Trade Unions and Social Dialogue in the Period of Crisis: The Serbian Case

International Labour Office

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Abbreviations

AM	Austerity Measures
BoJ	Bank of Japan
CDS	Credit Default Swaps
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CSOs	Civil Society Organizations
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EMEs	Emerging Market Economies
EMU	European Monetary Union
ETUC	European Trade Union Confederation
ETUI	European Trade Union Institute
EU	European Union
EU-15	"Old" member states of the EU before the accession of ten more states in 2004
EU-27	All 27 member states of the EU
FDIs	Foreign Direct Investments
FTEs	Full-Time Equivalent of Employment Rates
FTR	Flat Tax Rate
G20	Group of Twenty, a group of Finance Ministers and Central Bank Governors from 20 major economies
GDP	Gross Domestic Product
GJP	Global Job Pact
IFIs	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
ITUC	International Trade Union Confederation
KfW	Kreditanstalt für Wiederaufbau
LFS	Labour Force Survey
MOP	Marginal Odds of Participation
NBS	National Bank of Serbia
NGOs	Non-Governmental Organizations
NMS	New Member States (of the European Union)

PPP	Purchasing Power Parity
SBAs	Stand-By Arrangements
SEC	Socio-Economic Council (of Serbia)
SEE	South-East Europe
US	United States
USD	US Dollars
VAT	Value Added Tax

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Foreword

Working women and men in Serbia are currently suffering the effects of the global financial and economic crisis. Serbia, among other countries in the region, has been deeply affected by the crisis and therefore it has become vital to reinforce trade union capacity to plan strategically as a response to the rapid changes in the economic, social and political environments.

With the goal of strengthening efforts to mitigate the effects of the crisis on working people this publication aims to support the leaders and experts of workers' organizations in developing policy proposals and negotiating on behalf of their members. This volume is published within the framework of the Decent Work Country Programme for Serbia (2008-11) which, among other objectives, aims to strengthen the capacity of ILO constituents. It is published with the support of the Italian government which has generously supported important elements of the Decent Work Country Programme for Serbia.

The research underlying this publication is based on a comprehensive assessment of the origins and the impact of the crisis. In addition, it presents some policy responses and exit strategies proposed by international organizations and some countries in Europe, while focusing firmly on Serbia. The role of trade unions, their possibilities and challenges are also examined. Strategic choices of trade unions for developing and agreeing on an anti-crisis agenda in Serbia are outlined.

The document is also meant to be used by trade unions in the region as a tool for discussion and reflection in their efforts to improve their services to their members and to strengthen their influence in public policy debates. The volume can also be of interest to researchers and students of industrial relations.

It is the ILO's view that only strong, democratic and representative trade unions able to present viable and effective policy responses to the crisis can effectively perform their role as equal partners to governments and employers' organizations in policy formulation. This publication reflects that conviction.

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Introduction

The world economy has entered its third year of crisis. The crisis emerged initially in the USA, before spreading to other developed countries in Europe, Asia and Latin America. The crisis hit the real economy in Central and Eastern Europe (CEE) a year later.

The crisis then spread, with a certain delay, to South-East Europe (SEE), including Serbia. It is important to mention the initial expectations of some governments and experts from the region that banking, public finances and the real economy would not be affected. This optimistic prognosis did not stand up, however. Economic forecasts which predicted that transition states would not be as badly affected as the developed countries also proved unsound.

The economic situation in SEE was also affected by the fact that national governments do not have sufficient resources at their disposal to compensate losses or to inject massive amounts of fresh capital into industry, health care, education and infrastructure. So far, no effective counter measures have been put in place to serve as a shield against recession and growing unemployment.

The aggregate effect of crisis management measures depends to a considerable extent on the implementation and results of national and sectoral social dialogue. Crises may not be resolved successfully if there are no mechanisms or tools to reach national consensus on crisis-management efforts. National anti-crisis strategies should endeavour to protect low-income individuals and families, small and medium-sized enterprises, the self-employed and socially disadvantaged groups.

In the 1990s, Serbia experienced a severe economic downturn due to its controversial political transition, followed by a period of stable economic growth (2001–07). After 2008, the Serbian government took the first steps to develop a national anti-crisis strategy, which was to be coordinated with the initiatives and programmes of the international financial institutions (IFIs).

As demonstrated in numerous documents and recommendations from the ITUC, the ETUC and the ILO, as well as in the declaration issued by the G-20 Summit held in Pittsburgh (September 2009), anti-crisis measures and exit strategies must be the subject of consultation with the social partners at the national level. This recommendation may be realized if two basic conditions are met.

First, there must be political will and a spirit of partnership among the negotiating parties (government, trade unions, employers) with the active involvement of organized groups in civil society. Second, there must be intensive preparation on the part of the social partners and their experts to negotiate professionally and engage in responsible dialogue.

The purpose of this Guide is to help to develop strong cooperation among the leading social partners in Serbia. The Guide is designed to serve the needs of the leaders and experts of representative trade union organizations, who are involved in institutional negotiating procedures or act as consultants. The authors of the present Guide hope that its users have the relevant knowledge and access to national strategic analyses of the macroeconomic situation, employment trends and social developments.

The Guide is aimed at nurturing expert-based, policy-oriented discussions by national and branch trade unions. The information provided is intended to help in negotiations and the design of alternative anti-crisis strategies, relevant to Serbia. Information on the general characteristics of the global crisis and economic trends are kept to a minimum. The accent is on the regional situation, typical of the transitional economies in SEE, and the material presented is believed to be useful to Serbian trade unions in carrying out comparative analyses.

The broader aim of the present Guide is to describe how to deal with the aftermath of the current crisis in Serbia in an EU context. The argument is that Serbia has already started negotiations on EU accession and is engaged in numerous economic, social and institutional projects.

The Guide has three parts:

A. Analytical/explanatory;
B. Appendix – statistical and comparative information, presented in tables, figures and boxes;
C. Presentation slides

The analytical text and the Appendix comprise one document, while the presentation slides are provided separately.

The authors of this Guide believe that it may be used at two levels: (i) for the training of trainers and (ii) for nurturing discussion between leaders and experts, who may participate in social dialogue at the national and sectoral levels.

Part I. Genesis of the crisis

1.1. Beginning of global turmoil

Tracing the emergence of the crisis is important, not only for chronological purposes, but also for political and economic analysis. It is of great importance to chart the development of the crisis in detail, as it may help us to forecast the duration of the crisis, which is needed to develop effective anti-crisis and exit strategies. The spread of the global crisis has followed a wave pattern, and it is advisable that each country and institution objectively analyse and define the so-called "point-of-departure" in order to develop adequate crisis remedies.

Crisis broke out initially in the USA

As it is widely known, the crisis started in the USA, the country which is considered to be the world leader among the free market economies. The US financial system was shaken by a wave of bankruptcies of giant corporations, and therefore lost control of key aspects of national money flows, including mortgages for home-owners, loans to businesses, bank settlements and other financial tools. The financial collapse hit the real sector and key branches of the American economy, such as automotive industry, construction, transportation and textiles. Some of these branches of the economy experienced falls in productivity that had not been seen for 60 years.

Between December 2007 and February 2010, the unemployment rate doubled in the USA, reaching 9.7%, bringing the number of unemployed to 14.9 million. Several million American households filed for bankruptcy over the period, having ceased to be able to pay their debts, including repaying their mortgages.

This compelled the federal government to intervene in order to save the big banks and non-banking financial institutions, and to support small and medium-sized enterprises and households. The new administration under President Obama also developed a plan to help some of the big companies in the auto industry and a number of other corporations.

State intervention came at a very high cost, which depleted much of the resources of the country and increased the US budget deficit and total indebtedness to critical values. Thus, the worst-case scenario loomed: a combination of financial and economic crises, which led some analysts to forecast a rerun of the Great Depression in the USA.

Spread of the crisis to Europe

The global crisis affected all the most economically developed countries of the EU, and spread to other continents, such as Asia, Latin America and Africa. A large number of national economies in Europe – Iceland, Hungary, Ireland, Latvia, Romania and Ukraine – were seriously affected by the global turmoil; under the threat of financial insolvency these countries were compelled to obtain emergency loans and rebalance their budgets.

The European economies entered a period of recession of a seriousness not faced since the end of the Second World War.

A number of Eurozone states – such as Greece, Italy, Portugal and Spain – could be hit even harder than the USA. Although the mortgage shocks were weaker in Europe than in the USA, a long list of banks suffered serious financial losses and filed for bankruptcy, compelling some governments to implement extraordinary risk measures. For example, Germany, which is considered the economic locomotive of Europe, approved a €50 billion plan for recovery, which includes tax cuts and spending measures. The Greek financial system lay in ruins for a couple of months and the budget deficit rose to 12.7% (revised at the end of the fourth quarter of 2009 from 12.7% to 13.6%) of GDP, threatening insolvency.

Unemployment in the EU-27 reached 9.5% in January 2010, and is still rising. This trend throws some doubt on the targets set in the Lisbon Strategy and it will probably be revised very soon.

It is now clear that the most dramatic consequences of the financial crisis are being felt in the labour market. Negative GDP growth and the enormous loss of shareholder value suffered by investors since mid-2009 are relatively abstract notions for the average person active on the labour market, at least as long as they are lucky enough to keep their jobs. But when the financial crisis causes someone to lose their job, the largely abstract financial crisis becomes a cruel reality.

At the EU level, the apparently positive trend in the labour market cannot hide the fact, first, that the Lisbon criteria are impossible to attain in the near future and second, that qualitatively the functioning of the labour market has deteriorated from the point of view of employees.

Emerging markets in the CEE: vulnerability and outcomes

Strangely, some economists, politicians and analysts argued that the crisis would affect the newly emerging CEE markets to a very low extent. Their rather biased predictions failed to materialize. Other economic forecasts which predicted the delayed entry of these countries into recession did not stand up, either.

The actual time-lag proved minimal, at six months to a year.

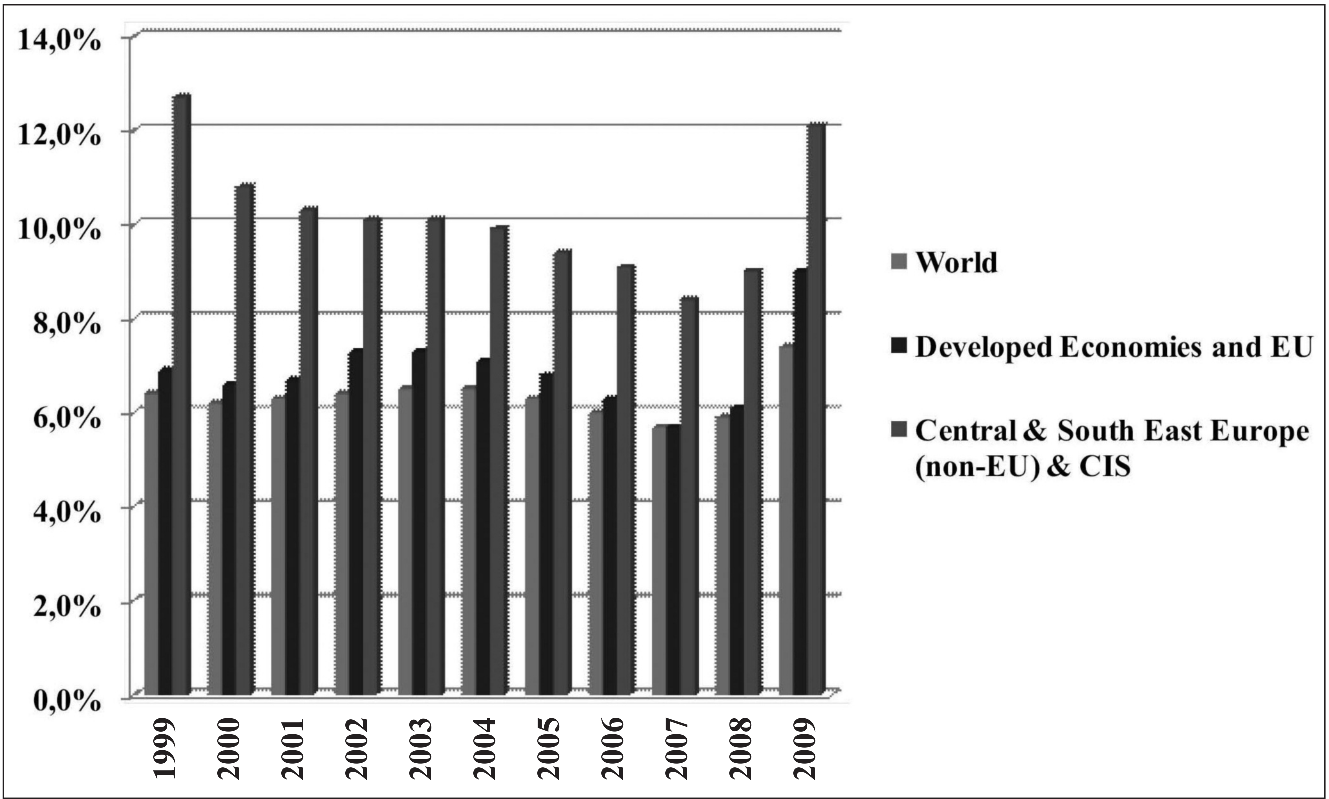
Economic crisis affected the emerging economies at different rates, hitting both the financial and real sectors. The most serious damage was done in the social sphere and in the labour market (see Table 1 and Figure 1).

Table 1 Unemployment rates in the world and selected regions

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
World	6,4%	6,2%	6,3%	6,4%	6,5%	6,5%	6,3%	6,0%	5,7%	5,9%	7,4%
Developed Economies and EU	6,9%	6,6%	6,7%	7,3%	7,3%	7,1%	6,8%	6,3%	5,7%	6,1%	9,0%
Central & South East Europe (non-EU) & CIS	12,4%	10,8%	10,3%	10,1%	10,1%	9,9%	9,4%	9,1%	8,4%	9,0%	12,1%

Source: ILO, Global Employment Trends – Update, May 2009, Adapted Table A2, p. 23.

Figure 1 Unemployment trends, 1999–2009



Surprisingly, the first group of countries which suffered financial and economic collapse was composed of the "champions" of economic growth after 2000, the Baltic States: Lithuania, Latvia, and Estonia. Even though the government finances in these countries were stable, the high rate of GDP growth in the previous years was based on credit and asset bubbles.

Romania and Hungary were hit by financial market turbulence at an early stage, due to their high dependence on external finance.

Ukraine was threatened by a financial collapse, but it is still considered a special case in many respects, including its geopolitical situation, its key role in European energy supply, its dependency on raw material prices and political instability.

Initially, the second group of countries – the Czech Republic, Slovakia, Poland and Slovenia – progressed relatively well. Bulgaria is considered to be part of this group, as well, as it enjoyed internal financial stability until the very end of 2008, although was burdened with a huge current account deficit. Bulgaria also had a relatively high share of Foreign Direct Investments (FDIs).

However, almost all CEE countries suffered from either economic shocks, coming from abroad, or domestic imbalance. Poland was urged to request an emergency loan from the IMF, under the newly introduced flexible credit line scheme. The auto industries of the Czech Republic, Hungary and Slovakia were affected by the decrease in production and exports. Bulgaria entered into recession, having pursued a course of irrational public spending, which guaranteed it a place among the countries at risk.

The third group of economies belongs to the region of the Western Balkans. Serbia is part of this group. Although there were some serious structural problems and financial imbalances, the global crisis was "imported" from outside, similar to what happened with the new member states of the EU.

It is difficult to predict how deep the crisis will become as it spreads from the developed countries to the states of the Western Balkans. The official statistics for the former Yugoslavia are not always available at the EU level, but are compiled from the corresponding national bodies (statistical institutes, economic departments of agencies or ministries), which distorts comparative national and overall analyses of the crisis. However, it may be expected that the crisis will have its full impact in these countries in 2009–11.

1.2. Pre-crisis situation in Serbia

1.2.1. Post-2001 macroeconomic performance

After the radical political changes in October 2000, the government of FR Yugoslavia (Serbia and Montenegro)[1] embarked on bold transition-related economic reforms, which have brought impressive results in many areas. During 2001–08, most of the main macroeconomic indicators were highly satisfactory. After an initial high average inflation rate of over 90%, average inflation was reduced to around 10% in 2008 (the December-to-December rate to less than 7%). These stabilization results were achieved with the help of a new course in monetary and exchange rate policy (see Appendix 1).

Serbia's growth performance has been remarkable since 2001

The average real GDP growth rate during 2001–08 was 5.4%. Gross fixed investment has increased gradually, from a very low 11% of GDP in 2001 to 21% in 2008. Rapid growth has permitted some economic recovery, although this has not been sufficient to compensate for the very sharp fall in GDP during the 1990s. As a result, by mid-2008, Serbia had reached only around 70% of the GDP registered in 1989 (EBRD, 2008), which is the lowest among all Southeast European countries.

Growth has been very uneven across sectors, leading to premature structural changes in the Serbian economy, characterized by a very fast increase in the share of services, particularly finance and retail, in parallel with the decline of industry, including many industrial sectors that traditionally were important providers of goods for export. Economic recovery has been modest in manufacturing, and the share of tradable goods has declined quite sharply, from 40.7% of GDP in 2000 to 24.6% in 2007 (Stamenkovic et al., 2009). These problems have contributed to rising external imbalances.

Serbia's exports registered a rapid increase after 2001, but imports have grown much faster, effecting a continuous increase in the trade deficit, to USD 9 billion in 2008. The insufficient increase in exports is mainly due to the structural weaknesses of the economy, including the limited restructuring and modernization of key industries which missed a whole decade of technological progress, although the strong real appreciation of the dinar has also hampered export growth, particularly since 2006.

The huge trade deficit is the main cause of Serbia's increasing current account deficit, which is among the highest in the wider transition region (over 17% of GDP in 2008). From 2001, the current account deficit was partly covered by official donors' assistance, but more important have been emigrants' remittances, totalling USD 16.8 billion (annually around 9% of GDP) over the eight-year period, and to a lesser extent, FDI amounting to USD 12 billion. Since 2001, capital inflows have ensured a comfortable surplus on the capital account, allowing a continuous increase in the official reserves of the National Bank of Serbia (at least until recently).

1 At that time, FR Yugoslavia was still one country. Serbia and Montenegro became two independent states in June 2006, after the Montenegrin referendum on independence organized in May 2006. Kosovo was also still part of Serbia, though governed by UNMIK (UN Mission in Kosovo). In February 2008 Kosovo declared independence, but has still not been recognized by the UN and a majority of countries, including 5 EU member states.

Serbia has a relatively high level of external debt – around USD 22 billion at the end of 2008 – most of which (almost 70%) is private sector debt. Since 2001, there have been several very favourable write-offs of Yugoslavia's/Serbia's external debt owed to the Paris and the London Clubs of creditors and Russia.

