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Pero Petrović

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For the Publisher
Duško Dimitrijević, Ph.D., Director
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Institute of International Politics and Economics

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Jelena ZVEZDANOVIĆ LOBANOV, MSc[1]
Anita MAČEK, Ph.D.[2]
Rasto OVIN, Ph.D.[3]

Institutional setting as a determinant of FDI attraction – example of Serbia

Abstract: South-Eastern European countries (SEE countries) are still net importers of foreign direct investment (FDI) in the form of cross-border mergers and acquisition. Their companies have not significantly involved in this type of expansion on the foreign markets. The main obstacles to entrepreneurship in their business environment are high levels of corruption and large state bureaucracy. Therefore, their economies are mostly characterized by low competitiveness, high trade deficit and insufficient inflow of FDI necessary to support their transition process from centrally planned toward market economy.

Design of an efficient, transparent legal and institutional framework is a crucial determinant of FDI. Institutional setting in SEE countries has an impact on the entry mode choice as undeveloped institutions drive up the costs of organizing business. Therefore, efforts towards the higher quality of institutional setting may help them to attract more FDI inflow and catch up more advanced economies. To enable an insight into the quality of institutional setting in Serbia, authors will show the most important economic and political events since the beginning of the 90s which had direct or indirect influence on the level of FDI.

Key words: institutional setting, transition, reforms, FDI, business climate.

[1] Jelena Zvezdanović Lobanov, MSc, Research Assistant; Institute of Social Sciences, Belgrade.

[2] Anita Maček, Ph.d., Docent, Doba Faculty, Maribor, Slovenia.

[3] Rasto Ovin, Ph.D., full professor, *Institute for Economic Diagnosis and Prognosis,* Faculty of Economics and Business Maribor, University of Maribor, Slovenia.

Introduction

The increasing volume of international capital flows has brought new opportunities to companies that are part of such international transactions; on the other hand it also brought opportunities to host countries. There are several studies showing the effects of FDI. Some relate to horizontal and other to vertical spillover effects of FDI. The findings of these studies differ. Some show positive effects (Barro, 1991; Barro & Sala-i-Martin, 1995; Lipsey, 2002; Baliamoune-Lutz, 2004), other neutral effects (Kokko et al., 1996) and there are also studies indicating negative effects of FDI on domestic companies (Aitken & Harrison, 1999; etc.).

The earliest statistical analyses of FDI relate to studies by Caves (1974) and Blomström & Persson (1983), who studied the existence of spillover effects by testing the effect of foreign ownership on productivity in a domestic firm. They concluded that the effects are positive, while the same conclusions were later also drawn by Nadiri (1991), Blomström & Wolf (1994) and Liu et al. (2000). Other studies (Estrin et al. (1997), Stephan (2005), Lin (2008) show that FDI affect the development potential of the economy as well as reduce unemployment, affect transfer of new technologies and knowledge, generate additional tax revenue for the state, support development strategies of individual sectors, affect the development of managerial knowledge, increase engagement of local companies in supplier and subcontractor networks and generate a better utilisation of the local infrastructure and service activities. According to Borensztein et al. (1995) and Pain (2001), inward FDI strongly contribute to economic growth in the host country, while Alfaro (2003) believes that FDI have a positive effect only if made in manufacturing, while the results of his study show that FDI in the primary sector tend to have a negative effect on growth. On the other hand, certain studies even prove negative effects of FDI on economic growth of the host country (Kawai, 1994).

The benefits of FDI are not self-evident and greatly differ among different countries. The results of Lin's study (2008, 31) show that the benefits from FDI are enhanced in an open investment environment with a democratic trade and investment regime, active competition policies, macroeconomic stability and privatisation and deregulation. The distribution of positive compared to the negative effects depends on the economic policy towards these processes and the entrepreneurial environment as well as other factors affecting their consequences. Reisen (1999) points out that positive effects of these transactions usually occur with a time lag. Cantwell (1989) believe that the occurrence and intensity of positive effects of ICF depends on the sector in which the foreign investment is entered.

