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HOW THE BANK EFFICIENCY CHANGES: THE CASE OF BULGARIA*

Abstract: *The paper traces the trends in the development of the Bulgarian banking system focusing on the dynamics of bank efficiency. Although the financial crisis in 1996-1997 and the following shift in monetary regime (introduction of Currency Board Arrangement) exerted significant influence on the development of banking sector characteristics, the study covers only period of 1999-2006 because of the lack of consistent available data prior 1999.*

During the analyzed period the impact on the bank efficiency of the following factors is studied: the change in property, penetration of the foreign commercial banks on the local banking market, competition, structure of bank assets and liabilities, central bank policy in respect to credit activity and so on. The traditional accounting approaches to bank efficiency evaluation are analyzed. The paper presents also a survey of literature on the banking system and bank efficiency development in Bulgaria.

Key words: *bank efficiency, Bulgarian banking system, foreign banks*
JEL classification: G21, P34

1. Introduction

The efficiency of the Bulgarian banking system has been subject to several studies during the last years. Most of them are comparative studies focusing on transition economies in order to measure the effect of privatisation on bank performance (Bonin, Hasan and Wachel, 2004a, 2004b; Athanasoglou et al., 2006) and the influence of foreign banks entry and foreign ownership with controlling power on bank efficiency (Havrylchyk and Jurzyk, 2006).). The operational efficiency of the Bulgarian banking system has been studied in a pool of transi-

* The paper was presented at the VIII international conference, SU HSE, Moscow, April 2007.

tion countries, using modern approaches like deterministic and non-parametric Data envelopment analysis (Grigorian and Manole, 2002; Tomova, Nenovsky and Naneva, 2004; Tomova, 2005) or stochastic and parametric Stochastic frontier approach (Yildirim and Philippatos, 2002). Those analyses provide an estimation of different types of banking inefficiency (average X-inefficiency, average profit-inefficiency or average technological inefficiency), covering the period till 2002. Only Nenkova and Tomova (2003) try to estimate the technical efficiency of the Bulgarian banking system alone but as the data covers only the period December 1999 - June 2001, their estimates are not reliable.

In this paper we use a simple based on operational efficiency accounting measures approach and we test two hypotheses on the efficiency of the Bulgarian banking system: hypothesis 1: the foreign-owned banks are more efficient than domestic-owned banks, and hypothesis 2: the large banks in the Bulgarian economy are more efficient than the small ones.

2. History of the Bulgarian banking system

Major institutional reforms in the banking system took place at the end of 1989. The reform in financial sector began with the reestablishment of the commercial banks. At that time, the Bulgarian National Bank (BNB) performed almost all of the functions of the banking system. The banking system was transformed from one-tier into a two-tier banking system with the BNB on the first and the commercial banks on the second tier. The sector-specific banks were transformed into universal banks (Miller, Petranov, 2001) collecting deposits and offering credits to different economic sectors. The banking sector reform was backed up by the adoption of new legislation appropriate for functioning of the recently established two-tier banking system. With the Law on the BNB of 1991 the authority defined the objectives and functions of the Central Bank and granted its independence from the government. A year later the Law on banks and credit activity came into force, where the different activities banks could perform were defined according to the type of granted license[1]. Following the transformation of 59 branches of the BNB into commercial banks in 1990, the number of banks reached 70. After 1992 it started to decrease as a result of their consolidation[2].

Many state-owned commercial banks existed and they turned out to be inefficient since they were forced by the government to provide credits to loss-making state enterprises. The commercial banks inefficiency was the reason for the

[1] The banks with full license could operate in the country and abroad, while the banks with restricted license could operate only in the country.

[2] In 1992 United Bulgarian Bank was created from 22 small banks, in 1993 Express bank and Hebros bank emerged, and in 1995 Biochim took over Sofia bank (see Berlemann, Nenovsky, Hristov, 2002).

establishment of the Bulgarian Consolidation Company (BCC) in 1992 (Miller, Petranov, 2001). The core objectives of the BCC were to consolidate, restructure and privatise state-owned commercial banks. The BNB also tried to encourage the process of consolidation by raising minimum required capital. Since the beginning of the banking system reforms the authorities have decided not to permit foreign banks to enter the market because of the fear that they could put pressure on local commercial banks[3]. Although the banking supervision regulations were developed according to the international standards, their enforcement was poor and the licensing policy of BNB was rather loose (Balyozov, 1999). The delayed privatization and the lack of financial discipline deepened the transfer of state-owned enterprises' losses to the banking system, which together with poor lending practices, led to the decapitalization of several banks. Deposit runs were a natural outcome and they started in late 1995 with the BNB performing as a lender of first instead of last resort (Berlemann, Hristov and Nenovsky, 2002)[4].

The banking crisis aggravated in 1996 and turned into a large-scaled financial crisis, which was resolved by the introduction of the currency board arrangement in the middle of 1997. A new stage of banking sector reform started: entirely new laws on BNB and commercial banks were adopted, entry of foreign banks was liberalized, supervision policies were strictly applied, and privatization and competition were encouraged. Regardless of the broad improvement in the environment, the commercial banks started to optimize their behaviour providing new products and improving their efficiency only several years ago when the international interest rates fell to extremely low levels thus pushing the banks to the very natural way of performing banking activities[5].

3. Bank efficiency of the Bulgarian banking system

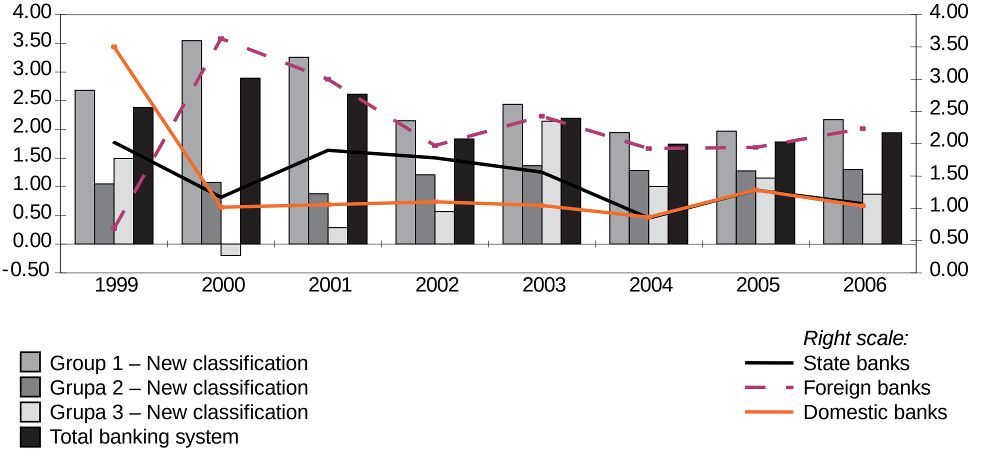
As we have seen there are numerous studies on the banking system efficiency. Most of them provide an analysis of the banking systems in the transition economies. During the last years the research has been focused on the bank efficiency comparison between the EU members, the new EU members and the candidate countries for full EU membership. The issue of the banking systems' efficiency of the new and future EU members is gaining importance in view of the fact that the more efficient are the banking systems, the more the country

3 The restriction of foreign banks entry was pursued until 1995 and their number as of end of 1995 is only 4 (Berlemann, Hristov and Nenovsky 2002).

4 Several studies provide a detailed analysis on the Bulgarian banking system and the main corner stones in its development. See for example those of Milller and Petranov (1996, 2001), Trifonova (2002), Vucheva (2001), Caporale et al. (2002), etc.

5 On the issues of financial repression, credit rationing, credit activity and credit capacity see Nenovsky and Hristov (1998), Hristov and Mihaylov (2002), etc.

Figure 1. *Return on Assets – ROA*



Source: BNB, own calculations

will have the capacity to converge to the EU because of the provided conditions through financial intermediation for higher economic growth.

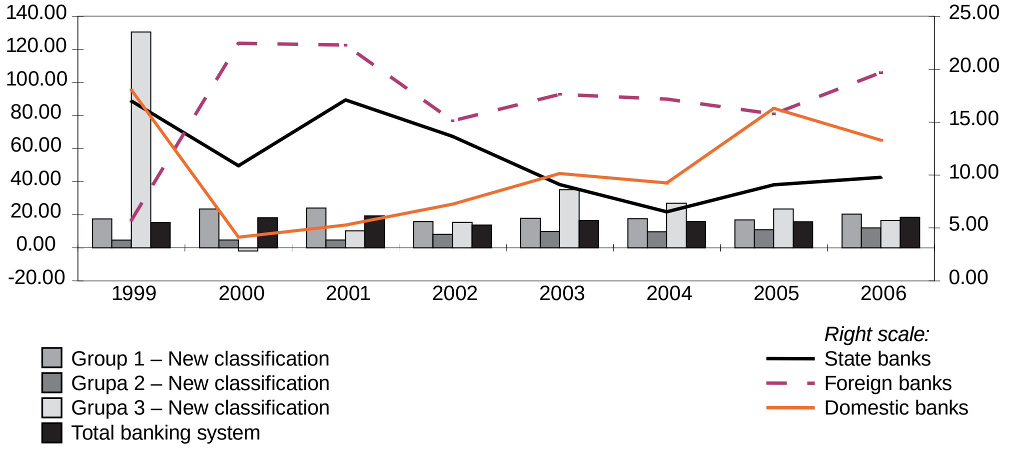
In the paper we focus on the analysis of the standard bank efficiency indicators like return on assets (ROA) and return on equity (ROE). Several ratios to total banks' assets are also analysed – those are operating profit, net interest income, non-interest expenditures and exchange rate revaluations. We use a three groups' classification of the banks[6]. The first ten banks form the first group, the remaining banks are in the second group and the last group includes the foreign banks branches. For the purposes of the study and ensuring the comparison for the analysed period we made a reclassification of the banking institutions for the period until 2003 in compliance with the three groups' classification.

In order to test the first hypothesis we produced an alternative classification of the bank units. Using the criterion of the ownership of the bank' capital we obtained three groups: foreign banks with the majority of shares held by foreigners, domestic banks with the majority of shares held by domestic owners, and state-owned banks with a government institution as a major shareholder.

By intuition we may state that the bank efficiency depends on the activity of the banking system, legislation, administrative measures imposed by the central bank and some external factors. By looking at the dynamics of the bank efficiency indicators it could be noticed that there is not specified trend in them,

[6] Until 2003 the bank groups were five. The classification was made on the basis of the amount of the banking assets. The first group included the banks with total assets of more than BGN 800 mln. (before 2000 – BGN 500 mln.), the second group included banks with total assets of more than BGN 300 mln., the third group included the banks with total assets of more than BGN 100 mln., the forth group included the banks with total assets of less than BGN 100 mln., and the fifth group included the branches of the foreign banks.

Figure 2. *Return on Eqity Capital – ROE*



Source: BNB, own calculations

because they depend on several factors simultaneously. By more detailed analysis we will try to identify the main factors, driving the bank efficiency in Bulgaria.

The return on assets indicator shows a relatively high efficiency of the Bulgarian banking system[7], because of the high profits realised in the sector (figure 1). Starting from very high level (4.98 at the end of 1997) it decreased for one year and again started to step up reaching 2.89 in 2000. The high values of ROA in 1997 might be explained by the possibilities of the banks to gain from the exchange rate movements as a result of the national currency depreciation, especially in the first half of the year. After the deep financial crisis in June 1997 the Bulgarian currency was pegged to the Euro and the banking system lost this opportunity. As a result the growth rates of the net profits of banks started to decelerate and the ROA slowed down. After 2000 the decrease in the indicator was driven by the decline in the interest rates on the international markets[8], and by the depreciation of the USD against Euro (Bulgarian Lev respectively) in 2002. During the next years the ROA remained relatively stable, with the exception of 2003, when a considerable credit growth in the banking system was observed[9] (figure 3).

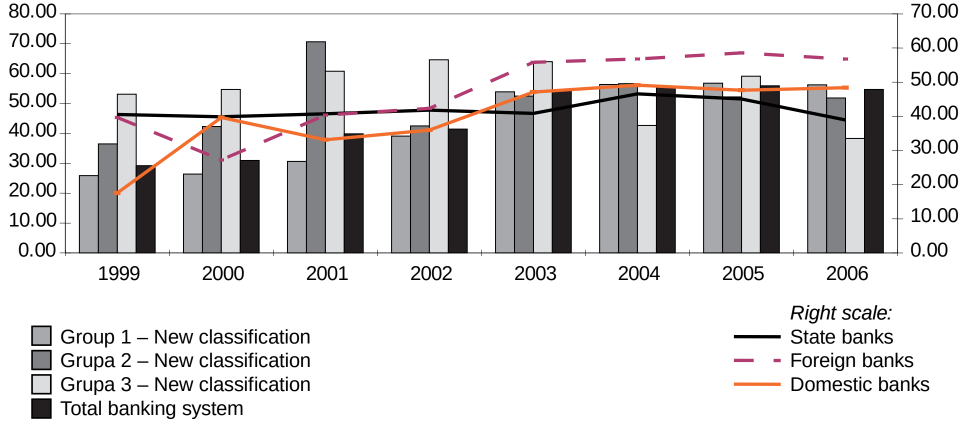
The ROA developments of the different banks groups reveal that ROA of the first group has the same dynamics as the ROA of the total banking system. Actu-

[7] For the purpose of comparison the EU-25 average return on risk-weighted assets is 1.44 as end of 2005 (ECB, 2006).

[8] In 2001 the main part of the bank assets was claims on financial institutions or bank assets invested abroad. The share of claims on financial institution was 33.1% of the total banks assets, whereas the share of claims on non-financial assets was 33.9% of the total assets in 2001.

[9] The credit growth in 2003 was 49.4%, while in 2001 and 2002 it was 37.2% and 45.5% respectively.

Figure 3. *Credits to non-financial institutions and other clients*

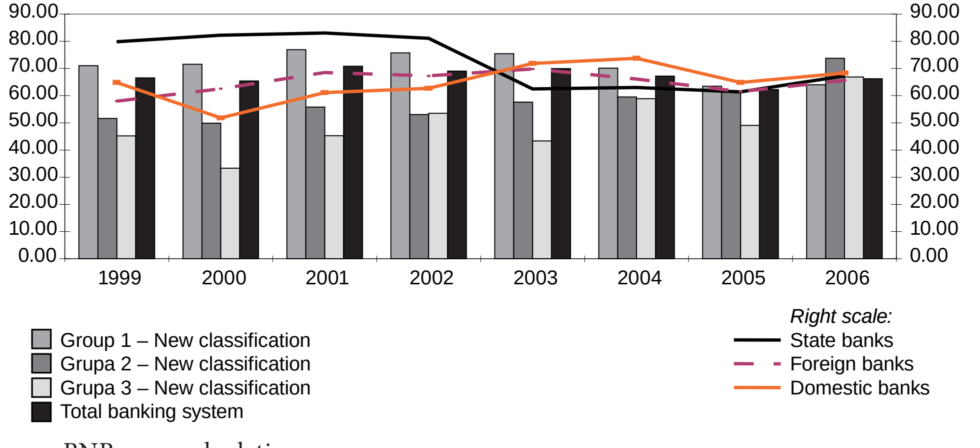


Source: BNB, own calculations

ally, the first group determines the dynamics of the ROA in the banking system because it comprises more than 75% of the total assets in the banking system (79.5% in 1999). The ROA of the second group is moving relatively steady with the exception of 2001 and 2003, where the same factors – the interest rates movements and the high credit growths – exerted influence on the respective direction.

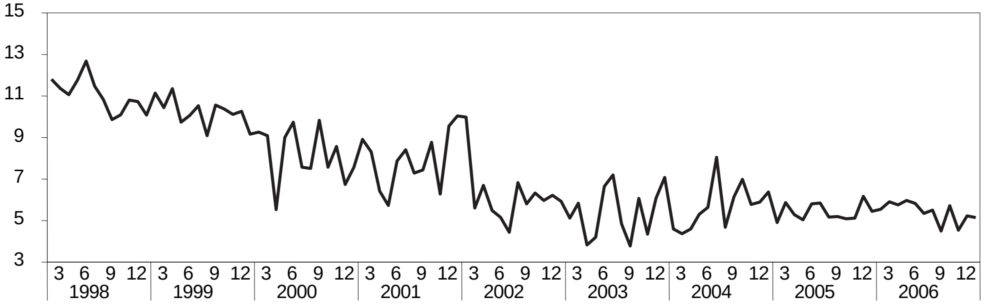
According to the ownership classification groups a considerable change in the ROA of the foreign banks and domestic banks is observed. In 2000 Bulbank was sold to a strategic foreign bank and this contributed to the significant increase in the ROA of the foreign banks group. As the ROA of the Bulbank increased more than sixty percent it could be claimed that the privatisation has

Figure 4. *Deposits to Non-financial Institutions and Other Clients*



Source: BNB, own calculations

Figure 5. *Interest spread*



Source: BNB, own calculations

some effect on the bank efficiency. In 2003 there was again a new spike in the ROA of foreign banks when bank DSK was privatised, which confirms the stated thesis. After this period there were not new foreign entries and the ROA stabilised. At the end of 2006 again there was an increase, this time due to the better performance of the foreign banks and probably decreased non-interest expenditures as a result of technological improvements. It should be pointed out that after 2000 the foreign banks have the highest profitability, measured by the ROA indicator, which could be explained with the transfer of the technological advance, experience and knowledge of the foreign banks in the bank management of the privatised domestic banks.

Since 2002 the state-owned banks and domestic banks have the same ROA, which could be explained with the high competition in the sector (see the Appendix)[10].

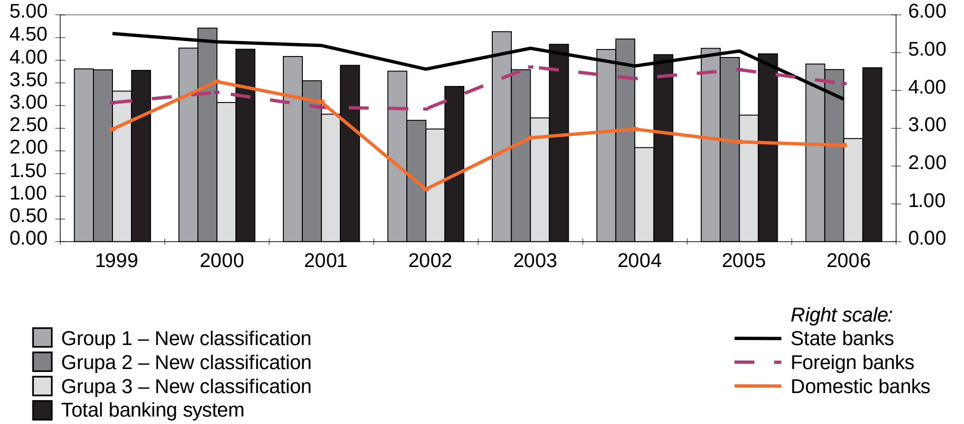
The bank efficiency, measured by return on equity (ROE), is also relatively high[11]. In 1999 it decreased to 15.2% in comparison with 1997, when it was 40.5%. The introduction of the Currency board, the strong monetary rules and the new capital requirements has contributed to this slow-down. In 2000 and 2001 it stepped up for a while and in 2002 again registered a decrease mainly due to the exchange rates revaluations. For the next years the indicator remained relatively stable with the exception of 2006, when it augmented because of the deceleration of the capital rise.

The ROE is different for the separate banking groups. The largest volatility is observed in the third group, where the indicator moves in the limits of -1.96 to 130.5%. The second banking group had moderate increase in the ROE, especially

[10] We measure the competition with Herfindahl index and the concentration coefficient in respect to bank assets, claims on non-financial institutions and other clients and deposits of non-financial institutions and other client.

[11] For the purpose of comparison the EU-25 average return on equity is 19.56 as end of 2005 (ECB, 2006).

Figure 6. *Net interest income*

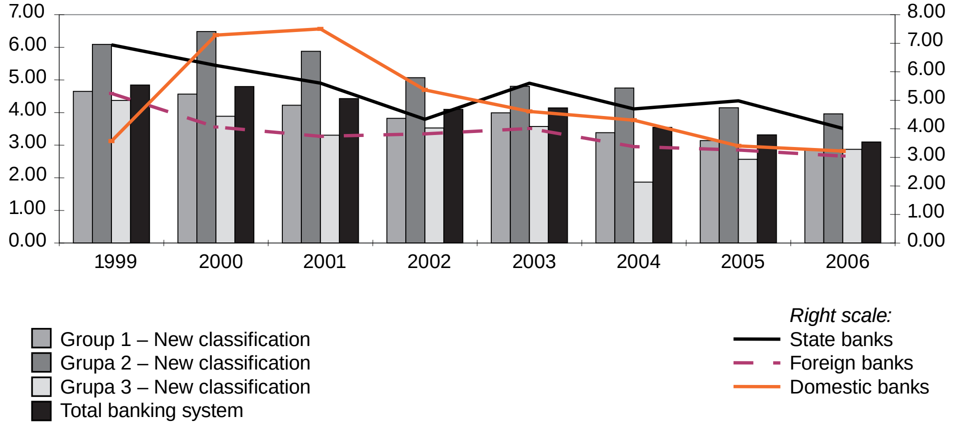


Source: BNB, own calculations

after the spike in 2002. Actually, the indicator for the entire banking system in Bulgaria is determined by the dynamics of the indicator for the first and third group.

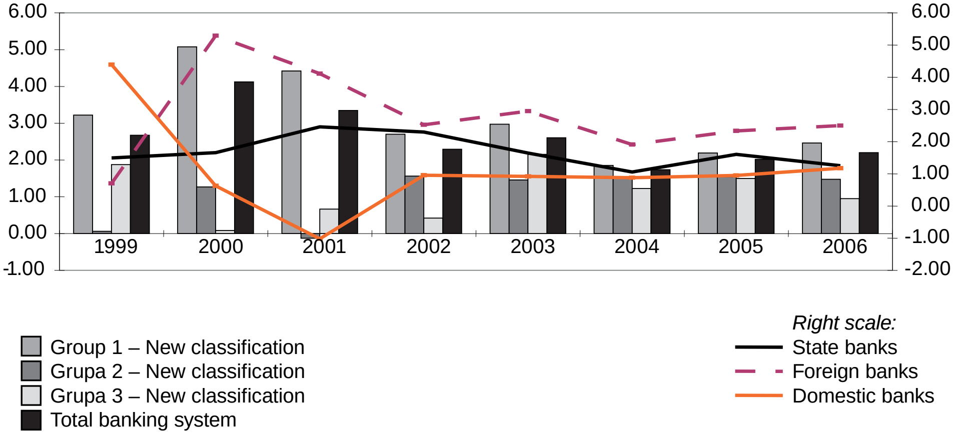
Concerning the ownership structure groups, the most efficient banks are the foreign ones, which is due to the reasons stated above. The dynamics of ROE follows the dynamics of ROA in the foreign bank group. However, the efficiency of the domestic banks followed an upward trend after the privatisation of Bulbank in 2000. In 2006 there was a slight decrease of the indicator due to restrained opportunities for net profits of the domestic banks as a result of the central bank measures for curbing bank credit activities (figure 3). Additional factors are the increase in the price of the attracted financial resources by domestic banks

Figure 7. *Non-interest expenditures*



Source: BNB, own calculations

Figure 8. *Operating profit*



Source: BNB, own calculations

(interest rates on term deposits increased by 0.23 percentage points in 2006 compared with 2005 interest rates of 3.24%) and the competition in the bank sector mainly in respect to deposits collection (figure 4). At the same time the state-owned banks are characterised with decreasing bank efficiency in most years in the analysed period. During the last four years they showed the lowest bank efficiency in the banking system.

A standard measure of efficiency improvement is the declining interest spread in the country as lower cost of credit encourages investment projects implementation and stimulates economic growth. Although the interest spread in Bulgaria is about 3-3.5 percentage points higher than its average level in EU, it follows steadily a downward path with the financial integration and the continued process of intermediation deepening (figure 5). Although the net non-interest income contribution to total income generation is steadily increasing, the net interest income remains the most important source of income for the Bulgarian banking system mainly because of the high interest spread (figure 6). However, since 2004 there is a slight decrease in net interest income (more pronounced for the second group of small and medium-sized banks), which reflects the higher costs on financing and the slow-down of credit activity.

Another positive impact on the bank efficiency comes from the non-interest expenditures of the banks (figure 7). Since 2000 the administrative costs follow a downward trend, driven by the improvement of banking institutions management allover the system. The most significant drop in those costs is observed in the group of domestic banks, as they converge quickly to the respective ratios of the foreign banks.

The observed tendencies are reflected in the dynamics of operating profit to total assets ratio, which after a significant drop in the period 2000-2003 stabilized and started to grow again. This, with lowering interest spread and decreasing non-interest expenditures reflects the improved efficiency of the banking institutions. The most efficient is the group of large banks due to the economies of scale, and in respect to the second classification – the group of foreign banks due to the flexibility of financing and better access to managerial and technology improvements. The stabilization of operating profit observed in the group of domestic banks proves that as a whole this group is improving its potential to operate under increased competition pressure and in that process it contributes to transforming the banking system into more efficient one.

4. Conclusion

In the paper we estimated and analysed the bank efficiency of the Bulgarian banking system by separating the banking system into several major groups, according to the ownership structure and bank assets. We used standard indicators for bank efficiency, namely return on assets, and return on capital, operating profit, net interest income, non-interest expenditures and exchange rate revaluations. The lack of data concerning particular banks prior to 1999 prevented us from providing a consistent analysis for the period preceding the Currency board introduction. However, using the official data we made some conclusions for the current state of the banking system profitability and confirmed the tested hypotheses.

On the ground of the analysis we come to the conclusion that during the analysed period foreign banks perform better than domestic and state-owned banks. Their efficiency is higher than that of other banks because of the technological improvements and better managerial knowledge and experience. Actually, the privatisation of the state-owned banks had a positive impact not only on the privatised banks efficiency but also on the entire system.

In addition the large banks turned out to be more efficient in comparison with the small ones. The reasons behind are the decreasing operating costs and the advantage of scale economies realisation. The accumulation of large financial resources, the need for better management and the increased competition in the banking system put pressure on the small banks, which inevitably led to the significant non-interest expenditures. However, such investments are expected to increase the small banks' capacity to further improve their efficiency in the future.

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Appendix

Table 1: *Measures of Concentration in the Banking Sector*

	XII 1999	XII 2000	XII 2001	XII 2002	XII 2003	XII 2004	XII 2005	XII 2006
Banks assets								
Herfindahl Index	0.12	0.11	0.09	0.08	0.08	0.07	0.07	0.07
Concentration Coefficient (%)	57	55.2	51.4	49.9	47	44.2	42.19	41.18
Claims on non-financial institutions and other clients								
Herfindahl Index	0.08	0.07	0.07	0.07	0.07	0.08	0.08	0.08
Concentration Coefficient (%)	43.6	42	41.1	41.85	43.15	45.36	44.98	44.19
Deposits of non-financial institutions and other clients								
Herfindahl Index	0.13	0.13	0.11	0.1	0.09	0.08	0.08	0.07
Concentration Coefficient (%)	61.7	62.2	58.2	55.8	53.07	50.32	46.79	43.79

Source: Miller and Petranov (1996), BNB, AEAF, own calculations.

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PRICE INDICATORS IN STOCK MARKETS

Abstract: *There are large numbers of investors, both large and small, in all stock exchanges, who are trying to find the right solution to the alchemy of stock prices. In this way, they are trying to beat the market and make a profit through differences between selling and buying prices of items on the stock exchange.*

Various analytical devices are used for the purposes of better acquaintance with the current situation and, especially, for predicting future changes in stock prices. One of the basic indicators of the general situation on a given stock exchange is the achieved level of prices and price changes during an observed time period. Numerous indicators are used in such analyses, and all can be classified into two basic groups: stock exhange averages and indexes.

The meaning of both is to offer reliable information to investors about (expected) price changes on stock exchanges. Exchange averages are simpler to calculate and have been highly popular in the past. However, due to the present-day methods of calculating, they tend to show more the direction than the degree of price changes on stock exchanges.

Price averages are more common in expert analyses, since they provide a clearer picture of the degree of stock exchange price variations.

The basic shortcoming of both methods is that they provide investors with ex post facto data, without providing the most important information: what is happening with individual prices of certain stock exchange items.

Key words: *stock exchanges, stock prices, Dow Jones Average, stock price averages, stock price indices*

JEL classification: E44, G12

1. Introductory notes

There exists a large number of price indicators on stock markets. There are great differences between them in the ways they are calculated and in their scope, but they all came about for the same reason. In striving to beat the market, investors always have in mind the basic principle of trading: *buy as cheaply as possible, sell as dearly as possible*.

In stock market trading, this universal trading demand can be modified in the following way: *buy when prices reach their lowest level, sell when the price is the highest*. Since all stock market participants have the same goal, mutual competition and a lack of real information prevent them from maximizing the profits they expect from stock trading. For this reason they use various methods for measuring the general level of stock prices and their changes in certain time intervals. On the basis of movements in the general level of prices, conclusions are drawn regarding future sector and individual changes in stock prices. On the basis of this, strategies of buying and selling stocks are formulated, with the goal of achieving maximum profits.

Stock change indicators do not try to determine how prices will change in the future but show how stock prices have changed in the past. In other words, the selected indicators do not have an *ex ante* approach, but only register the already occurred price changes (*ex post*). Regardless of this significant limitation, various indicators of stock price changes are today broadly used in analyzing stock market operations and in making decisions on whether to buy or sell stocks. In addition, such indicators have become irreplaceable indicators of the general state of the economy and the basic indicators of the most important economic aggregates.

The first indicator of stock price changes, created more than 100 years ago, was the *Dow Jones Average*, which encompassed 11 selected railroad companies and represented their average price. Since then, numerous forms of measuring stock price changes have been developed. These can be divided into two basic groups: 1) *stock price averages* and 2) *stock price indexes*.

2. Stock price averages

Stock price averages are calculated by totaling the stock prices of selected companies and dividing them by the number which is, for a specified period, defined as the *divisor*. The calculation portfolio includes one share of each company from the list, so that the weighting is defined by the *price level* of the said security. In other words, the higher the price of a given stock, the greater its relative influence on the average, regardless of the quantity of shares sold and the company's market value. Putting it another way, a change in the price of a more expensive share changes the value of the indicator more than an equivalent price change of a cheaper share. Changes in the value of the average and the weight depend only on the share's price movements.

The representative list contains at least 15-20 companies, which are usually divided into industrial and transportation sectors. Share price averages are calculated and published separately for both sectors, while some indicators also encompass utilities. Sometimes a synthetic indicator, which encompasses companies from all three sectors, is calculated.

In the past, share price averages were applied to daily changes, while under present-day conditions they are registered for each hour or each minute from the opening of the market.

2.1. Problems with calculation

Although various models of share price estimation are very popular both with stock market analysts and investors, there are at least a few problems that complicate the creation and application of these indicators. The greatest difficulties are caused by: 1) changes of stocks on the list, 2) changes in the size of the list and 3) stock splits.

Changes of stocks on the list. Occasionally, the list of companies whose stocks are used for estimating prices changes. The reasons why some shares are changed in favor of others vary: the company has been either integrated, transformed or become defunct. In addition, a company may lose its previous status and become insufficiently representative. As a result, its shares are no longer considered when price changes are gauged.

In case the stocks on the list are changed, regardless of the reason, those who compile the averages have two available options.

a) Choose another company's stock, which sells at a similar price. If such stocks do not exist on the given market, then the difference between the old and the new stock is harmonized with the needs of the analysis by adding or subtracting the necessary nominal amount relative to the previous estimate. This is certainly not a correct statistical method, but it satisfies the basic requirements of the price estimators.
b) According to the second approach, the problem that appears in case of a change of stocks on the list can be overcome by adjusting the divisor.

Changes of stocks on the list used for price tracking are rare. The list of industrial companies used for obtaining the Dow Jones indicator, the best known indicator from this group, did not change between 1950 and 1955. There were also no changes in the 1962-1986 period, while five stocks were changed between 1956 and 1961.

Changes in the size of the list. Problems with gauging stock prices can also appear when the size of the list is changed. Previous experiences with all evaluation methods show that the number of included companies has steadily increased. In such situations, the evaluation for the new list must be performed in the same way as for the old, if the serial is published continuously. This can be done either by recalculating the old averages for the entire period and, thus, accommodating to the new list, or by using a divisor that makes the new average identical to the old at the moment of change.

Expansions of the list rarely occur; thus, the Dow Jones industrial and railroad averages, as far as the number of stocks is concerned, have remained unchanged since 1928, while the Utility Average has remained unchanged since 1938.

Stock splits. In the process of evaluating price changes, the most frequent problems are caused by *stock splits*. This mainly happens during bull markets. In the period between 1968 and 1970, there were many cases of stock splits, which caused numerous problems for price-evaluating analysts.

If shares worth 200 U.S. dollars are split in a proportion of 4:1, 160 dollars would be subtracted from the total used for price evaluation, if no adjustment was made. If the average is based on 10 stocks, then the fall in the price would be 16 dollars per stock, which would cause a change (reduction) in the average, even though this did not actually happen on the market. That is why it is necessary to perform an adjustment in such situations, so as not to obtain skewed and inaccurate stock price evaluations.

Adjustment after a stock split can be performed in three ways.

a) The stock can be exchanged for another stock. This used to be done in the past with some averages, but it is very difficult to find stocks from the same sector and with the same price. The difficulties were even more pronounced if the stock in question belonged to an important company in its field, which is why this method was often criticized.
b) The second way to overcome problems caused by a stock split is to use multipliers. If a stock was split in a 4:1 proportion, the new price should be multiplied by 4. This is a simple and acceptable way of adjustment.
c) The third possibility is to change the divisor so that the degree of change remains the same. This kind of adjustment is used with the Dow Jones Average. This can be explained through the simple example of five stocks that are being evaluated:

Stock	Price	
A	30	
B	35	
C	20	
D	25	
E	40	
	150	150 : 5 = 30

If stock E is split 4:1, its price falls to 10. The total value of the evaluated stocks now equals 120, or 24 per item. Practically, the value of the average would have fallen from 30 to 24, even though nothing had essentially changed on the market. That is why the divisor is changed, in the following way:

$$\text{New divisor} = \frac{\text{New aggregate price}}{\text{Old price average}}$$

$$\text{New average} = \frac{\text{New aggregate price}}{\text{New divisor}}$$

New divisor =120:30=4; New average=120:4=30
The average has been restored to the value of 30.