However, there has also been increased borrowing on the world markets over the past two years, leading to an increase in Serbia's external debt, from USD 13 billion at the end of 2006 to USD 22 billion at the end of 2008. Debt repayment could represent a serious problem, in view of reduced capital inflows expected as a consequence of the current global economic crisis.

Serbia's post-2000 economic transformation has been facilitated by increasing FDIs, which has helped to compensate the increasing current account deficit and the privatization process. After a decade of no interest on the part of foreign investors in Serbia, FDIs has been picking up. Over the whole 1989–2007 period, the cumulative stock of net FDIs in Serbia amounted to almost USD 12 billion (or around USD 1,599 per head, lower than in Croatia or Montenegro), most of it invested since 2001.

As in many other transition countries, the largest part of FDIs in Serbia involves privatization deals in particular sectors – cement, tobacco, base metals and, more recently, banking, telecommunications and real estate – and there has been very little greenfield investment. In addition to Serbia's improved macroeconomic performance, during the past eight years progress has been made with many transition-related economic and institutional reforms.

In late 2000, Serbia was among the least reformed countries in the whole transition region; the only two areas in which some progress had been achieved at that time were small-scale privatization and price liberalization. According to EBRD transition indicators, however, by 2008 Serbia had caught up with the other countries in the region in most areas of reform.

With regard to enterprise reform, a new privatization law was adopted in 2001 which led to the privatization of almost 2,000 enterprises and the increase in the private sector share in GDP from 40 to 60% by 2008. However, the process has not yet finished. There have been many unsuccessful privatizations and only very limited microeconomic restructuring has taken place.

The process of large-scale privatization has been delayed and started only in 2006.

Prices and the foreign trade system have been liberalized, but there is still not enough market competition and competition policy remains ineffective. The regulatory business environment has improved, as many barriers to enterprise entry have been removed. However, the process of enterprise exit has been delayed by last-minute revisions of bankruptcy legislation and insufficient hardening of budget constraints, as a number of state and socially-owned firms continue to receive government subsidies or have privileged access to bank lending. As a result, a dynamic private sector has still not developed.

Banking sector reforms have been carried forward particularly rapidly since 2006, with the privatization of almost the entire banking sector to foreign banks. In 2008, among the 11 most important banks, the Serbian government had a minority stake in only one. The stock exchange has also developed during the past three years, although the capital market remains undercapitalized.

1.2.2. Social indicators (trends in unemployment, income and taxes)

In contrast to the excellent growth performance and substantial macroeconomic stabilization, most social indicators have been highly unsatisfactory since 2001. The strong post-2000 economic recovery brought neither employment growth nor a decline in the very high unemployment rate. Although 'jobless' growth has been a typical feature of other transition countries, its magnitude in Serbia has been much greater than elsewhere.

Over the period 2000–08, the unemployment rate in Serbia, based on the Labour Force Survey (LFS), has increased continuously, from 12% in 2000 to 21% in 2006. After a slight decline by October 2008 (mainly due to changes in the methodology), unemployment again increased to over 15% by April 2009. The official unemployment rate has been much higher, standing at 22.8% in March 2008. The long-term unemployment rate reached 17.3% in 2007. The employment rate has been oscillating, slightly increasing from 48% in 2002 to 53% in 2008. The share of persons unemployed for more than one year increased from 76.6% in 2004 to 80.6% in 2006 (Government of Serbia, 2007).

Serbia's participation rate, although increasing, remains relatively low (62.6%) in comparison to the EU average.

Although the government has implemented various measures to stimulate private sector employment, they have contributed only very marginally to alleviating the problem of unemployment.

Since 2001, privatization has led to the transfer of a large number of workers from privatized socially-owned enterprises to the private sector, leading to an increase in private sector employment from 49% in 2001 to 74% in 2008. However, the number of new jobs created in the emerging private sector has not been sufficient to absorb all redundant workers. The increased employment registered in 2008 is due primarily to the rise in the number of employees in the public sector and recent improvements in the LFS methodology, namely better coverage of various categories of informal employment, such as self-employment, employment of family members and traditional agricultural employment.

Despite measures to combat the informal sector, the size of the shadow economy in Serbia and Montenegro in 2002–03 was estimated to have actually increased to 39.1% of measured GDP, up from 36.4% in 1999–2000. The formal labour market in Serbia remains rather rigid and functions poorly, in contrast to its considerably more flexible informal counterpart.

Unemployment therefore remains a key economic problem in Serbia, also because it is likely to increase further under the impact of the current global economic crisis and the closure of enterprises envisaged by the end of the year.

Some of the problems on the Serbian labour market can be attributed to inadequate labour legislation. The first Labour Code, passed in 2001, was labelled "neoliberal", while a new Labour Code adopted in 2005 is somewhat more balanced, but fundamentally not very different from the first. This legislation imposed a high level of flexibility in labour relations and clarified the responsibilities of employers and employees. A single income tax rate of 14% was introduced and social insurance contributions were considerably reduced, down to 32.6% of the gross wage, but at the same time a rather high minimum wage of around 40% of the average wage was introduced.

A special feature of Serbia is the pronounced regression of the income taxation system in force between 2001 and 2007. Until the end of 2006, the tax burden for a person on a very low income – amounting to 33% of the average wage – stood at 47.1%, while for workers earning the average wage it stood at 42.2% and for workers receiving wages eight times the average wage, the tax burden was even lower, at only 34.5%.

Although in 2007 a modest zero tax bracket was introduced and the minimum social security threshold lowered, thus finally cancelling regression in much of the wage distribution, the tax burden on low-wage labour has remained quite high, the tax wedge now standing at around 38% of the minimum wage.

The regressive labour tax system introduced in 2001 put a disproportionate tax burden on firms and sectors employing a low-wage labour force, as well as regions with below-average wages, thus perpetuating sectoral and regional wage differences.

This has to a large degree prevented the formalization of informal employment, since the marginal tax rate at the potential point of entry for small labour-intensive private firms was at least as high as the average labour tax rate. For the same reason, it has impeded job creation among de novo private firms, which are essential for successful labour market reallocation.

Despite all these problems, post-2001 economic recovery has permitted, on average, a substantial rise in living standards in Serbia. GDP per capita has increased from 1,700 euros in 2001 to an estimated 4,700 euros in 2008. However, Serbia's PPP GDP is still only about 34% of that of the EU-27. Due to the increase in real wages and pensions, poverty has been reduced, with the proportion of those in poverty falling from around 11% of the population in 2001 to 7% in 2007.

Average net wages have increased by four times, from around 102 euros in 2001 to 400 euros in 2008. During 2001–08, net wages increased in real terms by 13.7%, on average, faster than productivity growth, which registered a 6% average increase.

It can be concluded that, in the pre-crisis period, economic dynamics in Serbia, as in many other East European countries, were based on a model of credit-driven, consumer-led growth, largely funded by foreign capital inflows (FDIs, foreign borrowing and workers' remittances). Immediately after the first signs of the global crisis became visible, exports started to shrink, investors withdrew from the market and the foreign and domestic lending activities of banks collapsed. It became clear that the Serbian economy, in fact, has serious structural problems and extremely unbalanced. Serbia's competitiveness on foreign markets is too low. In addition, Serbia's real sector was the first part of the economy to be exposed to the coming crisis.

Part II. Crisis duration and impacts

In general, not only were governments and politicians in CEE unaware of the true nature of the coming global crisis, but also many professional analysts, such as macroeconomists, business experts and financial strategists. In addition, international financial institutions and think tanks were unprepared, as well.

Element of surprise

The element of surprise is a good explanation for the forecast discrepancies, unreliable prognoses and unconvincing explanations delivered by analysts and experts. Statements varied in their forecasts, which ranged from one to two years of expected stagnation among the developed economies (three to five years for developing ones) to more pessimistic scenarios, which predicted a general downturn for more than 10 successive years. The pessimistic expectations were based on the assumption that the period after 2010 would be marked by secondary and tertiary shocks in the banking and financial sectors, accompanied by severe recession and high levels of unemployment.

Why was it at first thought that CEE new member states would not be affected by the spreading financial turmoil? The immediate answer is that their financial institutions were not involved in the opaque financial transactions characteristic of the USA and most Western banks. The governments of most developing countries hoped that the effects of the global crisis would unfold with a longer time-lag, which would give them enough space to respond to the regional outcomes, designing adequate national programmes and taking robust measures.

Furthermore, domestic political considerations were also part of the game of governments in the broader region of Eastern Europe. Traditionally, in pre-election periods, politicians are inclined to bombard the electorate with positive messages, not alarm signals. All these expectations proved wrong!

2.1. Proliferation of the crisis

Discussions on the causes of the current global crisis (sometimes referred to as the Second Great Depression) will probably continue for many years. The opinions of leading experts and institutions about this issue differ considerably and depend directly on affiliations to one or another school of economics or political ideology. A detailed review of opinions is beyond the scope of this Guide. However, certain milestones should be pointed out in this analytical chapter to help its users in their efforts to comprehend the national and regional crisis situations in their global and European context.

Crisis is a systemic failure

This statement brings us to the genesis of the global crisis, which broke out at the beginning of the twenty-first century.

Box 1 Genesis of the crisis: different views

Leading economists

According to Nobel laureate in economics Paul Krugman, the crisis in the US economy is a direct consequence of social inequality (income distribution skewed in favour of the top of the social pyramid). Krugman also points out the conscious rejection of welfare measures, of the kind introduced by President Roosevelt and which led to the formation of a comparatively homogeneous American society with a progressing economy and an active middle class.

Nouriel Roubini and Joseph Stiglitz emphasise the breaking of the link between the financial and banking sector, on the one hand, and the real economy, on the other. This nurtured systematic growth in speculative financial transactions, which are out of state, stakeholder or any other control. Stiglitz points out five fundamental mistakes in financial management, preceding the period of the crisis (see the slides).

Krugman, Roubini, and Stiglitz share the opinion that speculative financial transactions exploded due to the abolition of a series of acts, such as the Emergency Banking Act, the Glass-Seagull Act (the Banking Act), the Farm Credit Act, the National Industrial Recovery Act and the Truth-in-Securities Act, passed in 1933. More specifically, the Banking Act of 1933 separates banks according to the nature of their business into two categories: commercial banks and investment banks. The Act provides that commercial banks must guarantee the savings of citizens and corporations. After a successful lobbying campaign, however, which cost about $300 million, regulations were dropped, which enabled the shadow banking system to flourish and speculate with high-risk investments, including subprime investment packages.

IFIs evaluations

It is of interest to review the analyses of experts working for international financial institutions (IFIs).

For example, there is a presentation for the Board of the World Bank, according to which the pre-crisis period was marked by a series of illogical strategic decisions, as well as by the underestimation of a chain of regional and national crises, which should have served as early signals to the global financial system.

Ravi Kanbur underlines five challenges from the 1980s and 1990s (among many):

- disappointing results of liberalization in Africa and Latin America
- appalling results of shock therapy in Eastern Europe
- rapid growth of India and China without major liberalization, especially of capital accounts
- East Asia crisis, affecting those who had liberalized capital accounts
- sharp rises in inequality in fast growing countries, despite falls in poverty.

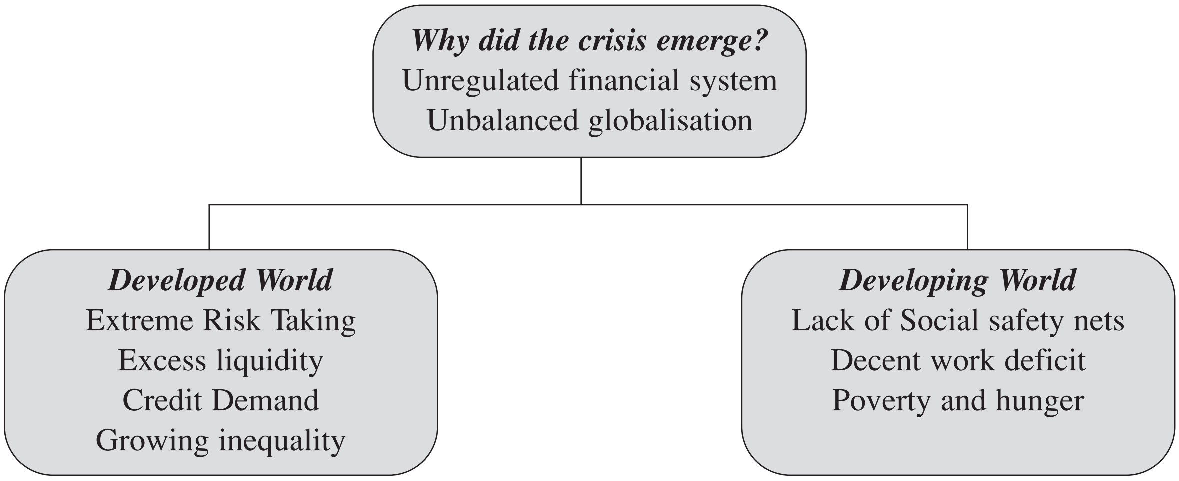
From an analysis by the IMF Research Department, the basic conclusion is that:

- The current financial turmoil is confronting emerging market economies (EMEs) with two shocks: a “sudden stop” of capital inflows driven by global deleveraging, and a collapse in export demand associated with the global slump. Although some EMEs were already ripe for a home-grown crisis following unsustainable credit booms or fiscal policies, and face large debt overhangs, the majority were just innocent bystanders. This note outlines policies to help solve the debt overhang and bring about recovery in both groups of countries.

ITUC position

- In a recent analytical paper, ITUC experts present the crisis as a product of globalization, which brought rapidly intensifying recession in both the developed and the developing world (see Figure 2).

Figure 2 The ITUC position



There were some earlier forecasts by the quoted influential economists, and some independent analysts, who predicted a few years in advance the outbreak of serious crisis in a global scale. However, their warnings were ignored by the financial institutions and political elites. Then came the moment at which pre-emptive intervention became useless. This is probably why Paul Krugman pointed out that the crisis is a result of short memory and foolishness. He added that classical economics textbooks may be considered useless from this moment on, as they fail to prescribe adequate anti-crisis measures.

It is high time that the prevailing economic paradigm (neoliberalism) and the system of global financial management, introduced via the so-called Washington Consensus, be changed. The global crisis, which originated in the USA, and spread throughout Europe, followed the paths described in the next section.

From the banking sector to the real economy

The various phases of crisis proliferation are intermingled and follow a wave pattern. Therefore, the crisis cannot be stopped by partial measures alone.

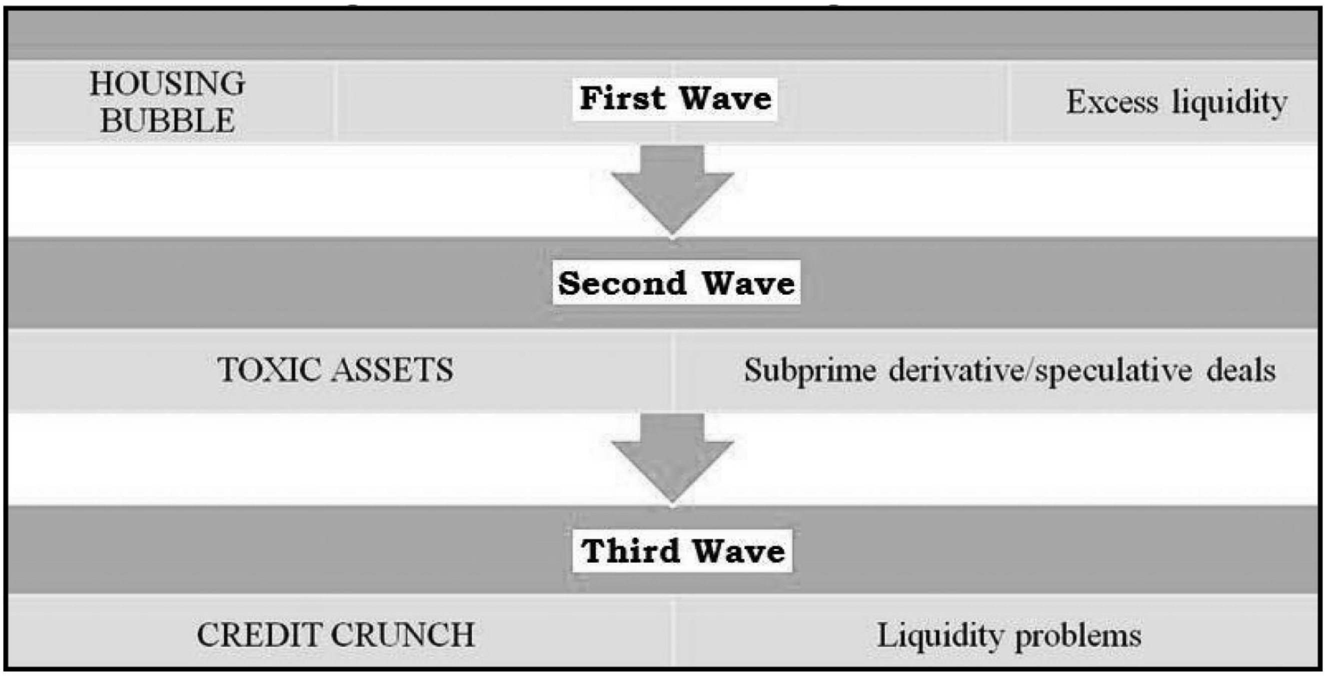
During the first phase, the bubbles of mortgages and consumer loans burst. That was when house prices started going down and households which relied on credit to pay their bills became insolvent.

In parallel, a second crack in the system emerged as the banking system started to suffer from “toxic assets”, landing them with huge losses. These financial losses destroyed their reputation for trustworthiness and professionalism.

The third phase was a logical consequence of the first two. The credit crunch arrived and the banks suspended their basic function, to provide citizens and corporations with loans. In turn, this reduced consumer demand, hitting production and services companies. The economic circle closed and recession came.

In the EU, the chain of economic dependencies was similar to the one described in the USA. However, there is a difference in terms of the speed of crisis diffusion with reference to the banking sector and to exports (see Figure 3).

