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## THE IMPACT OF THE ECONOMIC CRISIS ON THE SERBIAN ECONOMY

**Abstract:** The global financial crisis began in the USA as the continuous disposition of the financial institutions and funds to have new placements. In order to gain this, they had to create new financial derivatives, which in turn triggered their hyperproduction. This process was characterized by approving financial means to a large number of consumers with inadequate incomes. The regulatory bodies raised no objections to the high risk of those placements. The critical point was when mortgages were involved into derivatives.

**Key words:** global financial crisis, financial institutions and funds, hyperproduction of financial derivatives, mortgage, regulatory bodies and risk

## UTICAJ SVETSKE FINANSIJSKE KRIZE NA PRIVREDNU SITUACIJU U SRBIJI

**Sažetak:** Svetska finansijska kriza nastaje u SAD kao neprekidna želja finansijskih institucija i fondova za novim plasmanima. Da bi to postigli morali su da kreiraju nove finansijske derivate što dovodi i do njihove hiperprodukcije. Taj proces tekao je tako da su finansijska sredstva odobravana nekredibilnim korisnicima. Regulativna tela blagonaklono su gledala na visok rizik tih plasmana. Kritična tačka nastupila je onda kada su u derivate uključeni hipotekarni krediti.

**Ključne reči:** svetska finansijska kriza, finansijske institucije i fondovi, hiperprodukcija finansijskih derivata, hipotekarni krediti, regulativna tela i rizik

### 1. THE PRIMARY CAUSES AND START OF THE ONGOING FINANCIAL CRISIS

The strength of the crisis as well as the extent of its spreading in the real sector exceeded the gloomiest predictions. Therefore, many world experts do not dare to foresee the depth of the crisis. Namely, it is believed that the crisis has not reached the pinnacle yet. The United States and other developed countries did not apparently react on time, but they tried to stop process trends in 2008 by using the combination of easy monetary policy and fiscal stimulus. "Obviously, these measures were not sufficient, and it was wrong to expect that the key market instruments, financial institutions and modern financial instruments will be enough"<sup>1</sup> It was expected that the reactions to these measures were to be sharp. The crisis is, according to the majority opinion, the result of "fundamental structuring weaknesses that have existed in the field of financial regulations and control"<sup>2</sup>. Too liberalized banking sector led to significant, non-rational investments. Namely, in most cases the buyers of housing in the USA did not have real conditions to obtain a loan at the moment when they applied for it (and it was the same for other fields). There was the lack of control over banking investments and funds as well as over creating new complex financial instruments. For example, in the United Kingdom the banks created numerous financial derivatives which accounted for about 40% of the

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<sup>1</sup> Dušan Vujović, *Ekonomska politika u vreme krize izazovi, ograničenja, paradoksi* [The economic policy during crisis – challenges, limits and paradoxes], Kopaonik Business Forum, The Economists' Association of Serbia 2009, p. 30

<sup>2</sup> Ibid, p. 31

country's GNP. It was just a matter of time when that model would collapse. The collapse occurred now in the USA and UK, but the world economy is connected and subsequently the global financial crisis commenced. The investment banks and funds were wrongly believed to have been responsible and protective to the long-term interest of their owners.<sup>3</sup> Some respectful professors, such as Edward Gramlich (a former member of the Board of Governors of the Federal Reserve), warned that the concept of (neo)liberalism led the country and world into the verge of a global crisis. However, many economists neglected his attitudes and the true attitudes of other economists who were in the minority. The opinion of the leading economists was (which was also accepted by political establishment of the USA and other Western countries) that (neo)liberalism does not have any alternatives in the development of modern economy. They justified every criticism by stating that it was not the perfect model but the better one had not been developed. They replied to their critics that they make critics of (neo)liberal concept of social development without facts, comprehensive analysis and plausible arguments. However, that model began to show the signs of tremendous weaknesses when the financial crisis started as a result of the defaulted mortgages. Namely, the crisis of that model deepened when the classic financing model decreased in new markets and in the developing countries. Global conjunction and investing optimism led to the increase of savings. A significant increase of savings made investment banks and funds search for new possibilities for investing in the developed countries. It brought about the situation that financial intermediaries created very attractive new financial instruments (derivatives) by their "innovativeness", and they soon benefited a lot from it. The surplus of savings generated in the developed countries and so-called new market economies was fertile soil in the undeveloped markets within the USA itself.<sup>4</sup> The placements were applied mostly in the Midwest and other regions of America inhabited by lower and middle class. By granting large amounts of mortgages multiple effects for commission users and placement of savings were created, which is the condition for creating a new savings process. It is important that the enormous building workforce was initiated. It is widely known that every \$1 invested in this field generates \$3; therefore, it means that the benefits were large not only for direct participants but for indirect participants (the whole economy) as well. It brought about to the economic progress, the increase of employment, and the rise of living standard.