In September 1991, the Dow Jones Industrial Average used the divisor 0.559; the Transportation Average divisor was 0.709, while the Utility Average divisor was 1.997. The composite evaluation for all 65 stocks had a divisor of 2.751.

If the prices of the stocks used in the averages are added up and then divided by the divisor obtained in the previously described way, an exact evaluation is obtained. For example, if 100 stocks in the industrial estimate were sold for 30 dollars per share, the total value of 3,000 dollars must be divided by the divisor of 0.559 in order to obtain an evaluation equal to 5,366.73.

2.2. The Dow Jones Average

This is certainly the best known model of all the averages in use. In the daily reports from the New York Stock Exchange, the *Dow Jones* (*Industrial) Average* has a prominent place, as a basic indicator of the state and price changes of stocks on the world's best known stock exchange.

There are numerous reasons why the Dow Jones averages have acquired their exceptional popularity. First, they are the oldest of all the averages. Second, combined with the Dow Theory they represent an indispensable element for proponents of technical analysis of stock prices. Finally, careful analysts used the Dow Jones Average to call attention to the depth of the great crisis in the American economy at the end of the 1920s. Under present-day conditions, various technical analysis models have enjoyed unprecedented expansion, which has contributed to the reaffirmation of these evaluations. Due to all these factors, as far as the general public is concerned, the Dow Jones Averages – in spite of their shortcomings – represent the basic indicator of stock market changes and of the general state of the American economy.

These averages were developed by Charles Dow, who published his first list in 1884, with only 11 stocks. As can be seen from the tabular overview, the list contained almost exclusively railroad company stocks, which totally dominated the American economy at that time.

The first list used for the Dow Jones Average contained the following stocks:

Chicago & North Western
Delaware, Lackawanna & Western
Lake Shore
Louisville & Nashville
Missouri Pacific
New York Central
Northern Pacific Preferred
Pacific Mail
St. Paul
Union Pacific
Western Union

The original average with 11 stocks was expanded in 1897 to 20 railroad companies. This number has remained unchanged until today, except that the railroad average was changed into the Transportation Average on January 2, 1970, when 9 railroad companies were removed from the list and replaced with 6 airline and 3 truck transportation stocks. At the same time, several stocks on the list of transportation companies were replaced by others in 1970.

In March 2008, the Transportation Average consisted of the following stocks:

AMR Corp.
Airbrn Freigt
Alaska Air
Amer Pres
Burlington
Caro Feight
Cons Freight
Cons Rail
CSX Corp.
Delta Air
Fed Express
Norfolk So
Roadway Svcs
Ryder System
Santa Fe
Southwest Airl
UAL Corp.
Union Pac
USAir
Xtra Corp.

The first Dow Jones Industrial Average included 12 stocks and dates back to 1897. In 1916, the list was expanded to 20 companies. Until 1928, stocks on the list were changed frequently, and the multiplier method for adjusting stock splits was also used. In that year (1928), the method of constant division, which has remained to this day, was adopted while the list was expanded to 30 stocks.

Further changes in the structure of the list have been made since 1928, but the number of industrial companies has remained unchanged. All Dow Jones indicators are based on composite stock prices on their primary markets, rather than on their combined prices.

The Industrial Average list in March 2008 included the following companies:

Amer INTL Group (IT)
Alum Co (aluminum)
American Express (financial services)
AT&T (telecommunications)

Bank of America (banking*)*
Boeing (air industry)
Caterpillar (construction equipment)
Chevron (oil and energy)
Citygroup (insurance, financial services)
Coca-Cola (food and beverages)
Disney (media)
DuPont (chemicals)
Exxon (oil and energy)
General Electric (industry, media, financial services)
General Motors (automobiles)
Hewlett Packard (IT)
Home Depot (construction)
IBM (IT)
INTEL (IT)
Johnson & Johnson (medicines, hygiene)
McDonald's (restaurants)
Merck & Co (medicines, pharmacology)
Microsoft (IT)
Morgan J. P. (banking)
Pfizer INC (pharmaceuticals)
Procter & Gamble (maintenance and hygiene products)
Union Tech (mechanics)
Verizon Comunic (telecommunications)
Wal–Mart (distribution)

The stock of only one of the industrial companies on the original Dow Jones list in 1897, *General Electric*, has remained to this day.

The last change on the industrial list was performed on March 20, 1997, when the stocks of four companies were replaced. The stocks of *Westinghouse Electric, Texaco, Beth Steel* and *Woolworth* were excluded in favor of *Travelers, Hewlett Packard, Johnson & Johnson* and *Wal-Mart.*

The exclusion of *Westinghouse*, which had built up its power in the field of industrial plants, electrical plants and household appliances, was explained by the fact that the company had acquired the *CBS* television network and announced a division into two groups – one for industrial cooling plants and nuclear energy plants, and the other for the media.

Westinghouse was replaced by *Travelers*, a major insurance and financial firm that deals in various securities. Along with the *J.P. Morgan* company, *Travelers* represents brokerage companies in the calculation of the Dow Jones Average, and is the only representative of insurance companies.

The removal of *Texaco* from the average was explained by the fact that the existing list already included *Exxon* and *Chevron*, which are larger and more successful.

Beth Steel, it was explained, is the second-largest steel producer in the U.S. but has been racking up losses and is shedding unprofitable businesses. The second-largest computer producer in the U.S., *Hewlett Packard*, joined the leader, *IBM*, which was already on the list, while *Johnson & Johnson* joined *Merck & Co* as a representative of pharmaceutical companies.

Wal-Mart is the largest American retailer, ranking fourth on the list of 500 largest U.S. companies.

The first evaluation in the service sector (Utility Average) was performed in 1929, when a list of 18 stocks was compiled. It was quickly expanded to 20, only to be reduced to the present-day 15 in 1938. This average had less publicity from the very start and attracted less attention of both stock analysts and the public at large. As a result, it has been used mainly as a supplement to the industrial average.

In March 2008, the following stocks were on the Utility Average list:

Am El Power	*Cons N Gas*	*Panhandle*
Arkla Inc.	*Detroit Edis*	*Peoples En*
Centerior	*Houston Edis*	*Phil Elec*
Comwlth Edis	*Niag Mohawk*	*Pub Serv E*
Cons Edision	*Pacific G&E*	*SCEcorp*

2.2.1. Calculating the Dow Jones Average

Calculating the Dow Jones Average on the basis of the original list of 11 stocks from 1894 was quite simple: the prices of the listed stocks were added up and divided by the number of stocks, i.e. by 11. Thus, in its first years, the Dow Jones Average was actually a simple arithmetical average of the stocks on the list.

Problems that have appeared over time made it necessary for the Dow Jones Average to be calculated differently under present-day conditions.

Even though the indicators for industry (based on 30 stocks), transportation (20 stocks) and utilities (15 stocks) are determined separately, the same methodology is used. This methodology shall be described through the example of the Dow Jones Industrial Average (DJIA), since it is the most frequently used.

In present-day conditions, the DJIA is calculated according to the following formula:

$$DJIA = SSP / d,$$

where:

SSP is the sum of stock prices from the industrials list and
d is the divisor.

The basic problem in calculating the DJIA lies with determining the divisor. In order to do away with all the problems in this regard, the following formula has been in use since January 1, 1992:

$$\text{New divisor} = \text{Current divisor} \times \frac{\text{Total adjusted market value}}{\text{Total unadjusted market value}}$$

The total adjusted market value is calculated by adding up the final prices of the 30 stocks from the list.

The total unadjusted market value is calculated when the final price of a given stock is replaced with the new price.

The newly obtained adjusted market value of 30 stocks is divided by the previous, unadjusted market value of the stocks and then multiplied by the current divisor.

On a hypothetical example, in which 5 stocks of a total market value of 150 were used, and a 4:1 stock split occurred, the new divisor would be calculated in the following way:

New divisor = 5 × 120/150

New divisor = 5 × 0,8 = 4

Thus, the same divisor is obtained as in the previous example.

Besides the change in the way the new divisor is calculated, beginning with 1992 the divisor has been an eight-digit number, in order to reduce the deviations that occurred as a result of the round-offs to the third or fourth decimal that existed with the previous calculations.

Due to constant adjustments, the numerical value of the divisor was continually reduced, which significantly contributed to the situation in which the Dow Jones Average had come to equal about 12,500 in March 2008, even though no individual stock from the list had registered a price rise anywhere near that level.

2.3. Critique of the Dow Jones Average

Even though the use of the Dow Jones Average is the most widespread among all similar indicators of fundamental stock price changes, this approach has nevertheless attracted much criticism.

1. Some critics have taken issue with the inclusion of *AT&T* in the industrial average. This telecommunications company was on the utility list until 1939, where it belonged based on the nature of its business. At that time it was shifted to the industrial average, in order to increase the latter's evaluation weight, since the price of its stock was relatively high.
   The compilers of the Dow Jones Average have justified this decision by invoking the stability of the *AT&T* stock price, even after its split, which significantly contributed to the stabilization of the DJIA. As for its sector classification, it was argued that telecommunications are a sector complementary to industry and that these two fields form two parts of a whole, which, thus, makes it difficult to separate them.
2. The second criticism is of a fundamental nature. It is claimed that the Dow Jones encompasses an insufficient number of samples and that, as a result, it cannot be a representative indicator of changes on the stock market, on which about 1,700 companies and more than 2,200 different stocks are listed. This especially applies to the industrial average, in which 30 stocks are supposed to represent an entire series of different companies from the field.
   Supporters of the DJIA concede the point regarding the relatively small share of companies from the (industrial) list average relative to the total number of stocks on the New York Stock Exchange. However, they point out that the 30 stocks from the DJIA evaluation list make up about 25% of the total worth of all stocks on the New York Stock Exchange and 20% of the value of all stocks in the U.S.
3. The next criticism takes issue with the fact that the companies from the DJIA evaluation list are not typical representatives of the industrial sector but are, rather, the best (blue chip) representatives of the sector. Lower-priced stocks or those with a low rating are usually not used for averaging. When a stock begins to lose its popularity, it is exchanged for another, currently more attractive stock. As a result, according to critics, conclusions that are made, being based on changes in these, the highest quality stocks, cannot be reliable and cannot be taken as reflective of the general state of the stock exchange and the changes taking place on it.
   Supporters of the DJIA concede that the list contains only blue chip stocks but point out that this has been the practice since the very inception of this indicator, which means that the basic principle underlying the list hasn't changed.
4. Until the middle of 1960, the Dow Jones estimates served as a relatively successful indicator of market changes and their direction. However, since then, the critics say, they have lost their currency and reliability. Namely, since that time the DJIA has begun to indicate smaller growth during bull markets and slower declines during bear markets.

The criticisms were justified, since the list retained companies that were no longer the best representatives of the American industry they once were. *Chrysler* and *Esmark* were included in the average long after most analysts stopped considering them as blue chip companies. This is why changes on the averages list were made. In June 1979, the two above-mentioned companies were excluded and replaced by the stock of *Merck & Co.* and *IBM*. The unstable *Johns Manville Company* was replaced in 1982 by *American Express*. *General Foods* was also taken off the list, having been the main culprit for a sharp change in the movement of the DJIA following takeover rumors.

5. Another problem has to do with the size of the companies on the list. Since they are, as a rule, the largest in their business fields, product improvements or changes in ways of production take a while before they are reflected in sales and profits, i.e. in the stock price. The existence of a time lag contributes to the fact that the Dow Jones Average does not reflect the *current state* but, rather, *past trends*.
6. The high level of the Dow Jones Average is also a frequent target of criticism. Critics think that the breathtaking growth of this indicator during the past decade has formed an unrealistic picture of the state of the U.S. economy. In the second half of January 2000, the Dow Jones reached 11,722, even though not a single stock from the list (or outside it) had anywhere near that level of growth. Guided by this popular market indicator, investors make decisions that are not based on the actual situation, which can result in wrong decisions on whether to buy or sell stocks.

   Arguments in defense of Dow Jones in this case come down to the view that the calculation methodology has indeed remained unchanged but that the impressive results of the U.S. economy over the past several years have effected an increase in all stock market indicators, including this one.
7. The inconsistency of the estimate is in large measure a result of splits and replacements of listed stocks. Can the Dow Jones Average be a good indicator of market changes and shifts in such circumstances?

   “Yes” is the reply of Dow Jones’ compliers and proponents. The problem has been solved by the introduction of individual multipliers for each stock and of divisors for each group, which, it is claimed, has ensured a solid reliability for the estimates and the trust of analysts and the public at large.

These were only some of the criticisms most frequently directed at the most widely used market indicator. The basic complaints are the following: first, this indicator does not provide a real picture of the state of the New York Exchange, since it is calculated on the basis of changes in the stock prices of the most successful companies, which is not reflective of the general state of things on the market; second, due to the constant reduction of the divisor, the Dow Jones Average has seen a steep rise in the past several years: no individual stock from the list has, however, experienced such growth. This also forms an unrealistic picture about American stock exchanges and about the economy as a whole.

Regardless of the said shortcomings, the Dow Jones (Industrial) Average continues to be the most popular indicator of stock price changes on U.S. markets among the general public.

2.4. The Dow Jones Average and the prediction of stock prices

Both among serious market analysts and the general public, opinion is divided regarding the true scope of the practical use of the Dow Jones Average in predicting stock prices, either in the near or the more distant future. The pragmatism of this or any other market indicator depends on its applicability and the degree of its congruence with the direction and degree of stock price changes. What are the prospects for the successful use of the Dow Jones Average in making decisions about buying or selling stocks?

A brief reminder of past shifts in the DJIA can help us gain an answer to the above question.

During earlier years there was a firm conviction that changes in stock prices preceded changes in business activities. It was said that "…the stock market discounts business conditions months ahead of time… The theory was that stock traders who predicted better business and bigger net profits would be buying stocks. When a fall in business and profits was predicted, traders would get rid of the stock. Their ability to perform in such a way was a result of their being unusually well-informed and acquainted with production, sales and business conditions in general."

This view, that the stock market has the ability to predict business conditions and results, was brought forth many years ago by Huebner: "Without exception, each great business depression or expansion in this country (the U.S. – author's note) has been predicted by our securities market, between 6 months and two years before times of hardship or prosperity became reality."

A large number of studies regarding the relationship between stock prices and business conditions have been performed. Ayres, who studied 25 business cycles between 1829 and 1938, concluded that, in a typical business cycle, stock prices reach their peak seven months before the business peak, while the lowest point of stock prices is reached five months before a business depression.

A study conducted by the *Cleveland Trust Company* encompassed the period between 1871-1953, during which there were 39 cyclical business turning points. On the basis of this study, the following was concluded. In 29 cases (out of 39), stock prices reversed before business did; in two cases, stock prices reversed in the same month as business conditions; in 4 cases, a month later, while in 4 cases there was no satisfactory correlation. It was determined that the average time length of the interaction was six months, but that advance periods ranged up to 21 months, while lags were up to 3 months.

Another detailed study was performed by Geoffrey H. Moore) and associates from the National Bureau of Economic Research. The study analyzed 26 business cycles from 1899 to 1958 and showed that the Dow Jones Industrial Average preceded changes in business activity in 31 out of 52 reverses. The average anticipation was 4.5 months. It was also determined that the stock prices in one case preceded changes in the business cycle by 21 months, while in another case they lagged by 9 months.

With such a great variation range, the average time prediction of 4.5 months loses much of its significance as a reliable indicator of business activity reversals. After gaining this insight, researchers decided to retain stock price changes as one of a series of measures for evaluating economic activities used as indicators of business conditions.

In a second study published by the same team in 1975, it was concluded that in the course of the previous 100 years stock price changes anticipated 33 business cycle turning points, out of a total of 44, but that the average time of anticipated changes was extended to 5-9 months. The basic conclusion was: *generally, changes in stock prices can be a satisfactory indicator in predicting changes in business conditions over a longer time period but, in individual cases, a great degree of reliability is not always present!*

As a drastic example confirming the above conclusion, certain data from the period preceding the Great Depression were provided: construction contracts reached their peak in June 1928, wholesale prices in July 1929, industrial production culminated in August 1929, while the Dow Jones Average reached its peak in September 1929. Nothing indicated a coming recession, and then in October came the stock market collapse. The market showed its prediction ability only when it came to signaling the depth of the recession.

In the years following World War I, the American economy underwent great expansion. It gained superiority on the global market, and the one-time debtor became the greatest exporter of capital. Banking, public utilities, the automobile, food, film, oil and electrical equipment industries grew strongly. New industries, such as aviation and the radio industry, gave great promise of advancement. Other branches, led by the cinema, chemical and military industries, had stable development.

In such an environment, stockholding experienced a boom. Ordinary stocks became very popular, not only of companies already on the NYSE, but of newly established ones as well. The number of new stock issues grew from 1,822 (1921) to 6,417 (1929). At the end of 1929, 62% of all new security issues were stocks, while eight years earlier the figure was only 15%. The value of issued stocks in 1929 equaled 5,924 million dollars, compared to 1,087 three years earlier. Stock prices also grew impressively: the market value of all listed stocks on the NYSE increased from 27.1 billion dollars at the beginning of 1925 to 89.7 billion dollars in September 1929. The volume of trade grew at a previously unthinkable speed. From a yearly volume of 171 million stocks during 1921, four years later the volume had grown to 450 million; in 1928, the volume reached 920 million, and a year later – 1.1 billion.

Broker-generated loans equaled 8,549 million dollars. About one million people possessed 300 million stocks bought on margin.

The market was totally overheated. Euphoria was rampant on all the exchanges. Nothing signaled a dramatic reverse. And then, on Wednesday, October 23, 1929, the panic began. The Dow Jones Industrial Average fell by 31 points, with a trading volume of 6 million stocks. The plunge continued the following day, and stocks were changing ownership at breakneck speed – the trading volume reached 12,895,000 shares. The compilers of the Dow Jones Average were calling attention to the dramatic proportions of the oncoming crisis.

On October 28 of that year, the DJIA fell 49 points, and the next day 43 points more – when 16,410,000 shares changed hands.

From 1929 until the middle of 1932, the value of stocks melted away, while the American economy sank into its deepest and longest recession. The Dow Jones Industrial Average fell more then 89% - from 386 to 41, something not even the greatest pessimists had predicted.

The listed value of stocks on the NYSE fell from 89.7 to 15.6 billion dollars. The greatest decline was suffered by the leading companies: shares of *US Steel* fell from 262 U.S. dollars to 9 dollars; *General Motors* fell from 92 dollars to 7 dollars, and *RCA* form 115 to 3 dollars.

All the American exchanges were sinking into the darkness of the deepest recession ever recorded. The Dow Jones Average, like the other indicators, did not so much as signal the coming of any kind of a serious disruption, much less a crisis of unthinkable proportions.

From 1939, the market has shown a very uneven ability of prediction. Industrial production grew uninterruptedly in the 1939-1943 period. During that time, prices of industrial stocks constantly declined. Then industrial production, from its maximum in 1943, began to fall until 1946, while the prices of industrial stocks rose in the same interval.

The year 1946 gained the name "the year of the crisis that never happened." It was expected that, after the wartime expansion, stagnation would ensue, and another depression was predicted. Stock prices fell sharply in August 1946, and then again during 1947. However, industrial production continued to grow all the way up to 1953. When analysts became convinced that a crisis had been averted, stock prices began to rise in 1949.

A mild recession in manufacturing was felt in 1953 and the following year, while the prices of industrial stocks successfully predicted an economic recovery, having reached bottom and a turnaround during the next 11 months relative to changes in manufacturing conditions.

After the 1980s, stock price indicators in several situations led to totally wrong conclusions regarding shifts in the economy. The steep stock market fall of 1987 was not accompanied by a proportional lag in industrial production. On the other hand, the recessions of 1990 and 1991 were accompanied by record levels in the Dow Jones Average.

The correlation between stock price changes, as measured by the Dow Jones Average, and changes in industrial production conditions during the last decade deserve special attention due to the results that were achieved during that time.

2.5. The Dow Jones Average in present-day conditions

All the way up to the end of the 1970s, the Dow Jones Average, especially the industrial average, showed a tendency of moderate growth. The stability of this most recognizable of all market indicators was shaken only in recession years that periodically hit the American economy. After such episodes, the trend of moderate growth would be restored, without sudden and extreme changes in either direction.

At the beginning of the 1980s, the DJIA began to grow more rapidly, which confused market analysts. When the 1,000 point boundary was first breeched in the first half of 1984, the NYSE was caught up in a real euphoria. Politicians began to tout the good economic results and announced a bright future for investors; investors changed their securities portfolios – and ordinary stocks experienced a genuine expansion. Still, one question remained without a real answer: what was it that caused the expansion of the DJIA, unprecedented in history?

Two devaluations of the U.S. dollar within a short period of time brought on the disintegration of the Breton Woods concept on which the International Monetary Fund (IMF) was based, and confidence in the world's reserve currency was shaken. Many skeptics were making stark statements about the future of the American currency and the future of the world's strongest economy. Predictions regarding price movements on the leading American exchanges were highly pessimistic.

Despite such expectations, after a short-term stall, the DJIA began its rapid growth, which was a great surprise for the general public as well as for market experts. Explanations varied. Some thought that stock prices were growing because inflation, which had shaken all developed countries during the 1970s, after the oil shocks, had been defeated. Others were pointing to the effect of expectations among investors that a recession would be followed by economic revival and prosperity, which is the most favorable investment environment – demand pressures grow and stock prices rise. Still others accepted the above arguments but pointed out that the DJIA was significantly outperforming the growth of the social product and all macroeconomic indicators. According to this approach, the expansion of the DJIA was only partly a consequence of the American economy's good performance and investor expectations regarding future developments, and much more a result of the way in which this indicator was being calculated.

Stock splits had caused a constant lowering of the divisor in the formula for calculating the DJIA; thus, on January 8, 1987, its level had reached 2,000 points. After a recession in 1988, a new expansion of all economic aggregates ensued – the Kuwaiti crisis had picked up the military industry and, on the wave of great expectations, amidst growing military expenditures, the American economy underwent a new expansion. The market revived and stock prices began to grow once again. From 1989 until 1994, the DJIA had an upward trend, almost without interruptions and declines. From the beginning of 1995, when the 5,000 point boundary was passed, the bull market established total dominance and the Dow Jones Industrial Average recorded steep growth, breaking the 10,000 point barrier on March 16, 1999. During the past year, the DJIA has constantly been above 12,000 points. What had been considered impossible only a few years earlier had been accomplished.

Serious analysts could not come up with an entirely rational explanation. Market experts discretely pointed out that it was impossible to sustain such a tempo and that a fall in stock prices was to be expected. However, these were lonely voices. The results of the American economy were impressive, and an exceptionally favorable environment for investments was created. Inflation was reduced to a negligible level, the growth rate was the highest in the past several decades, unemployment the lowest since the end of World War II, the budget deficit was totally eliminated after several decades, the dollar was growing ever stronger. Nothing indicated any sort of reversal either in the economy or on the markets.

2.6. The Dow Jones Average and the trading volume of stocks on the NYSE

Since the beginning of 2000, stock prices had showed a growth tendency and by January 21 the DJIA had reached its highest level ever, an incredible 11,722.98 points. A further rise in the market and new investments were expected. However, it proved that those who thought that the market had become "overheated" had been right and that a significant decline in stock prices could be expected. And that's what happened: potential investors were surprised with the three-month decline that ensued, in which the DJIA fell to 9.811.24 points by March 12, 2000.

Just when everyone thought that the trend of decline would continue, another sharp reversal occurred. In an interval of one month, from March 12 to April 11, 2000, the DJIA recovered and rose to 11,287.08. And then came a shock that no one could have anticipated.

The Labor Department issued a report on April 14, according to which the prices of key products, except for food and energy, had risen in March by 0.4%, or twice as much as predicted by economists. On the basis of the March price movements, yearly inflation was estimated at 3.7%, which was almost double the 2% benchmark on the basis of which the Federal Reserve had conceived the growth in the money supply. The appearance of inflation requires growth in the money supply and an increase in interest rates, which results in a flight of stock capital into banks, a reduction in credits and an economic slowdown.

Thus, the news about the March inflation had the effect of "gasoline poured on a just-lit fire," and both big and small players on the market tried to sell everything they could at the highest possible prices.

In the course of one day, April 14, 2000 (Black Friday), the DJIA fell from 10.923.55 to 10,305.77 points, or by 5.66%, which represented the biggest daily fall in points since the founding of the exchange. On that day, the high technology NASDAQ index lost 9.67% of its value, which represented its biggest loss since its inception.

From April 10-14, the DJIA fell by 9.53% and the NASDAQ by 25.31%. During that week, investors lost about 2,000 million dollars, or 7,000 dollars per U.S. capita.

"The lesson that should be drawn is that the stock exchange is not a game, that the market is not a casino, that it is a serious thing for serious people, and if a man makes mistakes, he should be ready to sustain losses," explained Mark Cohedess, an expert for situations in which stock values are falling, since he is successful at predicting which companies will recover the most quickly.

After the markets closed, total confusion set in among market speculators and investors regarding the direction of further developments. Many were warning that a recovery should not be expected any time soon, since the main high-tech industry investors had lost a great deal and were lacking cash to prevent a further fall in those stock prices.

The beginning of the following week brought another surprise. Large high-tech companies (*Intel, IBM, Hewlett Packard*) rebounded from the abyss and the fall in stock prices and market indicators was stemmed. Numerous investors and market experts were compelled to admit that they had wrongly estimated the direction and intensity of stock price changes.

From mid April to the end of August 2000, the DJIA moved in the range between 10,500 and 11,100, with occasional cyclical deviations in almost regular time intervals.

The changes in the Dow Jones Industrial Average during the entire previous century, and especially during the last decade, confirm the already stated view about the unpredictability of market changes. During certain periods market prices were stable and analysts had little work to do. Then came periods of stable growth or mild market declines, in cyclical intervals, when relatively successful predictions regarding future changes were made.

Big problems appeared when large reversals occurred, ones that were neither indicated nor could have been predicted on the basis of rational economic activity. There are too many such examples for these to be considered as chance occurrences. Beginning with the crash of the New York Stock Exchange in October 1929, all the way up to the biggest daily plunge in stock prices of April 14, 2000, changes not predicted by experts have occurred, or loudly announced events have not come about.

In all the said situations, the Dow Jones Industrial Average, like most other indicators, was an unreliable parameter for making predictions, as these were often wrong. For this reason, critics have been saying that this market indicator could be used very successfully for *explaining past events but not for predicting the future*.

Others have said that the DJIA is reminiscent of a *fair weather ship*, i.e. that it is a reliable indicator under stable conditions but powerless to predict the great, sharp changes that occasionally occur on the markets.

Regardless of all its shortcomings and the criticisms to which it has been subjected, the Dow Jones Industrial Average has retained its great popularity among the public at large, and continues to be an irreplaceable component of subtle analyses performed by market experts.

3. Stock price indexes

Even though the concepts of *evaluation* and *index* are still treated as synonyms by the general public, these are in fact different methods for measuring changes in stock prices. Stock price indexes are technically more refined methods of measuring stock prices than are evaluations. This advantage is especially pronounced when analyses cover longer periods of time.

Indexes are calculated by dividing the total market value of select companies from the list in the present time by their market value in the previous, i.e. base period. The market value of the selected companies is calculated by multiplying the number of issued stocks held by investors (outstanding stocks) with their price. The weight of a company in the index is determined by the size of the market value of realized stocks, which means that companies with a larger number of stocks sold and those with a higher price have a decisive influence on shifts in the index. Thus, the value of the index depends on two factors: stock prices and the number of shares sold (or bought).

This method of index calculation provides undoubted advantages in comparison with various forms of *price averages* because it does not require adjustments in the divisor after stock splits, since the market value remains unchanged. Other company activities that have a bearing on market values, such as new stock issues, spin-offs, etc., require adjustments of the divisor so that the value of the index remains unchanged.

There is a large number of indexes that differ according to choice of initial base and sample inclusiveness, the most prominent being *Standard & Poor's 500 Composite Index, NASDAQ*, *Wilshire*, *Amex Market Value Index* and the *Russell 2000.*

3.1. Standard & Poor's 500

Standard & Poor's 500 Composite Index (S&P 500) represents the relationship between the total market value of 500 select companies on a specific day relative to their market value during the base period. The 1941-1943 period is taken as the base, and the market value from the base period has an index of 10.

Until 1957, two S&P indexes were used: the daily and the weekly. Since 1957, the two have been combined into a single combined indicator that encompasses four sub-indexes: industrial companies (S&P Industrials), transportation companies (S&P Transportation Index), service sector companies (S&P Utility Index) and financial companies (S&P Financial Index).

The S&P Index is specific in that it tracks price changes within developed as well as propulsive branches with rising significance in the U.S. economy. In order for a company to be included in the calculation of the S&P Index, it need not have the largest market value but it does need to be one of the leaders in its field. Thus, first a choice of representative branches is made, and then of the leading companies from these fields. At the end of 1997, the S&P 500 encompassed 88 economic branches from four sectors: 385 from industry, 55 from finance, 45 from services and 15 from transportation. The number of companies by sector changes in accordance with changes of relative significance in certain fields during various time periods.

In addition to the S&P 500 and the individual indexes for specific sectors, there is also the S&P 100, which has been calculated since 1983. Calculations of this index use stocks of 100 companies from the S&P 500 list, of which 82 are industrial, 9 financial, 5 transportation and 4 service sector companies. The market value of these companies is one half the market value of all the companies from the S&P 500 list, even though they represent only one-fifth of the total number of the encompassed sample.

The basic criteria for choosing companies when calculating the S&P 500 Index are:

1) Being part of a chosen branch – these are either the most developed fields or ones undergoing expansion;
2) A leading role in its branch in terms of realized market value on the exchange;
3) Speed of share realization (daily, monthly, yearly);
4) Stability of business operations, without sudden or frequent changes.

Companies are taken off the S&P list in the following cases: 1) in case of mergers and acquisitions; 2) in case of bankruptcy; 3) in case of restructuring and the spin-off of a company part, and 4) if the branch loses its representative status.

3.2. Comparative analysis of the DJIA and the S&P 500

The DJIA and the S&P 500 undoubtedly are the two best-known market indicators. No serious expert analysis of stock market operations is conceivable without the use of the DJIA and the S&P 500. When making stock-purchasing decisions investors always take heed of stock price movement trends, expressed through changes in the average or the index. Both indicators have gained great popularity among proponents of technical analysis, which uses their trend lines to construct price prediction models.

Even though indexes represent a more subtle way of determining market changes, the DJIA has nevertheless remained the most popular indicator, especially among small investors. Perhaps the biggest factor in the DJIA's popularity is its century-long tradition, as well as its connection with the Dow Theory, which plays an important part in the technical analysis of stock prices.

If a comparative analysis of the DJIA and the S&P 500 is made, it can be seen that there are essential differences between the two indicators, which must be taken into account in deciding about their analytical use.

1. Statistically speaking, the DJIA is an average while the S&P 500 is an index, from which it follows that the DJIA measures only price changes, while the S&P measures changes in market value. In other words, the S&P 500 is conceptually a broader aggregate than the DJIA.
2. In the DJIA, the change of weights is done in accordance with stock price changes. As for the S&P 500, besides stock prices, the weights are also changed in accordance with the number of realized stocks on the market.
3. The DJIA encompasses the stocks of 30 industrial companies, or 65 stocks as a composite indicator. These are representative companies on the NYSE. The S&P 500 includes a far greater number of companies (500), and these are the best representatives of both the leading and developing branches of business. In addition, the companies on the S&P 500 list are quoted not just on the NYSE but on other U.S. stock markets as well (Amex, NASDAQ).
4. The key difference in calculation is in adjusting the divisor. With the DJIA, the divisor is constantly reduced due to stock splits: in March 1997, it equaled only 0.27, having practically turned into a multiplier. In this way, the DJIA continues to show ever-growing changes even when prices are not genuinely rising or are not rising in the expressed degree. This information is important for making conclusions about real changes on the markets, before all on the NYSE, as well as in the American economy itself. Thus, conclusions about the incredible expansion of the U.S. economy based on the DJIA must be subjected to a critical analysis.

   In calculating the S&P 500, it is not necessary to adjust the divisor when stock splits occur, because these don't affect the realized market value. As a result, the S&P 500 divisor has not been changed significantly, since companies undertake simultaneous measures that both increase and decrease the divisor, which means that the effects of the undertaken activities are neutralized.

5. The constant increase in the DJIA divisor has resulted in this indicator's intensive growth over the past decade, bringing it all the way up to about 12,500 points in March 2008. As a result, the DJIA no longer objectively indicates the *degree* of stock price changes but only the *direction* of changes on the stock market.

Due to the way it is calculated and the scope of its sample, the S&P 500 has shown a lower degree of oscillation and a smaller scale of absolute changes over a longer period of time. As a result, it provides *greater reliability in the evaluation of real direction changes as well as of the stock price levels on the markets.*

A comparative analysis of the two undoubtedly best-known market indicators, the DJIA and the S&P 500, for the period of March-August 2000, points to some characteristic conclusions that may be drawn:

- there is a high degree of coincidence in the basic tendency shown by both indicators;
- even though the S&P 500 is palpably more encompassing, stock price oscillations are more pronounced than in the DJIA; this conclusion runs contrary to the basic multi-decade trend that was registered and out of tune with practical experience, by which broader market indicators have a lower degree of oscillations.

On the basis of a six-month analysis of the DJIA and the S&P 500, similar conclusions could be reached regarding stock price movements, but such a conclusion does not apply for a longer time period. The lower absolute amounts with the S&P 500 give a more objective picture of the degree of real price changes, while the DJIA is more indicative of tendencies than of the real scope of changes on the market. The longer the analyzed period, the more the above conclusion is confirmed.

3.3. The New York Stock Exchange Index

This combined index has been published since July 14, 1966, and it encompasses all the stocks quoted on the NYSE. About 1,250 stocks were included in its calculation when it was first published, while the present-day figure is over 2,000. All the stocks are divided into four groups: industrial, transportation, financial, and utility. The *New York Stock Exchange Index* is a synthetic indicator and represents a combination of the said groups of stocks, although individual indexes for each group are also calculated.

The indexes are calculated by multiplying the stock price with the number of stocks on the list. All four individual indexes are calculated in points, while the combined index is given in nominal amounts – dollars and cents. The basis for all four individual indexes is 50, which represents an approximate estimate of the prices of the stocks that were quoted when the index was first calculated.