Figure 3 The three waves of the global crisis



From epicentre to periphery

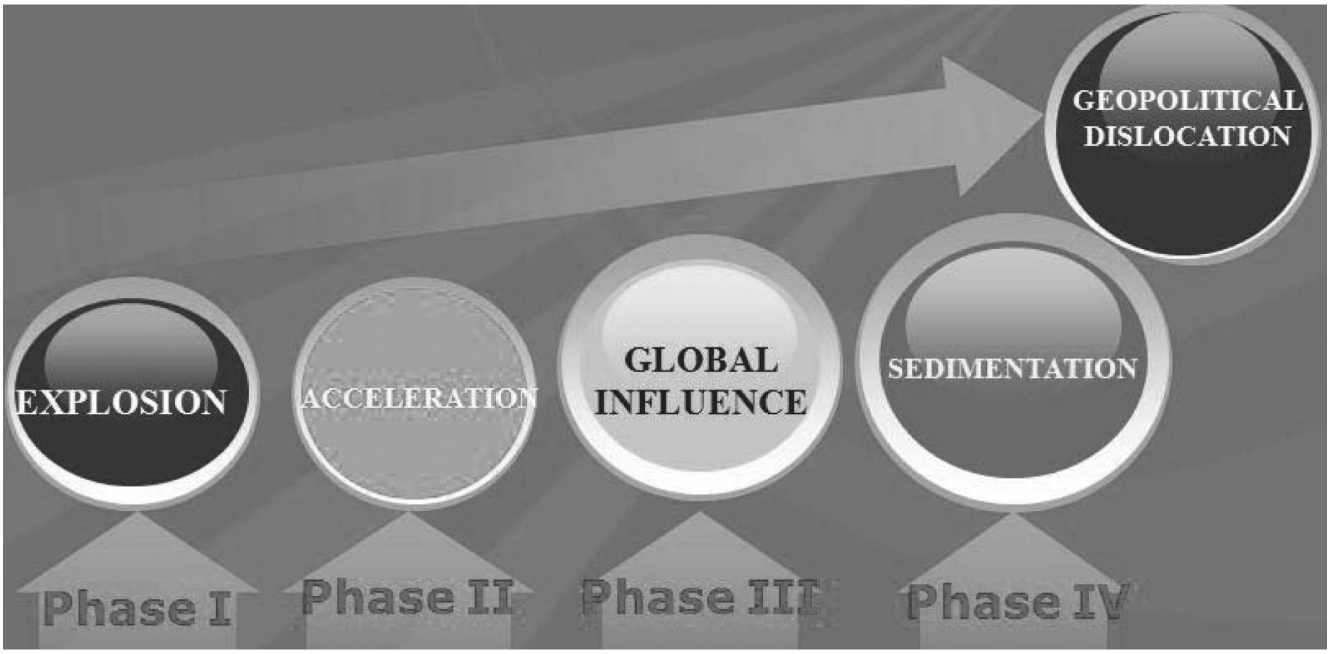
We focus our attention here on the ten CEE new member states, which entered the EU in the past two enlargement rounds (with some additional references to Ukraine, which serves as an illustration of how bad the crisis may get). The contagion was generated by the US sub-prime mortgage market and transmitted by various opaque financial instruments around the globe.

The main effect was "toxic assets", which represent huge losses in the books of financial institutions. This turned the previously abundant liquidity into a credit crunch, paralyzing the global banking system.

The contagion engulfed the European banking system and the dramatic effects of the financial crisis on the European economy surprised everybody.

It had first been thought that the new member states would not be affected by the spreading financial turmoil, as their financial institutions were not involved in the opaque financial transactions conducted by most Western banks. Figure 4 shows the evolution of the global crisis and its four main phases.

Figure 4 Main phases of crisis evolution



According to an ILO Analysis, the Crisis was "spread throughout the real economy by means of three mutually-reinforcing transmission channels, namely:

- the limited availability of credit for working capital, trade finance and viable investments in the real economy (the credit crunch);
- cautious spending decisions, leading to lower output, employment and prices; due to this, consumer confidence and investor confidence were affected (the vicious cycle of depression);
- international trade and investment linkages and remittance flows (the globalization channel)."

Proliferation of the crisis from its source to the periphery of the global economy was simultaneous in all directions. An analysis by the ETUI describes this process (Glassner and Galgóczi, 2009):

"The contagion has engulfed the European banking system and the dramatic effects of the financial crisis on the European economy have surprised everybody. The European financial system provided fertile soil for these opaque financial instruments, as accumulated profits desperately sought higher returns than investments in the real economy could offer. As late as the Lehman Brothers bankruptcy in mid-September 2008, the effects of the US crisis on Europe were still seen as moderate.

The basic mechanism by means of which the financial and banking crisis has hit the real economy is the failure of the banks – due to their financial losses and the evaporation of trust – to perform their basic function of financing the economy. Enterprises are unable to finance their daily operations, investments are blocked and consumption has collapsed in market segments in which credit financing had played an important role (construction in the US and in a number of European countries, automobiles generally in the US and Europe)."

2.2. The first wave: focus on the EU employment situation

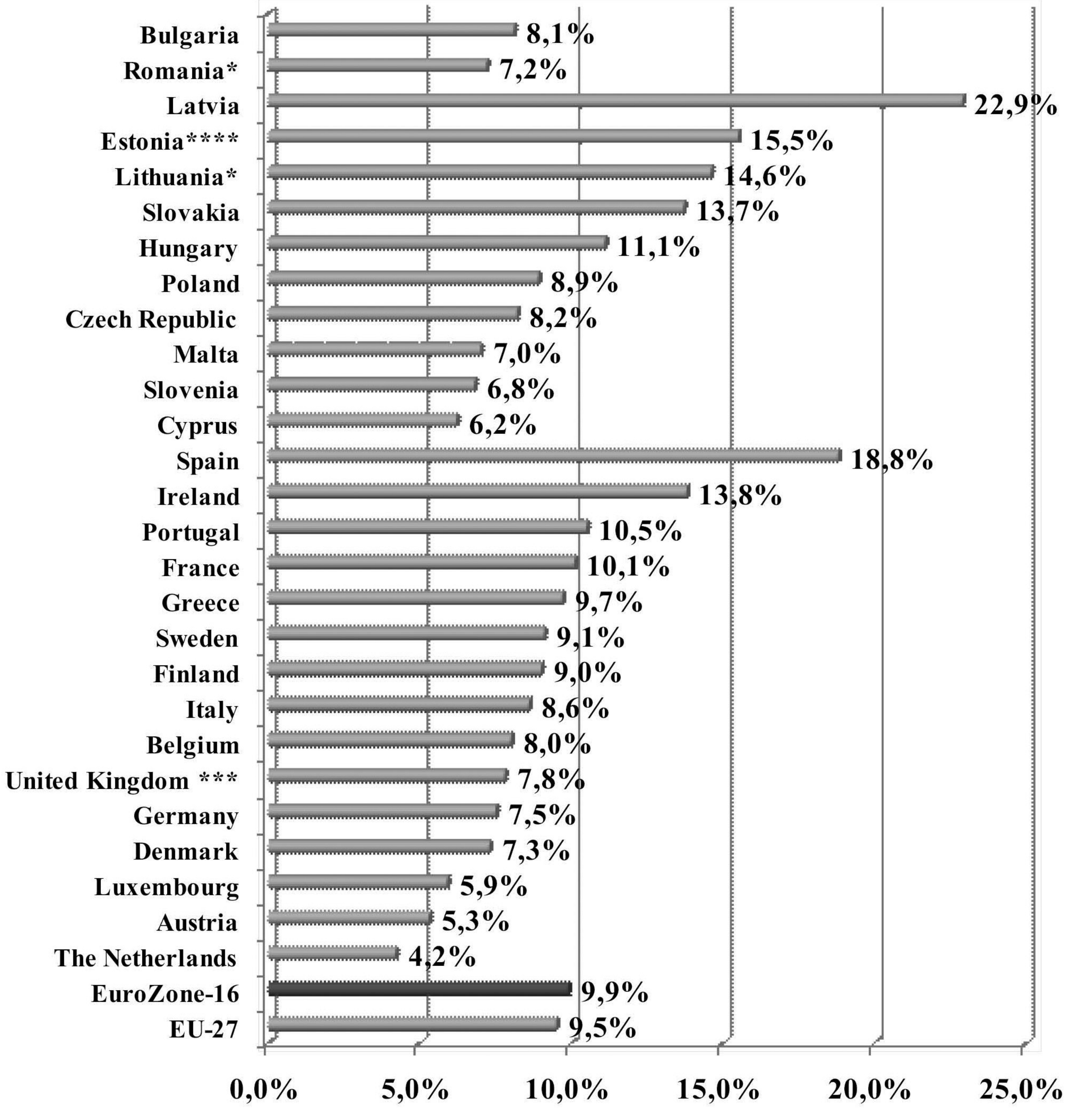
Being active on the labour market is generally seen as the most important element in the social integration of individuals in society. Moreover, nowadays, not only consumers, but also workers have more spending power and thus contribute to the economy. As tax payers, they also contribute to the state budget and the social security system. In this context, as it is well known, the EU has set as objectives, with the aim of preserving the European Social Model (Lisbon 2000, Stockholm 2001) a labour market participation rate for the population aged 15–64 of 70%, as well as targets of 60% for females and 50% for those aged 55–64, to be achieved in 2010.

In the pre-crisis period (2000–08), steady growth in employment occurred in most European countries. The EU-15 saw its employment rate for the 15–64 age group increase in that period from 63.4% to 67.3%, while for the EU-27 these figures are, respectively, 62.2% and 65.9%. It is difficult to imagine that the target of 70% will be reached in 2010; in other words, that the 3 to 4% gap can be bridged in the two years that separate us from 2010, when in the previous eight years a comparable increase of only 3 to 4% could be achieved. And this is without taking into account the negative effects on the labour market that started to appear only in 2009.

Unemployment: a temporary affliction

The unemployment figures are telling in this respect: from 2000 to 2007 the unemployment rate decreased (reflecting the increase in employment) from 7.7 to 7.0% for the EU-15 and from 8.6 to 7.1% for the EU-27. These figures in August 2009, however, showing a clear reversal of the trend, were respectively 9.3% and 9.1%. Some particular cases may be noted. France, for example, had an unemployment rate of 10.1% in January 2010, but even this compares favourably with that of Spain, which is 18.8%. The country worst affected by the crisis is Latvia, where unemployment stood at 22.9% in January 2010. The only notable exception (which we will explain later) is the Netherlands, with an astonishing 4.2% (see Figure 5).

Figure 5 Unemployment in the EU, by country, January 2010



(*) Q3/2009; (**) Dec/2009; (***) Nov/2009; (****) Q4/2009
Source: Eurostat

Looking at these employment figures is interesting, of course, but equally instructive are the full-time-equivalent employment rates (FTEs).

Flexibility processes and changes in work organization have led to an increase in "atypical" work forms (part-time and fixed-term labour contracts). If we look at these indicators we have to conclude that the increase in employment rates (of 3 to 4%, as documented above) look less impressive. For the period 2000 to 2007, the increase in FTE employment rates was only around 2 percentage points, meaning that many full-time jobs have been made part-time or fixed-term and/or that, to a considerable extent, the increase in employment must be imputed to newly created atypical work forms. In particular, part-time work is on the rise: up from 17.7% to 20.9% in the period 2000–07 for the EU-15 and from 16.2% to 18.2% for the EU-27.

In general, in the EU-15 more than 35% of workers now have a part-time or fixed-term labour contract (compared to 24.1% in 1990). The Netherlands is clearly the European champion with regard to this type of flexibility: in 2007, 65% of all workers had such contracts. The figures are most striking for women: of the female population active on the labour market (some 70% of the age group 15–64) no less than 95% work under a part-time or fixed-term contract, compared to 40% for men. It is precisely in this context that the Netherlands manages to have the highest employment rate in the EU, at 77.2% in 2008, but with an FTE rate of only 58.6% in 2007, which is lower than the 60.2% for the EU-15 in 2007. At the same time, the composition and flexibility of the labour market explain the low level of unemployment in the Netherlands mentioned above. In order to understand this drift towards ever increasing flexibility, it is important to examine European labour market policy that, recently, adopted “flexicurity” as a central concept.

After flexicurity

Soon after the formulation of the Lisbon labour market participation objectives, enumerated above, it became clear that they would be difficult to realise. Indeed, looking at the employment rates for the starting year of 2000, it is clear that the meagre increase of 0.4% (from 62.2 to 62.6% for the period 2000 to 2003 for the EU-27) is totally insufficient if 70% is to be attained in 2010 (Appendix 2).

The notion of flexicurity, after its recent “discovery” by EU policy-makers – having been applied in Denmark for more than 20 years, but within a totally different policy environment – is now at the centre of EU labour market thinking. However, so far the results have not been positive and may certainly not reverse the trend we have observed in recent decades: more labour market flexibility, but less (social) security. If we look at one element of labour market flexibility – part-time and fixed-term contracts replacing full-time jobs, as discussed above – we see that these “atypical” contracts increased in the EU-15, from 27.8% to 35.7% from 1995 to 2007.

2.3. Repercussions of the crisis for EMEs

In the past few years it has been taken for granted that there would be a convergence of CEE economies and candidate countries with the standards and realities of developed Western Europe. In the past decade, average growth rates in these states have varied, typically between 4% and 5%. Slovakia and the Baltic states attained growth dynamics of up to 10% in some years. Productivity soared and national currencies (those not pegged to the euro) experienced real appreciation.

The dramatic effects of the crisis in the CEE/SEE regions now call into question the sustainability of this economic and social convergence process. Some of the CEE new member states have been particularly hard hit. The most dramatic downturn is foreseen in Latvia, where GDP growth of above 10% in 2007 is likely to turn into a decrease of 18% in 2009 (Table 2).

Table 2 Real GDP growth of EU states, 2008–09

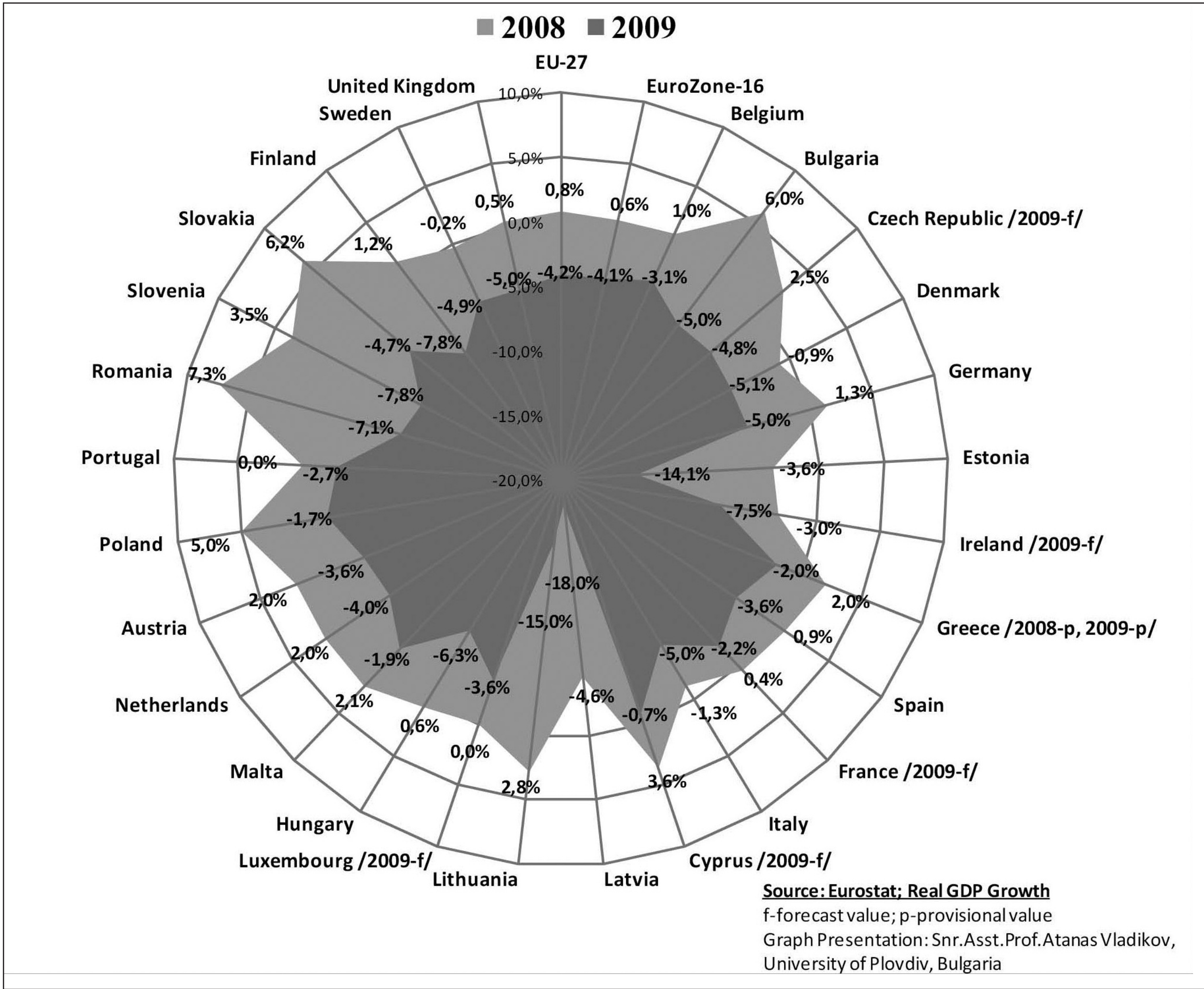
Country	Code	2008	2009
EU-27	EU27	0,8%	–4,2%
EuroZone-16	EA16	0,6%	–4,1%
Belgium	BE	1,0%	–3,1%
Bulgária	BG	6,0%	–5,0%
Czech Republic (2009-f)	CZ	2,5%	–4,8%
Denmark	DK	–0,9%	–5,8%
Germany	DE	1,3%	–5,0%
Estonia	EE	–3,6%	–14,1%
Ireland (2009-f)	IR	–3,0%	–7,5%
Greece (2008-p, 2009-p)	EL	2,0%	–2,0%
Spain	ES	0,9%	–3,6%
France (2009-f)	FR	0,4%	–2,2%
Italy	IT	–1,3%	–5,0%
Cyprus (2009-f)	CY	3,6%	0,7%
Latvia	LV	–4,6%	–18,0%
Lithuania	LT	2,8%	–15,0%
Luxembourg (2009-f)	LU	0,0%	–3,6%
Hungary	HU	0,6%	–6,3%
Malta	MT	2,1%	–1,9%
Netherlands	NL	2,0%	–4,0%
Austria	AT	2,0%	–3,6%
Poland	PL	5,0%	–1,7%
Portugal	PT	0,0%	–2,7%
Romania	RO	7,3%	–7,1%
Slovenia	SI	3,5%	–7,8%
Slovakia	SK	6,2%	–4,7%
Finland	FI	1,2%	–7,8%
Sweden	SE	–0,2%	–4,9%
United Kingdom	UK	0,5%	–5,0%

Source: Eurostat; f-forecast value; p-provisional value

The data from Table 2 may also be presented on a radar graph (Figure 6), where the outer area (coloured blue) presents the real economic growth of EU states in 2008 (per cent). It is clear that individual economies, and all economies together, shrank to the inner area (coloured red) in 2009. This figure is reminiscent of the “melting snow cap” of the South Pole and serves as economic proof of decreased economic activities in the EU, and diminished growth – the exact contrast of what was planned in the Lisbon Agenda.

Economic growth for all EU states is diminishing and thus bringing them to a situation of looming economic implosion.