In the essence of global financial crisis there is huge greed without adequate control. The constant inclination of financial institutions and funds for new placement caused the hyperproduction of financial derivatives. This process was characterized by approving financial means to a large number of consumers with inadequate incomes. The regulatory bodies raised no objections to the high risk of those placements. The critical point was when mortgages were involved into "derivatives". The processes that occurred in the USA caused a dramatic fall in the value of real estate, which triggered the fall of mortgage-based bonds. These processes had begun earlier but instead of "cleaning action" the problems got hidden so the opinion that the financial crisis occurred out of the blue is not correct. Powerful financial magnates (in the world) managed the process but the greed for earnings blurred their real image when they should stop with this model. Now when they lost the control over the process, all suffer serious damage. During the period of prosperity only they benefited from the model (that is to say, only small number of financial magnates), and now all are engaged to repair the damage. The USA is held up as a representative example of this since its financial institutions created the crisis but they exported it significantly. Therefore, it could be said that many countries in the world are victims of the mistakes made in the USA.

## **2. DEEPENING OF THE DOMESTIC ECONOMIC CRISIS AS A CONSEQUENCE OF THE GLOBAL SITUATION**

Even before the breaking out of financial crisis, the economic situation in Serbia was very difficult which was reflected in the fact that there is about one million of unemployed people (Serbia has a population of about 8 million), high rate of inflation as well as constantly growing trade deficit. Spreading of financial crisis will make it more difficult for Serbia to borrow financial resources from other countries. Namely, Serbia is forced to get into debt with other countries in order to preserve the maintenance of normal production process as well as the stability of its currency. Serbia is mostly getting into debts with banks and financial funds of European Union, IMF and the World bank. Due to the crisis in EU states, which is the

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<sup>3</sup> Ibid, p. 31

<sup>4</sup> Reinhart, Carmen M. and Kenneth S. Rogoff, (2008) *Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison* (January 2008). NBER Working Paper No. W13761

greatest crisis since the World War II, credit resource offer has decreased in these countries which will make more expensive for Serbian firms to get into debts with these countries. This will further lead to the growth of interest rate on loan capital and product price increase which will enable the reduction of competition among Serbian firms. The special problem for Serbia is the fact that banking sector is in the ownership of foreign capital so that they govern placement of capital into Serbian economy only taking into account their interest and not taking care about and consequences which will occur in certain businesses and in that way in the whole society. With the appearance of crisis the population in Serbia (since they were deceived a couple of times before) hastily withdraw savings from the banks, which additionally complicates the economic situation in Serbia because the credit potential for financing of economic activities is reduced. In order to prevent that, the Serbian Government is giving its guarantees to all deposits up to 50,000 euros which had a positive influence on preventing population from withdrawing their money from banks. As a consequence to all previously mentioned tendencies there was a 18%-drop of exchange rate of dinar to euro in a very short period, which the National Bank of Serbia tried to hold up by placement of its funds from its own reserves. However, it was concluded that these processes cannot be stopped without the help from IMF with whom the Serbian Government is making plans to alleviate the world financial crisis. The agreement was reached that IMF helps with 3 billion dollars the budget of the Government of the Republic of Serbia in 2009/2010 under the condition that Serbia carries out radical rationalizations in the public sector, cuts the salaries of budget beneficiaries (except from the education and health), increases excises to oil and taxes on mobile phone services. We are aware of the fact that these measures are only the first step toward further restrictions which Serbia will have to conduct because the temporary situation in all sectors has negative tendency and the 7% fall of GDP is expected (whereas the previous year it increased 7%). There is also the threat that the inflation will exceed the 10% (in all previous years it was under 10%), which will have very negative influence on the crisis in Serbia. These tendencies can best be seen in the table 1, which shows the basic indicators of macroeconomic movements in Serbia.<sup>5</sup>

**Table 1. Basic indicators of macroeconomic movements in Serbia**

Previous year = 100

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gross domestic product, current prices, bill. dinars (RSD)	762.2	972.9	1,133.0	1,384.3	1,687.8	1,980.2	2,362.8	-	-
Gross domestic product, mill. EUR	12,820.9	16,033.7	17,416.4	19,075.0	20,358.0	23,520.6	29,542.7	-	-
Gross domestic product, per capita, EUR	1,708.7	2,137.8	2,328.2	2,555.9	2,736.0	3,173.5	4,002.2	-	-
Gross domestic product, real growth, %	5.3	3.9	2.4	8.3	5.6	5.2	6.9	5.4 <sup>1</sup>	-
Prices and living costs, growth rate									I-II
Consumer prices, end of period	-	-	-	-	-	-	11.0	8.6	3.4
Living costs, period average	93.3	16.6	9.9	11.4	16.2	11.7	7.0	13.5	10.0