Stock divisions and splits do not require regulation in this index, because they do not influence the total market value. Still, adjustments are sometimes necessary. The appearance of new stocks or removals from the list require a certain correction of the base for determining the index.

The basic advantage of this market indicator lies in its scope. All stocks listed on the NYSE form the basis of its calculation, which produces a relatively reliable indicator of price changes on the NYSE. At the same time, the basic criticism is also connected to the broadness of the base for calculation. The size of the *New York Stock Exchange Index* is also affected by *blue chip* company stocks as well as those with an incomparably smaller relative influence on this market.

3.4. The American Stock Exchange Index

The American Stock Exchange (AMEX) changed its *Index Change Prices*, used since 1966, with the *Market Value Index* and 16 individual indexes, beginning with September 4, 1973. The original index level equaled 100 points, but it was cut in half, to 50 points, on July 5, 1983.

The index expresses the changes in the overall value of the market of the listed stocks, U.S. investment receipts and payment orders on the AMEX list. The total number of included elements that form the basis for calculating the American Stock Exchange Index equals 800.

One half of the partial indexes contain 8 industrial groups, through which all the companies on the market list are encompassed. Changes in the list and stock divisions and splits are not included in the calculation of this index.

Recently, the AMEX has developed several specialized indexes for measuring stock prices, which are used as a base for options traded on the market. The aviation index is based on five main aviation stocks. The oil index is based on 15 oil companies. The computer technology index encompasses 30 high technology stocks.

The most popular of all the partial indicators of the American Stock Exchange is the *Major Market Index*, which is an index of the measured prices of 20 stocks. On November 21, 1997, the stocks of the following companies were included on the calculation list of the *Major Market Index*:

American Express	*Exxon*	*Merck*
AT&T	*General Elektric*	*Minesota M&M*
Chevron	*General Motors*	*Mobil*

Coca Cola	IBM	*PhilipMorris*
Dow Chemical	*International Paper*	*Procter & Gamble*
DuPont	*Johnson & Johnson*	*Sears Roebuck*
Eastman Kodak	*Mc Donalds*	

A one-point change in the *Major Market Index* will occur when the Dow Jones Industrial Average changes by 5. The correlation between these two indicators varies little, while the degree of coincidence is over 90%. This should not come as a surprise, since the *Major Market Index* is, by its structure, more similar to an average than an index, while the stocks it has in common with the Dow Jones Industrial Average ensure a high degree of coincidence.

3.5. The Wilshire 5000 Equity Index

The *Wilshire 5000* encompasses more stocks than any other known index. It carries a value of more than 1,000 billion dollars and encompasses all ordinary stocks quoted on U.S. stock exchanges. It has been calculated since 1974.

The base of this stock price index is December 31, 1971. It is calculated similarly to the NYSE and S&P 500 indexes. More than 70% of its value is represented by stocks traded on the NYSE.

The broad basis for calculating the *Wilshire 5000* Index was chosen in order to reduce the influence of stable *blue chip* companies. That is why this index shows greater volatility in shorter intervals and is not suitable for operative application in creating models for the technical analysis of stock prices.

3.6. The NASDAQ OTC Index

The *NASDAQ OTC Combined Index* has been calculated since 1971, while the base year for its calculation is 1970. The combined system classifies all stocks into six categories: industry, banking, insurance, other finances, transportation and services. It encompasses a total of 4,300 stocks of American companies traded over the NASDAQ system. This pertains to about 2,600 stocks in the National Market System – NMS, and about 1,700 outside the NMS system but which are listed on the NADSAQ market.

In 1984, the NASDAQ NMS introduced two of its own indexes. One of them is the *NASDAQ/NMS Composite Index*, and the other is the *NASDAQ/NMS Industrial Index*. Both are measured on the market and have a base of 100. These two new indexes are consistently published in many financial publications, along with the NASDAQ Composite Index and some sub-indexes.

During the previous decade, the market value of NASDAQ rapidly increased. This was mainly the result of better communications, increased publicity and growth in the number of companies on the list. By 1986, it had 9 developed indexes. As many others, they were also conceived not only as indicators of that market but also as a base for trading on futures and options markets.

3.7. The Frank Russell Index

All the above indicators of stock price changes are oriented toward the largest companies or, eventually, toward a broad base composed of numerous participants. The *Frank Russell 2000* Index is specific in that it shows changes in the stock prices of small companies. The smallest market value of a company included in this index during 1993 equaled 58.7 million dollars, while that of the biggest equaled 591.5 million dollars.

The basic criterion for including stocks in the calculation of this index is company size. After June 30 of each year, the firms that form the index of the *Russell 3000* are ranked, and the 2,000 smallest companies make up the base for calculating the *Russell 2000 Index*.

The base value was set at 135 points, and had significance only at the start of the index. Since then, the base value has been the index level from the previous period.

Over time, the *Russell 2000 Index* has demonstrated the highest degree of volatility among all indicators, which is a consequence of the structure of its base for calculation. At the same time, this represents its main limitation in its broader use for making models for the technical analysis of stock prices, which is the key reason why this indicator has not gained greater popularity among stock market analysts.

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CAPITAL VALUE APPRAISAL – THE COMPARATIVE EXPERIENCES OF FRANCE & SERBIA

Abstract: *Privatization in Serbia is taking place under fairly different conditions than was the case in France. Nevertheless, some significant lessons may be drawn from the French model of privatization. In France, capital valuation had great significance, even though shares were not sold to employees and other citizens in accordance with appraised values. In Serbia, capital valuation has almost no role whatsoever, since majority capital stakes are sold to the highest bidder.*

Key words: *privatization, capital value, company, Serbia, France*
JEL classification: P14, P31

1. Introduction

Different approaches to transition, and especially to privatization, are a reflection of differing economic states, differing company states, as well as of the accommodation of solutions to specific conditions, habits, behavior and tradition. The state, which initiates the privatization process, must formalize the methodology of company value appraisal, that is, determine the framework for valuation. The issue of the accepted concept of value in transition economies is extremely significant because the expressed values of capital differ depending on the accepted value concept, while the value concept is reflected in the prescribed appraisal methodology. In Serbia thus far, the concept of privatization and, in accordance with this – the value concept objectified in the prescribed valuation methodology, has been changed several times. Since the beginning of privatization until today, the lawmakers have gone through numerous privatization models and appraisal methodologies. Thus, company capital was privatized according to book value (with or without discounting) in one period, according to reproductive value in a second period, average value between earnings and reproductive value in a third period, while at present capital is being privatized according to its market value. Numerous changes in conceptual solutions raise questions about the justifiability of the legal solutions and about the adequacy of the latest solution brought within the new privatization concept.

The passing of the Law on Privatization brought significant changes to the concept of privatization and the concept of capital value. It provided for the application of the earnings method for valuing successful companies and of the liquidation method for valuing unsuccessful companies. Following the change in the Act on the methodology for capital and property valuation, privatization of capital has been performed according to companies' market value, while capital has been appraised according to a method referred to by the lawmakers as the method of adjusted book value (ABV).

2. The accepted concept of value, the prescribed capital valuation methodology and implications for the privatization of companies in Serbia

Privatization in Serbia began on the basis of the federal Law on Social Capital of 1989, and has continued to this day. Differently from previous privatization models, the current model has a time limit. The deadline for ending privatization has already been extended once (to the end of the current year) and, according to announcements coming from the responsible minister, the deadline will be extended by yet another year.

It is interesting that the privatization process began with the concept of capital book value, i.e. without the appraisal of capital value, and that it is being concluded with capital book value, i.e. without the appraisal of capital value. Namely, according to the federal regulations from 1989, capital value was not to be appraised but social capital was to be transformed according to book value.[1] Book value was prescribed as the base value for privatization in many transition countries. Book value was used in our country as a base for determining the value of social capital for the purposes of privatization on four occasions, in four different ways:[2]

1 The Federal Law on Amendments to the Law on the Circulation and Disposition of Social Capital was in effect until the bringing of the republic Law on the Conditions and Procedure for the Transformation of Social Property into Other Forms of Property ("Official Gazette of RS," no. 48/91).

2 The prescribed methods for capital valuation, which are based on book value, most often have the book value as the base, while the value of capital is obtained by applying a certain methodology of capital valuation. The calculated value of own capital by way of certain methodologies can deviate to a greater or a lesser degree from the book value of own capital. For example, according to the Rule Book published in the "Official Gazette of SR Serbia," no 48 and 50/92, the book value of social capital was calculated by equating long-term earmarks and passive time deferments with own capital, even though, according to the then Law on Accounting and the Yugoslavian accounting standards, as well as inter-

- On the basis of federal laws from 1989,
- On the basis of republic laws from 1991,
- On the basis of federal laws from 1996,
- On the basis of republic laws from 2001.

However, the book value determined according to the previous laws was not the value according to which the capital of social companies was transformed, since pre-determined discounts were approved.

By an amendment of the Act on the methodology for capital and property value appraisal[3] from 2002, company book value was reaffirmed. To be sure, the Act continued to provide for the use of the DNT method, but book value was favored.

Admittedly, the lawmakers did refer to real book value, which was also used in previous legal acts, as adjusted book value in the Act itself, but here it stood for something totally different (the lawmakers defined adjusted book value as the value of total assets minus losses and total obligations, which include liabilities, deferred revalued earnings, long-term reserves and passive time deferments), which exposed the lawmakers' ignorance of elementary accounting categories. In addition, the lawmakers prescribed the application of the adjusted book value method, even though book value is not a result of the application of a specific capital valuation method but the result of balancing books kept according to accepted accounting standards and the law, with the purpose of separating business operations between successive business years.

The passage of the Act on amending the Act on capital value appraisal was, before all, motivated by the acceleration of the privatization process. The choice of book value as the starting point for forming the price of capital by way of auctions and public tenders was justified by the lawmakers with the argument that, according to the current concept of privatization, capital was sold at the price that buyers are prepared to offer (also taking into account other criteria in case of sale through tender), where the issue of the starting price was not of great significance but, before all, the issue of the minimum price. The second argument, which was supposed to justify the amendments to the Act, lay in the fact that, in the two years that preceded the Act, the index of retail price rises equaled 300, while the exchange rate remained stable. This anomaly led to a situation in which the nominal value of capital, expressed in dinars, was tripled – as a consequence of the revaluation of own capital by using the retail price growth rate in the Republic of Serbia – and, along with it, the foreign currency value of capital as well. The next argument lies in the fact that capital value appraisal requires not only time but substantial expenses. Many of our economists had warned that it was better to invest in new employment than to spend ten years investing

national accounting standards, long-term earmarks and passive time deferments could be equated with obligations only.

3 "Official Gazette of RS", no. 45/02

in capital value appraisal,[4] pointing out that "the real price of capital is the one dictated by the market, not the one arbitrarily set by the seller."[5]

These were the arguments used to proclaim company book value, whose function pertains exclusively to the starting value set at auctions where, however, the buying price might wind up being only 20% of this value. This was the way in which company value appraisal for the purposes of privatization was essentially wound up. Thanks to a privatization model by which company capital was sold according to market value at the time of auction or tender, and which was in certain expert circles judged to be "the most rational and the most acceptable solution,"[6] it might easily be concluded that capital value appraisal was irrational and unnecessary, and that it shouldn't even be performed, since "only the price obtained on the market is a realistic price,"[7] and that a value which does not require additional expenses for its determination – book value – should be accepted as the starting base.

In tandem with the prescribed privatization model, the above arguments seem truly convincing. It is not necessary to spend either money or time in order to determine a value that practically has no bearing on the further course of a company's privatization. However, a new question appears: is such a privatization model adequate?

We can see where the chosen model of privatization, which does not respect appraised capital value, can lead by looking at the example of the "Zdravlje" a.d. Leskovac pharmaceutical company. Namely, this plant was sold to a buyer from Iceland in October 2002. The revalued value of own capital at the time of sale equaled 2.7 billion dinars, while 70% of the capital was sold for 3.5 million euros, which comes to 11.5% of the total social capital value of the company, which had operated with a high profit rate, in excess of 15% annually. In this case, the acquisition price equaled less than 20% of book value. This happened thanks to the fact that the tender conditions were based on a valuation of the company's social capital based on a period that preceded the executed tender by almost five years (the valuation was performed in 1997). "Precisely that is a frequently employed game. If more favorable tender conditions are sought, the valuation period is moved back. For, in only three years time (1999, 2000 and 2001), inflation raised the nominal value of the capital by a factor of four."[8] In April 2007, shares of "Zdravlje," with a nominal value of 1,000 dinars, were sold at a price of

4 B. Šever, "Uzroci usporenog procesa tranzicije i vlasničke transformacije", collection of works: *Vlasnička transformacija preduzeća i banaka, Jugoslovenska i međunarodna iskustva i perspektive*, 2000, p. 34.

5 B. Šever, "Ekonomske (ne)logičnosti – ekonomska struka i tranzicija", *Ekonomski vidici*, no. 1, Društvo ekonomista Beograda, March 2003, p. 81.

6 Ibidem

7 Ibid.

8 According to: J. Ranković, "Previdi i promašaji u postupku privatizacije od 2001. do 2004. (1) – Ključna realna procena kapitala", *Politika*, 5/20/2005.

20,000 dinars; by August and September (by 9/12/2007), the market value of the shares had stabilized at 18,000 dinars.

3. Experiences of the privatization in France

Experienced with privatization in France are considered to be extremely important, since the French privatization program, begun in 1986, is considered to be one of the most significant successful privatization programs in the world.[9] According to research by Bortolotti, Fantini and Siniscalco,[10] in total sales for the period between 1977 and 1996, the French privatization program ranks third in the world, after Japan and Great Britain. In its scope, the privatization in France during the period between 1977 and 1996 made up about 12% and, from 1993 to 1999, about 8% of all privatizations in the world[11] and more than 11% of the privatizations within the OECD countries.[12]

The privatization process in France was performed during a period when privatization had become a widespread phenomenon in developed industrialized countries. According to Megginson and Netter[13], the share of state companies in the gross national product of these countries fell in slightly less than 15 years from 8.5% to less than 5%. Such a reduction of the role of the state has been even more pronounced in less developed countries.[14]

In France, leftist and rightist political parties alike unanimously rejected the option of privatization through fusion or acquisition by multinational companies without government control. The privatization program was halted in 1988, when the Ministry of Economy and Finance established control over both the total and the partial acquisition of state-owned and privately owned French companies. Until then, all foreign-based acquisitions of French companies' shares were subject to the approval of this ministry's Committee for Foreign Investments (Comité des Investissements Etrangers) whenever the acquisition exceeded 20% of company capital.

9 W. L. Megginson, *Sample Firms Privatized Through Public Share Offerings, 1961-August 2000*, University of Oklahoma, http://faculty-staff.ou.edu/M/William.L.Megginson-1.

10 B. Bortolotti, M. Fantini, D. Siniscalco, "Privatisations and Institutions: A Cross-Country Analysis", Working Paper, Fondazione ENI-Enrico Mattei (FEEM), Milan, 1998.

11 R. M. Levich, Q. Huang, "Underpricing of New Equity Offerings by Privatized Firms: An International Test", NYU Salomon Center Working Paper no. S99-5., SSRN Electronic Paper Collection, 28th November, 1998.

12 OECD, Recent Privatisations Trends, Financial Market Trends, no. 76, June 2000.

13 13 W. L. Megginson, J. M. Netter, „From State to Market : A Survey of Empirical Studies on Privatization", *Journal of Economic Literature*, vol. 39, no. 2, June 2001, str. 321-389.

14 H. Alexandre, G. Charreaux, L'efficacité des privatisations françaises : une vision dynamique à travers la théorie de la gouvernance, étude parrainée par l'Associazione Guido Carli, dans le cadre d'une étude portant sur les privatisations en Europe, octobre 2001, p. 3.

Also, there were no auctions of state-owned companies, even during the time of Chirac. The minister in charge of privatization explained that the high share prices that would be achieved at auctions would allow their purchase only on the part of big investors who, naturally, expect the biggest possible return on their investment. The government was guided by the concept of "humane relations," and held the view that a broad participation in the privatization process was necessary. Privatization in France was carried out with the aid of the following methods: public offer at a fixed price, direct sale of the company or a part of it to interested firms, and the sale of investment certificates and participative securities. The Commission for Privatization (Commission de la privatisation), charged with determining the share prices, was formed. The Commission had seven members appointed for five-year terms without possibility of replacement. It consisted of one former minister, a government adviser, two bankers, the former president of "Saint-Gobain," the former president of the Chamber of Accountants (Chambre da la Cour des Comptes) and a commercial law professor. After the balances were reviewed and the bankers and the accountants had given their views, the Commission for Privatization would set a limit below which the firm could not be sold. The Commission would then consult stock market professionals about the state of the stock market and possible reactions to a public offer. Several hours after the public offer, the minister in charge of privatization would set the final price based on the recommendations of the commissions while the Commission would confirm whether the price had exceeded the set minimum. This procedure lasted an average of three months. As a rule, the minister would set a price between 5% and 10% below the set price, while in certain cases the fixed price would be even higher. In the greatest number of cases the set (fixed) price was lower than the balanced price that eventually formed on the market.[15] The setting of a price lower than the balanced price represents the most important reason for the success of the privatization in France, even though it resulted in smaller budget revenues than were possible. The decision of the government was to fix the price below the market price, so that, amidst price variations due to inherent stock market risks, the market price would not fall below the acquisition prices, all with the aim of encouraging new stockholders by allowing them to make a profit after the expected subsequent increase in the stock price. During the time when the stocks of all the state-owned companies were being sold, the demand for them was greater than the number of offered shares, which meant that buyers could not buy as many shares as they desired. Thus, for example, during the first privatization of the Saint-Gobain company, 10.8 million company shares were offered, while the demand was 61.6 million – or almost 6 times greater.

15 E. Balladur, *Je crois en l'homme plus qu'à l'Etat*, Flammarion, Paris, 1987, according to: V. Andreff, "Technique et experiences de privatisation: la 'succes story' des privatisation en France et les besoins actuels des pays d' Europe de l'Est", Comunication á la Research Conference on: "Economics of Decontrol and Marketization in Europe: The Experience and Prospects of Eastern Europe," Davos, September 1990, p. 18.

The results of the privatization were impressive:

a) 14 large industrial, banking and financial groups were privatized, of which 12 were privatized by the fixed price public offer technique (the companies: *Saint-Gobain*, *Paribas*, *Sogenal*, *Banque du Bâtiment et des Travaux Publics* – BTP, *Banque Industrielle et Mobilière Privée* – BIMP, *Crédit Commercial da France* – CCF, *Compagnie Générale d'Electricité* – CGE, *TF1 Chaîne de télévision, Havas*, *Société Générale*, *Suez*, *Matra*), one was wholly sold to a private group and one was privatized by decree – all within a space of 14 months (from November 1986 to January 1988). The fifteenth privatized company was the *Crédit Aggricole* bank, which was acquired by its own regional branches. Of the 14 privatized concerns, five were industrial and commercial concerns (*Saint-Gobain*, *Compagnie Générale d'Electricité*, *Havas*, *Matra*, CGCT), five banking and financial groups, one insurance company and one Television Company. At the time of privatization, these 14 privatized groups had a total of 333,150 employees, and controlled 1,082 companies. The value of the privatized capital equaled 125 billion franks. In addition to these, a total of 277 other cessions of state-owned shares to the private sector were performed, including 262 industrial and 15 banking affiliates. Adding the number of 272 affiliates to the 1,082 companies controlled by the 14 privatized groups, we get a total of 1,359 companies privatized in 14 months. The average privatization tempo equaled 1 group and 97 companies or affiliates per month, which is an indicator of the privatization's success. As a comparison, in Great Britain between December 1979 and December 1985 (during the government of Mrs. Thatcher), 20 state-owned groups employing about 400,000 people were privatized for about 80 billion franks.

b) The second aspect of the privatization in France concerns a change in the relationship between bank-held savings and investment in stocks in favor of the latter. Before privatization, this relationship had a ratio of 1:20 in favor of bank-based savings. The development of the financial market was stimulated by the deregulation of the financial markets in 1984 and the availability of new financial instruments (investment funds, participative securities, etc.). This was what paved the way for privatization by way of public offer. A total of 16.6 million citizens participated in the privatization of the said 14 concerns. In Britain, the number of stockholders increased from 1.4 million in 1979 to 2.8 million in 1985, among which 50% of the small stockholders sold their stocks within 6 months (20% in France). The majority of small investors in France did not sell their stocks (in spite of large increases in price), not even after the stock market crash of 1985. Privatization popularized stockholding in France.

c) An additional reason for the success of privatization in France lies in the fact that the shares of the privatized companies retained a relatively good level after privatization, in spite of the stock market crash of October 1987. On the date of the first listing, the prices of 11 of 12 company stocks were higher than the selling price, from 6% (*Société Générale*) to 80% (*Sogenal*). Only shares of the *Suez* Company, which was privatized in November 1987, one week after the stock market crash, had a fall of 21%. In spite of the effect of the market crash at the beginning of 1988, the price of one half of the privatized company stocks was higher than the selling price.

The privatization of 1986-1987 brought in 70.8 billion franks, of which 45.9 billion were used to pay off the public debt. The rest was used to recapitalize state-owned companies ((*CGE*, *Sogenal Suez* after their privatization, *Renault*, *CDF-Chimie*, *SNCF* and the road construction companies).

In the French privatization process there were 4 groups involved in purchasing stocks: foreign investors, private sector employees, the hard nucleus (consistent stockholders) and the public at large.

A portion of the stock of the privatized concerns was offered to foreign investors, except for the stocks of the following concerns: *Sogenal*, *BIMP*, *BTP*, *Havas* and *TF1*, which was limited to 20% of the privatized capital. This protection applied only at the moment of privatization; already at the next quotation, this percentage would be open to change. In addition to the above, one more instrument of protection of the state interest was introduced: the golden share. During the sale of a company's capital, the government had the right of retaining ownership of a share qualified as a golden share of symbolic value (1 franc) during a predetermined time interval, giving it the right of decision in matters related to the future of the company, especially decisions about the sale of property. The golden share allowed the French government to oppose any attempt at gaining control of a concern during a five year period, i.e. the buying of shares on the part of either French or foreign entities in excess of 10% of the privatized company's capital. This type of share was institutionalized during the sale of the *Havas* and *Matra* concerns.

A 10% share was reserved for those employed in the concerns. In all the privatized concerns demand for employee shares was greater than the number of offered shares. Offers were 1.3 times greater during the privatization of *Saint-Gobain*, and 3.4 times greater during the privatization of *CGE*.

A hard nucleus of stockholders was constituted in all the privatized companies. Differently from the British model of privatization, according to which the state did not take interest in the stockholder structure once companies were privatized, leaving this to the marketplace (although the golden share was often used), the French model provided for the formation of a hard nucleus of stockholders in order to prevent the total atomization of company ownership. The government's fear of total atomization of ownership came as a result of the fact that, in case of the dispersion of capital into the hands of millions of stockholders, the company could easily be taken over on the stock market by a foreign or

French group deemed undesirable by the government. Industrial or financial groups could buy shares from small, isolated and ill-informed stockholders at low prices. This would run contrary to the government's intention to develop "people's" stockholding. On the other hand, mass stockholding without a hard nucleus has a destabilizing effect on running a company. It was decided that a hard nucleus should be formed in each company, made up of several dependable stockholders, with each holding between 0.5% and 5% of capital, or a sum total between 15% and 30% of capital. This hard nucleus would ensure the stability of capital and management during a period of two years.

The forming of a hard nucleus can be accomplished with the aid of several methods. One is to give 20% or 30% of capital to a group of mutually responsible stockholders, chosen by the minister in charge of privatization. A second solution could be to sell that part of the capital at an auction to the highest bidder. However, as the sale of capital at auctions is, according to one minister, "shocking," this solution was not accepted. What was accepted was a solution according to which the control package is sold off market. The control package was sold piece by piece on the basis of public offer, in the case of each company that was being privatized. Interested investors had a month to submit their offers. Investors had an obligation to pay a premium (the difference between the determined price and the market value) of 2.5% to 10%, had to possess the necessary technological and commercial capacities and to retain ownership of the stocks during the prescribed period (most often two years). The choice of stockholders that were to form the hard nucleus was made by the minister, on the basis of offers and offered guarantees.

The fourth stockholder bloc is made up of all interested citizens, who are offered a residual portion of the capital. More than 15 million registered shares were compiled for the first 10 companies. In the majority of cases, demand outstripped supply, which resulted in a purchasing limit of 10 shares per person.

It is thought that the use of diversified instruments intended for previously defined stockholder blocs contributed to the success of the French privatization. "The special treatment of previously formed groups of stockholders proved to be an undoubtedly useful experience for all subsequent privatizations."[16] It is also necessary to mention a fifth group of stock purchasers on the market: institutional investors. Their participation in the privatization was not negligible: i.e. 25% in *Saint-Gobain* and *Paribas* – including stocks purchased from small investors on the stock market, which caused a jump in stock prices.

In addition to the privatization technique, the success of the French privatization was also aided by the economic environment in which the privatization

[16] V. Andreff, "Technique et experiences de privatisation: la 'succes story' des privatisation en France et les besoins actuels des pays d' Europe de l'Est", Comunication á la Research Conference on: "Economics of Decontrol and Marketization in Europe: The Experience and Prospects of Eastern Europe," Davos, September 1990, p. 23.

was carried out as well as by the success of the companies whose capital was privatized in the period that preceded the privatization.

As for the economic environment, the raising of interest rates led to a lower inflation rate after 1983. On the other hand, there was an increase in the share of savings held in securities: a certain degree of securitization of savings occurred. This process was initiated in 1983-1984 by the Socialist government, which stimulated savings and their investment in industry, and which deregulated the financial markets. The increased investment of savings into securities instead of bank deposits led to a more dynamic development of financial markets from 1984 to 1987.

4. Neglected lessons from the French privatization model

Prof. Andreff points to the fact that profitable companies were privatized as a key factor of the success of the privatization in France. "According to our opinion, the most important factor in the successful privatization of state-owned companies was the pronounced raising of the companies' profitability between 1982 and 1985. By the end of the nationalization process in 1982, out of 21 industrial and commercial state-owned companies, only three were operating without a loss. By 1985, only five of these companies were not profitable, or three – if we exclude two steel plants in regression, whose restructuring process was already in its 15th year. After nationalization, the state-owned companies were managed in a "capitalist" way. The Socialist government aided the subsequent privatization by introducing economic criteria for the operations of state-owned companies, i.e. they demanded profitability, a commercial orientation, financing through financial markets (and less by way of government subsidies) and an enterprising spirit. The rehabilitation of profit as a business goal in 1983 (during the Socialist government), created a favorable climate for privatization among employees."[17]

An important lesson from the French experience is that it is necessary to raise a company's profitability before privatization, i.e. that it is necessary to turn its operations over to managers whose work is evaluated in the same way as in private companies. As Prof. Andreff underlined, the most important factors in the French privatization was the raising of companies' profitability before privatization and the privatization of profitable companies. Andreff points out that the privatization of unprofitable companies would have been unsuccessful for many reasons:[18] it is impossible to mobilize the public for mass privatization,

[17] V. Andreff, "Technique et experiences de privatisation: la 'succes story' des privatisation en France et les besoins actuels des pays d' Europe de l'Est", Comunication á la Research Conference on: "Economics of Decontrol and Marketization in Europe: The Experience and Prospects of Eastern Europe," Davos, September 1990, p. 24.

[18] V. Andreff, op. cit., p. 27.

because people invest money into stocks expecting dividends; it is impossible to find buyers for such companies (except by giving the company away), while it is not possible to privatize losses, which are by their nature public. In order for such a company to become profitable, it is necessary to introduce significant restrictions following privatization and to dismiss employees. This does not mean that there were no restrictions or dismissals in privatized companies in France, but this happened to a singificantly smaller extent than would have been the case had unprofitable companies been privatized.

The best companies were also privatized in China. As a consequence of the privatization of the best companies, post-privatization company performances in China have a lesser, perhaps even a negative significance.[19]

Instead of improving company performances before privatization, the opposite often occurred in Serbia and many Eastern countries – companies showed negative performance tendencies prior to privatization. As a result, it often turned out that companies were more efficient after privatization, which then supported the view that privatization should be done as urgently as possible. There are a number of reasons why company performances worsened before privatization: inadequate management, general management and employee apathy, political pressure by the authorities, insufficient motivation, prevention of timely investments on the part of the Privatization Agency, fraud connected with reducing company values for the purposes of easier and cheaper takeovers.

The French promoted mass citizen participation in this process as one of the goals of privatization. That is why they conceived a privatization model that allowed the broadest possible public participation. And they succeeded: following privatization the ratio of bank-based savings to investments in capital markets shifted significantly in favor of the latter. Prescribing a model by which 70% of capital is sold at auction certainly cannot mobilize savings and direct them toward the purchasing of stocks, for numerous reasons. First, individual savers often do not have sufficient means at their disposal to buy 70% of capital. Second, savers are primarily motivated toward making a profit with minimum risk, which is accomplished by way of diversification and not investment into only one company. Third, savers as a rule do not have aspirations to manage companies but only to reap dividends whose returns exceed interests on savings. Potential small stockholders are, thus, interested in buying stocks for the purpose of making a profit at a reasonable risk, and not in buying companies. The said research has shown that ownership diversified among small stockholders does not as a rule result in efficient management. It is precisely for this reason that hard nuclei were formed in France. On the other hand, small stockholders will not invest in stocks if they are not additionally stimulated by low prices. The French chose to allow the purchase of stocks at undervalued prices – but not at fire sale prices as

[19] C. Wang, "Ownership and Operating Performance of Chinese IPOs," *Journal of Banking and Finance*, 2004.

provided by our model, which allows purchases even at 20% of book value. In accordance with the results of the above analyses, due to potential difficulties with the formation of "hard nuclei" in some Serbian companies, that role can be taken over by the state. Secondly, portions of capital were not given away to employees in either France or Great Britain. At a purely legal level, according to the 1974 Yugoslavian Constitution, which enumerates all who are not owners of social property – the state, the organization, the company, the employees, etc. – it comes out that employees do not have the right to a free takeover of social property. Thus, from a purely legal standpoint, no one was the owner of social property. In essence, nothing belongs to the employees, since they had the privilege of working in successful companies, as opposed to those who worked in the public sector or in unprofitable companies, or who did not succeed in finding employment. However, since employee motivation is also stimulated through internal stockholding, the French lawmakers allowed employees to purchase a certain percentage of shares below price. It unclear as to why our lawmakers did not draw lessons from the French model and adjust it to our own specific conditions during the privatization of certain companies.

A portion of the proceeds from privatization in France was used for the recapitalization of companies. In Serbia, the current privatization model does not provide for the recapitalization model, nor are portions of privatization proceeds used toward that end. Taking account of the fact that the economy of the Republic of Serbia lacked long-term capital, it was necessary to provide for recapitalization as well. Experiences of developed market economies after World War II and numerous analyses performed in recent years on the influence of privatization on effectiveness and efficiency say that there should be no "fear" of state participation in the capital of recapitalized companies, i.e. that there should be no rush to transform the ownership of the entire state capital within a short time period at any cost.[20] Recapitalization secures additional capital necessary for exploiting existing capacities and for expanding them. State-owned capital, on the other hand, would allow the state to stimulate the development of the financial market, allowing the populace, along the lines of the French model, to buy stocks at slightly undervalued prices.

The recapitalization of state/social companies assumes their previous transformation into stockholding companies, after which the question of the price at which the initial public offering (IPO) will be offered is opened. In principle, the stock price corresponds to its current value on the condition that all the relevant information has been correctly reported and is known to investors. Lack of information or informational asymmetry is that fundamental element that prevents stocks from being sold at their rightful price.

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20 For more details, see: V. Pavlović, S. Kostić-Nikolić, "Uticaj privatizacije na finansijske i tehničko-tehnološke performanse preduzeća", Symorg, Zlatibor, June 2006.

However, a special challenge is posed by the appraisal of the value of closed, i.e. unlisted companies.

John D. Emory hoped that he could determine the objective market value of shares of unlisted companies if he could establish the change in the value of shares following the company's listing on the stock market relative to the initial public offering. For this reason, Emory investigated the relationship between the value of shares between the initial public offering and the market-formed price of shares on the stock market following the company's listing on the exchange. Emory published a series of researches done between January 1980 and the end of March 2000 in "Business Valuation Review," a specialized magazine of the Business Valuation Committee of the American Society of Appraisers. In his early research, Emory reviewed 2,200 prospects and analyzed 310 transactions. He eliminated developing companies, companies that operated at a loss and companies with an IPO value of less than 5 dollars per share.[21]

Table 1: *A review of Emory's research*

Research period	Number of transactions	Average discount value	Median discount
May 1997-December 2000[(a)]	283	50%	52%
May 1997-December 2000[(b)]	36	48%	44%
May 1997-March 2000[(c)]	53	54%	54%
November 1995-April 1997	91	43%	42%
January 1994-June 1995	46	45%	45%
February 1992-July 1993	54	45%	44%
August 1990-January 1992	35	42%	40%
February 1989-July 1990	23	45%	40%
August 1987-January 1989	27	45%	45%
January 1985-June 1986	21	43%	43%
January 1980-June 1981	13	60%	66%
Combined results[(d)]	593	47%	48%

(a) Extended study
(b) Limited study
(c) Dot.com study
(d) In order to avoid double calculation of a transaction from the dot.com study, limited studies were also included as a part of the extended study.

Source: R. J. Hitchner, *Financial valuation - Applications and Models*, John Wiley & Sons, Inc., New Jersey, 2003, p. 288.

21 R. J. Hitchner, *Financial valuation - Applications and Models*, John Wiley & Sons, Inc., New Jersey, 2003, p. 288.

Professor Vernimmen says that – if statistical studies are to be believed – the listing of a company on the stock market is generally reflected by an increase in the value of shares relative to the initial listing value by an average of 10 to 15 percent, depending on the country and the period (and the calculation method), while the placing of already listed stocks on the market is accompanied by a reduction of 2 to 5 percent.[22]

However, it should be born in mind that the process of initial public offer, from initiation to finalization, often lasts 4 to 5 months, which frequently obscures the results of the analysis, since that time period could see a change in company performance and a change in the environment, resulting in changes in investor perceptions. It was precisely changes on the stock market that resulted in a series of unsuccessful initial public offers of domestic companies in the second half of 2007, in the wake of a number of successful recapitalizations, primarily of banks, done during 2006 and in the first half of 2007. Thus, for example, the fifth stock issue of the Pirot-based "Tigar" company did not succeed (less than 4% of the shares were sold), while the Bečej-based "Sojaprotein" was compelled to suspend its decision to issue shares through initial public offer for an indefinite time. The main reason lay in the constant fall in the shares' market price, which resulted in a situation in which the pre-determined issuing price exceeded the market price of the shares on the stock market. The high market value of domestic company shares gave rise to thoughts about the possible option of recapitalization. However, following the "historical" maximums reached by many companies, there ensued a fall in the indexes of the Belgrade Stock Exchange, which was especially pronounced in November 2007, when the "Belex15" fell by 9 percent, while the "Belexline" fell by more than 7 percent.