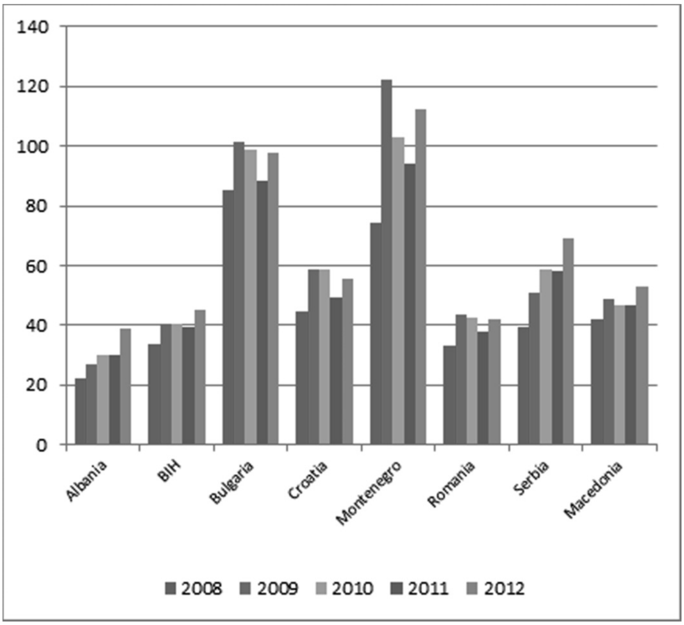
It is important to know, that with unfavourable conditions, FDI can bring also negative effects. These are especially evident in the form of reducing productivity of the host country (Aitken & Harrison,1999; Kokko et al., 1996), reducing employment (Kokko, 2006), diminished R&D intensity (Hitt et al., 1991; Blonigen & Taylor, 2000), increased concentration in the domestic market and the closing of companies (UNCTAD, 2007), shrinking of the domestic stock market because shares are being transferred to a foreign stock market (Tsang & Hauck, 2007), anti-competitive reactions of the acquired firms (Haller 2005), abnormally low sales prices of companies (UNCTAD, 2000b, 2) or eliminated competition in the domestic market (UNCTAD, 2000a; UNCTAD, 2007, 123). In their studies, Maček & Ovin (2006, 2011) stress the crowding out of domestic firms, too low prices paid for domestic companies and anti-competitive behaviour of foreign affiliates as the most common threats of C-B M&As in European countries. In recent years, negative effects often include also threats to national sovereignty and autonomy of the host country and thus losing control of strategic industries (Lin, 2008), whereby the threat of losing economic independence is especially emphasised (Kamaraj, 2008).

Data on FDI inflow in SEE

The amount of FDI flows between SEE countries varied significantly since the beginning of transition process. During the 90s, the highest amounts of FDI were attracted by Romania, Croatia and Bulgaria. During the second half of that decade, other countries in region recorded decline in FDI inflows. This situation can be partly explained by the Kosovo conflict, which prompted some investors to put projects on hold. As a reaction on this crisis, some countries developed new instruments in order to increase the degree of country openness to FDI and accelerated the major privatization deals (UNCTAD, 2000).

FDI experienced growth from 2000 to 2008 when this type of investment achieved its record level (USD 37 billion). Investment volumes declined sharply in 2009 (USD 16 billion) and this negative trend continued in 2010. FDI in this region started to recover in 2011, prompted by the dynamism of cross-border M&A deals (UNCTAD, 2012). Inflows remained concentrated in a few economies, with the top three destinations (Serbia, Bulgaria and Romania) accounting for 65% of the total inflows in SEE region. Despite the economic recovery, the FDI inflows in 2012 were also still below the peak recorded in 2008 (UNCTAD, 2013). Recesion in euro zone had negative impact on external demand and FDI in 2012.

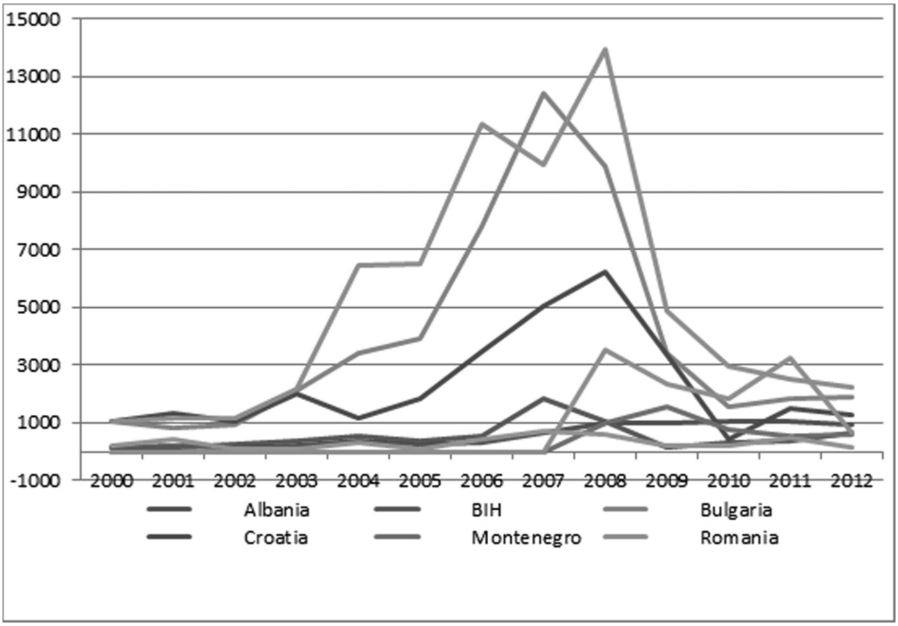
Graph 1. FDI inward stock as a percentage of GDP in SEE region



Source: UNCTAD Database.