<sup>5</sup> <http://www.mfin.sr.gov.yu>

Export, mill. EUR <sup>2</sup>									I-II
Export of goods	1,922.2	2,870.4	2,441.0	2,831.6	3,608.3	5,102.5	6,432.2	7,428.3	770.2
Export of goods to EU	892.4	960.7	1,202.3	1,456.5	2,117.6	2,942.9	3,602.7	4,028.4	440.4
Import of goods	4,759.2	5,956.6	6,585.5	8,623.3	8,439.2	10,462.6	13,506.8	15,580.5	1,611.8
Import of vital products <sup>3</sup>	-	-	1,779.4	2,495.3	1,971.6	2,429.8	3,495.9	3,829.8	361.6
Import of intermediary products <sup>3</sup>	-	-	2,251.9	2,830.6	3,027.6	3,781.4	4,892.1	5,331.0	506.3
Trade deficit	-2,837.0	-3,754.7	-4,144.3	-5,791.7	-4,831.0	-5,360.1	-7,074.5	-8,152.1	-841.6
									I
Current transactions deficit (without donations) <sup>4</sup>	977.0	-1,842.7	-1,674.8	-2,688.4	-2,050.0	-3,091.8	4,780.9 <sup>5</sup>	-6,086.2	-68.1
Current transactions deficit (without donations), % GDP	-7.6	-11.5	-9.6	-14.1	-10.1	-13.1	-16.2	-	-
Payroll, (total) <sup>4</sup>	559.9	981.1	813.5	360.2	1,627.6	4,316.1	742.1	-1,714.6	-382.9
Direct foreign investments, net, mill. EUR	184.0	502.2	1,205.7	776.6	1,244.6	3,492.2	1,820.8	1,812.1	62.5
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Monetary and foreign currency indicators, end of period									II
Dinar primary funds, mill. RSD	41,448	69,323	69,996	76,969	94,220	143,407	169,064	319,780	299,892
Monetary base M3, mill. dinars	125,415	191,491	245,062	323,465	459,650	638,505	903,698	992,533	1,026,571
Gross dinar and bank investments	75,187	97,589	141,498	231,866	394,118	521,770	759,457	1,037,037	1,092,148
Economy investments	68,377	77,845	109,047	161,776	255,965	306,918	439,937	632,423	673,788
Investments to the general public	5,277	16,139	29,333	66,354	131,845	205,146	305,665	381,462	395,900
Foreign currency reserves NBS, mill. EUR	1,320	2,175	2,840	3,117	4,935	9,025	9,641	8,148	8,236.00

Value of USD regarding the RSD	67.67	58.98	54.64	57.94	72.22	59.98	53.73	62.90	73.68
Value of EUR regarding the RSD	59.71	61.52	68.31	78.89	85.50	79.00	79.24	88.60	93.80
General public savings in mill. EUR, end of period	329.8	796.1	1,086.7	1,461.1	2,274.3	3,413.1	5,028.5	4,879.3	5,009.6
Employment, salaries and pension checks									I-II
Number of employed, average, per 000	2,102	2,067	2,040	2,051	2,069	2,026	2,002	1,999	1,977
Actively unemployed, end of period, per 000					896	916	785	728	750
Unemployment rate, MOR				19.5	21.8	21.6	18.8	14.7	-
Net salaries, period average, in RSD	6,078	9,208	11,500	14,108	17,443	21,707	27,759	32,746	29,991
- real growth rate	16.5	29.9	13.6	10.1	6.4	11.4	19.5	3.9	2.8
Average pension check, period average, in RSD	4,107	6,546	7,844	9,244	11,484	14,041	14,996	19,386	21,709
- real growth rate	18.4	36.7	9.0	5.7	6.9	9.5	5.8	13.9	11.1

Source: RZS, NBS, NSZ and RFPIO of employment.

<sup>1</sup> RZS estimate. <sup>2</sup> Montenegro was included in the export trade in 2006. <sup>3</sup> The new system of classifying has been implemented since 2004. <sup>4</sup> To calculate the currency values the average value of dollars and euros was used for the period from 2001 to 2006. For 2007, 2008 and 2009 the data is from NBS. <sup>5</sup> New methodology.