Changes in stock values due to speculative activities are a frequent phenomenon on undeveloped capital markets; in Serbia, the situation is exacerbated by the risk caused by the high balance of payments deficit and growing indebtedness, as well as by political instability.[23] The shallow and undeveloped Serbian capital market also produces more significant changes in stock price levels as a result of smaller transaction values.

In principle, during an IPO the goal is to establish a maximum stock price at which it is possible to successfully realize the IPO. A price set too low represents a loss for the company's current owners, while an overly high price can lead to a failed emission. However, when it comes to recapitalization as a model of privatization, the set price does not have to be the price at which shares will be offered to the public and the employees; here it would be useful to approve a certain dis-

[22] P. Vernimmen, *Finance d'entreprise, 6e édition par Pascal Quiry & Yann Le Fur*, Dalloz, Paris, 2005, p. 576.

[23] For more details, see: V. Pavlović, N. Simić, "Preispitivanje opravdanosti privatizacije srpskih preduzeća zasnovane na principima Vašingtonskog konsenzusa", 5th International Academic Gathering of Megatrend University: "Poboljšanje efektivnosti i efikasnosti preduzeća i privrede", Beograd, November 30, 2007.

count, as was done in France, in order to include the greatest possible number of citizens in the privatization process.

5. Evaluation of the current privatization model in Serbia

Following the regime change in 2000, the new Law on Privatization was passed in June 2001, which radically changed the way in which privatization was carried out. According to the new Law, the privatization process is “promoted, initiated, implemented and controlled” by the Privatization Agency, by which the previous Office for Capital Value Appraisal was abolished. The following privatization models were provided for: sale of capital by way of public tender and public auction, and transfer of capital without compensation, through the transferring of capital to employees and to the public. Should the Agency judge that the capital of the company which is the subject of privatization cannot be sold by the methods of public auction or public tender without previous restructuring, the company is obligated to perform financial rehabilitation within the process of privatization.[24] If rehabilitation cannot be performed, bankruptcy proceedings are initiated. The structuring and approval of privatization is accompanied by capital value appraisal, according to the prescribed methodology, while sale is performed at a price formed on the basis of supply and demand on the market. Seventy percent of the capital is sold on the market, while the remainder is transferred without compensation. The sales proceeds are transferred to the account of the budged of the Republic of Serbia, the shares that remain after the capital is sold are transferred by way of public auction to the Share Fund in order to be sold, while shares that remain after sale by public tender and uncompensated transfer to employees are evidenced in the register. With the purpose of improving the existing Law, a new Law on Amendments to the Law on Privatization was passed in February 2003,[25] while, slightly more than two years later, in May 2005, the Law was changed once more. This last amendment gave greater competencies to the Agency, in terms of granting it powers to act as liquidator should the bankruptcy council grant it such a role.

As for the prescribed appraisal methodology,[26] it may be concluded that the methodology is appropriate for the current model of privatization since, according to this privatization model, the appraisal essentially has no significance, which is why the use of book value really represents the most rational solution.

[24] The lawmakers do not mention rehabilitation anywhere specifically, but “status or organizational changes, or settlements of debtor-creditor relations and other changes that allow the sale of its capital or property” (Article 19).

[25] “Official Gazette of RS,” no. 18/2003

[26] Even though we are not dealing with a methodology for appraisal, since book value is not the result of a specific methodology of capital valuation.

However, capital value appraisal is necessary for the purposes of privatization since an adequate privatization model can be chosen only after the value and creditworthiness of the company are first determined. Privatization cannot be successfully carried out without knowledge about the value of the capital of companies slated for privatization. If capital is privatized at a value other than the appraised value, which is the case with us, then it is either a matter of inadequate appraisal of company capital or of an inadequate privatization model. It turns out that, in the case of Serbia, neither an adequate concept of appraising capital value nor an adequate privatization model was prescribed.

Privatization must not be an end in itself. An adequate model of privatization is one that allows the realization of goals set prior to privatization. The goals of privatization are: 1) the rehabilitation and revival of illiquid, insolvent, overly indebted and unprofitable companies; 2) expansion of capacities and the orientation of successful companies toward exports; 3) sustaining and increasing the employment rate; 4) stimulating the development of the financial market, stimulating the conversion of savings into long-term securities; 5) social justice; 6) filling up the pension funds; 7) repaying state debts. It is possible to fulfill these goals if the specificities of the economy in which privatization is being carried out are taken into account.

None of the passed laws on privatization, including the last one, is in accordance with the primary goals of privatization. The current privatization model overlooks the fact that the same model of privatization cannot be adequate for different companies and that, thereby, different approaches to privatization are necessary for different companies. It is not possible to find a universally good model of privatization that would be equally implementable for all companies: profitable companies, in which it would be hard to additionally increase business efficiency; unprofitable companies; companies without a market and/or access to modern technologies; companies with good market possibilities but a bad financial position; companies lacking working capital; companies in which it is necessary to expand capacities; companies with an adequate financial position and no need of recapitalization.

The current privatization model has the following consequences:

- The undervaluing of sold capital, done in various ways, especially by moving back the day of evaluation;
- The disappearance of social capital through budget spending;
- Capital flight from the country by way of transfers of profits from dividends and profit participation to foreign company owners;
- Hardships in paying interest and due installments of credits received for the acquisition of auctioned-off social capital;
- Additional disruptions of the financial structure, increased current and accumulated losses, leading to a higher rate of inflation;

- Additional increases in the ranks of the unemployed, who wind up becoming the burden of those still employed, which – as noted by Stiglitz – contributes nothing to the national economy;
- The inability to privatize financially ruined and endangered companies with almost 400,000 employees. This “might be the deciding reason for the state to solve the problem after the example of the “Sartid” steel plant, in which case the biggest price would be paid by all the creditors, followed by, in the longer term, all citizens.” [27]

Also recorded was the phenomenon of domestic companies bought by foreign ones seeking to place their own products, produced in their home countries, at the expense of domestically produced products. This phenomenon of company acquisition with the aim of “conquering” a local market has also been recorded in other transition countries,[28] and could have been taken into account when the privatization model was being formulated.

The current privatization model neglects the significance of rehabilitation, i.e. improving a company’s financial situation. Even contrary to this, in some cases companies’ financial situations were even made worse. Namely, one of the contract provisions in the process of selling capital via tender is the obligation to invest in accordance with an investment program. However, what was ignored were frequent situations in which a company was incapable of normal business operations even under existing capacities due to over-indebtedness or a disrupted financial situation. In such situations, rehabilitation, i.e. financial resuscitation takes priority, and this is a much broader concept than ordinary investment. “For, it seems strange that the Agency demands investment in production capacities while neglecting the fact that the company being sold is financially ailing, insolvent, not creditworthy, and that it is operating at a loss.”[29]

The current privatization model does not contribute to the development of the financial market. Yet, “financial markets represent the most significant factor of the total economic and business system in countries with a developed market economy.” [30]

In many cases, the existing privatization model resulted in the sale of capital at an exceptionally low price. Since buying is performed at a market price determined on the basis of supply and demand, it turns out that low prices are

27 According to: J. Ranković, “Rezultati dosadašnje privatizacije”, *Ekonometar*, Politika, 11/15/2005.

28 According to: M. Živković, “Restrukturiranje domaćih preduzeća – put ka jačanju konkurentnosti”, international academic gathering “Jačanje konkurentnosti preduzeća i privrede”, December 2005, p. 58.

29 J. Ranković, “Previdi i promašaji u postupku privatizacije od 2001. do 2004. (1) – Ključna realna procena kapitala”, *Politika*, 5/20/2005.

30 M. Kulić, *Finansijska tržišta*, Megatrend univerzitet, Beograd, 2007, p. 19.

the result of overly high supply coming up against overly low financially capable demand. Demand is low as a result of the impoverishment of the majority of the population, the poor financial state of companies that might have appeared as potential buyers, but also as a result of the exclusion of domestic savings from the processes of privatization through a privatization concept that calls for the buying of 70% of capital. Insufficient demand relative to the supply of capital at auctions and on stock markets indicates that the prescribed privatization model was not appropriate to the conditions in the country. Nobel Prize winner Milton Friedman also warned of this: "…no investor is going to come to a country to help. He will come in order to profit from it, and that is why the FRY would be forced to sell its best companies at the lowest price." [31] When demand is too low, then either the supply can be limited or a financially capable demand can be formed. For the majority of companies, both were needed.

The introduction of voucher privatization would create financially capable demand. This would entail a change in companies' legal form, i.e. the transformation of socially and state-owned companies into stockholding companies – the corporatization of socially-owned companies, which would be managed by a state fiduciary corporation. This would achieve the following:

1. A change in the way of management, which has been identified as a priority in any case;
2. Capital valuation with an adequate methodology, since the methodology would be determined on a case-by-case basis, bearing in mind the specificities of various companies;
3. An increase in financially capable demand on two bases:
   a) in and of themselves, vouchers increase financially capable demand;
   b) the sale of smaller share packages of successful companies has a stimulating effect on the investment of savings into stocks;
4. The reduction of supply pressure, through the sale of appropriate share packages (according to the evaluation of management);
5. Stimulation of the development of the financial market;
6. A solution to the problem of restitution of nationalized property, since the successors can be compensated with vouchers;
7. A reduction in possibilities for corruption, since the fiduciary corporation should be under the authority of parliament, instead of the government or a political party that forms the government.

Additional demand could also have been created by a timely passage of the Law on Investment Funds. Since the institutional possibilities for domestic-based investments into investment funds in Serbia were not created until 2006, small domestic investors were not able "to take advantage of the extraordinary

[31] According to: B. Šever, "Ekonomske ne/logičnosti – ekonomska struktura i tranzicija", *Ekonomski Vidici VIII*, no. 1/2003, Beograd, p. 82.

possibilities for relatively high profits in the first phase of the development of the financial market in Serbia during 2003-2006, connected with the privatization wave and the objectively undervalued stock prices of a large number of companies that appeared on the stock market for the first time, which is a chance that foreign investment funds and other foreign investors knew how to exploit." [32]

The state fiduciary corporation would be authorized to sell whole or partial packages of stocks or shares, as the majority owner, initiate rehabilitation proceedings (both judicial and extra-judicial), reorganize the macro organizational structure and legal status with or without recapitalization, and initiate, as the majority owner, bankruptcy and liquidation proceedings, if that was in the interest of the advancement of the economy. "The entire job of rehabilitation, recapitalization and privatization should be left to a professional institution and to experts, who will work under authorization from parliament and on the basis of formulated government policy and sound laws." [33] The management appointed by the state fiduciary corporation would be able to determine the adequate methodology for capital valuation, as well as an adequate privatization model and its timing. This concept was proposed here in the Draft Law on Privatization authored by Professor Ranković (1995).

The acceptance of the above model in its entirety is no longer possible, primarily due to the fact that a large portion of socially owned companies has already been privatized or turned into mixed companies.

6. Conclusion

From the beginning of the privatization process in Serbia, the accepted view has been that it is necessary to prescribe a methodology for capital valuation. In addition, the lawmakers went on to prescribe various privatization models and various valuation methodologies. Capital in Serbia was appraised according to book value during one period (with or without discounts), reproductive value during a second, average value between earnings and reproductive value in a third period, while today capital is appraised according to the book and earnings method, with book value being favored, which has made capital valuation meaningless.

Previous models did take capital valuation into account but, since discounts were most often approved, capital was privatized at a lower value than appraised. In addition, valuation methods that resulted in capital overvaluation were used as a rule. The insistence on the privatization of overvalued capital threatened to halt the privatization process or postpone it until the capital valuation was

32 P. Kapor, *Investicioni fondovi i investiranje u hartije od vrednosti*, Poslovni biro, Beograd, 2007, p. 9.

33 J. Ranković, "Šta donose nove uredbe o privatizaciji?", *Finansije*, no. 9-10, 2002, p. 512.

reduced as a result of the company's worsening performance. On the other hand, the current privatization model makes capital valuation meaningless, since it allows the sale of companies at fire sale prices.

It is necessary to mention that, for the most part, privatization in Serbia has been carried out in an extremely unfavorable economic environment, amidst great political instability. It is well known that the success of a given privatization is strongly influenced by the general economic environment and the country's political stability. Since 1989, when the privatization process was initiated, all the way to the present day, Serbia has faced large, difficult problems: the disintegration of SFR Yugoslavia, which resulted in large casualties and the inflow of scores of refugees from the seceded republics, sanctions and the NATO bombing, which resulted in the illegal declaration of the independence of Kosovo and Metohija and its recognition on the part of certain countries, including the US and the economically and militarily most powerful states of the EU, which has significantly contributed to regional instability. The above events have resulted, among other things, in a shrinking national market, political instability, the ruin of numerous companies, increased unemployment, general impoverishment of the population and the rapid growth of criminal groups and corruption.

Each of the above events has also born an exceptionally negative influence on the possibility of formulating and carrying out an optimized privatization model.

However, in spite of these negative factors, neither the chosen privatization models nor the prescribed capital valuation methods were adequate at the time of their bringing, nor are they adequate today. Because, while paying due attention to the conditions in which privatization is being carried out, the concept of privatization, operationalized by the appropriate model, should be an expression of demands to realize certain goals. None of the privatization laws were in accordance with the primary goals of privatization, since they were not conducive to improvements in profitability and financial standing. Things in Serbia went from one extreme, from the blocking of privatization due to capital overvaluation and the distribution of worthless social capital to employees (which was often the case during the process of privatizing bad companies according to previous models), to the other, which consisted of selling (giving away) social capital at fire sale prices (the cases of the sugar plants, "Zdravlje" a.d. Leskovac, etc.).

Even though the privatization in France took place under incomparably different conditions, certain lessons could still have been drawn and taken into account in the formulation of the privatization model and of the capital valuation methodology. Based on lessons offered by the French model, while taking into account the specificities of Serbia, the following conclusions may be drawn:

1) It is necessary to appraise company capital. Without knowledge of the real value of a company's capital and of its creditworthiness, it is impossible to choose an adequate privatization model.

2) It is not appropriate to prescribe a uniform valuation methodology for all companies. Numerous capital valuation models exist precisely because no single method is universally acceptable. Various methods are appropriate for application, depending on a company's prospects, its fields of business, size, organic composition of capital, earnings capacity, economic-financial state, phase in its life cycle, the phase of concentration of the company's business branch.[34] Thus, each company should be approached individually and an adequate valuation method(s) chosen.
3) Privatization should be preceded by the transformation of socially-owned companies into capital companies and the appointment of expert management with the goal of maximizing profits. This is possible by forming a fiduciary company firmly tied to the privatization ministry and directly responsible to parliament.
4) A company's appraised value and credit rating must be taken into account when choosing a privatization model for the company.
5) Privatization does not have to be carried out according to appraised value: it is advisable to approve a certain discount so that shares may be offered during the privatization process at a price lower than the balance price that will subsequently form on the market; also the privatization of a company's entire capital does not have to be carried out at once.
6) The fiduciary corporation should have – on the basis of the evaluated state and the company's prospects – an independent power to recommend the method, prescribe and change the conditions, and perform all operations necessary for carrying out privatization.
7) The privatization proceeds should be used for recapitalization, rehabilitation, development and debt repayment; under no circumstances should they be used for budget spending.
8) The privatization of successful companies should result in the development of the financial market and increased investment in stocks relative to bank-based savings. The Law on Investment Funds should be passed and the creation of investment funds should be allowed before the start of the privatization process.

No privatization can be absolutely just. However, there are privatizations that are more just and those that are less just. The present privatization model is exceptionally unjust. It is also important to have in mind that the privatization of monopolies without previously established anti-monopoly mechanisms is a catastrophe for a developing economy. For a small nation with an underdeveloped economy and a low birth rate, a loss of awareness about the undesirability of corruption can have far-reaching ramifications. Under conditions in which a small

[34] For more details, see: V. Pavlović, "Značaj i međuzavisnost finansijskih i nefinansijskih informacija za poslovno odlučivanje", *Računovodstvo*, no. 11/12, SRRS, Beograd, 2007.

number of families owns the greatest part of the economic wealth, while a large portion of the populace is living at the edge of existence, special care is required regarding the implementation of privatization. It is of crucial significance for the state and the economy to maintain stability after the transition. Russian philosopher Vasily Rosanov wrote at the beginning of 1912: "In Russia all ownership has been gained by exhaustion (of natural resources and people – author's note), the acceptance of gifts or fraud. Property has been earned in only a small number of cases, which is the reason why it is neither stable nor respected." [35] Such a perception certainly contributed strongly to the subsequent course of events in Russia.

Under conditions of rampant corruption and the criminalization of society, no privatization model is adequate, just as no economic system is efficient.

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[35] V. Rosanov, "Uyedinnoye", Moscow, 1912; prema: A. Radygin, "Privatization, Ownership, Redistribution, and Formation of the Institutional Basis for Economic Reforms", in: *The Economics of Transition*, edited by Y. Gaidar, The MIT Press, Cambridge, Massachusetts, London, 2003, p. 398.

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A COMPARATIVE OVERVIEW AND THE DEVELOPMENT PROSPECTS OF THE FINANCIAL MARKETS IN SERBIA AND SLOVENIA

Abstract: *The contemporary global stock market environment is characterized by a continuation of stock exchange integrations and market corrections amidst raises in interest rates due to fear of inflation, growing commodity prices and, most of all, changed expectations. On the territory of the former SFRY, small national stock exchanges, including the Ljubljana and Belgrade exchanges, are trying to survive and assume the role enjoyed by exchanges in more developed economies. The said exchanges are gradually starting to feel the increased influence of globalized capital flow, through the reactions of foreign investors, which is cutting away at the dominant influence of domestic market conditions. Also, ownership concentration, which serves in the initial phase as an accelerator of exchange activity, acquires a contrary, negative effect once takeovers are completed. Thus, in the long term, these stock exchanges become unattractive and less and less liquid. Hence, only the linking of Central European stock exchanges will ensure the survival of the region's stock exchanges.*

Key words: *development, financial market, stock exchange, investments*
JEL classification: G15, P23

1. Introduction

For the global financial market, the period between autumn 2005 and mid May 2006 was a period of rapid and constant growth. This was succeeded by a period of falling rates or *corrections*, as stock market declines are frequently referred to. A very similar situation occurred in the first months of 2007 – rapid growth followed by a severe correction in the fall.

The growth was stimulated by speculative money so a correction was to be expected. The only question was when it would happen. From a global viewpoint, a classical growth cycle has existed for 3-4 years, reaching its culmination in winter 2005-2006. However, the global relations of the economic powers are supported by an all too vulnerable balance. Strictly speaking, it cannot be said that the key member – the US – is stable. Its foreign debt is beginning to seriously imperil the basic foundations of the global economy's relations. Not only is the debt enormous, it keeps setting new records. Another indication of insecurity are the actions of central banks all over the world, who are abandoning American bonds and the American currency, whose value has been falling constantly for some time.

As in every other economic growth cycle, the boundaries of its rise are imposed by limits in raw materials. The availability of raw materials is equal to the technical-technological possibilities of their exploitation. Thus, it is not so much a question of oil, copper, steel, etc. shortages, but of the fact that processing and transportation capacities are limited, which pushes prices upward, aided by the enormous influence of speculators. And it is precisely the problem of more expensive raw materials that draws warnings in the above phase of the economic cycle – that it is necessary to cool off the growth rates so as to avoid generating inflation. The central banks respond to this with a stricter monetary policy, mostly through raising interest rates.

For a very long time, the predominant view was that the real and the financial sectors were only two sides of the same coin; this was, in turn, replaced by a view by which these two spheres started to be viewed entirely separately. However, even this latter view is gradually being revised, since it has turned out that the two spheres have lives of their own – although they still influence each other. This is best shown by the fact that a *real estate balloon* has often stood behind great stock market crises. This was repeated once again in 2007, in the crash of subprime mortgage credits in the US.

That the causes are not that simple is shown by the examples of the American market[1] and the Dow Jones Index, where it is possible to connect only two out of ten biggest changes in the index with a precisely determined cause.

In the global village of individual economies and the financial market, contrary to the integrational processes that characterized the previous several years, small national stock exchanges on the territory of the former SFRY have been fighting to survive and assume the role played by stock exchanges in developed economies.

Even though they were once parts of a common state, the countries that were formed on the territories of the former Yugoslavia possessed differing development predispositions. The majority of these countries experienced destruction in the economic, political and general social sense, which was reflected in the material impoverishment of broad population segments and the decline of recognized societal values. To a greater or lesser extent, all the economies of the

1 These are the 14.9% growth in the index in 1931, due to Hoover's aid package to banks in the amount of 500 million USD, and the 9.5% growth in 1932, due to the liberalization of the FED's interest rate policy. Source: Jermy Siegel, *Stocks for the long run*; A. Zupančič, "Naložbeni nasvet: Padajoči kapitalski trgi strašijo vlagatelje", no. 49, *Finance*, Ljubljana, Slovenija, 2007.

newly established states were faced with inflation, which had a distortional effect on the real, and especially on the financial sector. Instead of the long-sought transition, these economies found themselves caught up in a retro-process – the process of "restaurational recession."[2]

Each country started to develop its own domestic market, the stock exchanges did not resume their work and now, 15 years after the disintegration of the common state, it is interesting to compare the situation on the financial market of the Republic of Slovenia, which was also the most developed republic in the former common state, and that of the Republic of Serbia, which has gone through economic crisis, hyperinflation and war. Investors, both domestic and foreign, see the markets' short-term prospects in their undervalued stocks and the possibilities of taking over domicile companies.

The following question can be posed: *Is the stock market an organized place for matching capital supply and demand, a place where actors can secure capital or place their surpluses, or is the stock market a place in which the privatization of social/state property is carried out*? If the latter is true then, the end of the privatization process will also see the end of the need for the existence of the stock exchanges.

2. The development of operations and statistics of the Ljubljana Stock Exchange

The first working day of the securities and commodities exchange in Ljubljana began on August 8, 1924, in the present-day Philharmonic building. At the opening, 27 different securities were traded, of which the majority were state securities. In the first three years of operations, the biggest volume was achieved in commodities trading. From 1927, foreign currency transactions gained predominance after it became possible to conduct them. The base act of the Stock Exchange was the statute, which was signed by the minster of trade and industry. Among other things, the statute regulated what could be traded, operational formalities, membership conditions, members' rights and obligations, etc. World War II left visible effects on the Ljubljana Stock Exchange. Trade in foreign currencies and effects practically died down from 1942. After almost 50 years of interruption, the Ljubljana Stock Exchange, was reestablished in December 1989 as a stock holding company, and began regular operations three months later.

2 A concept introduced by Prof. Dr. Branko Horvat. He pointed out that alternative strategies of socio-economic changes exist today: **transition** and **restoration**. Transition is a move forward from one, worse economic system toward a second, better economic system, which has higher economic growth rates, which is more efficient. The alternative path is restoration, i.e. moving backward. That is a move from statism and self-managing socialism toward historically lower forms of capitalism, which other authors refer to as "wild capitalism" or "initial accumulation of capital," B. Horvat, *Tranzicija i restauracija*, Ekonomija, Zagreb, 1999, pp. 1-27.

In reviewing Table 1, which shows the statistics of the Ljubljana Stock Exchange, it is apparent that the growth in volume and the index earnings has not been constant in the last 8 years. Nevertheless, investment on the basis of the SBI 20 index has had impressive results.

Table 1: *Statistics of the Ljubljana Stock Exchange*

	2000	2001	2002	2003	2004	2005	2006	2007
Capitalization of stocks in billions SIT	705.10	850.00	1,010.50	1,339.68	1,705.80	1,604.64	2,758.99	4,730.49
Change relative to previous year		21%	19%	33%	27%	-6%	72%	71%
SBI 20 earnings	0.10%	19.01%	55.24%	17.71%	24.74%	-5.59%	37.90%	78.10%
Total volume in billions SIT	269.6	348.64	481.04	340.24	396.65	138.8	238.8	553.65
Change relative to previous year		29%	38%	-29%	17%	-65%	72%	132%
Total number of transactions	396,602	320,157	452,805	341,802	353,068	255,908	228,941	
Change relative to previous year		-19%	41%	-25%	3%	-28%	-11%	-100%

Source: http://www.ljse.si/

Note: Data for 2007 have been converted to SIT
according to the exchange rate of 239.64 SIT to 1 €.

Volume and number of transactions

In 2006, the Ljubljana Stock Exchange had a total volume of 238.8 billion SIT, or 72% more than in 2005.[3] Stocks made up 80.4% of the volume. There was a total of 228,941 transactions, or 26,967 less than the previous year.

In 2007, the total value of the volume equaled 2,226.0 million euros (or 4,730 billion SIT), or 123.5% more than the previous year. The volume structure changed relative to the previous year. The value of executed off-market transactions increased substantially.

[3] Despite an increase in volume, the Ljubljana exchange is among the least liquid in the European Union. Thus, for example, according to the data of FESE for 2004, among 20 European stock exchanges, Ljubljana's ranks 16th, and among 5 Central European exchanges, Ljubljana ranks 4th in volume. In comparison, the Budapest exchange had a volume 20 times greater in the same period.

Market capitalization

Total market capitalization on December 31, 2006, equaled 2,758 billion SIT, with stocks making up 60.75%, bonds 34.99% and investment funds 4.26%. In comparison with the previous year, 2005, market capitalization increased by 72%.

The capitalization of stocks at the end of December 2007 equaled 64.8% of the 2006 gross national product, which was an increase compared to 2006, when it came to 42.1% of the 2005 GNP. The greatest increase came after the stock of "Nova kreditna banka Maribor" was listed on the stock market. NKB Maribor was privatized through a public offer to interested citizens of the Republic of Slovenia, similarly to the sale of the stock packages of *THT* and *INA* in the Republic of Croatia.

Indexes

Four indexes are calculated on the Ljubljana Stock Exchange: **SBI 20** – the index of stocks listed on the exchange, **PIX** – the index of investment fund stocks, **BIO** – the index of bonds listed on and off the market, and **SBI TOP** – the index of Slovenian blue-chip stocks.

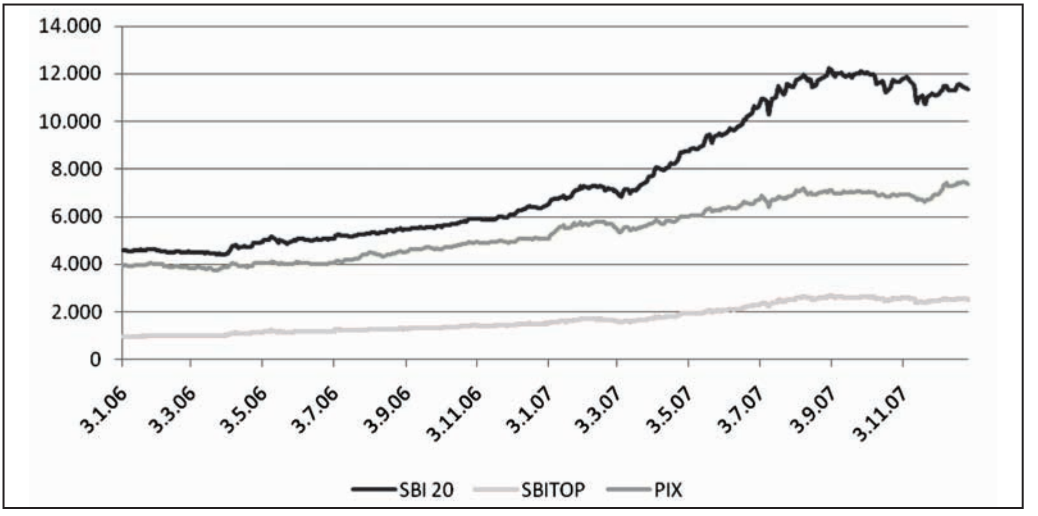
All the indexes of the Ljubljana exchange, except for BIO, reached their historic highs in 2006. SBI 20 grew 37.9%, SBI TOP 49.6%, PIX 28.3%, while BIO fell -3%. Graph 1 shows the movement of the indexes of the Ljubljana exchange.

The main index of the Ljubljana exchange, SBI 20, had a return of 78.1% in 2007, the blue chip SBI TOP index 71.05%, the PIX investment fund index 45%, while the BIO bond index lost 2.1% of its value. The indexes whose value increased also reached their historic highs in 2007.

One of the Ljubljana exchange's strategic orientations is to disseminate its acquired know-how to markets in Southeastern Europe, which would also promote the growth of the Slovenian economy's influence in that part of the continent. In that context, the Ljubljana Stock Exchange was the coordinator of a three-year project for the *Informational linking of the stock exchanges in Southeastern Europe.*[4] The project began to be realized in 2002 within the Stability Pact, with the goal of establishing the organization and infrastructure for gathering and providing information about the capital markets in the said region. The Internet site www.sem-on.net presented the stock exchanges in Sarajevo, Banja Luka, Skoplje, Belgrade, Varaždin, Podgorica and Ljubljana, as well as the securities traded on them. The goal was to provide online informational linkage for the members of the exchanges, allow the posting of price-sensitive information, improve and standardize preparations of statistical data, as well as allow the promotion of the said capital markets.

[4] www.sem-on.net

Graph 1: *Movements of the Ljubljana Stock Exchange indexes from 1/1/2006 to 31/12/2007*



Source: http://www.ljse.si/

The most important events

The year **2006** was characterized by the listing of the shares of *Autokomerc* and *Telekom*, two majority state-owned companies. In June, the *MP-Eurostock.si* investment fund was listed, to be joined in November by *MP-Balkan.si* and *Zlatna moneta I*, which was a novelty on the Slovenian capital market. Beginning with April 1, 2006, the SBI TOP index, which measures the returns of Slovenian blue-chip stocks, began to be calculated. December saw the merger of the Ljubljana Stock Exchange and the Swedish OMX exchange. This was not just a merger of ownerships but a technology-sharing partnership as well.

The main event of **2007** was the listing of "Nova kreditna banka Maribor" on the exchange. Small investors were offered subscriptions of up to 50,000 euros. There was also the invitation for offers for the second round of privatization of *Telekom Slovenije* (in accordance with the position of the European Commission, 49.13% was offered via international tender). The recapitalization of *Gorenje* was quite successful – 1,830,000 shares were subscribed and paid for. One of the more interesting takeovers was the takeover of the leading daily newspaper, *Delo*, by *Pivovarna Laško* brewery.

3. The development of operations and statistics of the Belgrade Stock Exchange

The Belgrade Stock Exchange was established in 1894, on the basis of the Law on Public Stock Exchanges of the Kingdom of Serbia. The first transactions were performed in January 1895. The exchange began its work on the first floor of the "Bosna" café on the Sava River. In 1936, it was moved to a large palace between Belgrade University and Dubrovačka Street. It did not gain full affirmation until after 1918. It worked more-or-less without pause until 1941, and was a significant center of economic life. According to the decision of the government of the Socialist Republic of Serbia, the stock exchange formally stopped working in 1953. It was reestablished on December 27, 1989, as the Yugoslavian Capital Market – Belgrade.

The first securities traded on the Belgrade Exchange after its reestablishment were bonds of the republic fund for the stimulation of faster growth of underdeveloped regions of SR Serbia, along with shares of Slavonska banka from Osijek, Croatia. Investors in our region have very negative experiences with state securities. For example, the bonds of the Serbian Red Cross Society from 1907, the bonds from 1946, the bonds of the Credit for the Economic Revival of Serbia. Owners of these and similar bonds suffered substantial losses as a result of the dinar's numerous devaluations, general inflation and/or cancellations of payouts.

It can be seen from the above that a stock exchange tradition did exist in Serbia. However, due to the long years of interruption in the work of the stock exchange, what is lacking is experience, financial culture and the education of a broader investor class.

Two significant moments marked the work of the Belgrade exchange: the beginning of trade in old foreign currency savings bonds and the beginning of privatization of more active trading in shares coming out of the privatization.

The beginning of the trade in old foreign currency savings bonds on November 19, 2001, showed that the financial market greatly depended on the quality of the market material, i.e. on confidence in it, and not primarily on the level of savings as the benchmark of available capital.

Volume and number of transactions

The value of the volume in 2006 exeeded that of the previous year by 108%, reaching 100.58 billion dinars (1.2 billion euros). The volume was realized by way of 141,499 transactions, or 18% fewer than in the previous year 2005. Stocks dominated the structure of the volume with 86.79% (an increaseof 123% relative to 2005) in 81.79% of total transactions, while the remaining 13.21% of the volume was made up of Republic of Serbia bonds (an increase of 45%) in 18.03% of total transactions.

In 2007, the total value of the volume traded on the Belgrade Stock Exchange was 164.6 billion dinars, or over 2 billion euros. Relative to 2006, this was an increase in value by 60%, while the number of transactions increased by 110%. Table 2 lists data on the volume and number of transactions on the Belgrade exchange from 1998 to 2007.

Table 2. *Volume on the Belgrade Stock Exchange*

Period	Volume value	Volume growth	Number of transactions	Growth in the number of transactions
1-12/2007	164,990,865,957	64.03%	301,210	112.87%
1-12/2006	100,583,951,914	108.03%	141,499	-18.44%
1-12/2005	48,350,670,609	19.14%	173,485	24.95%
1-12/2004	40,583,663,543	-56.39%	138,842	8.65%
1-12/2003	93,070,409,210	-9.02%	127,786	52.21%
1-12/2002	102,298,249,980	103.96%	83,952	82.22%
1-12/2001	50,156,494,837	461.95%	46,073	83.79%
1-12/2000	8,925,475,009	44.89%	25,068	336.72%
1-12/1999	6,160,024,047	2.59%	5,740	-37.65%
1-12/1998	6,004,271,574		9,206	

Source: www.belex.co.yu

Market capitalization

Total market capitalization on December 31, 2006, reached 809.02 billion dinars, or 10.24 billion euros. The share of stock capitalization in this was 81.4%, or 658.83 billion dinars. Relative to the previous year, total market capitalization increased by 41.9%, while the market capitalization of stocks increased by 70%. Total market capitalization on December 31, 2007 reached an impressive 1,440.48 billion dinars, or 18.17 billion euros. This was an increase of 96% in comparison to the previous year.