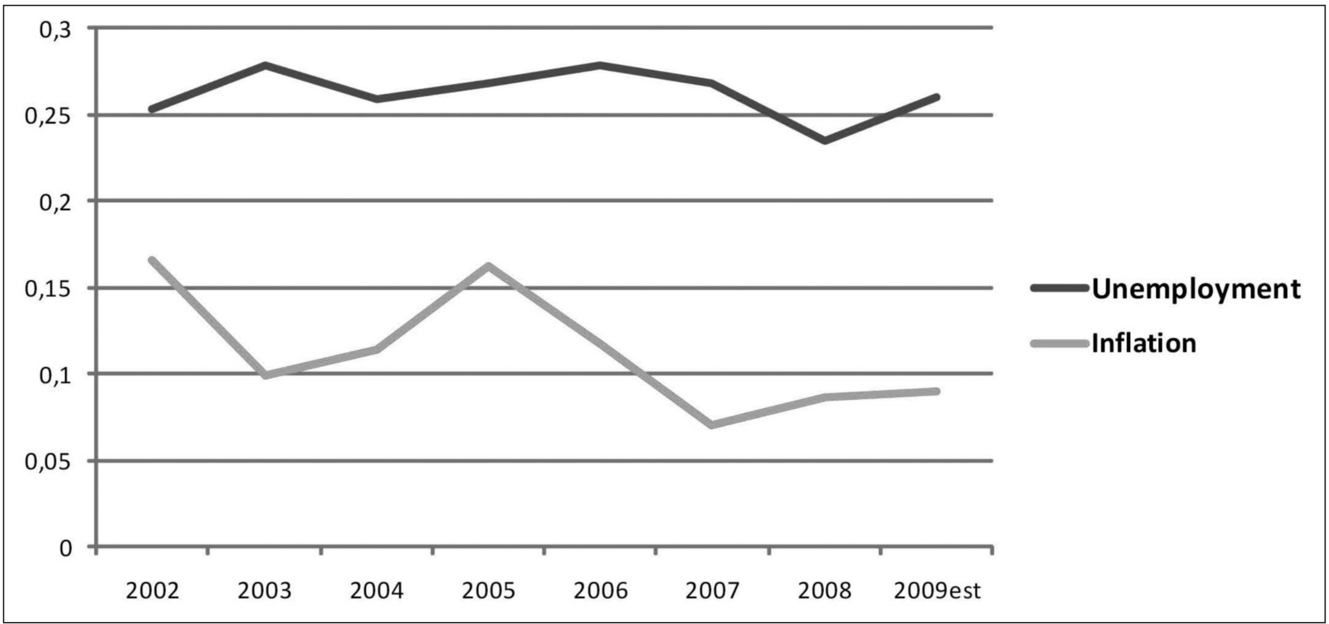
Figure 6 Real annual GDP growth of EU states, 2008–09



Previous high-growth economies, such as Estonia and Lithuania, are also expected to suffer, having registered GDP growth in 2009 of (–14.1%) and (–15%), respectively.

Employment creation had been very weak in Central and Eastern Europe (CEE), even in the boom years, as illustrated in Figure 7. Both the USA and the EU-15 experienced higher employment increases, with a fraction of the growth found in the new member states. Now jobs are disappearing on a massive scale.

Figure 7 Unemployment and real GDP growth, EU-15



Source: Eurostat

Unemployment in Latvia, Lithuania and Estonia has doubled within one year, jumping to over 12% in Latvia and to nearly 10% in Lithuania and Estonia by early 2009.

The unemployment rate in Hungary and Slovakia did not show such dramatic changes but the levels were already close to 10%.

Vulnerability of CEE economies

The underlying reasons for these severe effects in the CEE region are rooted in their economic and financial vulnerability – the most important features of which will be addressed in the following sections.

With the continuing paucity of domestic capital, ‘catching-up economies’ have been notoriously reliant on external capital throughout the whole transformation process. This includes Foreign Direct Investment (FDIs), financial investment (in state bonds and diverse corporate assets), foreign bank and government loans and EU transfers. This high external financing requirement made these countries dependent on the availability of investment capital and high risk-taking attitudes of investors. Current account deficits in most CEE countries have been notoriously high and in some cases this was accompanied by high external debt levels.

In a number of countries, consumption was largely financed by loans, while especially those states with a pegged currency witnessed high price and wage inflation, together with rising asset (especially house) prices.

Although government debt (which was previously the focus of attention) is substantially lower for most CEE countries than is usually the case for developed economies, the massive increase in company and household debt in the recent period drove their total external debt upwards. As a result, financial markets in the CEE region and the Western Balkans came under huge pressure and daily debt financing suddenly became difficult. National currencies were shaken, with devaluations of up to 50% in the case of the Ukrainian hrivnia, while the Polish zloty, Hungarian forint, Czech koruna and Romanian lei also suffered setbacks of up to 20–25%.

Credit ratings of state bonds were downgraded and country risk indicators deteriorated sharply, resulting in high interest rate margins, making debt financing difficult or, in certain cases, impossible. The default risk of state bonds is indicated by credit default swap spreads (CDS – Table 3) which express the probability of state insolvency: in the case of Ukraine, this was estimated at 39% and in the case of Latvia as imminent.

Table 3 Financial indicators, CEE countries

Country	5-year CDS	S&Credit rating
Bulgaria	617	A
Czech Republic	309	AA
Estonia	700	AA
Hungary	574	A
Latvia	1,001	BBB
Lithuania	833	A+
Poland	387	A+
Romania	719	BBB+
Slovakia	222	AAA
Slovenia	206	AAA
Ukraine	3,899	CCC+

Sources: The Economist, 28 February 2009, based on data from the IMF, Moody's and The Financial Times, as well as on Thomson Datastream, 27 February 2009.

The state bonds of Latvia, Romania, Serbia and Ukraine, meanwhile, have been rated as "junk bonds" (a rating of "B" or under). These developments triggered further devaluations of regional currencies (not only those of the affected countries), instigating a vicious circle and contagion across the region.

Role of Western banks

Over 80% of the banks of Central and Eastern European countries are affiliates of Western banks. These banks were eager to grant credits on a massive scale to the population and to enterprises in all countries of the region, often denominated in foreign currency (especially in countries where interest rates in the local currency were substantially higher).

According to a study by the Centre for European Policy Studies (Gros, 2009), residential mortgage debt in the so-called Visegrad Four (V4) countries – the Czech Republic, Hungary, Poland and Slovakia

– ranges between 11.7% of GDP in Poland and 15.3% in the Czech Republic, while levels in the Baltic states are over 30% (Latvia 33.7% and Estonia 36.3%).

Western banks made extraordinary profits in the region, with profit levels more than twice as high as in their home countries, and were expecting continued expansion in the region, even when the financial crisis was already around the corner. An analysis by the Deutsche Bank (Mühlberger, 2007), dated December 2007, foresaw huge growth prospects for the Central and East European banking sector, with an average credit expansion of 23% a year until 2011 (and even more dynamic credit expansion in SEE countries).

It also pointed to the underdeveloped nature of these banking systems, measured by the low levels of aggregated credit volumes (85%) compared to GDP, considering the usual levels in Western Europe (for the Eurozone: 230%).

The current situation is that, as a result of falling GDP, rising unemployment and weaker national currencies, the share of non-performing loans is rising and credit placements to CEE have become "toxic assets" for Western banks. Austrian banks have outstanding credits at their branch offices in Eastern Europe equalling 80% of Austrian GDP. Eastern borrowers must repay USD 400 billion in debt owed to Western banks during 2009.

Western headquarters (themselves in trouble) were reluctant to bail out their Eastern affiliates and even to continue lending. Emerging Europe has thus been hit hard by global deleveraging and frozen cross-border bank lending.

The impact has flowed through the same financial linkages with mature markets which previously allowed the region to build up a high degree of leverage through rapid foreign-financed credit growth. Cross-border bank funding is now being disrupted as the banking crisis in Western Europe intensifies.

Growth in credit to the private sector is falling rapidly, intensifying the vicious circle between output declines and deteriorating asset quality (IMF 2009). With household debt in several new member states (such as Hungary and Romania, Serbia and Ukraine, for example) largely denominated in foreign currency, as a consequence of currency devaluations of 20–25%, families face debt servicing up to 25% higher than originally planned.

According to a recent poll by Nielsen Research (Napi, 2009), 40% of Hungarian adults have a bank loan, mostly denominated in foreign currency.

In April 2009, 49% thought it would require serious efforts to repay their debt, while 11% thought they might be unable to do so. This is no longer just a problem of financial stability, but a burning social issue.

Economic and trade integration with the West

In a large part of the region, growth and modernization were mostly driven by Foreign Direct Investments. Levels of FDIs reached nearly 100% of GDP in certain CEE countries (for example, Estonia, Hungary and the Czech Republic), while almost all have FDIs worth over 50% of GDP. According to recent estimates by the Institute of International Finance, FDIs flows to the region are likely to be reduced from USD 393 billion in 2007 to around USD 220 billion in 2009.

Although FDIs were, on the one hand, an indispensable modernization lever, they led most countries to economic dependency, with strategic decisions being made at Western company headquarters and profit repatriation practices which had a negative impact on current account balances.

This factor adds to their vulnerability under stormy conditions. Moreover, NMS economies are integrated with the European and the world economy to a greater extent than most EU-15 economies and as such are highly dependent on external demand.

It had not been previously thought that the particular pattern of economic and trade integration with Western Europe – which relies to a great extent on manufacturing – might become a risk factor.

High dependence on the export of intermediary manufacturing products to Western Europe and other developed economies is, in particular, the major factor currently depressing growth prospects. The NMS from Central and Eastern Europe, and specifically the so-called Visegrad Four countries, are particularly exposed to the breakdown of demand from the West, particularly from Germany. The large automobile production capacities established in the Visegrad countries are highly dependent on the economic cycle, but also on their parent companies in Western Europe (in a few cases in Japan, Korea or the USA).

External debt – including enterprise and household debt – has reached high levels in the most recent period in most CEE and SEE countries. The current account balances for 2008 and for 2009 also indicate a high external borrowing requirement (for more on current account deficits in the region, see Shelburne, 2008).

After the shockwaves of the credit crunch and the bankruptcies in the US and Western European financial systems, investors' confidence and appetite for risk suddenly evaporated. With growing risk aversion, foreign investors turned their backs on emerging market assets (including government securities) and retreated to their domestic markets.

According to the Bank for International Settlements (BIS), US investors alone repatriated USD 750 billion in the last three quarters of 2008 (Financial Times, 2009a). BIS data also reveal that cross-border lending by banks shrank by USD 4,800 billion in the first nine months of 2008.

According to the IMF, the retreat from cross-border exposure is occurring more rapidly than the overall deleveraging process (Financial Times, 2009b).

The financing needs of the stimulus packages of G7 economies might also add to the diversion of money flows from CEE financial markets, as the amount of state bond issues in the G7 economies is estimated to grow from USD 1000 billion in 2008 to USD 3000 billion in 2009.

The components industry (an important part of manufacturing, not only in V4 countries and Romania, but also in the Baltic States), and especially contract manufacturers, are even more exposed to economic cycles.

As these industries constitute a large part of the reshaped industrial landscape in the new member states, they are vulnerable to external shocks.

Developments in Germany are crucially important for the CEE new member states, as most industrial investments and most of their industrial exports involve Germany. The severe downturn in Germany, estimated by the latest forecast at –6% for 2009, is having a dramatic effect on most new member states. The dependency also appears at the micro-level, as a large part of CEE economies are dominated by foreign multinational enterprises, with strategic decisions being made at the Western company headquarters.

The new member state affiliates of Western multinationals have adopted plant-level adjustment measures similar to those applied by their Western European parent companies, but with a heavier hand and less based on negotiations with social partners.

The plant-level effects of the crisis in Central and Eastern Europe are also harder than in the West, as fewer instruments to cushion the shock – in terms of labour market policy and collective bargaining –

exist. Only Hungary and Bulgaria have hastily adopted a specific labour market policy measure, with public support, to shorten working time along the lines of schemes existing in a number of EU-15 countries. Poland followed with a similar solution in July 2009.

The majority of Central and Eastern European countries have corresponding measures in effect or at the planning stage (for more on plant level effects, see Glassner and Galgóczi, 2009).

2.4. Crisis impacts on the Serbian economy

The global financial and economic crisis has seriously affected Serbia, although with more than a year's delay. Serbia shares some of the common features of other Central and Southeast European countries that have also been very badly hit by the global economic crisis (Uvalic, 2009a). Although Serbia is not yet a member of the EU, its economy has become highly integrated with the EU economy through trade, FDI, financial flows and the banking system, today predominantly owned by large EU banks.

In recent years, the Serbian economy has relied heavily on the availability of foreign financial resources to cover its large current account deficit, which was one of the highest in the region in late 2008. As already mentioned, since 2001, Serbia has received substantial FDI, portfolio investment and emigrants' remittances. During the past three to four years, subsidiaries of Western banks have also extended an enormous amount of loans to local clients, especially to households. With the present credit crunch in their countries of origin, these banks were no longer able to continue extending similar amounts of capital to their local clients. The high level of transactions in euros and foreign debt liabilities has put a strain on the national currency (dinar).

In addition to financial problems due to declining inflows of capital from abroad, the trade shock – the very sharp fall in export demand due to the recession in the EU, Serbia's main trading partner – has had a very strong impact on the Serbian economy.

Forecasts for 2009 indicate a substantial reduction in all forms of private capital inflows to Eastern Europe and more limited access to external finance. One of the major drivers of growth in Eastern Europe, also in Serbia, has been FDI inflows.

Overall, FDI declined by 17% in 2008, to USD 1.73 trillion, from USD 2.09 trillion in 2007, the high point of a four-year long boom in cross-border mergers and acquisitions and FDI. In 2009, global FDI inflows were forecast to plunge by 44%, to below USD 1 trillion. The big drop in 2009 occurred despite the improvements in the global economy in recent months. However, according to the most recent forecasts, emerging markets are set to attract more FDI inflows than the developed world in 2009, which was not the case in previous years (Kekic, 2009).

The global financial and economic crisis was felt in Serbia in the second half of 2008, when there was a deterioration in most macroeconomic indicators. By late 2008, there was a strong decline in domestic demand, a reduction in both public and private consumption and a strong reduction in exports.

Box 2 Serbian economy in brief, 2008–09

Although real GDP growth for the whole of 2008 was 5.4%, this represented a notable slowdown with regard to 2007 and was due mainly to high growth rates in the earlier part of the year. In the second half of 2008, there was a slowdown in all economic sectors except agriculture.

Industrial production during August–December 2008 declined by 3.4%, particularly manufacturing industry, which contributes about 95% of Serbian exports. In the first quarter of 2009, the physical volume of industrial production declined by –16.9%, retail trade by –11.7%, tourism by –6%, exports by –23.8%, imports by –25.7% and the total number of employed by –0.6%. The decline in industrial production was particularly severe during the first five months of 2009, but the decline stopped in June–July 2009, so the cumulative year-on-year decrease after seven months of 2009 was 17% (World Bank, 2009).

At branch level, an increase was recorded in base metal production, after the improvement of the situation in US Steel and the production of motor vehicles and machinery, owing to the programme of government aid to companies through subsidized loans. The unchanged poor situation in important branches – such as the production of chemicals, rubber and plastic – shows that the recovery of the Serbian industry will depend decisively on export demand.

In June 2009, the Ministry of Finance forecast for 2009 a real GDP growth rate of –2% and an inflation rate of 8.9%.

Exports were expected to drop by –20% and imports by –22.5%, leading to a decline in the current account deficit to around 13.5% of GDP in 2009. A decline in 2009 was also forecast in investment, by some –12.5%, as well as in average wages, by –4% (Ministry of Finance, June 2009).

However, since in the meantime the situation has deteriorated further, there have been major revisions in forecasts. Whereas in May 2009, the IMF estimated for 2009 a –2 percent fall in GDP in Serbia, the latest projections by the IMF, the EBRD (15 October) and the Economist Intelligence Unit point to a –4% decline in 2009 and a stronger reduction in the current account deficit to 7% of GDP (compared to 13% of GDP, forecast some months earlier). A modest economic recovery is expected in 2010, with GDP growing by 1–1.5% (IMF, September 2009). Projections for subsequent years show a slow recovery, with growth increasing to 3% in 2011.

If Serbian's macroeconomic indicators in 2009–10 are compared to those of other Western Balkan countries, it will be observed that the GDP slowdown in Serbia in 2009 will be somewhat less severe than the average in the Balkans, although similar growth rates are forecast for 2010. Serbia's inflation will be somewhat higher during 2009–10 than the average in the Western Balkans, but this is understandable, considering the relatively high inflation rates in Serbia in recent years in comparison to the other countries. Serbia's current account deficit will fall quite substantially, to below 7% of GDP in 2010, in line with the average in the Western Balkans.

Due to the economic crisis, by late 2008 Serbia's overall financial and economic conditions had deteriorated substantially. Output, all components of domestic demand, foreign trade and fiscal revenues were lagging significantly behind initial projections. However, the economic crisis did not have a significant impact on average wages in the first eight months of 2009: the average wage in Serbia for January–August 2009, in comparison to the average wage during the same period in 2008, was nominally higher, by 10.5%, and in real terms, by 1.7%.

During 2009, the dinar depreciated somewhat in nominal terms, but by autumn the situation had stabilized. The NBS' (National Bank of Serbia) overall foreign exchange reserves, which reached a peak at the end of 2007 of over USD 16 billion, declined somewhat, falling to below USD 13 billion by the end of 2008, but they recovered and were again over USD 15.6 billion at the end of September 2009 (www.nbs.rs).

The abrupt slowing of net capital inflows opened up sizable external financing gaps in 2009–11, estimated at about €3.5 billion (11.5% of GDP), despite the projected rapid narrowing of the large current account deficit (IMF, May 2009). This is why the arrangements agreed with the IMF have been of fundamental importance for Serbia.

Part III. Policy responses and exit strategies

Two important lessons

In the developed countries, crisis management relied upon some lessons from previous crises, mostly drawn from the Great Depression in the 1930s and the Japanese stagnation (the "lost decade") which started at the beginning of the 1990s.

Lesson One: The continuance and depth of the crisis are determined not only by the performance of objective elemental economic forces, but also by the subjective attitudes reflected in national crisis management.

- The Great Depression turned into a continuous and deep crisis as a result of the wrong anti-crisis measures taken by the administration of President Herbert Hoover.
- Getting out of the Great Depression was achieved under the leadership of President Roosevelt. His success was due to the fact that he concluded a "new deal" with the US public. As a result, the whole country took part in the campaign to get out of the crisis.
- The crisis in Japan, which started at the beginning of the 1990s, turned into a "lost decade" (a decade without growth) as a result of the wrong diagnosis of the crisis by the ruling politicians, from which followed the wrong anti-crisis measures. The positive lesson of this crisis was the clearer diagnosis of such crises.