In 2008, the highest FDI inward stock as percentage of GDP was recorded for Bulgaria (85%), Montenegro (74%), and Croatia (44%). These three countries were the main destinations for FDI also in 2009 and 2010. Since 2008 to 2012 the lowest level of the inward stock was recorded in Albania, BIH and Romania. FDI inward stock as percentage of GDP for Serbia increased from 39% in 2008 to 69% in 2012.

Graph 2. FDI inflows in SEE countries



Note: Data for Serbia and Montenegro are available from 2006 and onwards.
Source: UNCTAD Database.

SEE countries are still net importers of FDI. The main obstacles to entrepreneurship in a transition business environment are high levels of corruption and large state bureaucracy (Hellman et al., 2000). Therefore, their economies are mostly characterized by low competitiveness, high trade deficit and insufficient inflow of FDI necessary to support their transition process from an administrative state-led economic model toward market economy. Altomonte (2000) asserts that the design of an efficient, transparent and enforceable legal and institutional framework is a crucial determinant of FDI. For example, Meyer (2001) shows that institutional setting in transition countries have an impact on the entry mode choice as undeveloped institutions drive up the costs of organizing business. Therefore, efforts towards the higher quality of institutions may help transition countries to attract more FDI inflow and catch up more advanced economies.

Factors Influencing FDI Flows

Discussions on factors influencing FDI flows are very frequent in literature. Literature often mentions political risk, investment environment, infrastructure, regulatory framework, bureaucratic hurdles and red tape, judicial transparency and the extent of corruption in the host country as factors influencing FDI flows (Mottaleb, 2007, 4). Commonly mentioned factors are also the size of the host country, the country risk rating, the availability of skilled labour (Nonnemberg & de Mendonça, 2004, 2), the openness of the market and labour costs (Cheng & Kwan, 2000). Bevan & Saul (2000) add gravity factors and Chen (1996) additionally stresses transportation infrastructure and research and development capability in the host country.

The factors shown by these authors are derived from empirical analyses that the authors used to check the interdependence of FDI flows and the chosen factors. For this reason, individual authors show only a set of factors that influenced the increase of FDI in a country or a group of countries in a specific period of time. A complete set of factors influencing the development of FDI can be found in the World Investment Report 1998. According to this source, factors that determine FDI flows are classified in the group of microeconomic factors (factors related to acquiring new markets, extraction of natural resources and greater efficiency), economic and political factors (the privatisation policy, international FDI agreements, the trade policy, the fiscal policy, etc.) and factors that are related to business facilitation (investment incentives, promotion of FDI, location attractiveness, etc.) (UNCTAD, 1998, 91). The economic and political framework for FDI in the host country is an important determinant of FDI flows but liberalisation and globalisation have reduced its impact. Business facilitation has become more important and according to UNCTAD (1998), microeconomic factors hold the most important role.

As mentioned before, factors that determine FDI flows within different forms of FDI do not differ substantially, however, literature stresses two special factors in the foreign investor's decision on a "Greenfield" FDI or C-B M&As: speed and access to proprietary assets. In the sense of speed, C-B M&As represent the fastest means of building market presence, gaining market power, spreading risks or realising synergies. In order to increase proprietary assets, C-B M&As can further provide access to assets in the form of R&D, technical know-how, patents, brand names, etc. (UNCTAD, 2000a, 140).

Institutional setting development in SEE after 1990

Features and dynamics of FDI inflow in SEE countries are becoming more important with the completion of the privatization process and changing the institutional arrangements. The fall of the Berlin Wall in November 1989 was a crucial moment for the beginning of transition from a command (planned) socialist economy to a capitalist system. The experience of post-socialist countries shows that the success of the transition process to a large extent depended on the rule of law, strong interactions between formal and informal institutions and the introducing/protection of property rights.

Progress in transition of SEE countries was limited by the influence of inherited institutions. The transitional process was not accompanied by other changes in society, especially the strengthening of the role of law and protection of property rights. According to Ovin (2001), only a small part of the former institutions could be used and new institutions had to be established due to the lack of the effective pre-existing rules at the beginning of the first phase of transition. Pejovich (1997) indicates that the conflict between new formal rules and the old ethos has caused the rise of nationalism, ethnic disputes, or inflation and high unemployment in many East European countries. The mismatch between formal and informal rules has enabled incentives for creation of rent-seeking coalitions which have had an important role in subverting the transition from socialism to capitalism (Pejovich, 1997). Simple adoption of new legislation cannot be the adequate way to foster institutional reform because institutional change is more likely to be induced if it is supplemented by favorable coevolutionary factors (Stahl-Rolf, 2000).