Indexes

As of October 3, 2005, the Belgrade exchange started to publish a second, new[5] index, called the **BELEX15**, covering only the most liquid companies in

[5] On April 30, 2007, the Belgrade exchange calculated and published the value of the general BELEXfm index for the last time. During the previous three years, BELEXfm increased in

Serbia. BELEX15 was created according to the methodology of the most prominent global indexes and the performances of the most liquid domestic companies. Both the Belgrade Stock Exchange indexes grew in 2006: BELEXfin by 22%, or 357.79 points and BELEX15 by 58%, or 614.99 points. The movement of the BELEX 15 index is shown in Graph 2. As of April 2, 2007, a new index of the Belgrade Stock Exchange – BELEXline – began to be published, and grew by over 40% by the end of the year.

The most important events

A new framework that would ensure the further development of the capital market emerged with the promulgation of the new Law on the Market of Securities and other Financial Instruments. Among the status-related changes should be mentioned the bringing of a new founding act for the Belgrade Stock Exchange, by which it was to become a closed stockholing company with unlimited voting rights and operate as a profit-making company.

In 2006 and 2007, the banking sector appeared as the main market generator on the Belgrade Stock Exchange. Many banks underwent recapitalization in order to obtain additional moneys in the cheapest possible way.

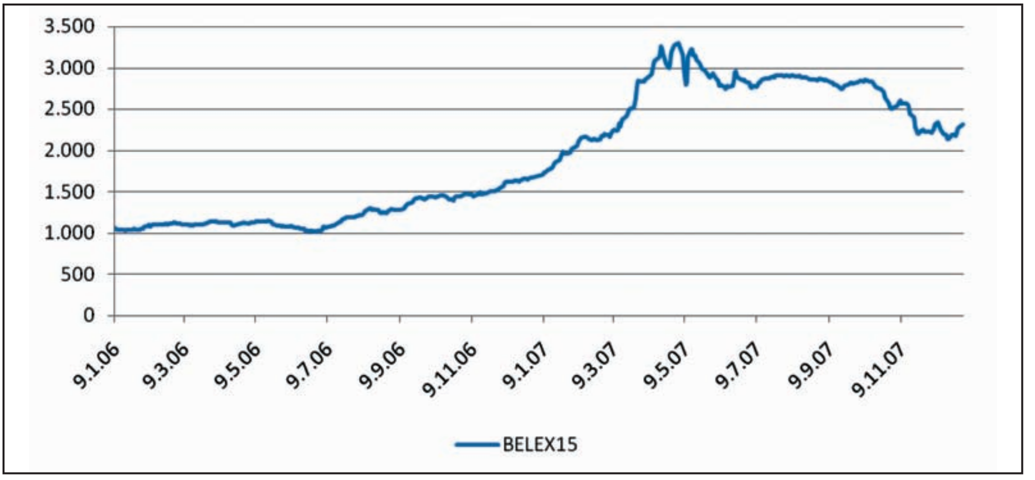
Table 3: *The structure of changes on the Belgrade Stock Exchange*

	2000	2001	2002	2003	2004	2005	2006	2007
VOLUME								
Stocks	3.36 %	0.19 %	6.90 %	32.76 %	62.89 %	73.01 %	86.79 %	89.92%
Bonds of RS & FRY	7.00 %	0.36 %	1.70 %	10.91 %	22.28 %	26.99 %	13.21 %	10.08%
Bonds	1.19 %	3.00 %	19.10 %	24.67 %	9.16 %	-	-	-
Commercial papers	78.00 %	42.00 %	22.10 %	13.49 %	5.66%	-	-	-
Cert. of deposit	8.00 %	49.00 %	46.00 %	14.83 %	-	-	-	-
TRANSAKCIJE								
Stocks	4.00 %	0.10 %	1.10%	2.25 %	49.59 %	80.99 %	81.97 %	94.81%
Bonds of RS & FRY	0.00 %	11.00 %	36.90 %	73.08 %	47.42 %	19.01 %	18.03 %	5.19%
Bonds	0.77 %	3.00 %	28.60 %	16.73 %	2.21 %	-	-	-
Commercial papers	93.00 %	82.00 %	32.40 %	7.39 %	0.81 %	-	-	-
Cert. of deposit	2.00 %	2.00 %	1.00 %	0.18 %	-	-	-	-

Source: www.belex.co.yu

value by more than 190%, reaching its historical maximum on April 19, in the amount of 3,002.48 points. The last value of this indicator equalled 2,904.97 points.

Graph 2: *Movements of the Belgrade Stock Exchange Index, from 1/1/2006 to 31/12/2007*



Source: www.belex.co.yu

The attractiveness of this kind of investment was illustrated by the fact that demand was so great that, initially, the worth of a single issue was subscribed several times over in all the recapitalizations. Besides the banking sector, companies engaged in infrastructure projects in Serbia also proved quite attractive.

Table 4: *Structure of changes on the Belgrade Stock Exchange*

Year		2007.	2006.		2007.	2006.
		BSE	BSE		LJSE	LJSE
Market capitalization of shares in mill. euros		16,312	8,340		19,740	11,513
Growth relative to previous year		95.6%	84%		71.5%	72.0%
Volume in mill. euros		2,062	1,257		2,227	996
Growth relative to previous year		64.0%	108.0%		123.5%	72%
Number of transactions		301,210	141,499			228,941
Growth relative to previous year		112.9%				
Index growth	Belex line	44%	np	SBI20	78.1%	37.9%
	Belex15	38%	58.0%	SBI TOP	71.0%	49.6%
				PIX	45.0%	28.3%
				BIO	-2.1%	-3.0%

Source: www.belex.co.yu, www.ljse.si

As for the companies *NIS, EPS, Telekom Srbija, Aerodrom Nikola Tesla, JAT Airways*, and *Galenika*, a new round of privatization was announced for the year 2008, by way of distributing shares to citizens who had not participated in previous privatizations. It is estimated that about 4 million citizens will take advantage of this right. These shares would not appear on the stock exchange before 2009.

Trade in shares from privatization

The majority of the privatized stock companies in the Republic of Serbia were privatized on the basis of the laws from 2001. Due to the privatization method based on the sale of 70% of social capital to a single strategic investor, as in other examples of consolidation and rehabilitation of already-privatized companies, the result was the concentration of capital under the ownership of one majority stockholder and a tendency to transform such stock companies into closed companies.

All stock companies in the Republic of Serbia may be roughly classified into two groups. The first group contains stock companies privatized according to the present-day law on privatization, controlled by a strategic investor. Besides the strategic investor, small stockholders, most of whom are company employees, are also holders of the stock. As a rule, contracts on the purchase of social capital obligate the investor to buy out the part belonging to small stockholders, at the social capital price in effect at the time of privatization. After the buyout of the remaining share, the strategic partners-investors become the owners of 85-100% of all shares.

The second group consists of stock companies privatized according to the laws from the 1990s, which is characterized by a large number of small stockholders – employees, retirees and a portion owned by the Share Fund. Due to their great economic significance, these stock companies are often the subject of takeovers either through public offers or recapitalization.

According to the Law,[6] all stock companies are open, regardless of the way in which they were formed. Open stock companies are established by way of a public call for the subscription and purchase of shares. The joining of new shareholders is not limited, nor is the transfer of shares. The new Law on Enterprises now regulates the work of open stock companies. The law also provides for the existence of closed stock companies that issue limited numbers of shares to a limited number of investors. The transfer of such stocks can be limited or even totally barred. Open stock companies are regulated by norms of an imperative nature, as opposed to the closed stock companies, in which this is left to the shareholders themselves. There are also other differences, related to dividend payouts, limits in acquiring own shares, the ways in which shareholder meetings are convened, the ways in which capital is increased or decreased, etc.

[6] The Law on the Market for Securities and other Financial Instruments

After privatization is completed and the strategic investors take control, concentration of capital will be a significant characteristic of stock companies in Serbia. As a rule, the interest of the strategic investor is to close or limit public access. Such companies prefer other forms of organization to that of the open stock company. This produces a tendency toward transformation into closed stock companies or even limited companies, with their possibilities for conflict with small stockholders.

4. Prospects for the development of financial markets in Serbia and Slovenia

Stock exchange performances are most frequently viewed through their market capitalization, which reflects the size of the observed market as well as potentials for investing. It represents the total value of all securities with a market-determined price. By comparing the relationship between this indicator and certain macroeconomic data such as, for example, gross domestic product, one can obtain relative indicators that, among other things, point to the degree of a capital market's development within a global context.

Looking at the data in Table 4, it can be seen that both the observed stock exchanges registered impressive growth in the market capitalization of stocks – from 71.5% to 95.6%. However, if these are compared to other stock exchanges in the region, the data is not so encouraging. For example, the Zagreb Stock Exchange has a greater market capitalization than Ljubljana and Belgrade together, while the Istambul exchange is larger than all the exchanges in Southeastern Europe together. Hence, we are dealing here with exchanges that are small not only in the European but even in the regional context.

Taking into consideration the various degrees of countries' normative orderliness and institutional build-up, the comparing of stock exchange indexes serves as an important indicator for the economies of certain countries and the efficiency of their economic policies.

In 2007, the Serbian capital market seen through the prism of the BELEX15 index, the index of blue chip companies grew by 38% - significantly less than in 2006, when it had a return of 58%. The Ljubljana Stock Exchange indexes did much better in 2007, by a factor of almost two.

The question of the future of the stock exchanges that have formed on the territory of the former SFRY appears within the context of the globalization of financial business. There are three possible directions of development:

- Independent existence, which is not very probable, having in mind the fact that even the stock exchanges in countries that have gone far down the road of transition are not able to exist independently;

- As part of a regional stock exchange and, through it, cooperation with a large European exchange, or
- Merger with a large European stock exchange.

The creation of a regional stock exchange would unify exchanges at a similar level of development. Additionally, this would also be desirable due to the similarities in mentalities and financial culture. Such a consolidation would lessen the problem of local market illiquidity and create a stronger starting position for negotiations about cooperation with some larger exchanges. Solving the problem of market liquidity is highly important, since it is well known that all smaller or growing markets suffer from lack of liquidity. A simple merger with a large exchange would only lead to the swallowing of the small exchange and the marginalization of that market.

Certain steps have already been taken. In November 2000, a cooperation agreement was signed between the Athens Securities Exchange and the Belgrade Stock Exchange, which opened the way for all future arrangements. The development of the Belgrade exchange greatly depends on taking over experiences from other markets, in this case the Athens exchange. Then there was the already mentioned Informational Linking of the Stock Exchanges of Southeastern Europe, which began to be realized in 2002 within the Stability Pact, as well as tendencies toward the merger of the Sarajevo and Banja Luka exchanges, the realized merger of the Zagreb and Varaždin exchanges, the takeover of the Montenegro exchange by the NEX Montenegro exhange.

Furthermore, on January 17, 2006, the Belgrade and the Vienna exchanges signed a memorandum of cooperation regarding joint work on improving markets in various fields, before all in the fields of derivatives trading, the development of new indexes and the joint distribution of data from the exchanges. In this sense, the Vienna exchange will provide consulting services to the Belgrade exchange in establishing a derivatives market, as well as halp with the introduction of structural products to the Belgrade exchange. The memorandum of cooperation with the Belgrade exchange is the fifth such agreement singed by the Vienna exchange. The Shangai, Dubai and Bucharest exchanges signed such cooperation agreements with the Vienna exchange in 2004, while the same was signed with the Zagreb exchange in 2005. Agreements with the exchanges in Shangai and Bucharest were concretized in that year, through the development of joint indexes, ROTX (Bucharest) and CNX (Shangai).

The Belgrade Stock Exchange and the International Finance Corporation (IFC), signed[7] a memorandum of understanding establishing cooperation of these two organizations on activities of improving corporate management in Serbia, as part of a three-year corporate management development project carried out by the IFC in the countries in the region. The goal of the project is the

[7] Source: www.belex.co.yu of April 19, 2006.

improvement of corporate management in the country, primarily by building the capacities of the carriers of its development.

Joint activities will first include the organization of “round tables” with members of the exchange and companies whose shares are traded on the exchange by the continuous trading method. These gatherings will be devoted to the improvement of corporate management in stock companies, especially from the aspect of realizing certain concrete questions in practice, as well as a review of their effects through the prism of other countries’ experiences. Toward that end, it is planned that international experts will also take part at these gatherings. The said gatherings, through a process of direct communication between companies, representatives of portfolio investors and market participants, have the added goal of developing mutual relations, primarily through a higher level of reviewing and understanding the role, possibilities and interests of the said persons within the bounds of the domestic capital market. On December 20, 2007, the Belgrade, Macedonian, Zagreb and Ljubljana stock exchanges signed a memorandum of partnership,[8] which heralded the beginning of closer cooperation in the promotion of the regional market, the international promotion of regional products, the further development of regional products, services and members, as well as the coordination, development and institutionalization of cooperation.

Specifically, the goals for 2008 are: the development and publication of regional benchmark indexes and a regional performance-tracking index, the preparation and organization of a regional and international investors’ conference toward the goal of promoting the leading regional products, the preparation and publication of a biennial regional bulletin and the construction of a web site that represents the regional market.

Ater the memorandum was signed, the initial participants invited the Banja Luka, Sarajevo, Montenegro and NEX Podgorica exchanges to join the project. Cooperation on the basis of this memorandum is open for all other initiatives and projects or organizations working toward the development of capital markets in the region.

As long as trading on the exchanges is primarily directed toward domestic investors, within a relatively closed environment, their development will be identical to the development of the stock exchanges of today’s developed countries. Having in mind the globalization process, hoever, that kind of development trend exhausts itself very quickly.

Once the inflow of foreign capital becomes larger and first-class stocks exhaust their possibilities, the domestic exchange will have to think about closer cooperation with some of the exchanges in the region or in the rest of Europe. Such cooperation is an inevitable process, since there is a long-term tendency of market concentration.

8 www.belex.co.yu

Investing on the Belgrade Stock Exchange can be observed from three angles: the creation of portfolios on the domestic capital market (from the domestic investors' standpoint), investing on the Belgrade exchange as a part of regional diversification and investing on the Belgrade exchange as a part of global diversification (from the standpoint of international investors). The question for the foreign investor is how many securities issued in Serbia can be included in his portfolio, without compromising the desired target – the targeted risk-earnings ratio. On the other hand, for domestic investors the question is to what degree is it necessary to invest abroad in order to stabilize the domestic portfolio.

5. Instead of a conclusion

Looking at the short term, we should count on changes on all the stock exchanges, including those in Belgrade and Ljubljana, which is essentially nothing new. The causes of the decline are well known: higher interest rates and the psychological insecurity of the participants in the exchange. The following question is posed: *How much time is it necessary to pass after the crisis for the prices to recover?* Experience shows[9] that the length of the period is not the same or, better said, equally short, for all securities. Investors in technological stocks have not yet returned to break-even point. The investor who bought before the Russian financial crisis (end of September 1997) needed six years to reach break-even point. If he kept these stocks subsequently, his average return was 10%. The investor who bought stocks at the end of March 2000 also needed six years for the price to recover to the level of the investor's buying price. All the above global causes should be supplemented with local political factors, since not only the Belgrade and the Ljubljana exchanges but all the region's exchanges are sensitive to them.

Crisis situations are a good opportunity for all investors, regardless of the market in which they are operating, to buy substantially undervalued stocks. However, very soon after, the market recognizes their true value. The crisis on the global financial markets indicates that, with each crisis, quality financial instruments are making a faster and faster return to their pre-crisis positions. In the panics that occur on all capital markets, irrational behavior is always present.

Therefore, all investors should count on the inevitability of crises, which means that the *condicio sine qua non* of avoiding them is investment diversification, which, despite globalization and the lightning-quick transfers of their consequences (contagion), is still the best instrument for moderating crises.

For each financial market, it is not only important whether the foreign investors stayed or began to withdraw at the beginning of the crisis (or not, as was the case with the Belgrade exchange in February-March 2007), but also whether domestic investors are able to successfully fill in and neutralize the resulting

[9] S. Petavs, "Dolgih šest let za nesrečne vlagatelje", *Finance*, no. 39, Ljubljana, 2007.

voids. Thus, the more a market is oriented towars foreign investors, the more sensitive it is to their coming/departure (liquidity problem), i.e. the less developed it is. **And it is precisely thanks to the non-reaction of global institutional investors that the Balkan exchanges did not react to the correction that knocked down the global exchanges.**

The purpose of a stock exchange is to ensure for all investors the investment/sale of securities at a fair market price. The shaping of a fair market price is an essential protection for small investors. The preconditions for this are: market liquidity, the existence of market mechanisms and an overall supervision of trading.

The existence of national stock exchanges will undoubtedly be reduced to four functions: the listing of local companies on the exchange, investor education, market oversight and the lobbying of local political representatives. On the other hand, informational support, clearing and custody operations, deal execution and technological support for operations will be at the international level. In this context, there will also be changes in the exchanges' ownership structures. The European market is being opened and harmonized amidst growing competition, which means that the exchanges will also be faced with demands for business success just like any other company.

Stock exchange statistics indicate that the capital market is greatly dependent on the process of transition. An individual country's progress in the transition process determines the amount of activity on its capital market. In the initial phase, activities are increased thanks to the process of privatization and takeovers (the stock exchanges in Belgrade, Podgorica, Skoplje, Sarajevo, Banja Luka). After the end of this process, the activity on the exchange falls, especially if it is a small capital market (the Ljubljana exchange). Liquidity then becomes a problem unless new investors are intensively included or a merger with another exchange(s) occurs.

The concentration of ownership in stock companies in Serbia was, in the initial phase, an accelerator of stock trading. However, subsequent takeovers with tendencies of closing stock companies had the opposite, i.e. negative effect. Thus, investments in the initial phase of privatization are of a more speculative character, with underlying expectations of company takeovers. It is a fact that the Belgrade Stock Exchange has become an efficient market that reacts to socio-political happenings and reflects the events taking place on the most important global stock exchanges. In the long term, with the tendency of such companies being withdrawn from the exchange, their shares become unattractive for trading (their liquidity decreases). This is just one more reason for linking up the region's capital markets. Certain steps have already been taken (in Montenegro, Croatia and Bosnia and Herzegovina) and it is only a matter of time before linking takes place, both on the local and on the regional levels.

Therefore, the linking of the Southeastern European stock exchanges is the only way for the region's exchanges to survive. Possible linkage with a larger exchange, i.e. the one in Frankfurt, is not the optimal solution, since the small exchanges would not have enough influence in the decision-making in that case, which is extremely important having in mind the significance of the region's stock exchanges for the local capital markets.

Due to the size of the European space, existing differences and investor interests, it is realistic to assume that five to six stock exchanges will become consolidated on the market. Euronext as the exchange of the Atlantic states, the London and Frankfurt exchanges, which are big enough to exist independently, the OMX – the Nordic exchanges, and the Central European exchange, which will include the exchanges of the countries that have formed on the territory of the former SFRY.

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THE ROLE OF BRAZIL, RUSSIA, INDIA & CHINA (BRIC) IN THE RECONSTRUCTION OF THE INTERNATIONAL ORDER

Abstract: *At the turn of the 20th and the 21st centuries, the historical process has quite visibly accelerated. This acceleration is in many ways tied to the phenomenon of globalization. The bipolar system that dominated the international order in the second half of the 20th century has "taken a historical rest," as the final result of the inability of the Soviet pole to adjust to the realities and conditions imposed by globalization. Subsequently, it seemed as though a system of unipolar domination had been established, with only one superpower left on the scene. However, the chimera of unipolar power during the 1990s prevented the observation and understanding of two factors. First, there is relative character of unipolar power. Second, there is also its transitory, historically brief character. The aim of this work is to describe the role of Brazil, Russia, India and China (BRIC) in the reconstruction of the international order.*

Key words: *globalization, international order, global economy, reconstruction*
JEL classification: F02, O57

At the REGGEN conference in Rio de Janeiro in 2003,[1] most of the participants presented pessimistic visions about the launching of a successful answer to unipolar hegemony. This was a natural reflection of the predominant mood at the time, at the beginning of the military occupation of Iraq and the assault of the interventionist forces. Contrary to this, in my comments presented at the said conference, I put an accent on the objective limitations of the unipolar project, on the weaknesses it was showing, and emphasized opposing tendencies connected with the appearance of new poles of development and international influence. I especially underlined that Iraq would be a great trap for Washington. Starting from those premises, I supported the thesis of quasi-unipolarity as

[1] The UNESCO/UN global economy and sustainable development network (REGGEN) organized an international seminar entitled "Hegemony and Counter-hegemony. The Impact of Globalization on the Regionalization Processes."

a way to characterize the situation that came abut at the end of the 20th century and the appearance of various symptoms of the historical negation of that quasi-unipolarity. I regarded that brief period, as I regard it today, as a transitional period in the evolution toward a multipolar world.

Today we have many more arguments for the confirmation and development of this thesis. The latest events in the global economy and politics show that the zenith of the power or the hegemony of the “lone superpower” has already passed. At the same time, the appearance of numerous essays that recognize and make future projections of the growing significance of an alternative pole is not accidental. We can even say that we have witnessed a genuine explosion in the bibliography concerned with this topic.

Prominent among these is the prediction made by Goldman & Sachs in 2003, which describes the accelerated development of BRIC (Brazil, Russian, India and China) and the resulting probability of change in the group of global leaders by 2050. Dominic Wilson and Roopa Purushothoman calculated the possible pathways of economic growth for the period up to 2050, taking into account changes in production levels and per capita income in the BRIC group, as compared to the six then-global economic leaders. Even though a relatively optimistic scenario was offered regarding BRIC, the authors of the prediction relied entirely on real indicators registered in the previous years and used well measured expert evaluations. Moreover, a scale of gradual decrease in the GDP growth rate was applied to the calculations regarding the BRIC countries, in accordance with the path followed by the traditional centers of the global economy, while the level and quality of development grew.

The following are the results of these calculations: during the next 30-40 years, the size of the BRIC economies will outstrip in absolute terms the size of the economies of the current “Big Six” countries (US, Japan, England, Germany, France, Italy). In 2050, only the US and Japan will retain their places among the world’s six strongest economies. At the beginning of the 2040s, India will overtake Japan. In the second half of the 2020s, Russia will overtake Germany (having already passed England, France and Italy). Brazil will leave Germany behind in the second half of the 2030s.

Speaking in relative terms (GDP per capita), the results will naturally be more modest. In 2020, this indicator might reach 12,500 US dollars in Russia, 6,300 in Brazil, almost 5,000 in China and 1,600 in India. At the same time, within the group of the current six, the said indicator would vary between 27,300 US dollars (in Italy) and 48,000 US dollars (the US). By 2050, Russia (with 49,600 US dollars) might leave in its wake not only Italy but also Germany, drawing quite near to France (51,600 dollars), while still trailing the US (83,700), Japan (66,800) and Great Britain (59,100). The Goldman & Sachs experts predict that, by 2050, China will reach 36% of the US level, Brazil 32%, and India almost 21%. Comparing this to the present-day situation, we should recall that in 2004 the index of the Russian Federation equaled 8.5% of the US, that of China 3%, Brazil 6.2% and India 1%.[2]

Only two years hence, the Goldman & Sachs experts brought out a new version of their prediction[3] - that, in current practice, the processes of change in the indicated direction are even faster than recently thought. They also point out that changes in the correlation between economic power and political influence cannot be limited only to the circle of the BRIC countries; we should bear in mind yet another view, which indicated the growing significance of other countries, such as Mexico, South Africa and Indonesia, for the global economy and international politics.

The changes in the mentality and the policies applied by the traditional centers vis-à-vis the potential centers are already evident. They are a mixture of concern (even fear in some aspects) and a moderately realistic approach. In a speech before foreign ambassadors, the new French president Nicolas Sarkozy pointed to the three greatest challenges facing the West. The challenge of BRIC was put on the same level as the danger of the West's confrontation with the Islamic world and the threat of climate changes. The recognition of the growth of new poles of global development is already a dominant fact in the West, including the United States. We can also say that there is an admission that this growth cannot be avoided. The invitation to and the presence of the leaders of China, India, Brazil, Mexico and South Africa at the latest G-8 meetings are clear proof that dialogue with the new poles toward the goal of solving global problems is unavoidable and necessary. Moreover, a mechanism of interaction and coordination in the relations between traditional and new centers is being formed step-by-step.

Of course, the motifs of *sui generis* are appearing in the views and policies of the West (especially Washington). The proposed dialogue and cooperation with the newly emerging giants are perceived to a certain degree as instruments for slowing down the advance of the emerging giants, to a degree that is possible, pointing them in directions that are less risky, while preserving their own leading positions in the most important sectors, i.e. those that are the most vital for the future.

It is symptomatic that, in the latest report of the North American intelligence service (February 2008), China and Russia are included in the list of the greatest challenges to the national security of the United States. The possible use of both countries' financial resources for the achievement of greater influence in international issues is especially emphasized. This approach logically leads to a prediction that Washington will try to wage a policy of containing China and Russia in the future.

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2 D. Wilson, R. Purushothoman, "Dreaming with BRICS. The Path to 2050", G8 Global Economics Website, Paper №99, 1.10.2003, pp. 19-20

3 Y. O`Nelly, D. Wilson, R. Purushothaman, A. Stupnitska, "How Solid are the BRICs?", *GS Global Economics Papers*, no. 134, 2005.

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In Russia, the concept of BRIC appeared with the coming of Evgeniy Primakov, the celebrated scientist and statesman, to the position of Russian foreign minister in 1996. His naming alone represented an indication of a coming revision of Russian foreign policy, in great measure influenced by a change in the public mood of the country. This change was caused by disappointment with the rapprochement with the West, which did not bear the expected fruits, and dissatisfaction with Russia's subordination to foreign interests. From that point began the search (with ups and downs) for a more balanced formula for acting on the world stage. In that context, Primakov proposed the introduction of the Russia-China-India triangle as a strategic foreign policy position. Subsequently, during his Latin America tour in 1997, he initiated and promoted the establishment of closer relations with Brazil. A formula for strategic cooperation appeared in bilateral documents, and a Russo-Brazilian "great commission" was formed.

The prevailing atmosphere during Yeltsin's time was not conducive to the practical realization of these suppositions. However, debates began at the academic level. At the beginning of the current decade, along with changes at the top of the Russian state, which created favorable conditions for a more balanced and more autonomous foreign policy and which put a stop to the state's passive role in the international arena, academic studies related to this topic began to find certain stimuli and understanding in decision-making centers.

The strengthening of Chinese economic power, on the one hand, and India's modernization advances, on the other, provided increasingly convincing arguments to Russian scholars and analysts who were pointing to the necessity of an appropriate reorientation in the country's external strategy. Unfortunately, the inertia of market approaches and Russia's economic weakness, which had not yet been totally overcome, did not favor an adequate perception of the topic of BRIC at the top of the Russian political hierarchy. However, later on, the level of bilateral cooperation with China and India was substantially raised. Multilateral interaction within the Shanghai Cooperation Organization (SCO) was deepened. In 2005, a precedent was made in the form of trilateral consultations at the foreign ministerial level, which are now being held annually.

The Brazilian "segment" is not as dynamic or significant, despite the fact that Brazil ranks first in Russia's trade with Latin America. This is partly understandable if we have in mind the geopolitical and geo-economic position of Russia, as well as the relatively modest economic exchange with Brazil (which currently does not exceed 4 billion US dollars) and other economic ties. This does not mean that Brazil's growth potential and influence are not being taken into account, but it does confirm certain inertia on the part of the Kremlin regarding the perception of its significance in a global context. At the same time, one should recognize Moscow's altogether positive stance within the dialogue and consultations of the G-8 with "guest countries," especially during this "club's" meeting held in St. Petersburg (2006).

When we evaluate the conceptual contents of Russian foreign policy, it cannot be said that the position of BRIC has been definitely constructed and that it has already acquired a functional character. However, step-by-step, the idea of using these huge reserves is beginning to impose itself upon this country's political elite. One of the symptoms that indicate this is the position of Yuri Luzhkov, a person of stature and importance in Russian politics (mayor of Moscow and member of the executive committee of the "party in power," United Russia). In his 2007 book, "Russia 2050," he writes: "In the coming years it will be necessary to make efforts toward the *formalization and institutionalization of the BRIC group, which is now only virtual*." It is evident that the formation of real structures of cooperation and integration of the four "leaders of the future," Brazil, Russia, India and China, will be of essential significance for the strengthening of these countries' joint influence on the global economy and politics.

Other developing countries with dynamic growth may also link up with the possible BRIC coalition in the future. Russia, which has the status of permanent member of the UN Security Council as well as a G-8 member, can create conditions for the strengthening of Brazil's and India's positions within the UN framework and, at the same time, act as a moderator in the dialogue between the old Western economic leaders, integrated into the G-8, and the new economic leaders representing BRIC, raising in the process its own power of influence in global politics.[4]

How might we characterize the way in which this topic is viewed in Moscow's academic circles? In the second half of the 1990s case studies were made within the traditional framework,[5] either at the Far East Institute or the Institute for Latin America of the Russian Academy of Sciences (RAS). Russian scholars and analysts were trying to gain an understanding of the secrets of China's advance and the reform experiences in India and Brazil, comparing these cases with Russia's insufficiently satisfactory experience and pointing out the faults of the model that was applied in it.

At the beginning of 2000, case studies began to intertwine and acquire a multilateral format. By then, BRIC was also being studied as a group within a global context. An important stimulus was a conference of a number of academic institutions, organized by the Institute for Latin America RAS in 2004.[6] In the Institute's central report (by Vladimir Davydov and Aleksandr Bobrovnikov), the

4 Ю. Лужков, *Россия 2050 в системе современного капитализма: о наших задачах в современном мире*, Москва, 2007, pp. 207-208.

5 The author is a direct "accomplice" and one of the initiators of studies on this topic in Russia.

6 А. В. Бобровников, В. М. Давыдов, "Восходящие страны – гиганты на мировой сцене XXI века", *Латинская Америка*, no. 5, 2004; Дискуссия по указанному докладу см.: *Латинская Америка*, no. 6, 2004.

topic was presented by way of an expanded approach. On the basis of an analysis of global economic and political prospects and a series of futuristic studies, the concept of rising state-giants (RSG), among which the BRIC group was featured as the first step, was proposed.

The report said: "State-giants with large resource potentials and a form of social organization that guarantees a measure of progressive (or even, frequently, anticipated) development, have always played a key role in the global economy and politics. History shows that these formations are able to grow, i.e. overcome their peripheral starting position and take their place among the progressive ranks of the global system, in order that they can later – to a lesser or greater degree – "command."[7]

The global situation over the last several years is putting the spotlight on the existence of large states which, in spite of their lagging (previous or current) relative to the first link in the chain of development, are accumulating the preconditions for rising to a higher step in the global hierarchy, and are starting to wage significant influence on the forming of a universal order and the global political climate. We shall also include these cases in the RSG category.

The growth of China and other RSGs (real or potential) is not a novelty contrary to historical experience. It is enough to recall the example of the United States on their 19th century path. In 1820, this group of former British colonies in North America had a smaller economy than any of the European powers. By the eve of World War I, they had become the incontestable economic leader. The US gross product became twice as large as that of its closest European economic rival. The gap between them increased during the 20th century, for which the European powers blamed the destructive consequences of the two world wars.

However, if we compare the North American growth with the current Chinese ascent, we can see that the latter is significantly more rapid. If we take the most successful jump in sustainable growth during a consecutive 25 year-period of US economic history since 1830, we will see that, in all cases, it averaged less than 4%. In China it has surpassed 8% for the last 25 years.[8]

* * *

When we speak about the BRIC group, we should certainly bear in mind the differences that exist between its members. China has already approached the top of the global hierarchy. It is currently the fourth-ranked power in terms of GDP, behind the US, Japan and Germany, while in 10 years' time the Chinese GDP, should it sustain the same rhythm of growth, will be able to surpass that of the US, which is growing moderately. In terms of the size of foreign trade, China ranks

[7] V. Davydov, A. Bobrovnikov, "Países-gigantes emergentes en el escenario mundial del siglo XXI", *Iberoamerica*, no. 2, 2005, pp. 17-18.

[8] П. Engardio, ed.: *Chindia. How China and India Are Revolutionizing Global Business*, New York - … - Toronto, 2007, p. 355.

third, but it is first in the accumulation of liquid reserves (1.33 billion dollars).[9] According to what the general secretary of the Chinese Communist Party said at the party's 17th congress in October 2007, China is planning to quadruple its GDP by 2020, and to become a middle-level developed country. Not a few analysts and observes think that China is on the cusp of becoming the second superpower.

At the same time, there are symptoms that China's export expansion is nearing the point of satiation. It is no accident that Chinese economists are recommending a reorientation toward the internal market, in order to take advantage of the local populace's increased buying power. Also, there is more and more talk of the sharpening of a series of fundamental problems that might derail Chinese development: the exhaustion of ecological reserves, growing internal inequalities (economic, social and territorial), growth in corruption. In that sense, China is still far from the "harmonic society" that the country has set as a goal and adopted as a motto.

In any case, China is presently the surest and the most self-sustainable power within BRIC. Its standard foreign policy approach is characterized by an absence of rigid alliances. Following the instructions set down by Deng Xiaoping, China's ruling establishment places greater emphasis on the consolidation of internal issues than on advances in the external sector, which is a tendency it will tend to retain in the mid term.[10] However, it cannot be ignored that the dynamics of Chinese expansion will cause greater resentment and resistance in the West (especially in Washington), which would compel the Chinese authorities to find a counterbalance. In that sense, it is logical to anticipate future cooperation and coalitions within BRIC or, possibly, at a broader level that would include other RSGs.

The rise of India began later, during the 1990s, and its current growth appears less dynamic than China's. As is rightfully observed, its profile of modernization is more "white collar" (by 2010, India's software exports may surpass 60 billion dollars) than "blue collar," bearing in mind its already acquired status of the "world's production plant." As is well known, within the BRIC group India is undoubtedly the country with the highest poverty levels and a legacy strongly marked by social caste stratification. On the other hand, it has rightfully earned the qualification of being the world's "largest democracy," having in mind the similarity of its political organization to the Western model.