Lesson Two (particularly relevant for emerging market economies): Since market-related tools and private initiatives do not generate sufficient demand, liquidity and lending, the state must assume this function for some time to come. The state must become a customer (creditor) of last resort until the operation of normal economic mechanisms is resumed.

3.1. Strategies of the international organizations

The ILO Global Jobs Pact

The Global Jobs Pact (GJP) is a framework for the period ahead and a resource of practical policies for international institutions, governments, workers and employers. It consists of five parts:

– promoting decent work in response to the crisis;
– principles for promoting recovery and development;
– adequate labour market responses, consisting of:
  - accelerating employment creation, recovery of employment and sustainable enterprises;
  - building up social protection systems;
  - strengthening compliance with international labour standards;
  - social dialogue: collective bargaining, identifying priorities, stimulating action;

– the way forward: shaping a fair and sustainable globalization;
– ILO action.

The Global Jobs Pact engages actors in the real economy – tripartite representation of the World of Work in the ILO – in order to:

– avoid “one-size-fits-all” solutions, while stimulating global action;
– focus on the likelihood that the recovery of employment will be slower than “economic” recovery;
– support policy-making: can policy-making speed up the recovery of labour markets and protect the vulnerable from permanent damage?

Box 3. Principles of the GJP for promoting recovery and development

(1) Devoting priority attention to maintaining and increasing employment through sustainable enterprises, quality public services and building adequate social protection for all as part of ongoing international and national action to aid recovery and development. Measures should be implemented quickly and in a coordinated manner.

(2) Enhancing support for vulnerable women and men hit hard by the crisis, including young people at risk, those on low wages, the low skilled, those working in the informal economy and migrant workers.

(3) Focusing on measures to maintain employment and facilitate transitions from one job to another, as well as to support access to the labour market for those without a job.

(4) Establishing or strengthening effective public employment services and other labour market institutions.

(5) Increasing equal access and opportunities for skills development, quality training and education to prepare for recovery.

(6) Avoiding protectionist solutions, as well as the damaging consequences of deflationary wage spirals and worsening working conditions.

(7) Promoting core labour standards and other international labour standards that support the economic and employment recovery and reduce gender inequality.

(8) Engaging in social dialogue, such as tripartism and collective bargaining, as constructive processes to maximize the adjustment of crisis responses to the needs of the real economy.

(9) Ensuring that short-term actions are consistent with economic, social and environmental sustainability.

(10) Ensuring synergies between the state and the market and effective and efficient regulation of market economies, including a legal and regulatory environment which promotes enterprise creation, sustainable enterprises and employment generation across sectors.

(11) The ILO engaging with other international agencies, international financial institutions and developed countries to strengthen policy coherence and to deepen development assistance and support for the least developed, developing and transition countries with restricted fiscal and policy space to respond to the crisis.

Positions of the ITUC, the ETUC and the GUF

The ITUC and other international and European trade union organizations are among those which have provided systematic and productive criticism of the global policy of deregulating financial markets, obvious imbalances in national economies (especially in the developing countries and transition economies) and the great distance between the financial sector and real economy. This criticism constituted the first warning that sustainable employment and decent jobs would be seriously affected.

Warnings issued by trade unions and NGOs were not heeded, however. The force with which the crisis hit national economies was almost immeasurable. This is why the current anti-crisis plans are focusing not only on damage limitation, but also supporting industries for the sake of preserving sustainable economic growth and employment.

To meet the challenges of the crisis, the ITUC and other international trade union organizations have initiated a series of proactive responses:

– campaigning, conferences, coordinated actions and so on;
– publication of analyses;
– online dissemination of views;

– participation in international forums;
– national and branch strategies;
– social dialogue.

Of particular importance and to be recommended to decision-makers is the position of the ITUC on the global crisis. The ITUC/TUAC released a special report, entitled "Evaluation of the 3rd G20 Summit (Pittsburgh, 24–26/09)".

Box 4. Trade union evaluation of Pittsburgh Forum: main points

1. The ITUC stresses the reinforcement of the IMF's role in tackling the crisis, despite its underlying conservative positions, including the imposition of "pro-cyclical" policies.
2. There is a positive note, referred to for the first time in a G20 statement (No. 13), according to which there must be household consumer protection against predatory lending.
3. No measures are considered to shield workers' pensions from excessive risk-taking or unregulated markets, despite the fact that pre-funded pension schemes have been hard hit by the crisis. At the same time, the ITUC insists that the activities of the G20 "remain characterized by a lack of transparency"; furthermore, " there is no explicit reference to women or young people anywhere".
4. The ILO is called upon (No. 45) "in partnership with other organizations, to convene its constituents and NGOs to develop a training strategy for our consideration". As the ILO's constituents are workers' and employers' organizations, this paragraph constitutes one of the two explicit references to trade unions in the G20 statement.
5. There is specific reference to the trade union demand for a G20 working group on employment, but the section on jobs concludes by committing the G20 to "continued focus on employment policies", to achieve which the US Labor Secretary is "to invite our Employment and Labour Ministers to meet as a group in early 2010 consulting with labour and business" – the reference to consultation with trade unions is a major advance achieved through trade union pressure up to and at Pittsburgh, and will require active follow-up to give it the fullest possible effect.
6. Unions' demand for a more diversified financial service landscape, including promotion of social finance (for example, mutual insurance schemes, cooperatives) and of public financial services, is not reflected in the statement.

To Europe and the SEE region, in particular, it is encouraging that the G20 agreed to work on an international framework for a transactions tax, to help ensure that the financial sector pays a fairer share towards economic recovery and development. The ITUC is pressing for rapid and real progress on this, as well as on the urgently needed reforms of international financial institutions' policies and structures.

With the global jobs crisis continuing to worsen, a meeting of G20 labour ministers, to take place in early 2010, will be a key focus for the global trade union movement in the coming months. The G20 labour ministers' meeting must push the maintenance and creation of decent jobs even higher up the agenda, with the implementation of the ILO Jobs Pact as a central objective.

3.2. EU and CEE/SEE responses

Policy responses from Europe addressing emerging market economies at the beginning of the crisis were neither timely nor adequate; the initiative was left, to a large extent, to the International Monetary Fund. The most dramatic and immediate effects of the crisis on CEE were due to the paralysis of financial markets and required immediate intervention. The IMF reacted and provided emergency loans for the first group of countries (see Table 4).

Table 4 IMF support, by country

			SDR –Special Drawing Rights (in millions)
Country	**IMF Stand By**	**Amount Approved**	**Amount Drawn**
Hungary	06 Nov. 2008	10,537.50	7,637.00
Ukraine	05 Nov. 2008	11,000.00	7,000.00
Iceland	19 Nov. 2008	1,400.00	665.00
Latvia	23 Dec. 2008	1,521.63	892.24
Belarus	12 Jan. 2009	2,269.52	1,831.59
Serbia	16 Jan. 2009	2,619,12	1,021.15
Romania	04 May 2009	11,443.00	8,263.00
Poland (FCL)	06 May 2009	13,690.00	0.00
BiH	08 Jul. 2009	1,014.62	182.63

Source: www.imf.org
FLC: Flexible Credit Line
Section: Data and Statistics, IMF Finances, Financial Data by Country (as of 28 Feb. 2010)

Rapid lending, but severe austerity measures

Although the decision by the G-20 to substantially increase the resources of the IMF and provide other forms of finance (such as a Flexible Credit Line) to emerging markets is an important step. At the same time, it highlights the inability of the EU to react in time and delivers over the CEE/SEE region even more to a non-EU policy influence. This cannot be seen as an excuse for the EU not to commit itself more decisively in favour of the troubled region.

Hungary and Latvia – followed by Romania – had to turn to the IMF for an emergency loan at the end of 2008 in order to fend off the immediate consequences of the financial turbulence and bottlenecks.

The conditionalities of the 7.5 billion euro IMF package for Latvia speak for themselves: a 20% cut in wages in public administration, and similar cuts in teachers' wages, pensions and health spending.

In view of the deteriorating growth prospects and the likely failure to meet the agreed 5% budget deficit target, further cuts were considered necessary to gain access to another tranche of the loan. In the case of Hungary, the 20 billion euro emergency credit package (12.5 billion euros from the IMF, 6.5 billion euros from the EU and 1 billion euros from the World Bank) included conditions to cut budget spending, including pensions and social benefits, to meet a 2.9% government deficit target.

While it is reasonable to impose conditions pertaining to sound finances on countries with a problematic fiscal record, the lack of differentiation and the rigidity of the application is threatening the objective of the whole operation. Sticking to a deficit target below 3% at times of further downward corrections of growth prospects and when most of the Eurozone is maintaining substantially higher deficit levels to cope with the immediate effects of the crisis, cannot be seen as a responsible policy.

How much support do EMEs really need?

Some initial calculations are already available, but they come mainly from external institutions. One recent attempt to satisfy national financial needs in the CEE region is illustrated in Table 5.

Table 5 Need for financing (% of GDP)

Country	GDP/capita 2008, USD PPS	Financing need, % GDP	Current account balance, % GDP 2008 2009	Export share in GDP (2008)
Bulgaria	12,372	29.4	–24 –12.9	61.0
Czech Republic	25,757	9.4	–3.5 –2.8	80.1
Extonia	20,754	20.0	–10 –6.3	72.0
Hungary	19,830	29.9	–6.5 –3.9	80.2
Latvia	17,801	24.3	–14 –6.7	46.6
Lithuania	18,855	27.1	–12 –4.8	59.0
Poland	17,560	13.2	–5 –4.9	42.3
Romania	12,698	20.2	–12 –7.5	34.4
Slovakia	22,242	12.5	–6 n.a.	90.5
Slovenia	28,894	n.a.	–6 n.a.	70.5
Ukraine	7,634	16.1	–6,5 06	45.0

Source: ETUI Policy Brief, European Economic and Employment Policy, Issue 4/2009, Béla Galgóczi, adapted from p. 3, Table 1, available at: www.etui.org/research/Media/Files/EEEPB/2009/4-2009

Are these financial forecasts realistic? And which approach should be implemented: discretionary measures or financial expansion, based on fiscal stimulus? An analysis carried out by ETUI experts contains the following findings (see Watt, 2008):

(1) The fiscal packages implemented or announced by European governments are not large enough. Given the size of the loss of output – an output gap widening by some 6–7 percentage points of GDP in 2009 – a discretionary stimulus of around 1% of GDP in the current year and, at the time of writing, provisions for some 0.6% in 2010, are too small.

(2) While longer-term sustainability and credibility is an issue in principle, it is argued that, at the prevailing debt and deficit levels in Europe, most countries should not be constrained in their attempts to run counter-cyclical policies. And where they are, the solution should lie in providing European-level fiscal support so as to remove those constraints.

Instead, countries – especially in the CEE and SEE regions – are being forced into contradictory policies that will worsen the situation there and also have negative knock-on effects throughout Europe. This negative situation requires that most governments in the two regions should consider and negotiate effective stimulatory measures. As stated in the ETUC document “The crisis: developments in Europe" (ETUC 2009): "In exchange for foreign currency loans, countries are forced to cut anything that is social: wages, social spending, workers' rights, public services. Moreover, access to the Commission's €25 billion balance of payment fund is conditional upon respecting the IMF adjustment programme. European funds are being used to help the IMF to cut the social dimension in Europe."

Other financial support schemes were also initiated outside the EU framework, including a pledge of up to 24.5 billion euros in 2009 and 2010 by the European Bank for Reconstruction and Development, the European Investment Bank and the World Bank to support banking sectors and bank lending to enterprises in emerging Europe. The reliance of the EU on the IMF is itself evidence of political weakness, an indirect admission that Europe lacks Union-wide financial institutions with the clout to deliver effective bail-outs.

Considering the IMF's record with regard to the consequences of its bail-outs in developing countries, even if the recently undergone learning process is taken into account, the conditionalities of the support pose risks to these countries' mid-term development and cannot be seen as based on values in line with the European idea. The speed-up of access to the resources of the European Social Fund was a useful measure but, given the magnitude of the crisis, cannot be regarded as any more than a symbolic gesture. The decision by the European Union to increase crisis support to non-euro members, albeit with adverse conditionalities, was welcome.

Lack of efficient European coordination of national financial support measures for parent banks to take into account the risk of introducing home bias that may stifle the timely resumption of banking inflows to their foreign subsidiaries was also a failure, with adverse effects on the CEE/SEE region, where Western banks have risky credit placements. The lack of clear rules for cross-border crisis management and burden-sharing raises uncertainty about the recapitalization of foreign-owned subsidiaries.

In relation to the abovementioned anti-crisis practices an additional challenge arises, namely a strategy for getting out of the anti-crisis measures. We should mention again the delayed reaction to the crisis in most of the CEE/SEE countries due to the dispute about whether the crisis would hurt their economies or not. Wrong diagnosis of the crisis's development was the prevailing reaction at the beginning, especially in the SEE region. The official interpretations were that (a) the crisis was imported and (b) the exit is also expected to be imported.

An important requirement of anti-crisis management in developing countries is **fixing the initial date.** It is recommended that this step be entrusted to an independent non-governmental organization. In the USA, this function is officially entrusted to the National Bureau for Economic Research (NBER). A similar approach was adopted in the European Union.

Now there is a general consensus that the massive monetary easing, fiscal stimulus and support of the financial system undertaken by governments and central banks around the world prevented the deep recession of 2008–09 from developing into the Second Great Depression. It is doubtful whether the IMF-based crisis management in the transition countries has achieved this success. Indeed, some analysts consider that the crisis in the Baltic countries has turned from recession into depression. The same applies to Ukraine. Whether the next in the list will be Romania and Hungary, and also Bulgaria, the near future will show.

Two Basic Models

The past and present experience of the developed countries can be used in the SEE economies only within certain limits. These limits are determined by the difference in the crisis management of the developed countries and the countries in transition. We can talk about two different models of crisis management:

– Model based on stimulus:
  • monetary stimulus;
  • Fiscal stimulus;
  • quantitative easing.

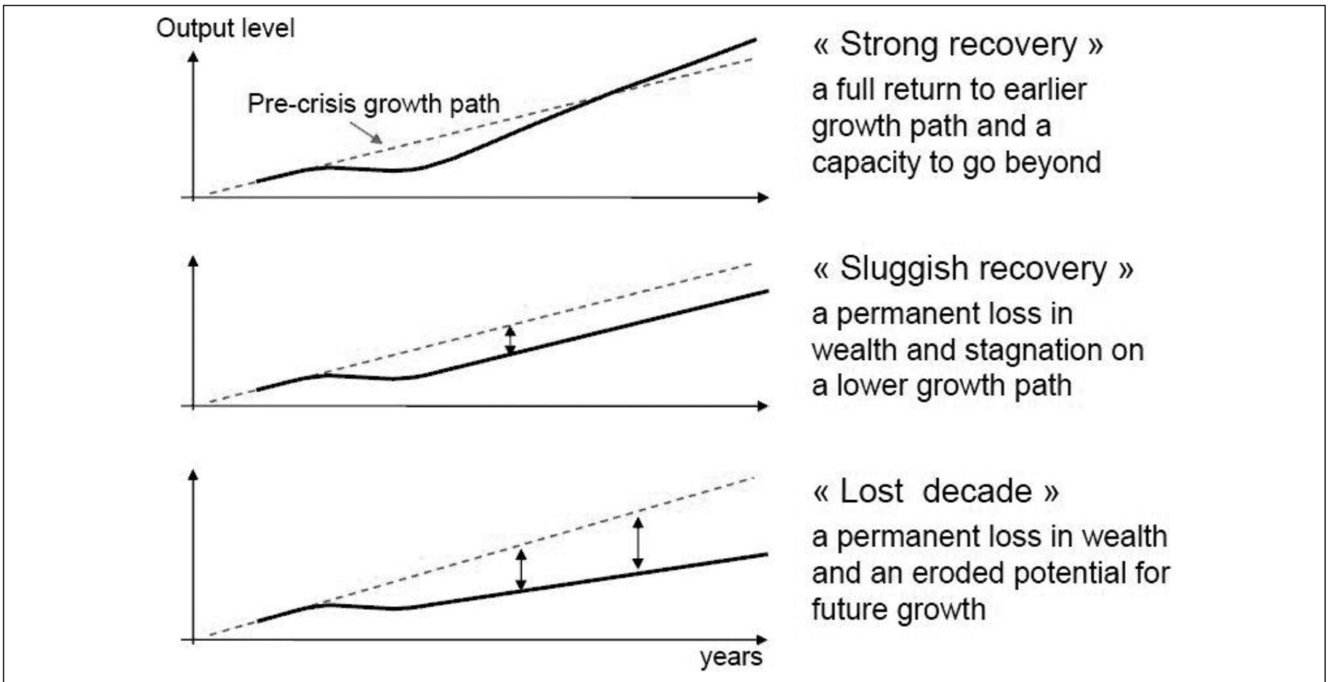
– Model based on the "new orthodoxy" of the IMF

According to an official IMF document, **in emerging market economies with debt overhangs, the "Keynesian" effect of fiscal adjustment is likely to be outweighed by "non-Keynesian" effects related to expectations and credibility.** Non-Keynesian effects have to do with the offsetting response of private saving to policy-related changes in public saving. In particular, if fiscal adjustment credibly signals improved public sector solvency, a fiscal contraction could turn out to be expansionary, as private consumption rises, based on the view that future tax hikes will be smaller than previously envisaged.

There are already signals that the EU will redefine its exit strategy through more active coordination of national action plans and new goal prioritization after the crisis. The evidence for such a new strategic approach may be seen in the Programme "Europe 2020 – A European Strategy for Smart, Sustainable and Inclusive Growth", which was presented by J.M. Barroso, President of the European Commission, to the informal European Council meeting of 11 February 2010.

He asked "where we want Europe to be in 2020" and proposed three strategic options:

Figure 8 J.M. Barroso's question: where do we want Europe to be in 2020?



Source: J.M. Barroso (2010), "Europe 2020", adapted from p. 7.

The "Europe 2020" strategy is focused on the alternatives for exiting the crisis in such a way that the exit process becomes a precondition for high economic growth and fiscal consolidation.

There are no doubts that this process will be difficult, as European states have different, even opposing views on how to combat the crisis. Coupled with the fact that the EU must face the challenges of an aging population, depletion of resources and Eurozone problems (the case of Greece and other similar examples) make concerted EU actions to exit the strategy extremely fragile.

The Barroso Programme delineates three priorities and a package of strategic policies to bring about growth, oriented towards new employment creation:

– growth based on knowledge and innovation
  • innovation
  • education
  • digital society
– an inclusive high-employment society
  • employment
  • skills
  • fighting poverty
– green growth: a competitive and sustainable economy
  • combating climate change
  • clean and efficient energy
  • competitiveness

For the new member states (NMS) of the EU, the challenges are even more complex; for the Western Balkan states, including Serbia, these challenges are immense. The delays in initiating anti-crisis strategies and the resource deficit with regard to stimulatory fiscal policies, in addition to dependency on foreign loans and increasing debts may serve as a toxic set of factors, which could bring to nought the efforts which are already under way.