The pace of reform was largely depended on the historical legacy and not only on the economic performance of the country, choice or the 'political will 'of policy-makers (Magnin, 2002). Not surprisingly, the interactions between formal and informal institutions are very complex and directions for future development are foreclosed or inhibited by directions taken in past (Mahoney, 2000).

Prevalent transformation paradigm was heavily influenced by Washington Consensus which focuses on structural adjustment policies of price and trade liberalization, macroeconomic stabilization and fiscal discipline, deregulation of entry barriers and privatization of the state-owned enterprises (Turley and Luke, 2010). Transition countries highlighted the macroeconomic stabilization as key element of the transition toward the market economy. Recommended policies (with exception of property rights) overlooked the potential role that institutions could play in accelerating the economic and social development of the countries in transition (Fukuyama, 2008). The creators of Washington Consensus ignored the fact that the process of transition in many countries was not accompanied by other changes in society, in particular the strengthening of the role of law and protection of property rights, which are the prerequisite for successful privatization. The creation of an appropriate legal framework and market institutions were also absent. In contrast to transition economies, building the legal and regulatory frameworks in the mature market economies lasted over a century and a half (Stiglitz, 2002). Transition countries that started reforms to create market economy didn't have to repeat this practice from the start because they could learn from the known experiences. By focusing on liberalization and macroeconomic stabilization, policy-makers tried to create a market economy without the preserving and strengthening strong institutional capacity of the state for ensuring good performance (Popov, 2000). Institutional fragility during transformation process has hindered a smooth reallocation of resources and has had a negative effect on performance at both micro and macroeconomic level (UNECE, 1999).

At the beginning of the transition to a market economy, Southeast Europe consisted of only four countries: Albania, Bulgaria, Romania, and Federal Republic Yugoslavia (FRY). All of them has experienced devastating crisis that is reflected in the sharp fall in output, consumption, employment, productivity and living standards in general (Veselica and Vojnić, 2000). Their transition process was accompanied by a number of adverse events starting from disintegration of the Yugoslav federation into five independent states: Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic (FYR) of Macedonia, Slovenia and FRY, wars and ethnic conflict, NATO bombing, authoritarian political regimes, the international isolation, the unresolved dispute over Macedonia's name, UN/EU sanctions directed against FRY etc. These shocks have had a negative impact on the course of their transition since many important reforms had to be postponed owing to the specific political and economic processes (Vukotić and Pejovich, 2002). In most countries there has been a social stratification of the population in terms of the rapid enrichment of minorities and impoverishment of the majority which contributed to the creation of social tensions, violence, social exclusion and discrimination. The economic crisis during the second half of the 1990s had a discouraging effect on FDI inflows. The inflow of foreign capital in the region was quite different since it was heavily dependent on the institutional characteristics of the recipient countries.

Each of the country of this region has made missteps during their transition that cost them political and economic stability. During the 90s, Romania experienced failure due to the necessity to rapidly establish the institutional arrangement for the initiation of privatization process. Pace of liberalization and privatization was not in line with the development of the institutional framework which was needed for the normal functioning of the market (Constantin et al., 2011). In comparison to the other countries in SEE region, Albania started its transition process as the most isolated, least developed and poorest country in Europe (Jarvis, 1999). From the early to mid 90s, this country had a problem with the pyramid financing by which it was collected high amount of citizens' savings. The collapse of pyramid savings schemes led to the emergence of a serious financial crisis and severe social tensions.

On the other hand, Bulgaria was faced with the deep currency crisis in 1996 which emerged as the results of inefficiently managed budget policy. Macroeconomic disturbances, together with inadequate implementation of structural reforms in the banking and real sector and ineffective prudential regulation, favored the occurrence of banking and currency crises (Roussenova, 2002). Bosnia and Herzegovina initiated its transition process to a market oriented economy in 1996 immediately after the signing of the Dayton Peace Agreement. Measures of transition were implemented based on the recommendations of the Washington Consensus which completely neglected the necessity of a clear and well-defined institutional framework. Since its independence in 1991, Macedonia recorded stagnation of economic activity with a substantial increase in the number of unemployed people as a result of mass layoffs and business closures. Strong barriers to the recovery of its weakened economy represent political crisis, inter-ethnic tensions between Macedonians and Albanians, long-term name dispute with Greece etc. Croatian macroeconomic situation is, not surprisingly, similar to most SEE countries. Several instances of hyperinflation during the 80s and beginning of 90s accompanied by the War of Independence made macroeconomic situation much more difficult (Šimurina and Belčić, 2010). Due to the war in the former Yugoslavia, Croatia broke off economic ties with the other Yugoslav republics, which prompted the creation of the financial chaos in the Croatian economy.