India is the most open to cooperation and coordination with the South, and has its own great internal imperatives that it needs to address in order to support its external growth. It currently has a highly diversified foreign policy and is coming out in favor of increasing South-South links. It is no accident that Brazil's initiative for the formation of a trilateral mechanism of cooperation (India, Brazil, and South Africa) was well received by New Delhi. This was soon fol-

[9] Zhang Xiaojing: "China's Growth and Its Implications for Latin America", XIII Congress of FIEALC, Macau, 2007.

[10] See: Б. Н. Кузык, М. Л. Титаренко, *Китай – Россия 2050: стратегия соразвития*, Москва, 2006, ch. 9.

lowed by the institutionalization of IBSA (India, Brazil, and South Africa), which is officially open to the participation of other rising giants. In addition, mutual solidarity of action on the part of Brazil and India can be observed within the G20+ and other international forums. India is also underlining its support for the revival of the non-aligned movement.

Increasingly close relations between India and Brazil are accompanied by an extension of this relationship to other Latin American countries. Trade with that region is still modest in comparison with the level achieved by China, which has surpassed 70 billion dollars. India's trade with Latin America is on the level of 7 billion dollars (2006). In other words, it is near the level achieved by Russia in that regard. However, in addition to this, India has become an important investor in the region of Latin America. In the last 10 years, Indian companies' investments in Latin America have reached 7 billion dollars, and it is expected that this figure will double in the coming period.[11]

In Indian interpretations and commentary in the international press it is emphasized that these investments bring certain positive effects to the Latin American side. In addition to the understandable interest of India, an extremely oil and gas-poor country, there is also the fact that Indian corporations are investing capital in production that creates much new employment and contributes to the solution of economic and social problems.[12] A good example is the pharmaceutical sector, in which the activities of Indian companies open the way for cheaper medicines, especially generics, which serves to broaden access to health protection.

Brazil is the most similar to Russia among the BRIC countries (relatively speaking, of course). Fernando Henrique Cardoso, former president of Brazil and a prominent sociologist, once described his country as a "tropical Russia." These two giants are close in terms of population as well as their gross products per average capita. They are the most endowed with natural resources within the BRIC group, far outstripping India and China. Further, they are unique in the world in terms of their ecological reserves, land resources and fresh water reserves.

Brazil has achieved impressive gains in avio-construction, as well as in the metallurgical and biotechnological fields. It is the world's leading producer of biological fuels. The Brazilian economy used to be quite deficient in energy reserves. This was probably its weakest point. However, the recent discoveries of large oil and gas reserves may transform the country into an influential exporter on the global market within only a few years. In addition to its huge natural resources in other fields, Brazil's new energy potential will undoubtedly strengthen the country's rising prospects within the BRIC group.

11 A. Nafey, "India – Latin America Relations: Economic y Political Dynamics", XII Congress of FIEALC, Macau, 2007, p. 13.

12 *Los Angeles Times*, 9.6.2007, cited in: A. Nafey, ibidem

In recent years, Brazil has achieved certain advances in its fight against poverty. However, it has retained a conspicuous leadership when it comes to inequalities in the distribution of earnings and is still not able to control its high crime rate. These are the two great interdependent challenges the country is facing. Advances in this field and in the creation of humane capital might neutralize many of the obstacles standing in the way of Brazil's economic ascendance, which still has a relatively modest dynamic of development when compared to the indicators of the other BRIC countries. A faster economic growth rate has been noticeable only in recent years. The Brazilian GDP growth rate, which equaled 3.2% in 2005, grew to 3.7% in 2006, and finally reached 5.3% in 2007.[13]

It is obvious that the Latin American giant is little integrated into the global economy, which it is attempting to resolve through the significant results it has achieved over the past several years. Its rise has been marked by its ability to be attractive to the countries in the region. Its continued activities within MERCOSUR in the South American Community of Nations on the one hand, and its opposition to the ALCA project on the other are no accident. It also recognizes the necessity of further strengthening its entrenchment in the South as a geopolitical reality.

In characterizing Russia, we can say that its position in the current international context is twofold. On the one hand, as the successor of the Soviet Union, it retained a multisectoral industrial and technological potential, a good educational legacy and certain advantages in human capital. It is the second-ranked military power in the world. It inherited permanent member status in the UN Security Council, and has participated in the work of the G-8 for quite some time now. From that standpoint, it has direct access to the global governance club.

On the other hand, the country has not yet entirely recovered from the economic and social losses suffered during the 1990s: regression in manufacturing, the impoverishment of a large segment of the populace, reduced spending for research and development. In that sense, Russia's socio-economic problems resembled those of a developing country.

Recovery began at the beginning of the current decade. For eight successive years, the Russian economy has grown at a pace above 7%. It is gradually shedding market fundamentalism and state minimalism. Economic activity, capital accumulation and investments are benefiting from the establishment of a measure of political stability, along with, of course, the strong trends on the oil and gas markets. The country now possesses the necessary minimal infrastructure of a market economy, which allows it to more successfully participate in the global economy.

Looking at the results from 2007, we can say that Russia has overtaken Italy and France in the size of GDP as measured through purchasing power. The net capital inflow into Russia has reached 82 billion dollars. It has become the third-ranked global power in terms of reserves of international water resources.

[13] *CEPAL. Balance preliminar de las economías de América Latina y el Caribe – 2007*, Santiago de Chile, diciembre de 2007, p. 80.

However, Russia's fundamental problem is related to its ability to "recycle" the financial resources it has accumulated thanks to oil and gas exports, in two ways. First – the recovery and renovation of its industrial and technological potential. Second – the fight against poverty and a drastic reduction of inequalities in income distribution. The strategic approach presented by Russian President Vladimir Putin and deputy Prime minister Dimitry Medvedev (presidential candidate) in February 2008, shows that the ruling nucleus, which has formed over the past several years, is prepared to adhere to this road, with the support of the parliamentary majority enjoyed by the United Russia party. The expected goal for 2020 is for Russia to become the world's fifth-ranked power, and first in Europe according to size of GDP, to reduce poverty to the lowest possible level and to definitely expand the middle class in order that it may become the majority segment of the population – financially capable consumers and active participants in civic society.

* * *

In evaluating the possibilities of BRIC's probable ascent, we can offer various observations. BRIC's increasing influence – both individual and aggregate – in the global economy is a process that is not based only on the (already affirmed) dynamism of their economic systems, but is also – and will continue to be – a consequence of the moderate (or halted) dynamism of the traditional power centers.

When we speak about the United States, it is clear that this country has preserved its decisive role in the global economy and current international politics. However, at the same time, there are convincing symptoms indicating that the zenith of its hegemonic power has already passed, as we have already underlined.

The dollar has already lost its monopoly as the world's reserve currency. The euro is making advances on that front, while the possible future appearance of a common Asian currency cannot be ruled out. The depreciation of the dollar over the last several years is a reflection of the accumulated internal weaknesses of the North American economy – its negative balance of foreign trade, its budget deficit and, most important, loss of competitiveness in various sectors on the part of the world's most powerful economy.

The market turbulences of 2007 (first on the real estate market, then in the banking and stock market sectors), have sharpened the structural shortcomings. The rhythm of economic growth has begun to wane, reaching only 1.4% in the last quarter of the previous year. The predictions for 2008 vary between 1.0 and 1.3%.

The North American recession and its possible projection onto the global economy was the central topic at the World's Economic Forum in Davos. It is certain that a protracted recession in the United States would put international economic stability at risk. Fortunately, the last decade has seen a noticeable tendency toward a gradual reduction in the international markets' dependence on internal North American market conditions. Since 2000, the coefficient of the correlation between the growth rates of the North American gross product and that of the global gross product has continually declined.[14]

Despite a certain slowdown in the economic growth of the European Union, this region is still resisting the negative influences from the other side of the Atlantic. However, what will happen if the recession in the United States becomes more protracted or, in a worse case, if a general crisis begins?

It is no accident that there was much concern at the Davos forum. However, the leaders of the transnational negotiations who gathered in Switzerland will find what reserves of resistance to the destabilization that originated on the North American market? Before all, the talk focused on BRIC, which would be able to “extinguish the fire” with their accumulated resources. It is possible that this is an exaggerated conclusion at this point. BRIC’s stable development, with the growing influence and growth inertia of their mighty internal markets, might indeed moderate the turbulences that have appeared in the traditional centers of the global economy, but they cannot neutralize them. In any case, in order to co-opt the rising giants into this task, they need to be genuinely admitted into the global governance club, and their presence needs to be expanded to the most important financial institutions. Of course, the said problem is not limited merely to the economic field. For the economic inevitably reflects onto the political.

The effects of the rise of the new giants are multiple. On the economic plane there is a pronounced phenomenon of the revaluation of natural resources and a heightened competition for access to energy, mineral and food sources. This is part of the explanation given for the improvement of the South’s external economic performances, especially in the case of Latin America. This is primarily a consequence of China’s influence, as well as India’s (budding) influence. New trade possibilities are appearing for Latin American and other developing countries. On the other hand, however, China’s exports present a unique challenge for both traditional and non-traditional industries. The example of Mexico is symptomatic. It is not just a matter of competition on the internal Mexican market, but also on the North American market, the most important market for Mexican exports.

Until recently it was claimed that one of the obstacles to the economic advance of BRIC’s rising giants was the lack of transnational corporations based in these countries. At the moment, the one hundred biggest corporations based in “fledging markets” are growing at 10 times the rate of the North American ones and 34 times the rate of those in Germany. The news that the Chinese “Lenovo” company acquired IBM’s personal computer division came as a surprise. But there are yet more surprises: Brazil’s “Embraer” has overtaken Canada’s “Bombardier” to become the world’s leading middle-distance aircraft manufacturer. On the international market, strong expansion is also being registered by India’s “Infosys,” Brazil’s CVRD, Mexico’s CEMEX and “Grupo Modelo.”[15] The

[14] See: *Economía & regiones*, no. 63, Buenos Aires, 21.1.2008, p. 8.

[15] *Newsweek*, 10/08/2007, pp. 40-45.

Russian corporations' transnational activities are currently mostly taking place in the energy and metallurgical sectors ("Gazprom," "Lukoil," "Severstal" and "NorNickel"). There are still very few experiences of this type in the manufacturing sector, except in the post-Soviet space. However, the growth dynamic and modernization will, with the mid-term saturation of the internal market, lead Russian corporations toward transnational negotiations.

All this undoubtedly increases the maneuvering space for developing countries. The field of alternative solutions and projects is expanding. The advance of BRIC and other RSGs is probably the most powerful factor in the transition to a multipolar world, to a real and practical multipolarism.

It is clear that Washington is not able to sustain its unilateral policy in the mid and long terms, and that it has already noted very serious limitations in that regard. The clearest example is the intervention in Iraq and its counterproductive consequences. The imperative of adjusting US foreign policy to the new reality is growing, and this is reflected on internal matters. North American politicians who advocate change are increasingly raising their voices, especially when it comes to the advent of BRIC. This tendency is even more pronounced in the European Union. A new approach surfaced in a speech made by the French president, who proposed that the G-8 become the G-13. But it is perfectly clear that a solution of this type is only a matter of time. The rise of BRIC in the global hierarchy is already starting to become evident in the reconstruction and reorientation of trade and financial flows on the global market and must, sooner or later, become reflected in the geopolitical order.

Of course, this does not mean that this process will inevitably roll down a rose-lined path. Absolutely not. It is quite probable that there will be tensions, conflicts and shocks on this long road. A great risk looms in case the international community does not find a way to create new global governance mechanisms on the economic and political planes.

Much depends on the degree of realism and pragmatism within the circle of traditional centers. And, to be sure, much will also depend on BRIC and other RSGs, which represent various regions and civilizations of the world; on the degree in which they will be able to face possible challenges and necessary questions.

In spite of the fact that convergence of interests is the prevailing trend, and that the BRIC countries are complementary in many sectors, possible tensions and conflicts of interests cannot be ruled out. However, practice has shown that, even in the most complicated case of Sino-Indian relations, it is possible to find possible positive solutions. This is yet more proof that togetherness can prevail.

Is the formalization of the BRIC coalition, thus, possible? Although it is not certain that it can be realized in the near future, there are indications of the possibility of its mid or long-term realization, since the consultative mechanisms on the basis of which the level of coordination can be eventually raised are already in place.

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COOPERATION IN THE REGION OF SOUTHEASTERN EUROPE WITHIN THE FRAMEWORK OF THE CEFTA AGREEMENT*

Abstract: *CEFTA is an agreement that presently defines a single free trade zone in Southeastern Europe. The agreement provides for the removal of trade barriers in the region, the harmonization of tariff and other administrative regulations with the standards of the World Trade Organization, introduces arbitration for dispute resolution and the rule of diagonal cumulation. As any other agreement, it is the result of compromise, which means that it has both advantages and drawbacks. Nevertheless, it is expected that it will strongly influence the mutual trade of the countries of Southeastern Europe and promote their process of integration into the European Union.*

Key words: *CEFTA, international trade, European Union, regionalization, liberalization, protectionist measures, free trade*

JEL classification: F15, O19

1. Globalization and regionalization in Southeastern Europe

Globalization and regionalization are modern-era phenomenons and, as such, are one of the main features of today's civilization. The essence of globalization is the creation of a unitary economic and political global space. Regionalization is its integral part and represents regional linking and cooperation, mostly of geographically neighboring countries.[1] In the process of the globalization and general interdependence of the modern world, protectionist measures (tariff and non-tariff barriers) represent an obstacle to the modern development

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[1] M. Božić, *Ekonomska politika*, Pravni fakultet u Nišu, Niš, 2006, p. 96.

of economy and trade. Hence, the process of the liberalization of the flows of goods, capital, services and people is the only logical path of accelerated development.

Seeing the advantages of removing trade barriers, certain countries have established regional organizations, within which they have gradually liberalized their mutual trade. In this way they additionally developed their economies and became an example of successful cooperation. The essence of regionalization lies precisely in the liberalization of mutual economic relations, which assumes the existence of markets for goods and services, the mobility of capital, technology and knowledge, possibilities for population migrations and the prominent role of organizations and institutions.[2] On the other hand, countries that have retained closed economies for fear of being exposed to foreign competition, have lagged further and further behind and, comparatively speaking, have become increasingly impoverished.

Serbia realized the significance of free trade and the advantages of regionalization, and thus began to take steps toward accession to the European Union (EU), which is currently the world's best institutionally organized regional association. Southeastern Europe, i.e. the Western Balkans, has been in the focus of political and economic interest of EU member countries for a number of years. Thus, as early as June 27, 2001, a memorandum of understanding, liberalization and facilitating trade conditions was adopted in Brussels, within the Stability Pact for Southeastern Europe. The memorandum was signed by Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Serbia and Montenegro, Macedonia, Moldavia and Romania. In the meantime 32 bilateral agreements between eight countries of the region of Southeastern Europe were signed. This gave birth to the idea of making a single agreement for the entire region and, practically, legally defining a unified free trade zone on a multilateral basis. Since the structure of the previously signed bilateral agreements was very similar, it was concluded that the regulations dealing with dumping, subsidies, and state monopolies could be harmonized, but that some solutions could also be improved, such as, for example, the provisions dealing with state aid. By insisting on the formation of a unified free trade zone, the European Union, by way of the Stability Pact for Southeastern Europe, is trying to stimulate economic development and these countries' process of stabilization and accession to the European Union.

2. Regional blocs in the world and CEFTA

According to the recommendations of the EU, countries seeking membership in the Union are encouraged to create free trade zones on their territories. All the CEFTA member-states had previously signed Stabilization and Association

[2] D. Đukanović (prir.), S. Jelisavac, "Ekonomski aspekti saradnje međudržavnih foruma – uporedna analiza", Zbornik radova *Međudržavni forumi za saradnju u Evropi: uporedni modeli*, Institut za međunarodnu politiku i privredu, Beograd, p. 192.

Agreements with the EU; thus, CEFTA actually has the role of preparing countries for full-fledged membership in the Union.[3] What is especially important is that the majority of CEFTA's foreign trade is conducted with EU countries.

As can be seen in Table 1, as one of the blocs with the smallest territorial scope, CEFTA has a relatively high gross domestic product (GDP) and could, in that sense, represent a relatively important bloc. Still, since this alliance is only a transitional step toward the EU, its short-term character limits it in the political sense.

3. Characteristics of a unified free trade zone

CEFTA is an agreement that presently defines a unified free trade zone in Southeastern Europe. As its very name says, the Agreement was initially formed between Central European states, i.e. the countries of the so-called Viszegrad Group: Poland, Hungary, and Czechoslovakia (later the Czech Republik and Slovakia). It was signed on December 21, 1992 in Kraków, Poland, and went into effect in July 1994.[4]

The member countries hoped that CEFTA would facilitate their more rapid preparation for and integration into the institutions of Western Europe and their accession to the political, economic, security and legal system of the EU (acquis communautaire). In the second round, the Agreement was joined by Slovenia in 1996, Romania in 1997, Bulgaria in 1998, Croatia in 2003, and Macedonia in 2006.[5]

All the state-signatories of the original Agreement, except for Croatia and Macedonia, have since joined the European Union and, thereby, left CEFTA. Under the patronage of the Stability Pact for Southeastern Europe, in the context of the Stabilization and Association Process, it was decided that the existing CEFTA was to be expanded with countries from Southeastern Europe. There was also talk of including Ukraine.[6] In the Balkan region, a model of bilateral free trade agreements already existed within the framework of the Stability Pact for Southeastern Europe.

The new agreement, called CEFTA 2006, was initiated on November 9, 2006, in Brussels and signed on December 19, 2006, at the Southeast European prime ministers' meeting in Buchurest. The agreement was ratified on March 31, 2007, and went into force on May 1, 2007 (see Table 2).

The CEFTA 2006 agreement is the result of years of pressure on the part of the European Union and represents a harmonization of previously signed bilateral agreements on free trade between the countries of the region. The good results, in terms of lowered tariffs and trade growth, which came out of the bilat-

3 Central European Free Trade Agreement (CEFTA).

4 See CEFTA Agreement: http://www.worldtradelaw.net/fta/agreements/cefta.pdf, 22/11/2007.

5 For further information, see: http://www.ukom.gov.si/cefta2003/eng/cefta/, 22/11/2007.

6 http://www.unian.net/eng/news/news-160543.html, 22/11/2007.

Table 1: The most active regional blocs since 2004[**]

Regional bloc[1]	Area (km^2)	Population	GDP (PPP) ($US)		Member states[1]
			in millions	per capita	
Agadir	1703910	126066286	513674	4,075	4
AU	29797500	897548804	1515000	1896	53
ASEAN	4400000	553900000	2172000	4044	10
CACM	422614	37816598	159536	4219	5
CARICOM	462344	14565083	64219	4409	(14+1)[3]
CCASG / GCC	2285844	35869438	536223	14949	6
CEFTA	298148	28929682	222041	7675	(7+1)[3]
EU	4325,675	496198605	12025415	24235	27
EurAsEC	20789100	208067618	1689137	8118	6
EFTA	529600	12233467	471547	38546	4
GUAM	810506	63764600	456173	7154	4
NAFTA	21588638	430495039	15279000	35491	3
PARTA	528151	7810905	23074	2954	(14+2)[3]
SAARC	5136740	1467255669	4074031	2777	8
Unasur / Unasul	17339153	370158470	2868430	7749	12
UN and the referent country[2]	**Area (km^2)**	**Population**	**GDP (PPP) ($US)**		**Unit of measure[4]**
			in millions	**per capita**	
UN	133178011	6411682270	55167630	8604	192
Brazil	8514877	188078261	1594482	9108	27
Canada	9984670	32507874	1165000	35200	13
India	3287590	1102600000	4042000	3700	35
Japan	377873	128085000	4220000	33100	47
China[5]	9596960	1306847624	10000000	7600	33
Russian Federation	17075200	143782338	1723000	12100	89
USA	9631418	300000000	12980000	43500	50

Legenda

- Lowest values among the observed blocs.
- Highest values among the observed blocs.

1 The included data is only for the most active member states.
2 Including the five countries with the largest area, populace and GDP value, but not #4 in population or #5 in GDP
3 Including non-sovereign autonomous regions or other states.
4 Members or administrative division.
5 Data for China does not include data for Hong Kong, Macao, Taiwan.

Source: CIA factbook, https://www.cia.gov/library/publications/the-world-factbook/index.html, 22.11.2007.

** See Appendix.

eral agreements, were a step forward; however, this was mostly a result of the fact that the comparison base was extremely low. In addition, the agreements differed among themselves, making for a complicated network of mutual trade ties. Also, a further handicap was the lack of harmonization of rules on product origin, which prevented investors from treating the region as one whole. CEFTA 2006 is a step further and represents a modernization of trade rules in the region (the inclusion of provisions on trade in services, public procurements and intellectual property protection), as well as their unification.

After the signing of CEFTA 2006, it was agreed that it was necessary for it to be ratified by at least five members before it could come into effect. The ratification acts were to be deposited with the Croatian Ministry of Foreign Affairs and European Integrations. During 2007, the agreement was ratified by Albania, the southern Serbian province of Kosovo and Metohija (UNMIK), Montenegro, Macedonia and Moldavia. Thus, CEFTA 2006 officially came into effect for the countries that had ratified it on July 26, 2007. The countries that had not ratified the agreement would continue to apply bilateral agreements with the countries in the region. Croatia was the sixth member country to ratify the agreement, and began to effectively apply it on August 22, 2007, while in Serbia and Bosnia and Herzegovina it became effective on October 24, 2007.

Table 2: *Central European Free Trade Area*

<table>
<tr><th colspan="2">State</th><th>Accession</th><th>Withdrawal</th></tr>
<tr><td colspan="2">Poland</td><td>1992</td><td>2004</td></tr>
<tr><td colspan="2">Hungary</td><td>1992</td><td>2004</td></tr>
<tr><td rowspan="2">Czechoslovakia</td><td>Czech Republic</td><td rowspan="2">1992</td><td rowspan="2">2004</td></tr>
<tr><td>Slovakia</td></tr>
<tr><td colspan="2">Slovenia</td><td>1996</td><td>2004</td></tr>
<tr><td colspan="2">Romania</td><td>1997</td><td>2007</td></tr>
<tr><td colspan="2">Bulgaria</td><td>1998</td><td>2007</td></tr>
<tr><td colspan="2">Croatia</td><td>2002</td><td>-</td></tr>
<tr><td colspan="2">Macedonia</td><td>2006</td><td>-</td></tr>
<tr><td colspan="2">Moldavia</td><td>2007</td><td>-</td></tr>
<tr><td colspan="2">Serbia</td><td>2007</td><td>-</td></tr>
<tr><td colspan="2">Bosnia and Herzegovina</td><td>2007</td><td>-</td></tr>
<tr><td colspan="2">Montenegro</td><td>2007</td><td>-</td></tr>
<tr><td colspan="2">Albania</td><td>2007</td><td>-</td></tr>
<tr><td colspan="2">Southern Serbian province
of Kosovo and Metohija (UNMIK)</td><td>2007</td><td>-</td></tr>
</table>

Source: http://www.worldtradelaw.net/fta/agreements/cefta.pdf

4. Areas covered by CEFTA 2006

In order to better explain what CEFTA 2006 has brought, it is necessary to recall the characteristics of mutual trade between the agreement's signatory countries. Intraregional trade as a share of total trade with the world differed from country to country – from 0.2% (Moldavia) to 35% (B-H). Also, there was a high convergence in the export supply (labor and resource-intensive goods, low added values, low growth rates of demand on the international market). Each individual CEFTA country already had a high share of trade with the EU, 50-80%, in which Italy and Germany were dominant.

With the intention of introducing rules of behavior in trade relations, CEFTA 2006 was supplemented by separate amendments that regulated certain areas and specific procedures, all toward the goal of its simplest possible implementation.[7] The free trade regime encompassed all industrial products and 90% of agricultural products, while for the remaining 10% the member countries could retain certain protection measures until 2010, in accordance with the rules of the World Trade Organization (WTO). The free trade zone was to be formed by December 31, 2010.[8]

Certain areas were more precisely regulated and deadlines for harmonization were defined:

- *technical trade barriers* – by 12/31/2010, the sides shall form an agreement on harmonization and mutual recognition of the procedure of harmonization assessment;
- *competition* – as of 5/1/2010, principles of competition shall start applying to all companies, including state companies and those with special and exclusive rights, with the active participation of an independent regulatory body;
- *public procurements* – by 5/1/2010, the sides shall secure non-discrimination and national treatment, which shall be subject to the review of the Joint Committee, which shall convene by 6/1/2008.
- *intellectual property protection* – by 5/1/2014, the sides shall, if they had not already done so, join the conventions in this area and begin with their implementation.[9]

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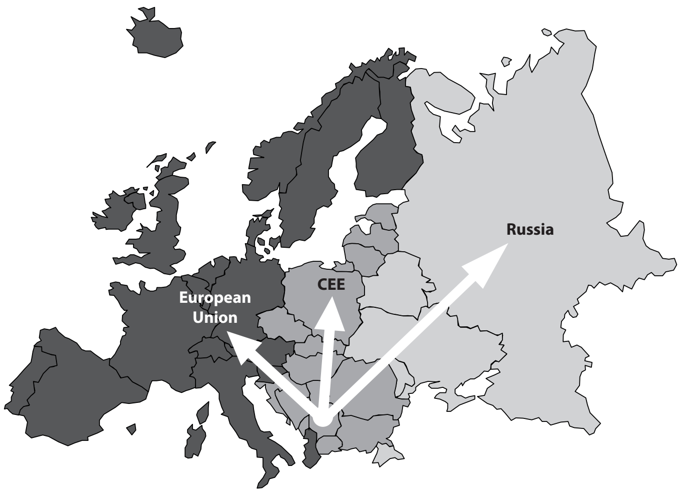
7 Agreement on the Amendment of and Accession to the Central European Free Trade Agreement: http://www.stabilitypact.org/trade/Cefta%20Agreement%20Amendment%20of%20and%20Accession%20to%20the%20Central%20European%20Free%20Trade%20Agreement%20-%20Preamble.pdf, 22/11/2007.

8 See CEFTA 2006: http://www.stabilitypact.org/trade/documents/tradeFINAL-joint%20-declaration.pdf, 22/11/2007.

9 See: http://www.stabilitypact.org/wt2/TradeCEFTA2006.asp, 22/11/2007.

The Agreement will lead to the harmonization of tariffs and other administrative regulations with the standards of the World Trade Organization (protection of intellectual property, public procurements, policies of contingents and limitations, protection of certain economic branches). Arbitration for the resolution of disputes shall be introduced, whose decisions shall be binding. Goods produced in one CEFTA member country will be considered as domestic, regardless of whether they were only partly or wholly produced in that country (rule of diagonal cumulation). Goods produced within the integration framework shall be labeled as *Made in SEE*, which will stimulate cooperation in intraregional production. This would make campaigns such as "let's by Serbian (Croatian, Bosnian, Montenegrin…)" redundant.

Figure 1: *CEFTA's potential market*



One of the more important issues is the so-called diagonal cumulation of origin. In practice, this originally meant that all CEFTA countries could export their products to the EU market duty-free. However, under "own products" were classified only products in which the share of domestic added value was more than 50%. Thus, a product that had 40% Chinese, 45% Serbian, and 15% Macedonian added value was an essential expatriate, i.e. without a defined origin, which means that it did not have preferential treatment vis-à-vis the EU. From now on, however, with the advent of the CEFTA agreement, the cumulation of Serbian and Macedonian added value would be allowed. This is very important, especially for textile manufacturers, where, for example, the cotton is imported from Egypt, the fabric produced in Serbia, and the shirt sewn in Bosnia.

CEFTA is an all-encompassing, modern, ambitious agreement appropriate to the current situation, and its goal is the formation of a regional free trade zone by 2010.

The advantages that CEFTA 2006 brings to its member countries and to the region as a whole are as follows:

- *The establishment of political stability.* Prior to CEFTA 2006, relations between countries in the region were partial, i.e. not all the countries had active political and economic relations (see Diagram 1). This agreement can be an instrument of economic and, subsequently, political stabilization.
- *The stimulation of the strengthening of economic cooperation and, subsequently, on the basis of this, exports to the EU*, which is the region's most important trade partner (diagonal cumulation of rules of origin). CEFTA represents a new framework for a stronger linking of the region's economies.
- *The facilitation of easier cross-border joint production*, thanks to the implementation of the protocol *on the cumulation of product origin in the region*. This will allow a more efficient and more economical transformation of economic capacities and avoid their irrational overlap. Future inclusion into pan-European and Mediterranean cumulations will secure easier tariff regimes for goods exported to the EU, EFTA members and the Mediterranean countries.[10]
- *The stimulation of foreign investmenti,* the prospect of easier access to a market of about 30 million consumers; in addition, the Agreement provides for the creation of stable, transparent and favorable conditions for investors, accompanied by a gradual coordination of investment policies, which can result in increased investment inflows.
- *A much clearer definition of trade rules* than was the case with the previous 32 bilateral free trade agreements. The Agreement allows easier implementation for the region's businesses, foreign investors and the local administrations. The Agreement provides for harmonization, transparency, stability and predictability, all of which is greatly conducive to trade.
- A new, more efficient *dispute-resolution mechanism* (consultations, recommendations of the Joint Committee, mediation, arbitration, the WTO mechanism) protects against arbitrary measures, which increases legal security in mutual trade.
- It sends a positive signal that the region is constructing an attractive and stable environment and an improved framework for mutual investments, as well as for foreign direct investments (FDI), especially *greenfield* investments, as the privatization process winds down. A greater inflow of investments allows for the modernization of production, the application of new technologies, knowledge, modern marketing and management, a better quality of goods and services and, thus, of exports to countries in the region and beyond.[11]

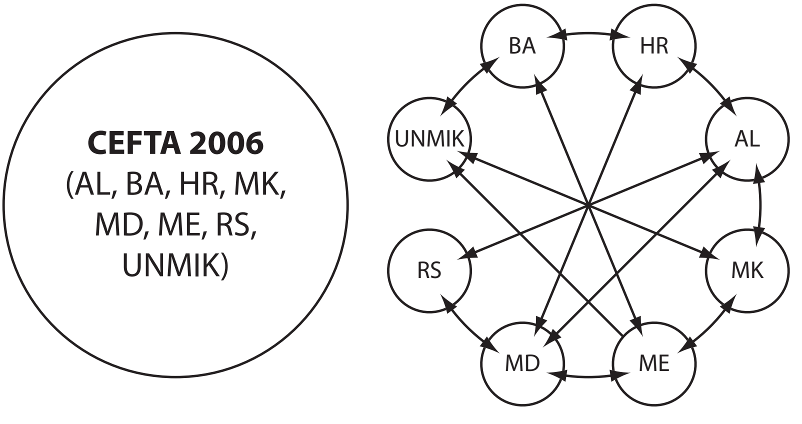
[10] EFTA – *European Free Trade Agreement.*

[11] See: http://www.bilaterals.org/article.php3?id_article=6746&var_recherche=EU+welcomes+signing+of+new+Central+European+Free+Trade+Agreement, 22/11/2007.

- *Facilitates the introduction of modern and stable conditions for the regulation of trade* in the region, including new areas; demands strict respect of WTO rules, and provides WTO accession support for the countries that are not yet members (RS, B-H).
- *Facilitates the process of integration into the EU* through harmonization with the legal structures and standards of the EU. The Union supported and emphasized the signing of CEFTA 2006 as one of the priorities of its regional policy vis-à-vis the Western Balkans; free trade in the reigon, by way of a single agreement, is mentioned as one of the conditions in the draft Stabilization and Association Agreement between Serbia and the EU. As additional confirmation that CEFTA is good preparation for accession to the EU stands the fact that Slovenia, Poloand, the Czech Republic, Slovakia, Hungary, Bulgaria and Romania, as CEFTA members, became full-fledged members of the EU; of course, this was neither the only nor the most important prerequisite.[12]

A necessary condition for the success of CEFTA 2006 is that all the countries that have accepted the Agreement should have the same obligations and fulfill all the accepted provisions. It is not enough to accept provisions only on paper, for the sake of satisfying the international community: it is necessary to genuinely carry out the principles of free trade, in order to secure the region's more rapid economic development and its convergence with the European Union. We believe that all the countries are aware of the fact that the road to the EU market, WTO membership, the size of foreign investments, etc. greatly depend on the individual implementations of CEFTA 2006.

Diagram 1: *CEFTA – Advantages*



[12] Belgrade Chamber of Commerce, Trade Association, *The CEFTA 2006 Agreement*, April 2007: www.kombeg.org.yu, 28/08/2007.

5. CEFTA – possibility or threat

CEFTA is expected to contribute to increased regional trade, to allow the signatory countries to participate in a multilateral trade system under the same conditions for all producers, allow the expansion and modernization of the free trade domain and the opening of a larger market for investments (since investors will look at the attractiveness of a unified region, rather than that of small individual countries).

The CEFTA 2006 agreement contains modern regulations wholly harmonized with the rules of the World Trade Organization. Except for the usual provisions regarding free trade, the text of the Agreement also covers some new forms of cooperation, such as links in the area of trade in services, stimulation and protection of investments, etc. The Agreement also contains modern provisions on protecting competition in the marketplace and intellectual property. As an important novelty, the Agreement contains a detailed dispute-resolution mechanism, which includes arbitration, all with the purpose of ensuring the best possible implementation. The Joint Committee's implementation of the Agreement is to be aided by the Secretariat, an administrative body seated in Brussels. Differently from the base CEFTA agreement of 1993, this agreement contains modern provisions that are wholly in accordance with the rules of the World Trade Association. The goal was to help countries which are not yet members of that organization (Serbia, Montenegro, Bosnia and Herzegovina, the southern Serbian province of Kosovo and Metohija) to adjust their trade systems to global trade rules as soon as possible.

CEFTA 2006 – topical framework of the Agreement

1. Liberalization of trade in goods, (chapters I, II, III, IV), based on CEFTA + bilateral agreements
2. Modernization of trade rules (rules of origin, competition, etc.), (chapter V), based on the EU *acquis*
3. New trade areas (services, investments, public procurements, intellectual property), (chapter VI), based on WTO provisions
4. Rules on functioning, (chapter VII)[13]

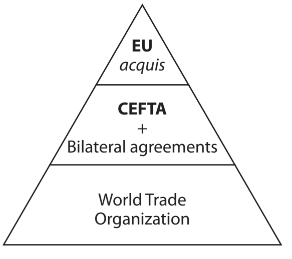
Countries with weaker economies need more time in order to develop their economic potentials and become more competitive, which is why integration within the region of Southeastern Europe is very useful. However, attractiveness to foreign investors depends on the implementation of the Agreement, and it is expected that the rules of this joint agreement will be much more consistently respected than were the previous bilateral agreements, as it will be wholly harmonized with the rules and discipline of the World Trade Organization.