We are left with the hope that the declaration in the "Europe 2020" programme that "Our futures are interlinked!" is not a mere aspiration.

3.3. Serbian approach to crisis management

First steps

The Serbian government and the National Bank of Serbia (NBS) reacted relatively early to the first signs of the global financial and economic crisis. The NBS took some preventive, countercyclical policy measures in terms of supervisory and monetary policy, offered significant foreign exchange support to banks in October and November 2008 and improved bank liquidity through a significant relaxation of NBS regulations.

Starting from late 2008, the Serbian government started preparing a stimulus package to alleviate the negative effects of the global economic crisis and asked for financial support from the International Monetary Fund and credit facilities from the EIB, KfW, the European Commission and the EBRD.

Box 5 Serbian anti-crisis package

A major stimulus package was launched in February 2009 in order to offset the sharp decrease in lending by domestic banks, as well as the lack of foreign credits and expected reduction in FDI. The government programme included subsidized loans for liquidity and investment to enable banks to support companies facing liquidity problems; subsidizing interest rates for commercial bank lending to firms and private households for the purchase of domestic durable goods; and the abolition of banks' obligatory reserves on new loans from abroad. The NBS also announced an increase in the guaranteed level of savings deposits to 50,000 euros, and the abolition of the taxes on capital gains and on foreign currency deposits (Ministry of Finance, June 2009). The stimulus programme included the bailing out of large firms, such as the Copper Mining and Smelting Complex in Bor, providing incentives for the consumption of domestic goods and increased investment in infrastructure. In late April 2009, the Serbian government adopted a new stimulus programme. The package was intended to increase overall liquidity through measures aimed at encouraging banks to give loans to enterprises at half the market interest rate; special liquidity and investment loans co-financed by banks and the government; and postponement of enterprise obligations through the rescheduling of debt, temporary debt–equity swaps and multilateral compensation.

In May 2009, additional measures were implemented: for liquidity loans with a foreign currency clause, the annual interest rate was substantially lowered (to 3%); new liquidity loans in dinars were offered at a 10.5% interest rate; the quantity of loans for exporting enterprises was doubled; and favourable consumer loans were offered for the purchase of construction materials. The package also includes measures to stimulate employment, including support for the employment of 10,000 young people, public works programmes, bank loans for young employees without the necessary guarantees and loans from the SME Fund.

Although Serbia took immediate measures to combat the crisis, it faced a serious fiscal problem, as the economic slowdown caused a substantial decline in the government's fiscal revenues. According to IMF estimates, Serbian state revenues are projected to decline by 5% in 2009 and a further 4% in 2010, and will begin to recover only in 2011.

As a short-term response to the fiscal crisis and in line with the terms agreed with the IMF, the government decided to freeze – in nominal terms – the wages of public sector employees and pensions in 2009 and 2010, and to cut public expenditure, primarily capital works and some other discretionary spending.

Over the medium term, various measures are under discussion that should lead to cuts in public expenditure, including such drastic measures as the transfer of the profits of all public enterprises to the government budget. The pension system, being the largest single programme of government expenditure, will need to be reformed. Presently, the system is based on generous benefits (the pension due to a new retiree in Serbia is equal to nearly 60% of the net average wage). The restructuring of public sector enterprises, which started only in 2006, is also a top priority on the government's agenda.

By September 2009, financial tensions in Serbia have somewhat eased. Foreign banks have largely rolled over their external exposure vis-à-vis Serbia, and the large current account deficit has been shrinking fast. With the NBS's comprehensive financial sector support programme, bank liquidity has improved. Households have begun to return deposits to banks and, as elsewhere in the region, sovereign spreads have narrowed substantially. The financial situation has also improved thanks to a **special agreement with the foreign banks operating in Serbia.** In early May 2009, the IMF sponsored the so-called "Vienna Initiative" which ensured an agreement with 31 foreign banks operating in Serbia in order to prevent the withdrawal of capital from their subsidiaries in Serbia.

Although based on the voluntary commitments of banks to maintain their exposure to Serbia and keep their subsidiaries well capitalized, this initiative was important to prevent bank withdrawals of capital from Serbia, and for obtaining IMF financial support. Despite these positive effects of the measures taken, it is reported that banks have adopted more conservative lending policies, since non-performing loans have been increasing.

Since the beginning of 2009, an increasing number of enterprises have faced financial difficulties – according to unofficial estimates, in mid-2009, some 69,850 out of 108,000 registered enterprises were facing serious problems due to lack of liquidity.

Negotiations with the IFIs

Since late 2008, the Serbian authorities have requested financial support from international financial institutions and the European Union to close the projected external financing gaps in 2009–11. The most important has been the early support offered to Serbia by the International Monetary Fund (IMF).

Box 6 Serbia's stand-by arrangement with the IMF

Serbia requested a precautionary stand-by arrangement (SBA) with the IMF as early as late 2008. In January 2009, the IMF mission and the Serbian government reached an agreement on a 15-month economic programme, supported by a 402.5 million euro precautionary SBA to strengthen its foreign exchange reserves. This arrangement was replaced by a new, 27-month SBA, whose terms were broadly agreed in March 2009. On 15 May 2009, the Executive Board of the IMF completed the first review of Serbia's performance under the SBA and increased IMF support to about 2.942 billion euros (USD 4 billion), equivalent to 560% of Serbia's quota or close to 10% of its GDP. The IMF also extended the SBA by one year, to mid-April 2011. These decisions enable the immediate release of SDR 701.55 million (about 788 million euros). The Board also granted a waiver of applicability for the end-March fiscal performance criterion. On 9 September 2009, the IMF approved a special allocation of SDR 41.7 million or 45.2 million euros to Serbia's SDR account. Significant inflows also came from loans of the European Investment Bank and the Council of Europe Development Bank (14.2 million euros) (www.nbs.rs).

The original SBA with the IMF called for an overall fiscal deficit of only 1.75% of GDP in 2009 and 1% of GDP in 2010, but these conditions have been eased in the meantime, in view of the deteriorating financial situation: the 2009 fiscal deficit target was first increased to 3% and then to 4.5% of GDP. The overall reduction of the fiscal deficit in 2009 was to be achieved largely through limits on public expenditure, the most important adjustment being the temporary suspension of pension indexation. Pension levels would reflect the two large increases granted in 2008, but would not be increased during 2009. In addition, increases in public sector wages in 2009 would be limited to the projected rate of inflation. Non-essential hiring was to be suspended. Taken together, these measures were expected to confine growth in the government's wage bill to 6%. Public enterprises and local governments were expected to follow similar restrictive wage policies. The government also committed itself to a freeze in most spending on other goods and services (in nominal terms) and reductions in agricultural subsidies, including the abolition of the per-hectare land payment to legal entities.

Existing commitments to a joint venture project with Fiat and Zastava would continue, however (expenditure amounting to around 0.5% of GDP).

The revised IMF arrangement is supporting the Serbian government's economic programme. It was agreed to raise the 2009 fiscal deficit target to 4.5% of GDP in order to avoid excessively pro-cyclical fiscal policies and adjust to lower revenues. The new SBA arrangement also calls for additional, more severe, measures, which would include a freeze on the nominal wages of government employees (including employees of public enterprises) through 2010, an extension of the nominal freeze on pensions through 2010, a freeze on hiring employees (with very limited exceptions), a reduction in transfers to local governments and sharp reductions in the discretionary budgets of all budget users. Agreement was also reached on initial steps to initiate key medium-term structural reforms of the pension, health and education systems.

Severe austerity measures

Present Serbian plans for fiscal adjustment in 2010 envisage a significant downsizing of the public administration, continuing the wage freeze in most state enterprises and imposing additional nominal freezes.

The government plans to start reducing employment in the public administration by some 10% and to eliminate redundancies in the health and education sectors, although reforms would be targeted to preserve the quality of public service provision.

The authorities would maintain the 2009 budget cuts, while introducing further nominal freezes, including for a large portion of spending on goods and services, subsidies and untargeted transfers to households. It was agreed, however, that targeted social spending on family and child allowances would remain protected. The IMF mission suggested that a VAT increase might be effective in closing the remaining fiscal gap, but this was not accepted.

It will be necessary to cut subsidies to some state enterprises that are running large quasi-fiscal deficits as a result of the economic downturn, but also because of long-standing structural problems. The IMF mission also recommended improving the framework for claims enforcement, through the blockage of delinquent borrowers' bank accounts (see IMF, 2009b).

In support of the forthcoming reforms in Serbia, the World Bank prepared a report on Serbia's public sector in mid-2009, offering a number of concrete suggestions on rationalizing public expenditure (see World Bank, 2009).

In terms of the overall fiscal impact, the most important will be reforms of the pensions system. Extending the nominal freeze in pension benefits through 2010 would yield savings equal to about 3.5% of consolidated central government expenditure.

Thereafter, the World Bank proposes to revert to inflation-only indexation in order to bring the replacement rate more in line with levels in EU countries, limit early retirement costs by reducing the number of years a worker can retire early, reduce pension benefits for such workers regardless of their years of contribution and raise the retirement age for women to match that of men.

Indeed, a new draft pension law is planned to be ready for submission to the Serbian Parliament, with key measures to include raising the retirement age for women, tightening early retirement limits and reducing the extra service credit for women.

The World Bank study (World Bank, 2009) also suggested a number of reforms that could lead to cuts in public expenditure in the health sector (such as closing or consolidating underused primary clinics, reducing staffing in hospitals and re-examining benefit packages); education (such as consolidating underenrolled primary classes among different schools in the same municipality); and social assistance (such as lower cap and shorter duration of maternity benefits, but an increase end in the MOP (Marginal Odds in Participation) and child allowances).

The MOP is an anti-poverty programme of last resort, activated only when all other social protection mechanisms are exhausted, benefiting the poor individual or household. Eligibility for MOP is determined by a means test, taking into consideration all household earnings, except those from other social benefit programmes. The MOP eligibility threshold is determined as a percentage of the average wage and adjusted for household size with a steeply declining (and same for children and adults) equivalence scale and the benefits go to poor households.

Further savings are proposed through changes in the benefits for farmers in agriculture, cuts in subsidies and loans to some loss-making firms, and more realistic budget phasing of Corridor X works, increasing toll collection efficiency, raising fuel tax and the reduction of railway staff.

Regarding the outcomes of these arrangements with the international financial organizations, there is no doubt that IMF support has been fundamental in covering Serbia's short-term external financial needs and sustaining its fiscal stimulus packages. In the short run, the Serbian government has mainly pursued the measures specified in its agreements with the IMF, also because the conditions have been eased with respect to the initial arrangement. Although some of these measures may be politically unpopular and difficult to implement, they were officially presented as “necessary”.

However, in the longer run, substantial efforts will be needed to rationalize the whole public sector, through measures aimed at reducing public expenditure and changing the structure of spending. Pensions cannot be frozen in nominal terms indefinitely, as inflation will rapidly diminish their purchasing power. A long-term freeze on salaries will make it difficult to attract and retain competent workers. The freeze on hiring in the public administration carries the risk of generating arbitrary gaps in public employment, as staff who retire are not replaced.

In addition to the announced reforms of the pensions system, the government will need to address the issue of public sector enterprises. Although a number of public enterprises are among the most important Serbian firms, some of them are incurring substantial losses, requiring continuous government subsidies.

Complementary support

In addition to financial arrangements with the IMF, the Serbian government has in the meantime also negotiated support from other international organizations. Loans to the real sector have been secured from credit lines of the EBRD, the European Investment Bank, KfW, as well as Western governments. The World Bank announced it will help Serbia’s budgetary needs in 2009 and 2010 with around USD 450 million. In mid-October 2009, the governor of the NBS warned that the outcome of the forthcoming negotiations with the IMF will be crucial for getting support for financing its budget deficit also from the European Commission (100 million euros) and the World Bank (USD 250 million).

3.4. Recovery and exit: towards more realistic forecasts

Since the summer of 2009 more realistic forecasts of crisis recovery and exit could be observed, with more modest expectations of recovery.

More recently, the influential BIS issued a warning that new, post-stimulus bubbles may emerge. And many more analysts and independent experts and institutions also raised concerns that, after the first weak symptoms of revitalization, a new economic trough may follow, the so-called “double-dip” scenario.

Two international institutions also stated their modest expectations:

- EBRD: Recovery will be slow to minimal in comparison with the large increases in GDP before the crisis, including 7% in 2007. *“It is also clear that the social costs of the global economic crisis are only likely to be felt in earnest next year, when corporate bankruptcies and unemployment will continue to rise”.*

- ILO: Employment and social protection measures taken by G20 governments since the economic crisis began will have created or saved an estimated 7 to 11 million jobs in the G20 countries this year;
  But, *the ILO forecasts that continued labour market deterioration around the world in 2009 would produce an estimated increase in global unemployment of between 39 and 61 million workers relative to 2007, which could result in global unemployment ranging from 219 to 241 million – the highest level on record.*

Part IV. Trade union strategies: challenges, responses and opportunities

Contrary to the stated objectives concerning the preservation of the European Social Model (combining "sustainable economic growth with ever-improving living and working conditions"), the Lisbon dynamic has not contributed much to improve social cohesion. In fact, by adhering to a policy that was, and still is, increasingly employer-driven, the European Commission has promoted the "regulation of deregulation".

Trade unions have, for various reasons, not been able to bring a halt to the deregulation spiral: loss of membership, an increasing lack of support from the political parties that traditionally were trade union–friendly and the difficulty maintaining a coherent approach internationally (how should trade unions at Volkswagen Germany react to the establishment of a union-free plant in the USA?) are among them.

However the current financial crisis can also serve as a lever to obtain more influence. Certainly for the new member states, where the crisis has on average hit harder than in the EU-15, a trade union agenda should be applied consistently. Based on the European Social Model, trade unions (at the European and national levels) have to challenge the governments of aspiring new member states to comply with the obligations of EU membership.

The ILO has laid down guidelines, but now is the time to forge ahead.

4.1. Social dialogue and the crisis in Serbia: trade unions under pressure

The global financial and economic crisis in Serbia has come on top of a number of economic problems which were being accumulated over the past few years, particularly stagnating employment, increasing unemployment, insufficient restructuring, unsatisfactory export performance and severe external imbalances. The economic crisis has had a significant impact on most Serbian enterprises, many of which have been affected by the decline in the availability of loans and, more generally, by the general lack of liquidity, also due to the inability of many clients to fulfil their obligations.

The government stimulus packages implemented from February 2009 onwards were indeed aimed at easing these financial problems through subsidized provision of liquidity, which has helped many enterprises in difficulties, although they have benefited primarily large enterprises.

However, the end of the emergency measures implemented by the Serbian government – such as liquidity loans to enterprises facing difficulties and subsidies to large loss-making firms – is likely to bring a number of enterprises to the verge of collapse. In July 2009 alone, proceedings were initiated to close down some 237 enterprises.

Increasing social tensions

Establishing an official position among trade unions in Serbia will be a challenge. The strong impact of the global economic crisis up to mid-2009 and the government's response (so far and in 2009–10) will undoubtedly have a number of negative social effects: a further increase in unemployment and a decline, in real terms, of wages and pensions.

Particularly with the announced reforms of the pension system, cuts in public employment, rationalization of public sector enterprises and the closure of a number of loss-making public sector firms that have still not been privatized, there is a great risk of increasing social unrest in Serbia.

As a result of increasing social tensions, an increasing number of strikes took place in 2009 – according to some estimates, from the beginning of 2009 every day workers in 25–30 enterprises were on strike. In the summer of 2009, according to estimates of the Serbian trade unions, there were more than 32,000 workers on strike – in 'Kopaonik' (Kursumlija), 'Rudnik' (Gornji Milanovac), 'PKB' (Beograd), 'Svetlost' (Belgrade), 'Eterni' (Kula), 'Ikarbus' (Zemun), 'Niskogradnja' (Cacak), 'Kopaonik' (Krusevac), and many others (see Rad – Sindikalni Poverenik, 31 August 2009). The reasons vary, from delays in paying wages and social security contributions (sometimes for more than three years), to questions related to privatization.

Bearing in mind the growing concerns and level of dissatisfaction with regard to political destabilization, social dialogue in Serbia could become a solid tool for addressing the negative outcomes of the crisis. Serbia has enough experience in promoting social partnership in the period of revitalization after the war and there has been some economic growth since 2001.

A number of advantages arise as a result of institutionalized social dialogue, which could be used for the purpose of crisis management:

- availability of a national network of negotiating groups, which has developed into an institution for consultation and the exchange of information;
- availability of initial incentives, aimed at achieving sustainable partnership.

In practice, all parties/actors in the national negotiations are already known. Taking into account the European Social Model and the experience of some transitional economies which demonstrated good results in their search for alternative policies to revitalize their economies and successfully exit the crisis – such as Slovenia, the Czech Republic and Poland – Serbia could shorten the crisis cycle and achieve economic stabilization sooner. The problem here, however, is whether the available mechanisms and tools could be used by Serbia within the framework of social dialogue and to what extent the social partners in Serbia are willing and motivated to use experts in the application of these tools and mechanisms.

Social partners' response

Although the strong impact of the global crisis was already evident in Serbia in early 2009, the social partners' position was initially somewhat vague. On 16 April 2009, members of the Socio-Economic Council (SEC) evaluated the package of government measures presented by the Prime Minister. The largest Serbian trade union – the Confederation of Autonomous Trade Unions of Serbia (SSSS) – criticized the government measures and announced that the trade union would go ahead and organize a general strike scheduled for 29 April. The representative of the trade union Independence (Nezavisnost) was somewhat less critical, supporting the most recent programme of measures, launched in March 2009, as more consistent and economically more rational, for example, by involving those on higher incomes by means of various new taxes, but he criticized the government for its lack of an exit strategy.

The President of the Union of Employers criticized the trade union methods – the choice of open protest, instead of criticism of the government's programme – and was generally supportive of the government's plan, stressing that public sector reforms have been on the agenda for years and that the plan should secure significant savings in the government budget.

There was also joint action by the social partners, in cases where their positions were the same: for example, in summer 2009, they tried to dissuade the government from increasing taxes (as proposed by the IMF). The Serbian Union of Employers, together with the two main trade unions SSSS and Nezavisnost, made an appeal to the Prime Minister on 27 July 2009 against additional taxes, stressing the enormous responsibility of the government if the economic situation and livings standards of the population deteriorated further.

One of the arguments put forward is that the government is also a major debtor, since many enterprises have carried various commissions for the government, but have not been paid. In their letter, the social partners warned of the negative effects that an increase in VAT and other taxes would have for employers and employees.