From 2000 until the onset of the global economic crisis, the SEE region has recorded significant economic growth. However, in comparison to other fast-growing economies, the countries of the SEE region have achieved lower rates of economic activity while domestic demand was the main driver of their growth (Handjiski et al., 2010). During this period, there has been significant progress in the implementation of reforms since some countries have undertaken crucial steps on their path to a market economy, especially in the areas of privatization and liberalization (EBRD, 2000).

European integration processes involving post-socialist countries started soon after the breaking up of political systems in Eastern and Central Europe and the collapse of the Soviet Union. Countries that became candidates for EU membership had to accomplish the various institutional requirements, primarily the Copenhagen economic accession criteria. Requirements were related to stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities, functioning market economies, and the capacity to cope with competition and market forces within the EU (Commission of the European Communities, 2002). Owing to the aim to fulfill institutional criteria posed by EU, some transition countries succeeded to improve the quality of institutional setting by fostering institution building or improving the existing legal and institutional framework. Integration with EU had played a role of external anchor for institutional changes and the prospect of membership was a powerful magnet for the transition process (Roland, 2006). The desire to join the EU has further stimulated the SEE countries to redouble their efforts in order to adapt of the existing institutional arrangements to the institutional development levels seen in EU member states. Bulgaria and Romania joined the EU in January 2007 which practically completed the fifth enlargement process of the EU, while Croatia became member of the EU on 1 July 2013. Serbia and Macedonia have a candidate status for EU membership while Albania and Bosnia and Herzegovina are potential candidates for joining the EU.

In comparison to the Central Europe and Baltics (CEB) countries which gradually strengthened the performance of their institutions, SEE countries were faced with numerous challenges and obstacles which resulted in their lagging behind the mentioned-above countries. Despite the numerous legislative and regulatory changes, SEE countries were burdened with low quality and efficiency of their implementation. The institutional framework was characterized by gaps and inconsistencies between the system and the implementation of the law, their arbitrary interpretation, cumbersome and inefficient administration and corruption. Given the inability and unwillingness of institutions to undertake appropriate measures to improve the existing situation, these countries were burdened with difficulties related to the prevention and elimination of macroeconomic imbalances.

As the first comprehensive strategy on conflict prevention, International Community adopted the *Stability Pact for South Eastern*

Europe in 1999 in order to strengthen the efforts of the countries in this region to foster peace, democracy, respect for human rights and economic prosperity. This Pact provided a framework to stimulate regional cooperation and rapid integration of the SEE countries into European and Euro-Atlantic structures. *Process of Stabilization and Association* has contributed to the stabilization of the region since it was aimed at maintenance of democratic institutions, guarantee the rule of law and creation of sustainable, open and prosperous economies. EU policy implies conclusion of the *Stabilization and Association Agreement* (SAA) which will enable countries to get the status of an associated member of the European Union. In order to join the EU, SEE countries have been encouraged to establish the closer cooperation with the EU member states and improve the relations in their region. By signing the *Central European Free Trade Agreement* (CEFTA), liberalization of trade and greater co-operation in a number of other trade-related areas such as investment, services, public procurement, and intellectual property rights were achieved.

Table 1. World governance indicators for SEE countries (2012 vs. 1996)

World Governance Indicators		Albania	BIH	Bulgaria	Croatia	Macedonia	Montenegro	Romania	Serbia
Voice and Accountability	2012	0,01	-0,14	0,38	0,48	0,00	-0,23	0,30	-0,17
	1996	-0,76	-0,18	0.37	-0,16	-0,50	-	0,24	-1,32
Political Stability and Absence of Violence	2012	-0,16	-0,54	0,33	0,58	-0,44	0,56	0,07	-0,22
	1996	-0,43	-0,64	-0,20	-0,18	-0,63	-	0,49	-1,15
Government Effectiveness	2012	-0,28	-0,47	0,14	0,70	-0,07	0,13	-0,31	-0,11
	1996	-0,80	-1,26	-0,31	0,07	-0,62	-	-0,51	-0,92
Regulatory Quality	2012	0,17	-0,06	0,54	0,44	0,35	0,01	0,54	-0,08
	1996	-0,42	-0,70	-0,12	-0,16	-0,25	-	0,07	-0,74

