evade high government taxation on these grounds. As a whole, foreign trade becomes more expensive.

As has been mentioned earlier, there is no legal hard currency market which seriously limits foreign trading. Suffice to mention that a possibility for companies to be fined due to illegal trade of foreign currency also exists.

Current tariff policy is characterized by high dispersion of tariff rates (current rates fluctuate from 0 to 40), high presence of exemption from customs duties at discretion, frequent and unpredictable changes in customs duties and other regulations. In addition, there is no long-term concept for pursuing tariff policy. Weighted average (in comparison with the value of import) prescribed customs duty in 1999 amounted to about 16 . However, due to undervalued customs base (due to the use of the official exchange rate), as well as due to mass exemption from duty at discretion, average effective customs burden is considerably lower and amounts to 7-8 . When import (black-marketing) was to be taken into consideration, average effective customs burden would be below 5 .

Apart from all existing sanctions, ‘white lists” imposed by the EU to encourage foreign trading turned out to be a External limitations related to carrying out foreign trade discrimination of Yugoslav companies by most important business partners (EU in the first place). Consequences of negative discrimination are: reduced export, deteriorated terms of trade and export losses. The latest sanctions imposed by EU will additionally hinder foreign trade. Some transactions will practically be disabled, while others will be carried out with additionally aggravated terms of trade.