It is obvious that the economic crisis strongly affected Serbian economy, and we expect that in the following period the intensity would be more outstanding. As a small country, Serbia with its measures of economic policy can only defuse the crisis but cannot act completely to remedy economic situation in Serbia until the crisis is first resolved in all developed countries. The end of crisis must first occur in the USA and only then it can expand like chain to the other developed, partially developed and undeveloped countries. The causes of crisis that have been mentioned in this paper even did not exist in Serbia; for example, Serbia does not have any problems with mortgages at all, and there are no problems with default of loan by citizens. However, as a consequence of crisis, the firms in Serbia have problems with default of loan and thanks to the agreement between IMF and the Serbian Government, the decision was made that foreign investors give grace period to our firms for the reimbursement of debts.

### 3. REFORMS OF THE REAL AND THE FINANCIAL SECTOR IN SERBIA IN THE PERIOD BETWEEN 2001 – 2008

In the first eight years of the transition economy and society have been significantly reformed. The consequences of such events were a relatively fast economic growth, the increase of foreign direct investments, of foreign currency reserves, the growth of the financial sector and the increase of savings

deposits in banks. All of the listed positive events were significantly endangered by the influence of the world economic crisis. Many of the positive trends have ground to a halt while some even started to show signs of decline. In order for our economy to begin its recovery it is necessary for the world crisis to end. According to the *Doing Business Report 2008*<sup>6</sup> Serbia is on the 86th position of composite index.

**Table 2. Position of Serbia according to the *Doing Business Report* in 2008**

Category	Rank
Ease of doing business	86
Enterprise renewal	90
Permit issuing	149
Employment	110
Property ledgers	115
Loans	13
Labor protection	64
Tax collection	121
Exceeding trade	58
Court execution of contracts	101
Enterprise closure	103

The previous indicators show the unfavorable trends in our economy. Also, if we were to compare the listings with the countries from the region we can see that we fall behind in our level of global competitiveness because i.e. Slovenia in 2008 had 4.5, Croatia 4.22, Montenegro 4.11, Romania 4.1, Romania 4.1, Bulgaria 4.1, while Serbia only had 3.9<sup>7</sup>.

The world financial crisis has seriously severely affected our economy which, even besides the positive trends starting from 2000, has not still managed to consolidate. However, the positive signs seen on the global scene regarding the end of the world financial crisis should have a positive effect on the recuperation of our economy.

Serbia needs to significantly revive the production sector in the following period. However, during the revival we need to take care of its exporting orientation in order to reduce our export deficit. The increase of our competitiveness in the global market is a without which there is no hope for prosperity. Creating a positive environment to attract foreign investments is of multiple use for our economy and society. The structuring of the full legal state is also a condition for the realization of all of the previous factors. Last (but not the least) is the quality of education which is vital to the progress of economy and society. The negative trends grasping our educational system need to be stopped promptly being one of the factors which we can actually control.

## **Conclusion:**

The world-wide financial crisis started in the USA, and Serbia, along with all other countries, is suffering the consequences of that crisis. The basic cause for the crisis in the USA was the greed of their financial institutions and funds to achieve as big a benefit as possible by a large spread of investments. Due to the growth of savings in the USA the financial institutions needed to find new markets to invest which they did through presenting mortgage loans to the middle and lower classes of the society. The regulatory institutions were all but cautious in their controlling the investments and failed to properly evaluate the risk involved in such actions which later led to the breakdown of the whole system of mortgage loans and spurred the crisis in the USA.

The crisis had actually started much before that only the financial experts chose to hide its existence instead of proposing measures to remedy it. That is why it appeared to the general public that the crisis came about suddenly and overnight. The population of the USA is now paying the price for such irresponsible actions, but it took maximum advantage of the previous policy of financial investments. The biggest issue is that the price for actions taken in the USA is now also being paid by people all over the world (most of all underdeveloped and partially developed countries) without, unlike the USA, ever having any benefits in the

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<sup>6</sup> Taken from Bošnjak, M., *The Reforms of the Real, Financial and the Public Sector in the Period of Transition Between, Transition in Serbia and the Global Economic Crisis*, Faculty of Economy, Belgrade, 2009.

<sup>7</sup> Ibid, p.122.

period before the crisis. It is very well known that the USA exploited the rest of the world by mass printing dollars since the dollar was widely accepted as a global currency. The dollar had a particular impact on the oil market which considerably affected the world economic trends. It is expected for a solution to be found in the USA and other developed countries which should have a positive effect on the problems of Serbian economy.

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