World Governance Indicators		Albania	BIH	Bulgaria	Croatia	Macedonia	Montenegro	Romania	Serbia
Rule of Law	2012	-0,57	-0,23	-0,12	0,21	-0,24	-0,01	0,02	-0,39
	1996	-0,93	-0,26	-0,46	-0,61	-0,41	-	-0,02	-1,28
Control of Corruption	2012	-0,72	-0,30	-0,24	-0,04	0,02	0,10	-0,27	-0,31
	1996	-1,09	-0,35	-0,78	-0,82	-0,96	-	-0,22	-1,03

Note: From 1992 to 2006 FRY was composed of Republic of Serbia and Montenegro. World governance indicators for Serbia are therefore related to Montenegro.

Source: World Bank Database

The table 1 shows the World Governance Indicators based on which it is possible to assess the institutional environment of the SEE countries, as well as their evolution in the period between 1996 and 2012. The value of these indicators range from -2,5 to 2,5 (the higher the number, the higher the quality of institutions). Indicator "Control of corruption" has a negative score for the whole period and all the countries except Macedonia and Montenegro. Croatia and Bulgaria have relatively good performances compared to the other SEE selected. Based on indicators, it is possible to conclude that the quality of governance has improved in almost all countries. Only Romania, during the period, has a shift from a higher score to a lower one for two indicators: Political Stability and Absence of Violence and Control of corruption.

Table 2. Transition indicators for SEE countries (2012 vs. 2000)

Country	Year	Large scale privatization	Small scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and Forex system	Competition policy
Albania	2012	3,7	4,0	2,3	4,3	4,3	2,3
	2000	2,7	4,0	2,0	4,3	4,3	1,7
BIH	2012	3,0	3,0	2,0	4,0	4,0	2,3
	2000	2,0	2,3	1,7	4,0	3,0	1,0
Bulgaria	2012	4,0	4,0	2,7	4,3	4,3	3,0
	2000	3,7	3,7	2,3	4,0	4,3	2,3
Croatia	2012	3,3	4,3	3,3	4,0	4,3	3,0
	2000	3,0	4,3	2,7	4,0	4,3	2,3
Macedonia	2012	3,3	4,0	2,7	4,3	4,3	2,7
	2000	3,0	4,0	2,3	4,0	4,0	2,0
Montenegro	2012	3,3	3,7	2,3	4,0	4,3	2,0
	2000	1,7	2,0	1,0	3,7	2,3	1,0
Romania	2012	3,7	3,7	2,7	4,3	4,3	3,3
	2000	3,0	3,7	2,0	4,3	4,3	2,3
Serbia	2012	2,7	3,7	2,3	4,0	4,0	2,3
	2000	1,0	3,0	1,0	2,3	1,0	1,0

Source: EBRD Database.

Progress in the transition countries of SEE countries can be seen from the EBRD indicators which are used for monitoring the status and relative progress of basic reforms starting from 1989 up to date. The achieved results are evaluated based on the standards of industrialized market economy with a rating from 1 (little or no change from a rigid centrally planned economy) to 4 (developed market economies). Considering the data from 2000 and 2012, there is an evident improvement of the SEE countries on their transition path. Since some countries have earlier implemented the necessary institutional reforms, there has been a significant progress in some areas while in others more effort is needed to reach the desired goals.

Challenges of institution development – the case of Serbia

The social and economic crisis, which began as far back as the 70's of the twentieth century, caused very serious consequences, which primarily reflected in a drastic decline in the living standards of the population and an increase of unemployment, but also in causing an ever greater inter-layer differentiation (Popović, 1991). The end of 1989 is associated to the reforms of Ante Marković who initiated the first programme of economic reforms, "Programme of economic reform and measures for its realization", which included the stabilization of the dinar, as well as implementing the privatization process by granting shares to the workers. This resulted in stopping high inflation, which rose dramatically during the 80's of the twentieth century, as well as a fast, but short-termed, increase of living standards (György, 2003). The economic transition formally began in this period with the bringing of the *Law on Social Capital.*