[13] Per Magnus Wijkman, *A Reader's Guide to 'CEFTA 2006'*, Expanding Trade and Investment in South Eastern Europe, Friedrich Ebert Stiftung, Brussels, 18-21 April 2007, str. 9.

As the Western Balkans are attractive to many Western countries, the Agreement opens the way for the latter's greater participation in our market. The exclusivity of the Serbian market lies in its current Free Trade Agreement with the Russian Federation, the only such agreement signed by Russia with a non-CIS country.

Bilateral free trade agreements in Southeastern Europe that preceded CEFTA had already brought foreign trade growth to all the signatory countries. Since they are all now parties to the single, multilateral CEFTA 2006 agreement, it is expected that trade cooperation will continue and that its scope will grow. It is estimated that, thanks to that document, it will be easier for companies to do business in Southeastern Europe, since export and investment procedures will be additionally simplified. On the other hand, this will be a sort of a test of competitive ability, since CEFTA 2006 represents "Europe redux" and partly reflects the relations and ways of doing business on the European market.

Diagram 2: *Pyramidal diagram depicting the foundations of CEFTA 2006*



In addition to replacing and transferring all the concessions from the 32 bilateral agreements on tariff-free trade between the countries in the region, the multilateral,CEFTA 2006 introduces new areas:

- trade in services – gradual liberalization is anticipated;
- public procurements – by May 1, 2010, all parties to the Agreement will secure non-discrimination and national treatment;
- investments – stable conditions for investors will be secured and investment policies shall be coordinated.[14]

6. Possible negative effects and obstacles

A single free trade agreement, in the form of a revised CEFTA, will facilitate the further trade integration of Southeastern Europe. Nevertheless, as with every other agreement that "strips" the state of some prerogatives of sovereignty, this agreement also has negative consequences for internal economic development. Paradoxically, both CEFTA and other accession processes of Southeastern

[14] Belgrade Chamber of Commerce, Trade Association, *The CEFTA 2006 Agreement*, April 2007: www.kombeg.org.yu, 28/08/2007.

Europe into the European Union erect short-term trade barriers, despite the fact that, in the long term, they are opening the way to a unitary market.

Joining a regional integration can lead to a sudden growth of imports, which affects uncompetitive products and leads to further consequences for a country's trade balance of payments. Also, as a rule, such agreements bring reductions in customs revenues. And, finally, due to increased imports and reductions in product costs in the amount of customs duties, certain sectors will experience increased competition.

In order to avoid the said negative effects, countries most often resort to measures of protecting the domestic economy. Domestic protection measures are carried out in accordance with WTO measures and laws on foreign trade in cases of:

- dumping and subsidized products whose imports bring serious damage to domestic production;
- exaggerated growth of imports, threatening production, employment and domestic sales;
- exceptional situations and growth in agricultural imports, if these cause serious disruptions on the market.

Another possible obstacle to the implementation of CEFTA 2006 are *non-tariff barriers*. Fortunately, the Agreement provides for organized activity toward the elimination of non-tariff barriers, through the work of three subcommittees:

- *Subcommittee for non-tariff and technical barriers*, whose task is to identify and eliminate non-tariff barriers, and cooperate with other similar organizations, especially with the OECD Investment Committee and the CEFTA Permanent Forum of Chambers of Commerce;
- *Subcommittee for the cooperation of customs organs, including rules of origin*, which simplifies and facilitates customs procedures and formalities ("single counter: and regional data harmonization), and acquaints business people with rules of origin;
- *Subcommittee for agriculture, including sanitary and phytosanitary measures*, which facilitates trade in agricultural products, harmonizes rights in that field and strives to implement further liberalization.

7. Trade problems that are solved within CEFTA 2006 – examples

Besides the numerous advantages CEFTA 2006 brings, it was not possible to avoid certain problems during negotiations between the agreement's signatories. One of the typical disputes was the situation in 2006, when B-H violated bilateral agreements with Serbia and Croatia and raised tariffs on the import of meat and meat products, and milk and dairy products. It should also be recalled that on July 31, 2007, B-H postponed ratification of CEFTA, one of the reasons being that the agricultural lobby demanded that the 40% import tariff for meat and milk be raised to 100 percent. Still, the B-H delegation succeeded in imposing Article 23.bis into the Agreement, which is not too precise and offers the possibility for countries to introduce certain protection measures in case of market disruptions, although for not more than 200 days. In any case, in order to avoid such problems in the future, strict rules of the game were established.

The Joint Committee of all the CEFTA members has the task of overseeing the implementation of the agreement and resolving all open issues. A country that does act in accordance with the agreement can expect sanctions in the form of denial of economic privileges. CEFTA serves as preparation for EU accession and any departure from the rules worsenes that country's integration prospects. The signatory countries are candidates or potential candidates for entry into the EU, and if they do not adhere to the Agreement, they will be punished in a certain way in terms of their accession period. CEFTA provides for three government-level subcommittees and three work groups at the chamber of commerce level, which will be responsible for diagonal cumulation, non-tariff barriers and agriculture. In Serbia's exports to the countries in the region, agriculture's share equals between 40 and 50 percent, which is why CEFTA is very important for our country. All the CEFTA countries, with the possible exception of Moldavia, are important partners for us in the trade of agriculture and food products, especially countries of the former Yugoslavia – Croatia, B-H and Macedonia.

By signing this agreement, in the light of future accession to the World Trade Organization and other international organizations and the future signing of other international agreements, questions regarding the position of the domestic tobacco and tobacco products industry and excise taxes on tobacco products have been raised. This has created a need to carry out necessary changes in the domestic laws in the direction of harmonization with WTO and CEFTA rules.

Serbia and Croatia have not yet agreed upon the terms of the CEFTA agreement dealing with cigarette tariffs, but negotiations between the two states are still in process and heading in the direction of compromise. The ratification of CEFTA, negotiations on entry into the WTO and other international organizations, and the forming of other international agreements directly require the removal of the existing differential tax treatment of domestic and imported cigarettes and the removal of obligatory buy-outs or the obligatory production of domestic processed tobacco. The fulfillment of these demands, without the appropriate adjustment of the legal framework in the area of taxing, production and sales of tobacco and tobacco products would bring into question all the results achieved thus far, especially the stability of public revenues and the sustainability of investments into the domestic tobacco industry.

On March 22, 2007, the Government of the Republic of Serbia adopted a plan of action for the implementation of the CEFTA agreement in the tobacco industry, which equalizes the excise taxes on domestic and imported cigarettes and raises import duties on cigarettes to 57.6%. This plan also introduced stimulation to tobacco producers for the import of raw materials for the production of tobacco products, in the form of a 10% tariff reduction on raw material imports. This plan of action was adopted in order to secure equitable and stable conditions for the development of the domestic tobacco industry, the preservation of its market share relative to the import segment, a stable economic position for the producers and processors of raw tobacco, greater productivity in this agricultural branch, stable fiscal revenues from the sales of tobacco and tobacco products and the harmonization of national laws with laws of the EU and the rules of the WTO.[15] In this way, the problem with Croatia on the issue of the tobacco industry was resolved.

The tobacco industry is an important economic branch in Serbia as well as in other countries in the region, with an established practice of protecting domestic producers; tobacco product consumers are a source of large tax revenues, while tobacco production and processing employs large numbers of people, some of them in underdeveloped regions. Also, having in mind that the tobacco industry's chain of production and sales employs about 130,000 people, which represents 6% of total jobs in the Republic of Serbia, or 11% in the economy, the fact that over one billion euros have been invested in the tobacco industry over the past several years, as well as the fact that the industry generates exceptionally high excise revenues – the failure to adopt the necessary changes in the domestic legal system would bring extremely damaging consequences to the Republic of Serbia. However, CEFTA 2006 must not stand in place for the sake of the tobacco industry but must move forward, both out of political and economic considerations. It is necessary to change the Law on Tobacco in order to enable the domestic producers to break out of the local market and expand into the regional one, if they so choose. It would be best to harmonize the tobacco market in the CEFTA 2006 region, in terms of market transparency and fairness.

Although many agree that CEFTA will raise the levels of trade, investments and employment, it is still too early for evaluations. An additional limitation for the achievement of good results is the small share of intraregional trade as a share of trade with the world: the CEFTA countries export a maximum of 30% of their goods to the region, since the European Union is the most important trade partner for almost all of them, led by Germany and Italy. There is also the problem of the high overlap of goods that the CEFTA countries can offer to their neighbors. Still, the CEFTA agreement helps producers in the region to find partners in the EU and to export their joint products without tariffs and limitations to the market of the EU 27.

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15 Conclusion on the action plan for the implementation of the CEFTA agreement, "Official Gazette of the RS," no. 29/2007, pp. 1-2.

8. Free trade in the region

The European Union is the most important and the biggest trade partner of the countries of Southeastern Europe. [16] It is also the main source of foreign direct investment into the region. Thus, the process of strengthening trade relations between the Southeastern European economies forms an important part of the EU's broader strategy regarding economic growth and strengthening stability in the region. The experiences coming out of economic liberalization in Southeastern Europe represent an important step toward the countries' economic cooperation, which brings them a step closer to EU membership. Regardless of the fact that it is not a party to the Central European Free Trade Area, the European Union has supported these negotiations and continues to extend consistent political, technical and financial support at every step toward the liberalization of Southeastern Europe.

Table 3. *EU trade with SEE countries in billions of euros, in the 2000-2005 period*

Country	EU exports			EU imports			Total trade (exports + imports)		
	2001	2005	Growth (%)	2001	2005	Growth (%)	2001	2005	Growth (%)
Albania	1.114	1.320	18%	336	459	37%	1.451	1.779	23%
Bosnia and Herzegovina	2.047	2.703	32%	696	1.324	90%	2.743	4.027	47%
Bulgaria	4.436	7.133	61%	3.741	5.282	41%	8.177	12.415	52%
Croatia	7.042	10.371	47%	3.128	3.968	27%	10.169	14.340	41%
FYRO Macedonia	1.409	1.340	-5%	693	954	38%	2.102	2.294	9%
Moldavia	508	797	57%	258	363	41%	766	1.160	51%
Romania	12.103	21.789	80%	10.135	15.278	51%	22.238	37.067	67%
Serbia and Montenegro	3.179	4.945	56%	1.266	1.744	38%	4.444	6.688	50%
Western Balkans	**14.791**	**20.679**	**40%**	**6.119**	**8.449**	**38%**	**20.909**	**29.128**	**39%**
Total	**31.838**	**50.398**	**58%**	**20.253**	**29.372**	**45%**	**52.090**	**79.770**	**53%**

Source: Comext; Serbia and Montenegro: 2004 data.

In 2005, total trade between the EU and Southeastern Europe (SEE) equaled 79 billion euros, which represents a growth of 53% relative to 2001 (see Table 5). All the observed countries experienced growth in trade with the EU during the 2001-2005 period. The largest growth in trade with the EU was achieved by Romania (+67%) and Bulgaria (+52%), which leads to the conclusion that the effects of trade and economic integration carried out by these two countries within the process of accession to the European Union were positive.

[16] The observed countries of the region were: Albania, Bosnia and Herzegovina, Bulgaria, FYRO Macedonia, Macedonia, Croatia, Moldavia, Romania and Serbia (including Kosovo).

The European Union offered free access to its market to the Western Balkan countries beginning with 2001 and, since then, these countries' exports to the EU have grown by more than a third.

Mutual trade between the Southeastern European counries has grown thanks to the forming of bilateral free trade agreements (see Table 6). In 2004, regional trade reached the sum of 3.5 billion euros, which represents a growth of 33% compared to the 2.6 billion euros in 2002. Croatia's exports to the countries in the region reached 227 million euros within two years (220-2004), which is a growth of 27%. Even better results were achieved by Romania, whose exports to the countries in the region reached 244 million euros (47%). All the observed countries experienced growth in exports to other countries in the region of Southeastern Europe.[17]

It is interesting to note that the countries that achieved the highest growth rates in bilateral trade with the EU are also those that have most developed their trade within the region. This fact shows us that greater trade in the region and greater trade with the EU are mutually complementary.

Table 4. *Trade between the SEE countries in millions of euros, in the 2002-2004 period*

Country	Exports to SEE			Exports to the world		
	2002	**2004**	**Growth (%)**	**2002**	**2004**	**Growth (%)**
Albania	13	15	15%	348	426	22%
Bosnia and Herzegovina	164	267	63%	874	1.174	34%
Bulgaria	570	727	28%	5.942	7.204	21%
Croatia	839	1.066	27%	5.111	6.215	22%
FYRO Macedonia	421	512	22%	1.101	1.196	9%
Moldavia	65	98	51%	680	967	42%
Romania	519	763	47%	14.634	17.560	20%
Serbia and Montenegro	60	70	17%	1.519	1.673	10%
Total	**2.651**	**3.518**	**33%**	**30.209**	**36.415**	**21%**

Source: Commission calculations based on IMF (DOT) data.

The creation of a Southeast European free trade area has turned the newly-formed trade zone into a quite respectable market and an attractive region for a greater engagement and inflow of foreign capital and investments. It is, thus, justified to expect that the implementation of the free trade agreement will expand and improve the structure of the exchange of goods and lead to the establishment of balanced trade between the region's coutries, which would bring a gradual reduction and elimination of the current foreign trade deficit, as well as a reduction in the number of intermediaries in trade, which had resulted in increased margins and, thereby, unjustifiably high prices; in addition, this will contribute

[17] European Union, *A New Regional Agreement to Develop Trade in South Eastern Europe*, MEMO/06/502, Brussels, 19 December 2006, p. 1.

to higher levels of economic cooperation, to the overcoming of technological backwardness, an increased competitiveness of domestic products, a lowerinf of production costs and respect for international standards.

In the first place, each country expects that the new CEFTA agreement will result in greater exports into countries that have joined CEFTA, as well as a better position for domestic companies on those markets due to the obligation of all new members to apply the modern provisions that have been built into the agreement. A growth in visible trade between the region's countries can also be expected, due to their similar economic structures and complementary economies. Also to be expected is a greater attraction of foreign direct investments, due to the broader possibilities of placing goods onto the markets of the signatory countries as well as third markets. The new agreement allows for the development of higher forms of economic cooperation, such as, for example, the establishment of long-term production cooperations, the forming of joint-venture companies by residents of the signatory countries, etc.

Another advantage of forming a free trade zone is the possibility of a direct flow of goods and services, by reducing the number of middlemen in trade, which in the final instance leads to a reduction in margins as well as the end prices of goods and services. An eventual reduction in technological backwardness and dependence, and in production costs, along with respect for international standards, could lead to trade in goods of a higher level of technological processing and, thus, to greater competitiveness in third markets.

9. The role of trade and investments

Trade is a very important stimulating mechanism for the generation of national growth and prosperity. It provides local companies access to global markets and knowledge in general. On the other hand, increased trade gives consumers a wider choice of goods and competitive (lower) prices.

There is a positive interdependence between trade and investments, which facilitates economic growth and greater employment. This mutual influence comes about thanks to three factors:

- Liberal trade regimes stimulate investments, because they lead to specialization and increased rates of production, which are very important, especially for small economies.
- Presently, in most cases direct foreign investments are more motivated by possibilities for increasing productivity than by needs to enter local markets. Therein lies the explanation why multinational companies are relocating the labor-intensive portions of their chain of production to transitional economies or developing countries. Local companies in transition

economies can benefit from such a development by taking on the role of subcontractors, i.e. domestic suppliers.

- Trade and foreign direct investments can bring greater competitiveness to the exports of domestic entrepreneurs through knowledge and technology transfers.[18]

Table 5. *Real GDP growth rate (%) in SEE countries*

Country	2004	2005*	2006**
Albania	6.7	5.5	5.0
B-H	6.0	5.8	5.0
Bulgaria	5.7	5.5	6.0
Croatia	3.8	4.3	4.6
FYRO Macedonia	4.1	4.0	4.0
Moldavia	7.3	7.1	3.5
Montenegro	3.7	4.1	5.5
Romania	8.4	4.1	6.5
Serbia	9.3	6.3	6.5
SEE average	**6.9**	**4.7**	**5.9**

* Estimate ** Projected

Source: EBRD Transition Report 2006.

Table 6. *Trade balance (in millions USD) of the SEE countries*

Country	2004	2005*	2006**
Albania	-1586	-1868	-2160
B-H	-2832	-3123	-3107
Bulgaria	-3643	-5399	-6504
Croatia	-8350	-9296	n/a
FYRO Macedonia	-1112	-1052	-1100
Moldavia	-758	-1162	-1641
Montenegro	-518	-640	-645
Romania	-6611	-9873	-13125
Serbia	-6643	-5563	-6000

* Estimate ** Projected

Source: EBRD Transition Report 2006.

18 Anthony O'Sullivan, *The Economic Situation in South East Europe and the Role of Trade and Investment*, OECD, CEFTA 2006 – Expanding Trade and Investment in South Eastern Europe, A Seminar for Parliamentarians from South Eastern Europe, Brussels, 19. April 2007, p. 13.

Gross domestic product growth was strong in all Southeast European countries. This growth is being negatively affected by the jump in energy prices but, regardless of this, it is expected that the gross national product will continue to experience strong growth in the observed countries.

The trade balance, or the trade balance deficit of the Southeast European countries, shows us that their export competitiveness is still quite weak. Even though intra-SEE trade is growing, most of the trade flows are still in the direction of EU countries.

Foreign direct investments are especially important for the countries of Southeastern Europe. The reason for this is that a sudden and successful transition toward a market economy, as practice has shown us, is not possible without the knowledge and capital of foreign investors. From the above data we can see that the distribution of foreign direct investments to the countries of Southeastern Europe is varied. The greatest inflow of foreign direct investments is enjoyed by Bulgaria, Romania, Croatia and Serbia, while the region's other countries lag significantly behind these four. It is expected that such a trend will continue in the future. Of course, the biggest investors come from the EU-15 countries.

Table 7. *Net inflow of foreign direct investments (in millions of EUR)*

Country	**2003**	**2004**	**2005***	**2006****
Albania	142	232	212	280
B-H***	306	343	240	456
Bulgaria	1656	1944	1838	2400
Croatia	1546	610	1207	n/a
FYRO Macedonia	77	109	78	240
Moldavia	57	104	180	152
Montenegro	35	44	379	119
Romania	1725	4458	5270	6922
Serbia	1088	676	1185	2800
Total	**6631**	**8520**	**10589**	**14576˙**

* Estimate ** Projected *** Excluding capital transfers for reconstruction

˙ Including data for Croatia for 2005

Source: EBRD Transition Report 2006.

10. Serbia's place in regional trade

Serbia readily awaited the signing of this free trade agreement. Experts predicted that the signing of CEFTA 2006 would increase competition on the Serbian market and allow the signatory countries the free placement of their products (except for agricultural products, which were to retain the quota regime). In this way, the Western Balkans would become significantly more attractive to foreign investment. This would also open the door for an eventually greater engagement on the part of businessmen from the EU as well as other investors.

It is believed that the CEFTA agreement will be good for Serbia and that it will lead to an increase in trade. Serbia is already profiting from Bulgaria's and Romania's entry into the EU, as the same trade regime now applies toward them as toward other countries of the Union, i.e. Serbia exports without any barriers while their exports to Serbia are tariffed, putting them in a relatively less favorable position.

The Serbian parliament ratified CEFTA 2006 on September 25, 2007, with 137 MPs (out of 250) voting in favor. In practice, entry into the SEE free trade zone has allowed domestic businessmen to sell their goods duty-free to a market of 25 million people.

Before CEFTA was implemented in Serbia, cigarette excise taxes were equalized, excise taxes on fruit juices were removed, mandatory buyout of tobacco was abolished, quantitative limitations on oil and oil derivatives were removed, as were export subsidies for agricultural products. The dispute regarding oil imports was resolved when all the signatory countries, including Croatia, accepted the continued monopoly of NIS (Naftna industrija Srbije – Serbian Oil Indusry) on oil imports for an indefinite time (in accordance with WTO rules).

Also, some of the provisions from the bilateral free trade agreements, dealing with levels of liberalization, were taken over:

- total liberalization with B-H, Macedonia, Montenegro and UNMIK;
- 97% liberalization with Moldavia – with only 8 product groups on tariff quotas (wine, cigarettes, tobacco);
- partial liberalization with Croatia and Albania:
- from 1/1/2007, total liberalization of trade in industrial products,
- partial liberalization of trade in agricultural products (10% of tariff positions with Croatia and 24% with Albania), and further liberalization by 5/1/2009.

It should also be pointed out that the share of domestic exports to the region's countries has been falling. Since the signing of most of the bilateral agreements (middle of 2004), the significance of this part of the world has been falling, as exports to the region have grown more slowly than total exports (see Tables 8 and 9).

The region's 2003 share of 36.2% of total exports fell for the first nine months of 2006 to 30.7%. In the same period, the share of imports grew slightly, from 6 to 7.7%. The reason for this is that the region's countries have technologically dated industries, compete with each other for exports to the EU and, in fact, do not have much to offer to each other. Serbia's trade with the countries in the region is primarily made up of food products, agricultural raw materials, electrical power, non-ferrous metals, textiles and chemical products, which resembles the trade profile of developing countries. The most frequent forms of cooperation are pure buy-sell transactions, while higher forms of business cooperation are negligible.

The most important Serbian export products to CEFTA

- Significance for the placement of agricultural and food products (50% of total exports to the world are directed toward CEFTA), exports increased by 30%, along with a higher import rate, accompanied by a significant surplus (beer, corn, bisquits, processed meats, water, flour, cooking oil, milk)
- Petroleum oils
- Electrical energy
- Metal products – refuse, strips
- Medicines
- Furniture
- Paper, cardboard

The most important Serbian imports from CEFTA

- Petroleum oils
- Coke and coal
- Processed wood
- Electrical energy
- Rods, wires, pipes, metal constructions
- Medicines
- Glass containers
- Agricultural products – wine, cigarettes, tomatoes
- Paper

If we look at the results of Serbia's trade with the CEFTA countries in the 2004-2006 and 2006-2007 periods, we will observe great improvement in the field of exports.[19] Namely, the economic indicators for the 2004-2006 period are:

- after the EU, the second-ranked trade partner,
- growth of total trade by 37.5%,
- export growth rate is lower – 8.5% - than the import growth rate – 13.7%,
- a net trade surplus,
- surplus – with Albania, B-H, Macedonia,
- deficit – with Croatia and Moldavia.[20]

[19] Source: Ministry of Economy and Regional Development of the RS: www.merr.sr.gov.yu, 19/11/2007.

[20] Source: ibid.

For 2006, the trade results were the following:

- ranked according to size of exports to CEFTA (as against total exports to the world):
- B-H (2), Montenegro (4), Macedonia (6), Croatia (8), Albania, Moldavia – the highest export growth rate was toward Albania and Croatia;
- ranked according to size of imports:
- B-H (8), Croatia (10), Macedonia (19), Montenegro, Moldavia and Albania;
- Share of CEFTA in Serbia's total exports is 30%, and in imports 8%.

In 2007, exports were twice the size of imports, and the export growth rate (44%) was slightly higher than that of imports (38%). The index of export growth relative to the same 2006 period is higher than the index of import growth in trade with Albania, Moldavia and Montenegro, while deficits were registered with Croatia and Moldavia. CEFTA's share in Serbia's total exports in 2007 was 32%, and 7.8% of total imports. The share of consumer goods was 40% of exports and 20% of imports vis-à-vis CEFTA.

Table 8. *GDP (PPP) per capita, USD*

Croatia	17 100
Bosnia and Herzegovina	9 163
Serbia	8 100
FYRO Macedonia	7 645
Albania	6 259
Montenegro	5 028
Moldavia	2 962
Southern Serbian province Kosovo & Metohija	1 800

Source: http://www.worldtradelaw.net/fta/agreements/cefta.pdf

11. Serbia's future within CEFTA

In Serbia, the following effects of the CEFTA are already evident: a sharp growth in imports and its effects on uncompetitive products and further effects on trade and the country's balance of payments, reduced customs revenues, increased competition in certain sectors. Serbia succeeded in resolving all problems during negotiations (tobacco, meats, oil), which means that there are no open questions for Serbia within CEFTA.

Serbia has to urgently solve the problem of its product standard and quality, as the domestic companies are not doing particularly well in that regard. The state needs to stimulate companies to raise the level of product quality and certification. It might be possible to eventually create a general program of certification.

Serbia could initiate an action for the simultaneous registration of new products in all the CEFTA 2006 countries, which would serve to protect intellectual property. Specifically, a system of international product registration should be created within CEFTA 2006, with the intention of simplifying their protection in multiple countries and making the process more economical. The goal of this system would be to create, on the basis of a single international registration, the possibility of simultaneous product protection in multiple cuntries.

The state, and especially the chamber of commerce and other associations, need to launch a great project of educating businesses: informing the business community about the rules of CEFTA 2006 and the WTO, regulations, regimes for specific products, standards. It is necessary to aid businesses in all processes of integration and to inform in detail all interested parties, by creating some form of information system. In addition, timely information about state policy is necessary, in order to allow for a period of adjustment. Specifically, it would be good if the web sites of the chamber of commerce or the ministry for foreign economic relations would post the complete list of tariffs applying to Serbia and all the other CEFTA 2006 countries, along with the dynamic for lowering them in the coming years. This would be of significant help to the economy, at a relatively small cost.

The government of the Republic of Serbia could form a section within the ministry for foreign economic relations tasked exclusively with overseeing the implementation of this agreement in the other signatory countries, to which businesses could directly apply and report all trade limitations imposed on Serbian products by other countries, in violation of the Agreement. As for the implementation of the Agreement itself, the creation of a work group for certain products and of an eventual subcommittee for investments should be considered.

Since, in the end, all the CEFTA 2006 countries will adjust to the standards and regulations of the EU, Serbia should choose the direction of harmonization within CEFTA 2006. The Republic of Serbia needs to continue working on the resolution of all open questions (the implementation of protective measures, Kosovo and Metohija, oil and oil derivatives, and the tobacco industry) through dialogue with interested parties and through compromise.

It would be advisable to expand the existing mechanisms of aid to domestic companies that are in accordance with WTO rules. In that sense, the experiences of the chamber of commerce and various non-governmental organizations in the implementation of such programs could prove quite valuable.

12. Agenda of development possibilities

Differently from the bilateral agreements that preceded it, CEFTA 2006 anticipates a gradual liberalization in the service trade, in addition to requiring improvements in the field of intellectual property protection, public procurements and investments. These are the fields in which the greatest changes will take place in the coming years.

The Agreement stipulates a May 1, 2010 deadline for the securing of equal treatment of all bidders in public procurements, which means that Serbia will have to change the law that protects domestic companies. Also, by May 1, 2014, in the domain of intellectual property protection, it is necessary to achieve international standards from the TRIPS agreement, which means that all the parties to the CEFTA agreement will have to join the conventions in this field and implement them.

When it comes to investments, the deadlines are not precise, but it is expected that all investors will have equal treatment. In addition, according to the CEFTA agreement, beginning with May 1, 2010, principles of competition will apply for all companies, including public corporations and those with special and exclusive rights, accompanied by the appropriate activity of an independent regulatory body.

The end of 2010 is the deadline for the formation of a free trade area in Southeastern Europe, and it will be established when at least 90 percent of trade is liberalized. The ten percent of goods that will continue to be protected will be agricultural products that each country protects individually. Certain areas are more precisely regulated, which means that technical trade barriers will also be harmonized through multilateral agreements on the harmonization and mutual recognition of the procedure on harmonization assessment. In later phases, the integration of the signatory countries into the market and structures of the European Union, as well as the tempo of that process in various countries, will also have great influence.

The creation of a free trade area is the fundamental goal that guided the CEFTA signatory countries. This specifically means respect for the basic principles upon which free trade agreements are made, which are:

- the liberalization of at least 90% of the value of mutual trade and tariff items in a transition period not longer than six years;
- the implementation of preferential rules on product origin (the principle of bilateral cumulation of product origin);
- the implementation of transparent and non-discriminatory measures in the field of public procurements, state aid and state monopolies;
- harmonization of laws with the legal system of the European Union, before all in the area of customs procedure, rules of competition, the tax

and banking systems and agriculture-related laws (the so-called phyto and veto agreements);
- protection of intellectual property in accordance with EU and WTO standards;
- harmonization of domestic laws with WTO rules in the areas of anti-dumping, compensatory and other protective measures.[21]

On September 28, 2007, a ninisters' conference was held in Ohrid, FYRO Macedonia, on the occasion of the inauguration of the agreement on free trade in the region – CEFTA. Representatives of the member countries adopted a series of key decisions, which were to secure CEFTA's effective implementation. Among the decisions adopted by the ministers was the establishment of a high-level sub-committee, which would deal with the most important issues having to do with implementation in the field of agriculture, inspections cooperation and customs.

The statements of the high-level representatives at this gathering were very optimistic. It was judged that the signing of the CEFTA agreement would double the mutual trade of the parties to the Agreement, while the door was also opened for greater trade with other countries. The highest EU and Serbian representatives agreed that CEFTA, in fact, represented the region's preparation for accession to the EU, emphasizing that Brussels was directly interested in the successful implementation of the agreement, i.e. in supporting it financially, as well as that the implementation of CEFTA is exceptionally important for Serbia, since more than 30% of domestic exports go to neighboring countries.

In November 2007, a summit of prime ministers of the CEFTA signatories was held in Skoplje, FYRO Macedonia, at which a document on greater regional cooperation in free trade was signed.

CEFTA 2006 – chronology of events

Sofia, June 2005 – At a Southeast European ministers' conference, a decision was brought to establish a unified agreement on free trade in Southeastern Europe, at which time the working group on trade within the Stability Pact for Southeastern Europe was given the mandate to prepare future steps.

Zagreb, November 2005 – Amendments to existing criteria for CEFTA membership were adopted, the so-called Zagreb Declaration, enabling all countries and territories of Southeastern Europe to join the Agreement.

Berlin, February 14, 2006 – Romania, as the presiding country of the CEFTA agreement, and supported by other CEFTA members, proposed measures that would ease and simplify the creation of a unified free trade agreement, by way of simultaneously broadening and amending the CEFTA agreement. It was concluded that the negotiatons would take place under the auspices of the working group for trade of the Stability Pact for Southeastern Europe.

21 D. Jovović, "Sporazumi o slobodnoj trgovini u regionu Jugoistočne Evrope", *Ekonomski anali*, no. XLVIII, Ekonomski fakultet, Beograd, 2004, p. 235.

Brussesl, March 28, 2006 - The Stability Pact for Southeastern Europe informs the ministers on the feasibility of a unified free trade agreement, including the principles underlying the system and a draft text. It was recommended that agreement should be reached by way of simultaneously broadening and amending the CEFTA agreement, and that the countries in question should gain formal mandates for future negotiations.

Bucharest, April 6, 2006 – A high-level political meeting was held in order to formally initiate the process of broadening and amending CEFTA. The prime ministers of the Southeast European countries adopted a Joint Declaration. The European Union Presidency, the European Commission and the Stability Pact for Southeastern Europe supported the Joint Declaration on the principles of the future CEFTA 2006.

June-November 2006 – In this period, four rounds of technical negotiations were held, under the presidency of the Stability Pact for Southeastern Europe and with the support of the European Commission, which brought about the agreement's acceptance on the part of eight Southeastern European countries, on November 9, 2007, in Brussels. The possibility of signing the new agreement along with the others on December 19 was offered to Bosnia and Herzegovina and Serbia.

Bucharest, December 19, 2006 – After seven months of intense negotiations, all the countries of Southeastern Europe, including the southern Serbian province of Kosovo and Metohija (UNMIK), signed the new and amended CEFTA agreement, thus creating a free trade zone in Southeastern Europe.

July 26, 2007 – CEFTA 2006 goes into effect for five Southeast European countries: Albania, FYRO Macedonia, Moldavia, Montenegro and the southern Serbian province of Kosovo and Methija (UNMIK).

August 22, 2007 – CEFTA 2006 goes into effect in Croatia.

September 24, 2007 – The Serbian parliament and the House of Nations of Bosnia and Herzegovina ratified CEFTA 2006.

Ohrid, September 28, 2007 – The first CEFTA 2006 ministers' conference.

Skoplje, November 21, 2007 – Summit of the signatory countries, adoption of the CEFTA 2006 Declaration and the signing of a document on greater regional cooperation in free trade.

Source: The Stability Pact for South Eastern Europe, Internet, http://www.stabilitypact.org/pages/events/detail.asp?y=2007&p=576, 05/10/2007.

13. Conclusion

Free trade agreements are quite current in today's world. It is estimated that just about every country in the world is a member of one or several regional free trade agreements, and there are more than 300 such agreements in force today. Another new trend is the forming of interregional agreements. About 70 percent of the world's trade takes place within the framework of free trade agreements, while in Europe this figure exceeds 80 percent.

The goal of signing the agreement on the Central European Free Trade Area is the advancement and improvement of the overall trade and economic relations between the countries of Southeastern Europe. CEFTA 2006 is supposed to lead to a harmonization of the development of economic relations through the development of trade, faster development of commercial activities, rising standards of living and better employment opportunities. Other important effects of this agreement for each of its signatories are expected rises in productivity and the achievement of financial stability, all on the basis of principles of the market economy and trade liberalization, in accordance with the provisions of the General Agreement on Tariffs and Trade (GATT, 1994), and the agreement on the establishment of the World Trade Organization.

CEFTA 2006 secures:

- full accordance with the rules of the World Trade Organization;
- the free trade of all industrial products and a large number of agricultural products (up to 90%);
- modern trade-related regulations;
- innovative clauses regarding new trade issues (i.e. protection of intellectual property rights);
- mechanisms for a successful implementation of the agreement and dispute resolution;
- a step closer to accession to the European Union.

It is not unimportant that joint CEFTA products will appear not only on the regional market but on other markets as well, thus providing access to a large number of consumers. In addition, through cooperation, the contries of the region will strengthen and increase their efficiency and adopt international standards.