On other issues, there was no consensus among the social partners. At the meeting of the SEC in late July 2009, there was no agreement between the representative trade unions and employers' representatives on the increase in the minimum wage. The trade union proposal was to increase labour costs by 5 dinars per working hour, raising it from the present 87 to 92 dinars, taking account of the very difficult situation of many workers as a consequence of the economic crisis. However, representatives of the Serbian Union of Employers categorically rejected such a request, stressing that in a situation in which industrial production is 20% lower than in May 2008 and where only one-third of enterprises are solvent, minimum wages cannot be increased. Given that no agreement was reached by the social partners, labour law envisages that the final decision must be taken by the government. The Ministry of Labour and Social Affairs, in consultation with the Ministry of Finance, proposed a fairly symbolic increase in the minimum wage of 1, 2 or 3 dinars, as a sign that, in the difficult conditions of an economic crisis, the government cares about the position of workers, but this decision will depend on whether experts in the Ministry of Finance are in favour.

In response to the mounting social problems caused by the economic crisis, the government has initiated a new tool to resolve workers' problems.

Working Group for resolving workers' problems

Box 7 Draft document of the Working Group

The draft document was discussed with the social partners in late August 2009 and envisages the following main points:

1. Pensions: The full coverage of workers' social insurance for pensions and invalidity, during those periods when social contributions were not paid to the Pension Fund by the employer. This refers to the period from January 2004 until 30 June 2009, when there were many cases of unpaid contributions. The employers will not be exempted from their legal obligations of paying contributions, but workers will be allowed to draw benefits before such payments are made.
2. Health insurance: Measures to ensure health insurance for all workers for whom health contributions have not been paid by the employer.
3. The Serbian Ministry of the Interior, in cooperation with the Agency for Privatization, the fiscal police and other institutions, will undertake measures to investigate criminal activities and misuse of their position by the new owners of privatized enterprises.
4. Support for the most vulnerable categories of workers through (a) one-off cash payments from the government budgetary fund to workers who have not received wages for three months or longer (subject to some further conditions); (b) rescheduling of electricity bills for workers not receiving wages for more than three months.
5. Investigate the possibility of debt–equity swaps, the conversion of enterprise debt into government capital in case of the non-fulfilment of enterprise obligations and the rescheduling of the debt of enterprises presently in difficulties.

6. Agreement on Social Partnership between the government representatives, and representative trade unions and employers' organizations, in order to investigate and overcome problems that have led to an increase in the number of strikes and to prevent their radicalization in the future.
7. The Ministry for the Interior must ensure the personal safety of people during strikes.
8. Fiscal authorities and commercial banks will undertake measures to ensure that payments of workers' social contributions are undertaken at the same time as the payment of wages.
9. The Working Group will be active primarily with respect to those employers who have not been able to fulfil their legal obligations towards workers (regular payment of wages and social security contributions).
10. The Working Group should also include representatives of representative trade unions and employers' associations in order to stimulate social dialogue and reach consensus on the most appropriate measures to take.

In August 2009, at a meeting with the social partners, most of these 10 measures proposed by the government were deemed satisfactory, although there were doubts about whether they will be implemented effectively. There was scepticism in particular about the Agreement on Social Partnership, since similar measures in the past were not respected by the government. Another complaint was that, although the package of possible reforms was to be discussed at the SEC, this has not been done.

The first steps taken to implement social dialogue serve as evidence that, to be used successfully to combat the crisis, this mechanism should be implemented by the voluntary and ad hoc decisions of the participants. That is how an anti-crisis strategy could be designed which is concerted at the national level and consistent with European policies. The government's efforts alone will not be enough to exit the crisis. Moreover, due to the great dependency on IMF aid and the pressure from the international trade union organizations, Serbia is left to rely primarily on "austerity measures" to combat the crisis.

4.2. Trade union anti-crisis agenda in Serbia

The global economic crisis came on top of a number of problems that have been accumulating on the trade unions' agenda in Serbia in recent years. During the past three years, several issues have greatly contributed to increasing social protests and trade union activities (see Box 8).

Box 8 Trade union agenda

• Post-2001 privatizations: There is widespread dissatisfaction with the privatization implemented according to the 2001 law, since the new owners have frequently not fulfilled their obligations regarding investment and social programmes. In quite a number of privatized enterprises, workers have not been paid, while payments of social security contributions have been greatly delayed for varying periods of time; in some of these enterprises, production has simply ceased. Out of 1,717 enterprises sold at auction in Serbia since 2001, there have been 403 cases of broken contracts, most frequently because of the failure to meet obligations regarding investment and social programmes, halted production, inability of the buyer to pay the agreed price or illegal sales of enterprise assets. In discussions with the government, the trade unions stressed the need for a revision of all dubious privatizations. According to Rasim Ljajic, the government plans to investigate all cases where new owners have not respected their obligations.

• Uncertain terms regarding the distribution to workers and citizens of free shares in state enterprises that have been privatized in the last two years, or are about to be privatized, is another reason for strong worker and public dissatisfaction (although it is minor in comparison to the dissatisfaction with post-2001 privatizations). A law adopted in December 2007 envisages that shares in six mainly state-owned enterprises planned for privatization will be freely distributed to all adult citizens who have not benefited from earlier privatizations (15% of capital) and to current and former employees of these enterprises (2–5% of capital). The companies are the oil and gas company NIS, Telecom Serbia, the electricity company EPS, JAT Airways, Belgrade airport and the pharmaceutical company Galenika. However, there have been delays in distributing the free shares, presumably due to technical problems (for example, free shares in NIS were due in August 2009). The trade unions have stressed that workers have also been cheated through the recalculation of the amount of free shares they are supposed to receive.

• Social and Economic Council (SEC): Many trade union representatives have been complaining that the SEC has not been functioning well, because representatives of the government frequently do not attend SEC meetings. Another complaint concerns the representativeness of the social partners in the SEC; there was some obstruction of the activities of the committee for establishing representativeness, since some consider there is a need to verify once more which social partners are representative.

• Collective agreements have been very difficult to conclude and they are not being respected. The general collective agreement, which aims to introduce a more efficient system for the protection of workers' rights, was finally signed on 29 April, 2008, after three years of negotiations between representatives of the representative trade unions and the Serbian Employers Union. On 6 November 2008, the document providing for the broader application of the general collective agreement was also signed, while the Minister for Labour and Social Policy, Rasim Ljajic, signed a document which approved the broader application of the general collective agreement.

• Although these agreements should have ensured the implementation of the general collective agreement, with the outbreak of the economic crisis, the application of the general collective agreement was suspended. Due to budgetary cuts, in January 2009 an Annex was adopted which froze its implementation during the period of the crisis.

During the 1990s and in the first decade of the twenty-first century, trade unions in Europe have been affected negatively by economic deregulation, labour market flexibilization, changes in technology and work organization and, last but not least, weakening ties with traditionally labour-minded political parties.

However, the current crisis can serve as leverage to give momentum to reverse this trend and gain more influence. To this end, a new trade union agenda has to emerge, reclaiming the European Social Model and demanding that the governments of aspiring new member states live up to the obligations EU membership implies.

There are some key questions which need answers with regard to trade unions operating in Serbia, which are called upon to play a new and different role in a period of global crisis.

1. **What is the major trade union goal at the national level?** Immediate responses to the crisis? Yes. They were undertaken in the period 2008–09. But in what direction? "If we do not know where we are going, we will never get there." Trade unions must be asked what their longer term vision is. In other words: what kind of national economy and labour market will exist after the crisis, in the run up to EU membership? More concretely: is a social market economy possible in Serbia in the long term?

2. **What is the trade union mission?** Are the trade unions in Serbia facing a historical second chance (after the post-war improvements)? If the unions do not want the government and employers to continue with "business as usual", should they only be reactive partners and continue in the same way as in 2008–09? While the Milosevic regime suppressed independent unions, the transition weakened them. Will the current crisis further undermine their role, or are they ready to use it as an opportunity to expand influence among members and in society at large?

The right answer should be: trade unions, too, cannot simply continue with business as usual.

Union disagreements on many economic and social issues in Serbia need to be reduced; this is a historic opportunity for the trade unions:

- ***to restore lost influence among workers;***
- ***to show the political will to work jointly on anti-crisis measures;***
- ***to act boldly, with the ITUC, the ETUC and the ILO behind them; both the expert support and the political leverage of these institutions must be taken advantage of by Serbian unions (for more, see Dimitrova, 2005).***

Trade union actions in a period of crisis

Trade union strategies at the national level should be constructed based on a clear understanding of the process, substance and sequencing of action. The final decisions should be made by the autonomous trade union confederations, first separately, and then in concert.

A concerted position must be included in a national package to exit the crisis and to follow an after-crisis period of economic development; such a package may include the following elements:

- **understanding** the causes and dimensions of the crisis in Serbia;
- **shaping policies:** parallel processes of preparing for negotiations for signing anti-crisis agreements (pacts) and for industrial action (building **expertise,** on the one hand, and **mobilizing by strengthening *direct contacts*** with members in companies, regions and so on;
- shaping **public discourse in terms of the trade union perspective** (work with the media, internet and so on);
- fostering **dialogue with employers** within the framework of "national interests" and formulating joint proposals;
- conducting **consultations** – including informal ones – **with government** bodies to explore common ground before entering into formal negotiations on an agreement (pact), if feasible;
- **preparing trade union proposals for the pact** to address social concerns (backed by economic policy proposals, which is the main objective of this Guide);
- **pact negotiation process and outcome,** if signed (what does successful implementation exactly mean in the Serbian context? What are its targets?);
- **monitoring** mechanisms (including periodical reviews);
- **trade union strategy in case of failure** (industrial action? Or something else?).

In summary, a trade union strategy should include **additional recommendations,** relevant to Serbian trade unions:

- **Insist on entrusting the fixing of the initial date of the crisis to an independent institution in which you have confidence.**
- **Present and discuss the issue publicly: Will your country go through a "lost" (without growth) decade? Insist that the government commits itself officially to answering this question. In order to do so, the government must have a programme, not only within the standard one-year budgetary cycle, but for a budgetary cycle that covers the whole expected period of the crisis.**

- **Insist that the strong fiscal measures be part of a long-term programme for the restoration of Serbia's international competitiveness, and not just current measures for managing the annual budget.**
- **Insist that the government's anti-crisis programme become a national project: that is, its adoption should be the result of crafting a national consensus.**
- **Closely follow the development of relations between the government and the international financial institutions.**

It is recommended that the government should investigate opportunities to use the IMF's new flexible credit lines as a new form of financing.

If the Serbian economy remains in deep recession, the government should be pressed to fashion a long-term anti-crisis programme; without such a programme, Serbia could not make use of the IMF's Stand-By Arrangements (SBA).

V. Conclusions and recommendations – Points for the expert discussion of priority issues

Immediate and short-term measures also need to be discussed explicitly, although this is difficult, given the unpredictable global environment and future crisis developments in Serbia.

Policy issues

1. Austerity measures (cutting or freezing wages and pensions, reducing public spending and so on) are being imposed in a number of countries, which have received emergency loans from the IMF: Hungary, Latvia, Romania and Ukraine; Serbia is following the same pattern (Poland is an exception, making use of the IMF's Flexible Credit Line [FCL]). In Bulgaria and other SEE countries, austerity measures are voluntarily implemented by the government.

   Important: Trade unions in Serbia should contest the alleged no-alternative austerity approach; it provokes social discontent and long lasting political instability: compare the protests in Latvia, Romania, Bulgaria and so on.

2. There is no specific labour market policy tool available for handling the crisis in the new member states and SEE. Problematic in light of the expected rise in unemployment appears to be the paucity of measures directed at the labour market (active labour market policy). The lack of ambition with regard to green measures and green employment is also worrying.

   Task: There is an obvious need for the trade unions in SEE and Serbia to take action: to limit non-standard work and regulate informal employment.

3. **Income issues and polices are becoming crucial within the framework of crisis management:**

– **wages:** lower purchasing power, erosion of savings, reduction of demand, poverty and so on;
– **growing indebtedness** of households and SMEs;
– **taxation models:** massive shift to the FTR, leading to an increase in the budget deficit; upward distribution (the rich benefit more); negative reactions from the EU-15 and so on.

   Challenge: Income/taxation policy should be the core of the trade union agenda in negotiations with governments and employers in SEE. This issue needs regional coordination and EU involvement in the evaluation of taxation patterns imposed by the IFIs in the region. An ETUC policy document in this field is also necessary.

4. **Protection of workers' rights: some optimistic sign.**

Trade union struggle highlighted the first global **symptoms of change:**
– World Bank publication Doing Business: use of the Employing Workers Indicator (EWI) was ended (April–October 2009);
– FTR model is under revision (IMF announcement in Riga, summer 2009);

– Other indicators with regard to global change are: transaction taxes; high corporate bonuses; ILO-GJP acceptance and so on.

An important lesson: All positive changes and new opportunities came as a result of sustained trade union pressure, coordinated with Civil Society Organizations (CSOs) and the ILO.

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INFORMATION APPENDIX

Appendix 1. New monetary and exchange rate policy, Serbia (2001–08)

On 1 January 2001, a managed float regime was introduced to replace the previous fixed exchange rate, along with current account convertibility of the dinar, and various exchange rate restrictions were abolished.

In August 2006, the National Bank of Serbia (NBS) switched its exchange rate policy to inflation rate targeting, which increased the use of the NBS referential interest rate as the main instrument for reaching the target inflation goal.

There has been some fiscal consolidation, although the overall results have not been very satisfactory. The public deficit of over 6% of GDP in 2001 was cut to only 1.2% in 2003 and was transformed into a surplus in 2004 and 2005, but it again increased after 2006, reaching 2.5% of GDP in 2008. Public expenditure represented more than 40% of Serbia's GDP throughout the post-2000 period and the structure of expenditure has not changed substantially.

The largest single item of consolidated central government expenditure consists of pensions, which represented over 11% of GDP, and consumed 30% of public expenditure in 2008; health is the second largest item, accounting for 15% of the total; while education represented another 10% (World Bank, 2009). Serbia spends relatively little on social assistance: spending as a whole averaged less than 2% of GDP in 2005–09; as a share of GDP, this is lower than the average spending in the OECD (2.5%, 2006) and in the EU countries (2.5%, 2006) (see World Bank, 2009).

Since 2001, radical reforms of the tax system have been implemented, including a major simplification of taxes, the switch to gross wages for social contribution purposes, broadening the tax base and lowering overall tax and contribution burdens on wages. A flat tax on personal incomes was introduced in 2001, which was clearly an unfavourable regime for people on low incomes. Value-added tax (VAT) was introduced in 2005, with a standard rate of 18%. Corporate profit tax has a uniform rate of 10%, one of the lowest in Southeast Europe. A number of measures have been implemented to fight the informal economy, such as the obligation to issue receipts for all payments, as well as fines if these new regulations are not adhered to. Measures have also been applied to prevent the evasion of wage tax and social contribution payments.

Appendix 2. EU Flexicurity Policy: The Kok Report

In that context, the Commission charged a group of experts, chaired by the former socialist prime minister of the Netherlands, Wim Kok, to reflect on the functioning of the labour market. The so-called Kok Report, "Jobs, jobs, jobs: creating more employment in Europe" (November 2003) advocated the abolition of a number of rigidities: *"Member States should work towards the removal of obstacles to temporary work agencies, rendering them more effective and attractive intermediaries in the labour market, offering improved job opportunities and high employment standards."*

The result of the organization of temporary agency work (TAW) is also important as "it accounts for around 1% to 2% of total employment" (Dublin TAW, 2006: 37), although, of course, it is not enough to contribute significantly to the realization of the Lisbon employment rate.

In the subsequent report, "Facing the challenge: The Lisbon Strategy for Growth and Employment" (November 2004), by the Kok "high level group", the inherent contradictions of the Lisbon Strategy could not be hidden: no credible solution could be found to reconcile a US-type growth model based on more flexible labour market functioning ("abolishing rigidities") and the sustainable preservation of the European Social Model(s). One of its central recommendations "Greater focus is required to build understanding of why Lisbon is relevant to every person in every household in Europe" (Kok, 2004:7) illustrates the narrow basis of the Lisbon Strategy.

As a logical further step the Commission concluded that a revision of the Lisbon process was necessary. Unluckily, the prevailing policy options "more flexibility, less rigidities" were not questioned, despite the disappointingly low rise of labour market participation rates from mid-2000 on. Thus, in 2006 the "Green Paper" on modernizing labour law (where, of course, modernizing means, again, more flexibility and less rigidity) and the 2007 Communication "Towards common principles of flexicurity: more and better jobs through flexibility and security" can be seen as exemplifying this coherent but flawed, because ineffective, policy.

Appendix 3. Not an ordinary recession (the balance sheet recession)

Nomura's Chief Economist Richard Koo wrote a book called The Holy Grail of Macroeconomics, which introduced the concept of a "balance sheet recession", which explains economic behaviour in the United States during the Great Recession and in Japan during its Lost Decade. He explains that the factor connecting these two episodes was the concerted actions of the economic agents (businesses) to reduce debt, even in the face of the massive monetary accommodation.

When debt levels are enormous, as they are right now in the United States, an economic downturn becomes a matter of survival for many, forcing people to reduce debt. Recession lowers asset prices (houses and shares), while the debt used for purchasing those assets remains. Because debt levels are so high, suddenly every one becomes over-indebted. Many are technically insolvent, their assets now worth less than their debt. And the three Ds come to play: a downturn leads to debt inflation, deleveraging and, ultimately, depression. The D-process is what truly separates depression from recession.

This recession is different. Balance sheets of consumers, firms, and banks are under strain. The private sector is bent on reducing debt and this offsets Keynesian stimulus more than standard flow calculations would suggest. Bank deleveraging is by far the most dangerous. Fiscal stimulus will not have much effect as long as the financial system is deleveraging.

This is not an ordinary recession that differs from other recent episodes simply by being somewhat more severe. It differs in kind. The end of the Cold War brought a decline in military spending and a recession which impinged most heavily on the States, like California, where the military-industrial complex was an important part of the local economy. The nationwide unemployment rate rose from 5.25% in 1989 to 7.5% in 1992. It then fell every year, reaching just under 4% in 2000. The "free market" took care of the recession of the early 1990s. Resources moved from the defence industries, trickling into other uses through innumerable channels. The federal government did not need to take a hand. Beginning in 1993, the federal deficit in fact shrank every year, turning into a modest surplus in 1998. That was a very ordinary recession.

If the current situation were at all similar, we would expect a recession in residential construction, with unemployment among construction workers and mortgage brokers. Naturally, recent boom areas would be hard hit but we would expect resources gradually to trickle into alternative employment. Instead, we are threatened by a veritable disaster.

Balance sheet recessions

What is the difference? It resides in the state of balance sheets. The financial crisis has put much of the banking system on the edge – or beyond – of insolvency. Large segments of the business sector are saddled with much short-term debt that is difficult or impossible to roll over in the current market. After years of near zero saving, US households are heavily indebted.