The disintegration of Socialist Federal Republic of Yugoslavia (SFRY), caused by ethnic hatred and great historical and political antagonism of the Yugoslav nations, led to significant macro-economic instability and an increase of social tensions (Mijatović, 1998). The FRY, composing of Serbia and Montenegro, was founded on 27th April 1992, after Slovenia, Croatia, Macedonia and Bosnia and Herzegovina declared independence. With a significant delay, FRY started to adjust its institutions to new economic conditions and build the open market economy with dominant participation of the private property and high level of competition. Previously, immediately after disintegration of SFRY, the *Law on Transforming Socially-owned Property into Private Property* was brought, which was based on the model of insider privatization (distributing shares of the companies free of charge to its workers up to 70% while 30% went to state funds) (Šuković, 2011). Such a form of company privatization was abandoned in 1995 with the argument that hyperinflation contributed to devaluation of instalments to shareholders who decided to purchase the shares of their companies. Economic and political sanctions were imposed on FRY by the international community in May of 1992 and were lifted in November of 1995 after signing of the Dayton Peace Accords. These sanctions have influenced trade flows, FDI, bank transfers, access to international financial markets, membership in international organizations, general inflow of information and free travel abroad (Uvalic, 2007). A sharp decrease of economic activity was marked in 1992 with an inflation rate expressed in thousands of billion index points. With an aim of curbing inflation, stabilizing economic trends and revitalizing the economy, a second stabilization programme was implemented in the beginning of 1994 under the title "Programme of Monetary Reconstruction and Economic Recovery".

The position of FRY was further worsened by the NATO military intervention, from March to June 1999, during which the transport and communication infrastructure of the country was considerably damaged. Numerous restrictive measures and sanctions towards FRY, brought by the EU starting from 1998 because of the crisis which arose in Kosovo and Metohia, were gradually abolished only after political changes in October of 2000, which represented a clear signal of support by Western countries for the new political course of the country. In 2001, the new authorities singled out the creation of new institutions and the market environment for the economic and investment activities, as well as harmonization of legal system with the *acquis communautaire*, as the main direction of institutional adjustment. EU provided financial support to Serbia which was aimed at institutional strengthening, economic reforms and modernization of the economy and society in general. On the way to EU membership, Serbia and Montenegro has made efforts to establish a legal and institutional infrastructure that already exists in European countries and create favorable environment for strengthening entrepreneurship and greater investment by domestic and foreign investors (Bošnjak, 2002). As a major route restructuring of the real sector, it was determined the privatization and FDI, the rehabilitation of the banking sector and the entry of foreign banks. In this period, the quality of governance was improved, price and exchange rates were liberalized, artificial administrative restrictions on foreign trade were eliminated and stabilization and healing of banks and financial sector were achieved (FEFA, 2008).

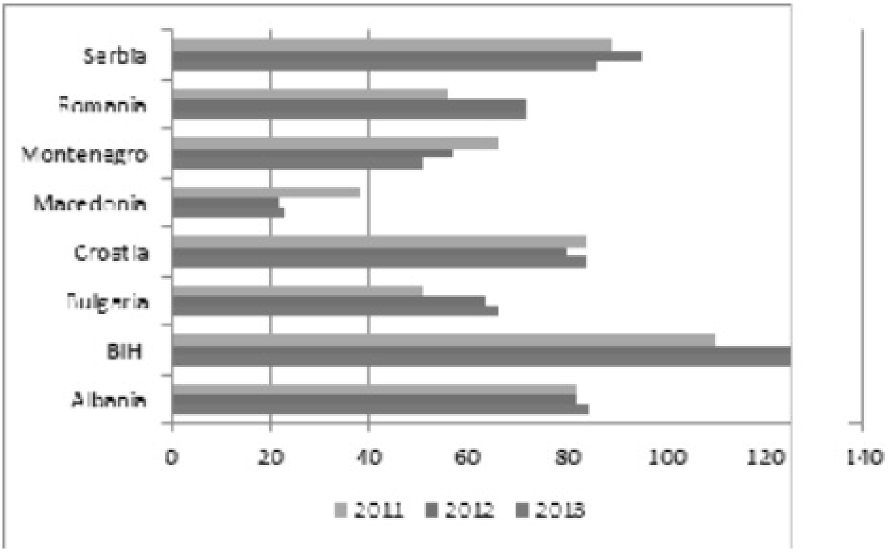
With the overthrowing of the old regime, Serbia was restored, using emergency procedures, to international institutions, starting from the UN, WB, IMF and others. The state union of Serbia and Montenegro ceased to exist in 2006 based on the results of the referendum on state-legal status of Montenegro, while Kosovo and Metohia self-proclaimed unilateral independence from Serbia in 2008. After the political changes in the year 2000, conditions for developing more intense relations with the European Union were created. With an aim to support the rule of law and implementation of democratic changes in Serbia, the EU unilaterally applied duty-free access to the EU market for products coming from its markets. Serbia submitted a request for EU membership on 22nd December 2009. The Agreement on Stabilization and Association with Serbia was signed in April 2008 together with the *Interim agreement on trade and trade related matters*, and presently is in the process of ratification. Serbia began implementation of the Interim agreement on 1st January 2009. A significant move towards the EU was realized with the liberalization of the visa regime for citizens of Serbia travelling to the "Schengen" zone on 19th December 2009, approved by the European Council after consultations with the European Parliament. The Serbian Government adopted the National Programme for Integration with the EU for the period 2008-2012, in October 2008, with an aim of coordinating its legislation with the legal attainments of the EU. Taking into consideration the significant progress towards fulfilling the Copenhagen criteria, as well as conditions from the *Process of Stabilization and Association*, the European Council brought a decision in March 2012 that Serbia be awarded candidate status for EU membership (EC, 2011).