The holes that have opened up in the balance sheets of the private sector are very large and still growing. A recent estimate by Jan Hatzius and Andrew Tilton of Goldman Sachs totals capital losses of USD 2.1 trillion; Nouriel Roubini thinks the total is likely to be USD 3 trillion.

About half of these losses belong to financial institutions, which means that more banks are insolvent – or nearly so – than has been publicly recognized so far. So, the private sector as a whole is bent on reducing debt. Businesses will use depreciation charges and sell off inventories to do so. Households are trying once more to save. Less investment and more saving spell declining incomes. The cash flows supporting the servicing of debts are dwindling. This is a destabilizing process but one that works relatively slowly. The efforts by financial firms to deleverage are the more dangerous because they can trigger a rapid avalanche of defaults.

Appendix 4. Need to correct the official diagnoses of the crisis

Professor Michael Porter says that many countries do not know what to do once they reach stabilization. Some of these countries have fallen into a post-stabilization crisis. Typical examples are Argentina and Turkey. Main lesson of the post-stabilization crisis: fiscal distortions depress the growth rate and this is the main reason for the post-stabilization crises. There is an intensive debate in relation to the post-stabilization crises about the role of the central banks in maintaining macroeconomic stability. The classical concept is limited to price stability, but there is already being developed a concept of stability which goes beyond price stability. In this connection, one of the main theses of crisis management is currently being debated – a dual mandate for the national bank.

✓ Vulnerabilities accumulated in "fair weather" are the root cause of the crisis.

Eastern Europe tops the list of emerging market regions susceptible to a full-blown financial crisis. Unlike emerging markets elsewhere, Eastern European economies are heavily dependent on external financing and current account deficits have been the norm. So, the sharp falling off in capital inflows will not only be a major blow to growth, but it could also potentially trigger a regional financial crisis. The Baltic countries, Bulgaria, Romania and Hungary stand out as particularly vulnerable, but a crisis in one country could trigger a regional domino effect.

The strong foreign banking presence in the region, long hailed as a strength, now increasingly looks like a potential weakness. Depending on the country, foreign banks hold about a 60–90% market share. These foreign parent banks, under pressure from the global financial crisis and slowdowns in their home countries, are reducing lending to their Eastern European offspring. In an extreme (albeit unlikely) scenario, there is the risk that foreign parent banks, in the face of rising defaults and prohibitively expensive refinancing, would pull out of these markets. Despite a strong banking system and a prudent fiscal target for 2009, Serbia's vulnerabilities are growing. The current-account deficit, at an eye-catching 18% of GDP in 2008, is among the highest in the region, while the currency has declined 20% since October 2008, despite repeated central bank interventions. As a precautionary measure, Serbia reached a USD 520 million standby agreement with the IMF in November 2008 which it is hoped will help stave off crisis in the face of the sharp re-adjustment. Also worrying are the vulnerabilities in Serbia's western neighbour, Croatia. The large external debt (at around 90% of GDP), current account deficit (around 10% of GDP) and short-term financing needs of the government and corporate sector are key challenges, given the tighter global financing conditions. To bolster investors' confidence, Croatia's government may also seek a precautionary programme from the IMF.

In sharp contrast to the crisis management in the developed countries, the governments in the countries in transition are becoming increasingly mired in short-term (fiscal year) measures for fiscal consolidation. Little attention is paid to the strategic task of avoiding recession turning into depression. Policy-makers in developed countries were able to avoid a depression because they had learned from the policy mistakes made during the Great Depression of the 1930s and Japan's near depression of the 1990s. As a result, policy debates have shifted to arguments about what the recovery will look like: V-shaped (rapid return to potential growth), U-shaped (slow and anaemic growth) or even W-shaped (a double dip). During the global economic free fall between last autumn and this spring, an L-shaped economic and financial Armageddon was still firmly in the mix of plausible scenarios. The trade unions should press their governments to make public their scenario for crisis development.

The crucial policy issue in developed countries is how to time and sequence the exit strategy from this massive monetary and fiscal easing. Clearly, the current fiscal path being pursued in most advanced economies – the reliance of the United States, the Eurozone, the United Kingdom, Japan and others on very large budget deficits and rapid accumulation of public debt – is unsustainable. Even if the crisis management in the countries in transition is still far from this phase of the crisis, now is the time to think about how to exit the policy of austerity measures and how to move on to normal macroeconomic management.

Appendix 5. Quantitative easing

Central banks engage in quantitative easing when they increase the monetary base by a pre-determined quantity via open market operations. This new money is injected into the private banking system when the accounts of the vendors of the securities purchased by the central bank through the open market operations are credited. This begins a process of increasing the money supply. Quantitative easing differs from the more usual monetary policy of setting a target for a specific interest rate (such as the federal funds rate) and continuously adjusting the amount of money to achieve that target. Central banks switch from interest rate targeting to quantitative easing when the interest rate is zero and they want to ease further.

In March 2001, the Bank of Japan (BoJ) began an historic new monetary policy known as “quantitative easing” in an effort to revive Japan’s economy and end the deflationary decline in consumer prices. Five years later, on 9 March, the BoJ ended the quantitative easing policy, satisfied that the Japanese economy was on the path to stable, reflationary growth.

In setting monetary policy, central banks normally target a specific short-term interest rate, such as the Fed funds rate in the USA or the uncollateralized overnight call rate in Japan. The central bank sets a target level for the interest rate and then controls it on a daily basis, injecting money into the financial system or withdrawing money from it, as needed, to keep the interest rate at the targeted level.

Under quantitative easing, the BoJ stopped targeting the level of the overnight call rate, which had already been lowered to zero in an effort to end deflation and stimulate the Japanese economy. Instead, the BoJ set the level of its current account as the operating target and raised the target level of its current account to USD 250–300 billion, which was far in excess of the roughly USD 40 billion level needed when the operating target was the overnight call rate, at zero per cent. Operationally, the quantitative easing policy required the BoJ to purchase trillions of yen in financial securities, including about USD 120 billion per year of Japanese government bonds, in an operation known as “Rinban”. The BoJ also purchased asset-backed securities and equities, and extended the terms of its commercial bill purchasing operation up to 12 months. The combined effect of these operations was to effectively flood the Japanese financial system with excess liquidity.

The BoJ also explicitly pre-committed to maintain the quantitative easing regime at least until year-on-year changes in the consumer price index, excluding fresh foods (the core CPI), became positive in a stable manner. With quantitative easing tied to the core CPI, the BoJ's explicit commitment to its policy regime was much stronger than the Fed's commitment to maintain easy monetary policy for a "considerable period" or its commitment to being "patient" in raising rates. So what exactly is quantitative easing, what disease is it supposed to cure, how is it supposed to work and what are the possible side-effects?

The theory

Quantitative easing is a method of boosting the money supply. Its aim is to get money flowing around an economy when the normal process of cutting interest rates isn't working – most obviously when interest rates are so low that it's impossible to cut them further. In such a situation, it may still be possible to increase the "quantity" of money. The way to do this is for the central bank to buy assets in exchange for money. In theory, any assets can be bought from anybody. In practice, the focus of quantitative easing is on buying securities (like government debt, mortgage-backed securities or even equities) from banks. Where, one might ask, does the central bank get the money to buy all these securities? The answer is that it just waves a magic wand and creates it. It doesn't even need to turn on the printing presses. It simply increases the size of banks' accounts at the central bank. These accounts held by ordinary banks at the central bank go by the name of "reserves". All banks have to hold some reserves at the central bank. But when there is quantitative easing, they build up "excess reserves".

If banks swap their securities for reserves, the size of their own balance sheets shrinks just as the central bank's balance sheet expands. Assuming they want to keep their own balance sheets static – admittedly a big assumption in the current climate – they will then start lending to end-borrowers and so start putting more liquidity into the economy. To some extent, central banks have been engaging in quantitative easing for the past year. The Fed, for example, has had a range of programmes and ad hoc initiatives that have resulted in it acquiring securities from the banking system and, more recently, from the US government. The Fed may not have justified these under the rubric of quantitative easing. But its balance sheet has certainly mushroomed: it is up 18-fold in the past four months, to USD 820 billion.

Does it work?

Such quantitative easing certainly hasn't yet done the trick so far in this recession. Credit conditions have continued to tighten in the USA. Things, of course, could have been even worse if there hadn't been any easing. Equally, although an 18-fold increase in the reserves on the Fed's balance sheet sounds impressive, it is still below 6% of GDP. It may therefore only be once quantitative easing properly gets going that the benefits will flow through. Similarly, history isn't much use in judging the therapy's effectiveness. There has been only one significant trial - in Japan between 2001 and 2006. Excess reserves held by banks at the Bank of Japan rose from Y5 trillion to Y35 trillion, roughly 6 per cent of GDP.

Scholars cannot agree on whether the technique worked. On the positive side, Japanese GDP did not shrink. On the negative side, GDP growth was moderate and not sustained after quantitative easing ended. Also, the experiment coincided with a big programme of government spending, so no one can tell whether it was the unusual monetary policy or the intense fiscal policy that kept the wolf from the door. Almost no one would argue that Japanese quantitative easing was an unqualified success. But some economists think the Japanese were too slow and too half-hearted in applying the therapy. What's more, the Japanese record isn't necessarily all that meaningful for the USA and the UK. Quantitative easing may work better – or worse – in a country like Japan with a cultural preference for saving and a huge trade surplus than in countries where borrow-and-spend have been the rule for years.

Unintended side-effects

Even if quantitative easing is not necessarily effective, it would certainly be worth a try if it carried no danger. But its safety is far from certain. It could, theoretically, lead to the debauchment of a nation's currency and inflation. Again, history does not provide much of a guide. Japan has not suffered any bad side-effects – inflation is low and the yen is strong. However, in some more extreme examples of old-fashioned money printing, the results were disastrous.

Witness the assignats of the French Revolution, Confederate dollars in the Civil War, Reichsmarks in Germany after World War I, Russian roubles after the fall of communism and the current hyper-inflation in Zimbabwe. The USA and the UK are, of course, in a far healthier state than revolutionary France or the Weimar Republic. So there isn't a danger of such alarming consequences. But central banks might lack the will to engage in "quantitative tightening" when the economy starts to pick up. In theory, reversing the policy should be quite easy. The central bank could just sell the excess assets on its balance sheet, sucking money out of the system. In practice, the political pressure to keep the party going might be too hard to resist.

This is particularly so because, in order to engage in quantitative easing in the first place, some central banks may well need the permission of their governments. The more they work in cahoots with politicians, the more their independence will come under threat. Already, Alastair Darling, the UK Chancellor of the Exchequer, has made it clear that the government – not the Bank of England – will play an active role if quantitative easing proves necessary. It is therefore essential that both central banks and finance ministers commit themselves to reversing quantitative easing when the good times return – before they go wild and open the spigots. Quantitative easing is risky. It needs to be practiced safely.

Appendix 6. Definition of internal devaluation

"Internal devaluation" is a Swedish instrument, but it is spreading rapidly in the formulation and explanation of economic policies around the world.

"Devaluation" refers to a process in which something loses its value in comparison to another thing. According to the definition, the latter is "external" with regard to the former. This typically refers to the currency of a certain country which reduces its value in relation to other currencies. The phrase was coined in Sweden at the end of the 1990s when they examined the available mechanisms for managing their economy and whether they should join the euro. Recently, this phrase became famous as a way of describing the adaptation processes applied by Latvia to gain access to IMF funding.

The essence of the concept is that a country with a fixed exchange rate can still manage its relative competitiveness by reducing its labour costs via fiscal measures. For example, the country may finance the reduction of payroll taxes through increased income taxes. This change reduces real labour costs and thus increases export competitiveness, while at the same time it is budget-neutral and reduces domestic consumer demand. In theory, it achieves a result similar to the devaluation of the currency (because the goal is the reduction of labour costs in comparison to those in the country's trading partners, it is logically known as internal devaluation).

In Latvia, use of the term deviates partly from its original meaning. The plan sponsored by the IMF calls for a 20% reduction of wages in the public sector, a 20% reduction of pensions, a VAT increase from 21 to 23%, an increase in the average effective rate of personal income tax and so on. There is not much focus on labour productivity or unit labour costs. The point is to reduce the budget deficit. Obviously, Latvia has been forced onto its knees with regard to loans from Swedish banks – the consensus is that devaluation of the currency will take away a large part of what is left of the private sector, given the influence it would have on the debt denominated in euros.

What is the international dimension? Certain important currency relationships in the world are effectively fixed, such as the Eurozone and the exchange rate between the USA and China.

If we consider the USA–China relationship, we can see that the latter applies its own unique brand of "internal revaluation". Despite allowing its currency to become more expensive, China will apply "rebalancing measures" to increase domestic consumption by increasing social insurance and health benefits. The USA, on its part, after China pegged its currency to the dollar, faces the same obstacles in trying to engineer higher export competitiveness. The market will respond in the only way it can – by increasing the army of unemployed, by means of which reform of the labour market will be forced through. It will not be surprising if soon they also say that internal devaluation is what they need. The strange thing is that the USA is doing the opposite of what the IMF has prescribed as medicine to Latvia. Everybody knows that there are limits to the debt a government may issue. The question is, how close the USA is to that limit.

Debates in Germany

Stagnation and high unemployment require far-reaching reform of the labour market in Germany. This will involve exerting pressure on real wages, which will help to increase employment. The pressure on wages will reduce wage costs and prices (of goods and services) in relation to foreign competitors. Such real depreciation will accumulate the demand needed to meet the increase in production which will come when employment rises. But there is one major problem. In economies with low inflation, it takes a long time for labour market reforms to adjust real wages. In the UK and the Netherlands, it took more than 10 years (in the 1980s) to get results. The basic explanation lies in the difficulties experienced in bringing down growth in nominal wages under 1–2% a year. In all developed market economies there is strong social resistance to reductions in nominal wages.

In order to accelerate the effects of the reforms, they must be supplemented by demand incentives. If Germany were not a member of the European Monetary Union (EMU), this could be achieved by lower interest rates as well as devaluation of the mark. But this option no longer exists; nor does the option of fiscal expansion. Rises in the budget deficit in Germany would also undermine the framework of fiscal policy in the EU. Some authors think that other options need to be examined, for example, so-called internal devaluation. This option was discussed in the Scandinavian countries and applied some time ago.

Internal devaluation means reducing the pay-roll taxes paid by employers. Since this cannot be funded by cutting public expenditure, taxes on employees must be increased. In Germany, the option of considerably reducing employers' social contributions could be considered – for instance, by 5–10%. However, the insurance contributions of employees would have to be increased. A VAT increase could also supplement funding. Such tax changes could bring about a decrease in real labour costs and real devaluation in a manner similar to currency devaluation. An increase in net foreign demand for German production would result, which would compensate the low combined demand in Germany. Over the long term, the resulting income expansion would also increase internal demand. The tax revenue increase related to this would improve the budget position of the government. Internal devaluation would be more effective in increasing employment than the other measures being discussed. For instance, the increase in working hours at constant total pay will lead to production growth because labour costs per hour will fall, but the effect on unemployment is uncertain. The tax change would be less reliable than currency devaluation would have been in the absence of EMU. Internal devaluation would bring about the reduction of real wages by political means. In contrast, voters tend to consider currency movements as a result of the market rather than as a consequence of political decisions.

Successful tax reform must be preceded by a long period of discussion in order to achieve a consensus that this is necessary. This will be very difficult. One important reason for this is the lack of sufficient debate in Germany on the conditions entailed by EMU membership before it started in 1999. This is in complete contrast to the Scandinavian countries, where the decision on whether to join EMU was preceded by a serious discussion on such issues as the need for new instruments of economic policy, such as internal devaluation, in the event of membership.

A successful employment strategy requires a dual approach, covering both supply-side and demand-side measures. A one-sided supply-side strategy may turn out to be politically self-defeating, because there will be a resistance to reform, if it takes a long time to achieve positive results. Internal devaluation – that is, the transfer of contribution burdens to the social insurance funds from the employer to the employees – should be examined very seriously by the political class as a way of accelerating labour market reforms.

One of the main problems now facing the European economy is wage cuts. Such a general reduction in wages and living standards has not taken place since the 1930s. Furthermore, in some European countries – in particular, Greece, Hungary, Ireland and Latvia –there is a danger of systematic price deflation.

Evidences from Latvia

At the end of December 2008, Latvia signed a 27-month Stand-By Agreement with the IMF in the amount of SDR 1.5 billion (approximately 1.7 billion euros). At the same time, the country received another 5.5 billion euros from the EU and Nordic banks. The agreement includes an engagement by these banks to roll over inter-country loans to their subsidiaries. The agreement was concluded without the Latvian Central Bank abandoning the self-imposed currency peg. The last IMF consultative report was interpreted by some as an implicit criticism of government monetary policy, against a background of rapid wage increases. Productivity started to lag behind and investments in non-tradable activities, starving the tradable sector of funds. As a result, the trade balance amassed a significant deficit. In similar situations elsewhere, the IMF inflexibly demanded that countries devaluate or abandon pegged or other fixed exchange rates before receiving financial aid. The Fund gave in to the Latvian Central Bank's insistence on the peg and, in return, demanded macroeconomic stabilization and the recovery of competitiveness. Among the control criteria in the agreement a "ceiling on the general government wage bill" was included. Many economists believe that this is key to the long-term success of the adjustment programme.

Generally speaking, the reduction of labour costs represents the basis for recovering competitiveness and thus the vitality of the Latvian economy. This would also have been the effect of a direct nominal devaluation. But the IMF and the Latvian authorities are right in claiming that nominal devaluation would unleash a new wave of double-digit inflation and thus render the first wave of devaluation ineffective, leaving the country in an inflationary spiral. What Latvia is aiming for with the IMF package is internal devaluation, which should not be mistaken for regular external (nominal) devaluation. The IMF is against this: its analysts claim that successful internal devaluations are rare (in Hong Kong in 1998 and in Germany in the 1990s and at the beginning of the 2000s).

In principle, internal devaluation is the best solution to declining competitiveness. However, it is difficult not only to obtain the approval of parliament, but to implement this policy.

The main policy choice for Latvia is between internal devaluation, under which domestic wages and prices are adjusted, and regular devaluation of the nominal exchange rate (or “external devaluation”). At first, the IMF and a number of economists claimed that the internal devaluation option would be the most effective way for Latvia to remedy both its internal and external imbalances and to reduce the inevitable pain of adjustment. On balance, regular internal devaluation in combination with one-sided introduction of the euro would be the best approach. In the current circumstances, the main reason for this is that it would remove all the uncertainty surrounding the current currency regime and get the economy moving again. In addition, devaluation would bring about across-the-board adjustment of relative prices, both for exports and imports, which would be immediate and affect the entire economy, reducing the need of individual companies to enter into tough negotiations on wages and prices. Wage reductions which have already taken place will make adjustment easier than it would otherwise have been. This adjustment will not have been in vain if Latvia now chooses to devalue and to introduce the euro.