The current state of the Serbian economy is owed to unsuccessful transition and privatization. Since the transition models can be defined as roads with no signs which are full of challenges, it is not surprising that too much precious time have been lost in their selection and numerous errors and omissions have appeared (Maksimović, 2009). Many enterprises stopped working due to the disorientation in condition of increased competition, standardization, and the inevitable changes brought by the Internet and globalization. The owner of big business significantly contributed to the collapse of Serbian economy. With the support of political and legal system of our country they ook on the attractive property and land, incompleting the obligations from their sales contracts. Their motive for such step was not an aspiration for improving economic efficiency of enterprise but stopping the business process and capitalization the property. Another problem were the employees but the new owners payed off severance pay to them from the funds created by selling the profitable parts of enterprise (Sekulić et al., 2009).

The global economic crisis caused a decrease of the GDP per capita in 2009, bringing about serious consequences in the whole region of the country and especially in the south-western, southern and south-eastern parts of Serbia (Radovanović, 2010). The recession of the growth of economic activities in Serbia is also in direct connection with all happenings in the country, which have been previously mentioned. The relatively low level of overall economic and investment activity, high unemployment, foreign debt and trade deficit, strong social tensions, low competitiveness of the economy are just some of the problems that impose restrictions on the economic development of Serbia and justify why Serbian economy has not yet managed to reach the level of GDP from the early 90s. (Graph 3)

In condition of unfinished transition process, economic policy was faced with a number of development restrictions, which require new and fast solutions. Since the 2000s, Serbia has applied the inappropriate development model based on unrealistic assumptions. Strong FDI inflows provided the macroeconomic stability of the domestic economy, where most of the economic growth in the previous period was based on a disproportionately large share of the service sector. Considering their share in GDP and export, industry and agriculture didn't have a great impact on economic growth, while the service sector dominated. According to the annual report "Doing Business 2013" prepared by the World Bank, Serbia was ranked 86th out 185 countries in the Ease of Doing Business rating. This indicates that Serbia is still in the group of countries with the unfavorable operating conditions. From the micro- and macro – economic aspects, a key obstacle to greater economic growth has been a reduced demand, together with low levels of productivity and competitiveness, and a high degree of uncertainty about the future course of events in the international and domestic environment. From the graph it is obvious that Serbia, Montenegro and Macedonia have improved their

Graph 3. Ease of Doing Business in SEE region – Global ranking out of 185 countries from 2011 to 2013



Source: Doing business.

business environment and encouraged the entrepreneurship while the ogher countries didn't manage to keep positive dynamic.

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INSTITUCIONALNO UREĐENJE KAO DETERMINANTA PRIVLAČENJA SDI – PRIMER SRBIJE

Apstrakt: Zemlje Jugoistočne Evrope i dalje predstavljaju neto uvoznice stranih direktnih investicija (SDI) u formi prekograničnih merdžera i akvizicija. Kompanije iz ovih zemalja se nisu značajno uključile u ovaj vid ekspanzije na inostrana tržišta. Glavne prepreke razvoju preduzetništva u njihovom poslovnom okruženju predstavljaju visok nivo korupcije i glomazna državna administracija. Kao posledica, njihove privrede karakteriše niska konkurentnost, visoki trgovinski deficit i nedovoljan priliv SDI za podršku njihovog procesa tranzicije sa centralno planske u tržišnu privredu.

Kreiranje efikasnog i transparentnog zakonskog i institucionalnog okvira predstavlja ključnu determinantu priliva SDI. Institucionalno uređenje u zemljama Jugoistočne Evrope ima uticaj na način ulaska SDI budući da nerazvijene institucije doprinose povećanju troškova otpočinjanja poslovanja. Stoga im napori u cilju podizanja kvaliteta institucionalnog uređenja mogu obezbediti veći priliv SDI i brži razvoj i sustizanje razvijenih zemalja. Kako bi omogućili uvid u značaj institucionalnog uređenja u Srbiji, autori će ukazati na najznačajnije ekonomske i političke događaje s početka 90-ih godina koji su imali direktan i indirektan uticaj na nivo SDI.

Ključne reči: institucionalno uređenje, tranzicija, reforme, SDI, poslovno okruženje.