The Southeast European countries' trade deficits tell us that their competitiveness is still quite weak. Even though intra-SEE trade is still growing, most of the trade flows are still directed toward countries of the European Union. The establishment of a Southeast European free trade area is turning the region into a very respectable market, an attractive area for the greater engagement and inflow of foreign capital and investments. It is, thus, justified to expect that the implementation of the free trade agreement will result in the improvement in the structure of trade and the establishment of a balance in intraregional trade, which will open the way for a gradual reduction and removal of the existing foreign trade deficit, a reduction in the number of trade intermediaries, which have been responsible for higher margins and unjustifiably high prices, as well as the development of higher forms of economic cooperation, reduction in production costs and respect for international standards.

It is also necessary to take measures toward the removal of non-tariff barriers and a general improvement in the infrastructure necessary for strengthening regional ties. Paradoxically, the process of accession of the SEE countries to the European

Union is creating short-term obstacles to trade but, in the long term, it is leading toward a unitary market. Advances in economic development, and the improvement of social and political conditions in Southeastern Europe are a function of cross-border cooperation, especially the cooperation of the business community.

The countries that have achieved the highest growth rates in bilateral trade with the European Union are also the ones that have most developed their trade within the region of Southeastern Europe. This tells us that greater trade in the region and greater trade with the EU are mutually complementary.

The processes of integration in the region of Southeastern Europe are very important for our country. Accession to CEFTA 2006 is one more step bringing Serbia closer to entry into the European Union. Serbia must be an active participant in these processes, must work on finding solutions to its own benefit in its relations with other countries, submit proposals to other countries, resolve open issues, participate in dialogues, develop good neighborly relations and, especially, develop economic relations. This is the best way for it to realize its own developmental goals and move a step closer to joining the European Union, as well as shedding the status of a developing country.

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Appendix

AGADIR – The Agadir Agreement for the Establishment of a Free Trade Zone between the Arabic Mediterranean Nations.
AU – African Union.
ASEAN – Association of Southeast Asian Nations.
CACM – Central American Common Market.
CARICOM – Caribbean Community.
CCASG/GCC – Cooperation Council for the Arab States of the Gulf (CCASG), also known as The Gulf Cooperation Council (GCC).
EurAsEC – Eurasian Economic Community – EurAsEC or EAEC.
EFTA – The European Free Trade Association.
GUAM – The GUAM Organization for Democracy and Economic Development.
NAFTA – The North American Free Trade Agreement.
PARTA – The Pacific Islands Forum.
SAARC – The South Asian Association for Regional Cooperation.
Unasur/Unasul – The Union of South American Nations.

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CHARACTERISTICS OF THE U.S. FOREIGN TRADE

Abstract: *The subject of research in this work is U.S. foreign trade. The first part deals with the genesis of the concept of competitiveness, while the latter part concentrates on the competitiveness of American exports. The obtained results show that it has substantially fallen in the period of 1948-2005. An analysis of foreign trade dynamics reveals that the 1995-2005 period has seen a rise in the foreign trade deficit, which is a partial consequence of a more rapid growth of import prices and the nominal depreciation of the U.S. dollar. Comparison with countries at a similar level of development reveals that the widely held view regarding the large American deficit is absolutely justified, with one-fourth of its value laying in trade with China. The foreign trade imbalance is a consequence of a modest level of exports rather than of large imports. In addition, about 88% of the foreign imbalance is taken up by the foreign trade deficit, which is dominantly financed by the investment of foreign accumulations into American securities, especially debt securities.*

Key words: *export competitiveness, economic openness, foreign trade deficit, the geographical structure of visible trade, financing the foreign trade deficit*

JEL classification: F14, O51

1. Introduction

One of the most intriguing segments of the American economy is foreign trade. There is no doubt that the American balance of payments is far and away the least comprehensible and the most confusing part of the American economy. The predominant view within academic circles is that the U.S. economy is burdened by a high foreign and current accounts deficit, which is rising dynamically under the influence of highly diverse factors. It is especially important to emphasize that the foreign deficit has reached a record level in both absolute and relative terms. There is great concern regarding these balance of payments tendencies and, one could say, fears about the ability to finance it and its long-term sustainability. The goal of this research is to examine American foreign trade from various angles, limitations of space notwithstanding. The research focuses on the competitiveness of American exports, the dynamic characteristics of foreign trade, a comparative analysis of the openness of the American economy and the size of its foreign trade deficit, the geographical structure of its foreign trade and the structure and means of financing the foreign imbalance.

In accordance with this, this work is conceptualized in the following way. The next part is a brief overview of the genesis of the concept of competitiveness and of U.S. export competitiveness. This is followed by an analysis of the characteristics of American foreign trade, from four different angles. Attention is first focused on the dynamics of foreign trade. This is followed by a comparison between the U.S. and other countries, in terms of economic openness, size of the foreign trade deficit and of the export-import coefficients. The third dimension of research deals with the geographic characteristics of foreign trade, while the last part of the work is devoted to an analysis of the U.S. balance of payments, the structure of its foreign deficit and the ways in which it is financed.

2. The competitiveness of the U.S. economy and exports

There is a large number of definitions of competitiveness in theory and in literature throughout the world. All the way up to the beginning of the 20th century it was thought that competitiveness was a company's ability to produce products and services and to place them, under fair conditions, on the domestic and the foreign market. The distinction between competitiveness on the domestic and the foreign market was made because the conditions for domestic companies on the domestic market were significantly more favorable than for foreign companies due to the presence of tariffs, non-tariff measures, transport costs, and commissions for middlemen. Still, such a perspective would be correct only if a company produced only one product or service. In that case, it would make sense to talk about the company's competitiveness on the domestic and international markets. Practically all companies, especially in economically prosperous countries, diversify their production programs with time, which means that the said perspective is in a large sense outdated. Diversification of a company's activities allows it to be very competitive on the domestic (foreign) market in the case of one product and, at the same time, totally uncompetitive in the case of another product (service). In such circumstances it is hard to analyze the total competitiveness of a company on the domestic and foreign market, and it makes more sense to focus attention on competitiveness in the production of a concrete product (service).

In literature one often encounters the concept of export competitiveness. The methodology frequently used for its quantification is Constant Market Share Analysis - CMS.[1] This method starts from the premise that the geographical

1 This method was introduced into theory by H. Tysyzynsky, "World Trade in Manufactured Commodities, 1899-1950", *The Manchester School*, vol. 19, 1951, pp. 272-304. The first

structure of exports by countries and the structure of commodity exports within each country do not change. The method begins with the calculation of potential exports, which could have been achieved had the observed country's exports in a given period retained a constant share of global exports. Thus obtained, potential exports are then corrected by the effect of the geographical export structure by country and the structure of commodity exports within countries.[2] Once potential exports are calculated they are compared with achieved exports. If achieved exports is smaller than the potential, it is concluded that export competitiveness fell in the observed period and vice-versa.

At the end of the 1970s (1979) the Institute for Management Development and the World Economic Forum presented the first ranking list of countries according to the competitiveness of their economies, taking into consideration both domestic and foreign markets. This did not pass without opposition from numerous economists who thought that it was not countries that competed on the international market but their companies. Some of the researchers remained consistent in this view, even as late as the mid 1990s. One of them is the brilliant Paul Krugman, who thinks that the concept of an economy's competitiveness is a dangerous obsession.[3] In spite of this, the elaboration of the concept of macro-competitiveness continued.

A large number of different definitions of the concept of competitiveness exists today and, according to some researchers, there is nothing close to a consensus when it comes to this issue.[4] The already mentioned Institute for Management Development and the World Economic Forum issue two publications: "World Competitiveness Yearbook" and "Global Competitiveness Report," respectively, in which countries are ranked according to their economies' competitiveness. The World Economic Forum ranks countries according to a) potential long-term growth sustainability of the economy and b) conditions for business development. The first ranking list is called the *Global Competitiveness Index* (GCI).[5] The methodology was developed by Xavier Sala-y-Martin, a professor at Columbia University, and the countries are ranked on the basis

empirical analysis with the use of this method was carried out by P.R. Narvekar, "The Role of Competitiveness in Japan's Export Performance, 1954-1958", *IMF Staff Papers*, vol. 8, no. 1, 1960, pp. 85-100. This method later served as a basis for the development of its various modifications, about which see: B. Balassa, *The Newly Industrializing Countries in the World Economy*, Pergamon Press, 1981; B. Balassa, *Development Strategies in Semi-Industrial Economies*, The Johns Hopkins University Press, 1982; I. B. Kravis, R. E. Lipsey, "Price and Market Shares in the International Machinery Trade", *The Review of Economics and Statistics*, vol. 64, no. 1, 1982; J. D. Richardson, "Constant Market Share Analysis of Export Growth", *Journal of International Economics*, vol. 1, no. 2, 1971.

2 Kovačević (2003), pp. 155-161.

3 Krugman (1994).

4 Kovačević (2004), pp. 35-79.

5 http://www.gcr.weforum.org/.

of twelve fields. The second ranking list is called the *Business Competitiveness Index*. The methodology was developed by famous Harvard professor Michael E. Porter. Prior to the construction of this ranking list, countries are ranked according to: a) sophistication of company operations and strategies and b) quality of the national business environment. On the basis of these two sub-indexes a single ranking list is formed.

In its publication, "World Competitiveness Yearbook," the Institute for Management Development ranks countries according to their ability to create and sustain an environment supportive of company competitiveness.[6] This publication, which has been published without interruption since 1989, reviews all the significant issues of global competitiveness and ranks national economies using 323 different criteria. In 2007 a total of 55 countries were ranked.

It is especially important for the needs of this research to emphasize that, according to both the said publications, the U.S. was ranked first in 2007. According to the Global Competitiveness Index, the U.S. is first, followed by Switzerland, Denmark, Sweden, Germany, Finland, Singapore, and Japan. According to the Business Competitiveness Index, the U.S. is again first, followed by Germany, Finland, Sweden, Denmark, Switzerland, Holland, Austria, Singapore, Japan, etc. Also, on the Institute for Management Development ranking list, the U.S. is the best-ranked country, followed by Singapore, Hong Kong, Luxembourg, Denmark, Switzerland, Iceland, Holland, Sweden, and Canada.

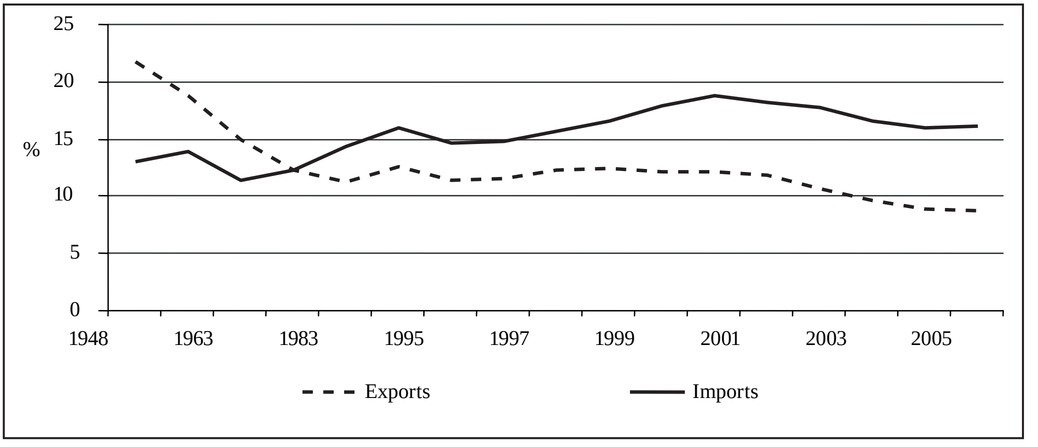
One of the questions that could create confusion in connection with the concept of competitiveness is whether the ranking of a country according to the competitiveness of its economy automatically translates into high competitiveness of its companies, i.e. in growth in its export competitiveness. The best example that this is not the case is that of the United States. As for the competitiveness of the U.S. economy, we have seen that, according to the Global Economic Forum, it is the best-ranked country for 2007, although it is important to emphasize here that the U.S. was also either the leading country or near the top of the ranking lists for a number of years before that. At the same time, the U.S. has the world's most competitive economy and, according to research by the Institute for Management Development, this has been the case since 1994. On the other hand, using the simplified CMS analysis, we have evidence of an obvious decrease in U.S. export competitiveness (Graph 1).

Evidently, over a relatively long period of time, U.S. exports did not follow the tempo of growth of global exports, which means that its value for 2005 was significantly lower than its potential exports value.[7] Generally speaking, a com-

6 See more at: http://www.imd.ch/research/publications/wcy/announcing.cfm.

7 We have already explained that potential exports, calculated on the basis of global exports growth, should be corrected for the geographical structure of exports by country and the commodity structure of exports for each individual country, which was not done here for lack of data.

Graph 1: *Share of U.S. commodity exports and imports in global imports and exports*



Source: Calculated on the basis of: *International Trade Statistics 2006,* pp. 28, 29, 195, 199.

petitive economy is in fact an excellent prerequisite for achieving an increase in exports and a relatively balanced foreign trade balance. Still, this important prerequisite is not sufficient. In order for a country to dynamically increase its exports, it is necessary to undertake a series of measures both on the macro and the micro levels, such as: marketing measures, chamber of commerce measures, measures on the part of state agencies charged with financing and insuring exports, conducting an appropriate foreign exchange policy, crediting exporters under favorable terms, crediting the establishment of new businesses, increasing investments, extending support to businessmen participating in international fairs, providing factoring and forfeiting services, fiscal allowances for exporters, measures by relevant ministries, signing preferential trade agreements. Thus, countries that have competitive economies but neglect export incentive meas-ures might wind up suffering from balance of payments difficulties.

3. U.S. foreign trade

3.1. The dynamics of U.S. foreign trade

An analysis of U.S. foreign trade for the period 1995-2005 indicates unsat-isfactory trends. Growth of total commodity exports slowed, except for a mild pick-up in 2005 (Table 1). Export growth of 6.9% in 1996 was by 2004 reduced to only 3.8%, which was partly alleviated by a rise in average yearly growth of 4.5% in 2005. At the same time, the growth of commodity imports increased.

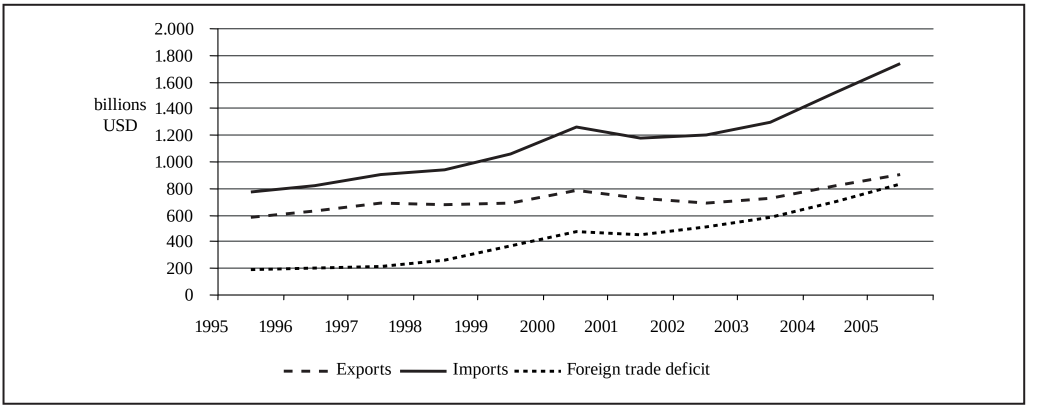
From 6.6% in 1996, growth of imports increased to 7.9% and 8.4% in 2004 and 2005, respectively. The expected consequence of slowing export growth and more rapid commodity imports growth, along with the fact that imports are significantly greater than exports, is a more rapid rise in the foreign deficit. Deficit growth accelerated from 5.8% in 1996 to 16.1% in 2005. The degree of import coverage with exports also fell significantly, from 75.9% in 1995 to only 52.2% in 2005. Thus, the most conspicuous characteristic of the U.S. foreign trade balance in the observed period is the strong growth of the foreign trade deficit, especially since 2002 (Graph 2).

Table 1: *U.S. commodity exports, imports and foreign trade deficit 1995-2005*

	In $ billions					Average yearly growth (in %)				Percentage of imports covered by exports				
	1995	1996	2000	2004	2005	1996	2000	2004	2005	1995	1996	2000	2004	2005
Exports	585	625	782	819	904	6.9	6.0	3.8	4.5	-	-	-	-	-
Inports	771	822	1,259	1,526	1,732	6.6	10.3	7.9	8.4	-	-	-	-	-
Foreign trade deficit	186	197	477	707	828	5.8	20.7	16.0	16.1	75.9	76.0	62.1	53.7	52.2

Source: Calculated on the basis of: *International Trade Statistics 2006*, p. 195.

Graph 2: *U.S. foreign visible trade, 1995-2005*

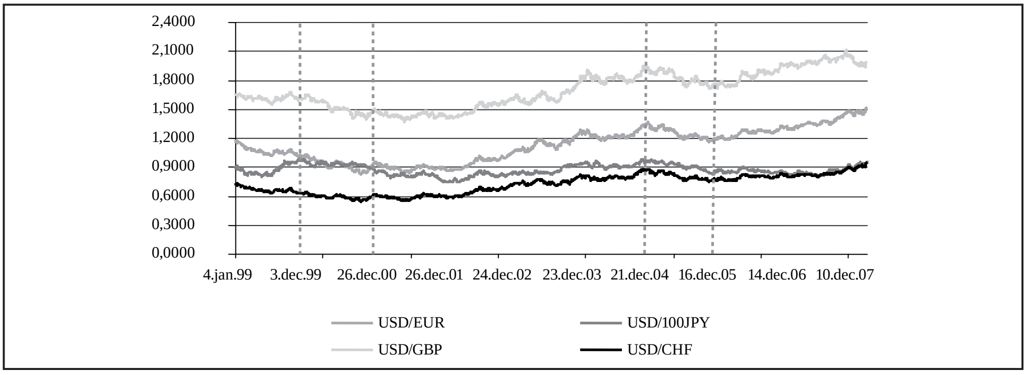


Source: *International Trade Statistics 2006*, pp. 195-203.

Nevertheless, research objectivity compels us to separately consider two factors that contributed to making the image of U.S. foreign trade worse than it actually is. The fist factor is the nominal depreciation of the U.S. dollar. During the past seven years, the U.S. dollar has nominally depreciated in relation to the euro, pound sterling and the Swiss franc, while it has retained practically the same level in relation to the Japanese yen. This is indicated by data in Graph 3,[8] where the growth in value of various currencies in relation to the U.S. dollar is clearly evident. The dollar's nominal depreciation against the said three currencies increases the value of exports paid in these currencies. Namely, assuming

8 The period between the two red lines represents the year 2000, and the one between the other two lines the year 2005.

Graph 3: *Nominal exchange rate of the world's leading currencies in relation to the U.S. dollar, 1999-2007*



Source: www.federalreserve.gov/releases/

that the same amount of goods was exported in 2005 at the same export prices as expressed in the said currencies, i.e. assuming the same export level, conversion into U.S. dollars, due to the nominal depreciation, deforms the picture, because it indicates an increase in exports. The same applies for imports, except that the growth of imports due to currency depreciation is larger than export growth, as American commodity imports are almost twice as large. There is no doubt that this leads to an accounted growth of the foreign trade deficit. The intensity of this effect depends on the currency structure of exports and imports.

The second factor that influences growth in the value of exports and imports are export and import prices. There is no question that the dynamics of export and import prices favored an increase in the value of both the foreign trade aggregates (Graph 4).

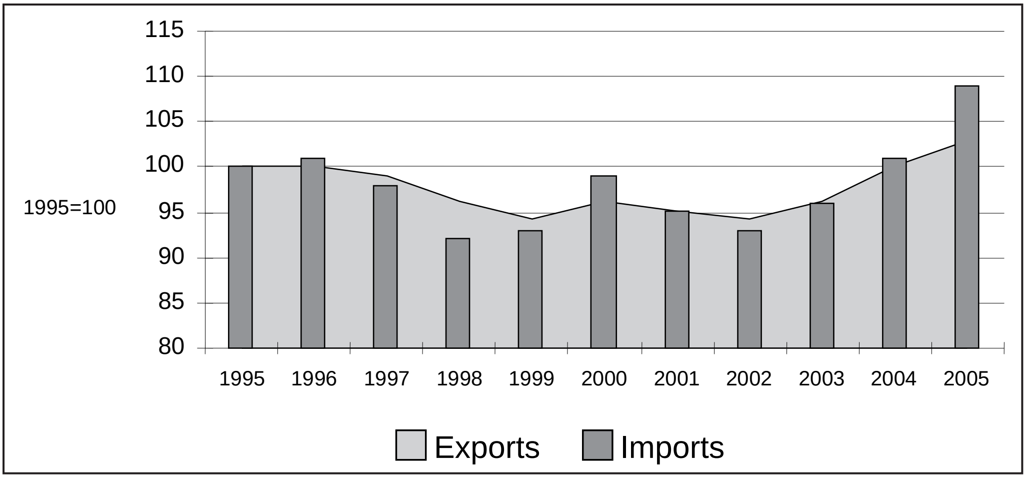
Still, export prices grew by only 3%, while import prices grew by 9%, which undoubtedly contributed to the expansion of the foreign trade deficit. Thus, since prices and currency exchange depreciation increased both the foreign trade aggregates, with stronger influence having been waged on imports, it is probable that the picture of the foreign trade deficit would be somewhat more favorable if we were to annul these effects.

3.2. A comparative analysis of U.S. foreign trade

A familiar view in economic theory is that larger and economically more developed countries are less open than smaller countries more lacking in resources and production inputs, whose modest-sized markets represent a bottleneck for dynamic and sustainable long-term economic growth.[9] Thus, it makes sense to compare the opennes of countries of approximately equal size and eco-

9 Jansen, (2004), p. 2.

Graph 4: *Indexes of U.S. export and import prices*



Source: Calculated on the basis of: *International Trade Statistics 2006,* pp. 243-244.

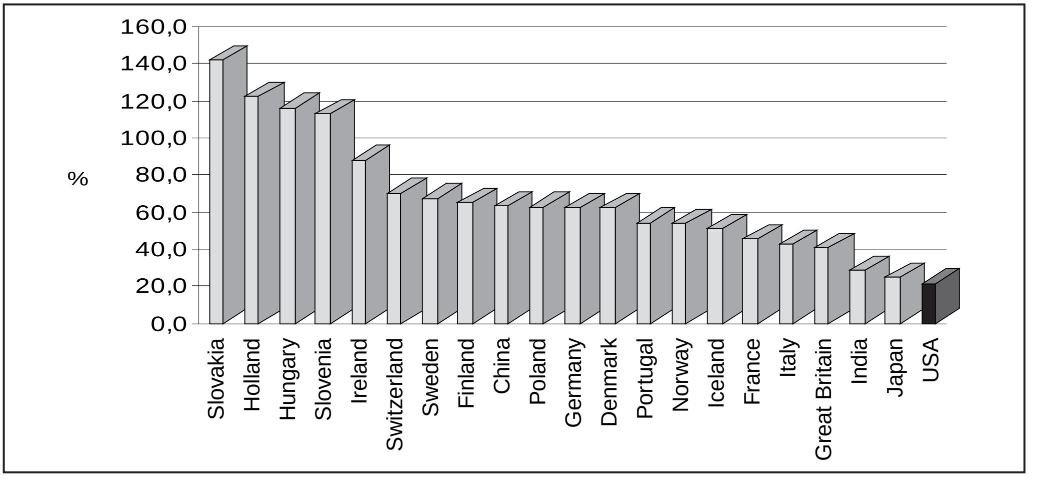
nomic development. Still, we would like to emphasize here that the characteristic of low openness is quite pronouced in the case of the U.S. If we quantify the degree of openness as a quotient of the total scale of visible trade and GDP, as is usually done, we may clearly conclude that the U.S. economy is less open not only in comparison to smaller and less developed countries but in comparison to a great majority of more developed economies (Graph 3.4).

It can be seen that Slovakia, Hungary, Slovenia, even Poland, have a significantly larger degree of openness than the majority of substantially more developed countries. The U.S. is of course at the rear end of the selected list, joined by countries such as Japan, Great Britain, Italy, France, Norway. Nevertheless, there is no dilemma that the U.S. is the most closed country.

In the previous part we saw that a significant characteristic of the U.S. foreign trade is its foreign trade deficit. It would be useful to examine just how big it is relative to other countries and whether the widely held opinion that it is too big is misplaced. On the basis of a comparative analysis of export coverage of imports (Graph 6), it can be seen that the U.S. economy, with its indicator value of 52.2%, is at the rear of the observed country sample.

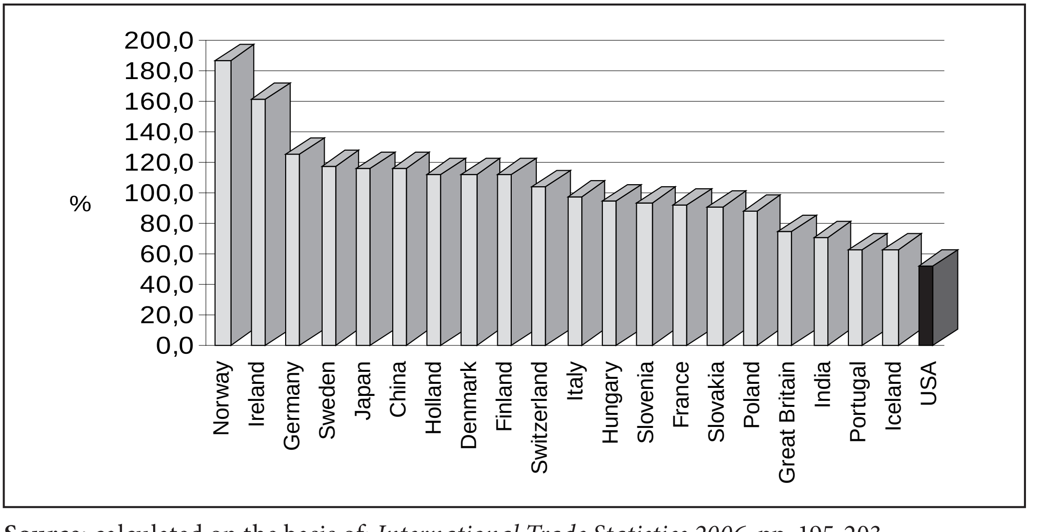
Still, is this sufficient for reaching a conclusion with a high degree of reliability that the U.S. foreign trade deficit is too large? We can provide an answer to this question on the basis of an analysis of the relationship between the foreign deficit and the GDP. Countries with greater openness most often have a larger ratio of deficit against GDP, the reason being that – if exports and imports relative to GDP are high – usually the ratio of their difference relative to GDP is also high. Thus, just as in the case of openness, it makes sense to compare by ratio of deficit to GDP countries of approximately the same level of development

Graph 5: *Degree of openness of national economies (export-import)/GDP, 2005*



Source: Calculated on the basis of: *International Trade Statistics 2006,* pp. 195-203 and web.worldbank.org.

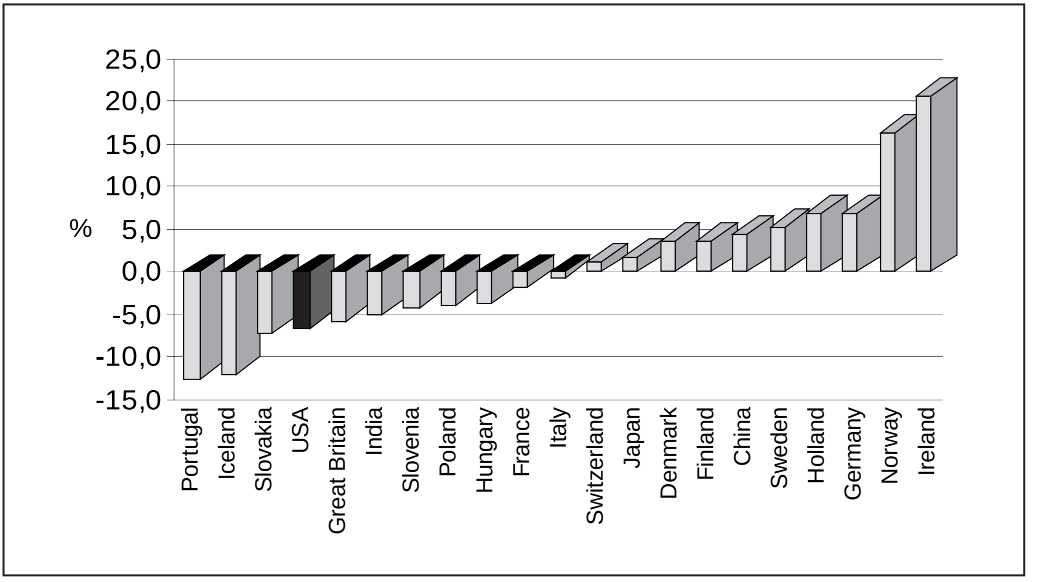
Graph 6: *Degree of export coverage of imports, 2005*



Source: calculated on the basis of: *International Trade Statistics 2006*, pp. 195-203

and size. Such an analysis (Graph 7) shows that the U.S. economy, with the value of its indicator of 6.7%, is among the lowest-ranking countries. All developed countries comparable to the U.S. either have a surplus or a smaller deficit. The only three countries with a higher deficit are Slovakia, Iceland and Portugal, which are, however, smaller and less developed, so their lower ranking is not a surprise. Moreover, countries such as Slovenia, Poland and Hungary, which are

Graph 7: *Quantitative relationship of commodity trade balance and GDP, 2005*



Source: Calculated on the basis of: *International Trade Statistics 2006*, pp. 195-203 and web.worldbank.org.

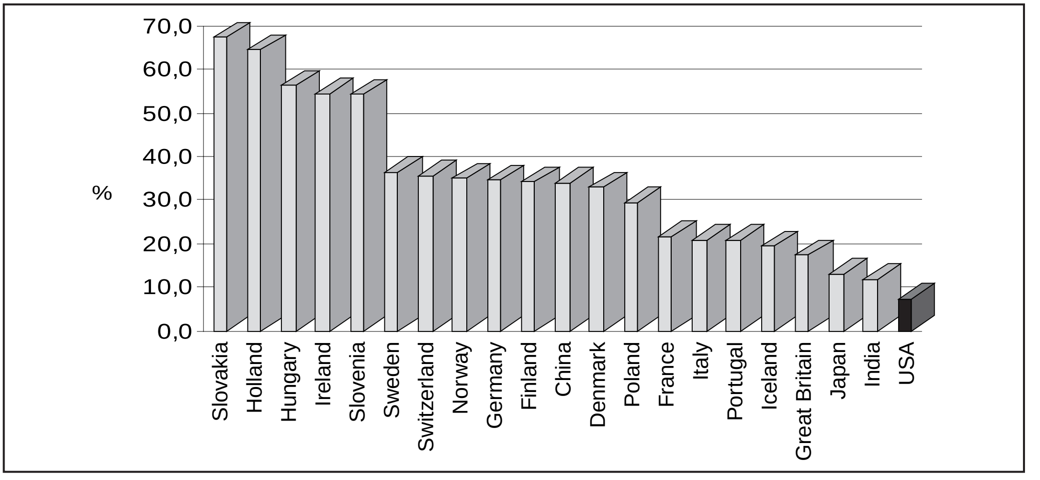
substantially smaller, less developed and, thus, more open than the U.S., and which should be lower ranked, have smaller deficits. Therefore, the result of this analysis is compatible with the analysis of the degree of import coverage with exports, and shows that the U.S deficit is very high.[10]

It would be interesting to see what it is that is causing the high U.S. deficit – whether low exports, high imports, or both at the same time. For this purpose, an analysis of export and import coefficients will be appropriate.[11] It is to be expected (Graph 8) that Slovakia, Hungary and Slovenia are ahead of most of the far more developed economies. At the same time, the U.S. has the lowest export coefficient, significantly lower than that of more developed and comparable countries. Thus, the U.S. foreign trade deficit is in large part a consequence of low commodity exports.

[10] The predominant view in professional circles is that the U.S. current deficit is high, which may be seen in: Edwards (2005); Cohen (2005); Karczmar (2004); Chinn (2004); Mann and Plück (2005) and Greenspan (www.dawn.com/2007/11/12/ebr14.htm). Still, opinions differ regarding whether this should be a cause for concern, since this primarlily depends on the possibility and sustainability of its financing.

[11] In researching foreign trade, the ratio of exports or imports relative to GDP is standardly referred to as the export or import coefficient.

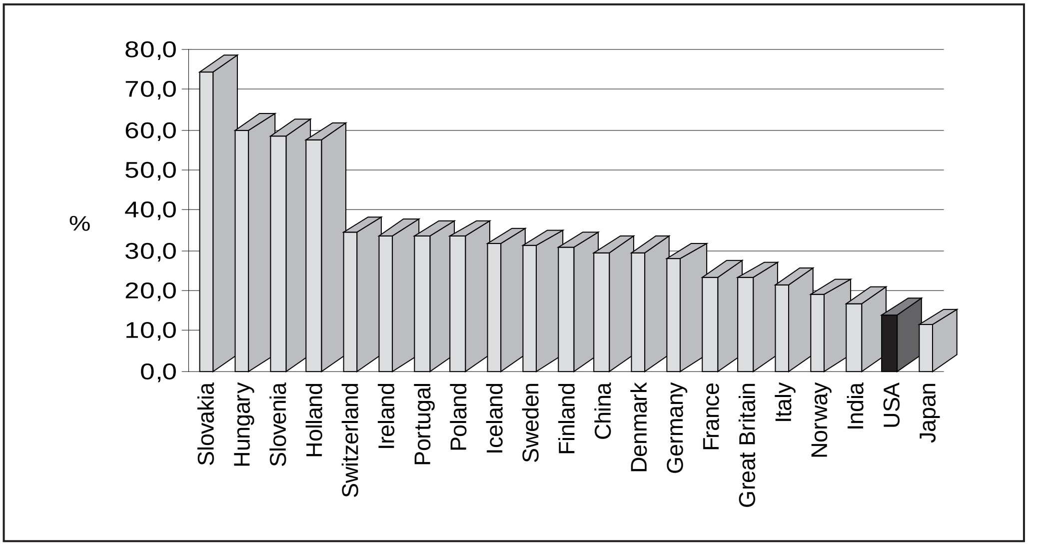
Graph 8: *Export coefficients for select countries, 2005*



Source: Calculated on the basis of: *International Trade Statistics 2006,* pp. 195-199 and web.worldbank.org.

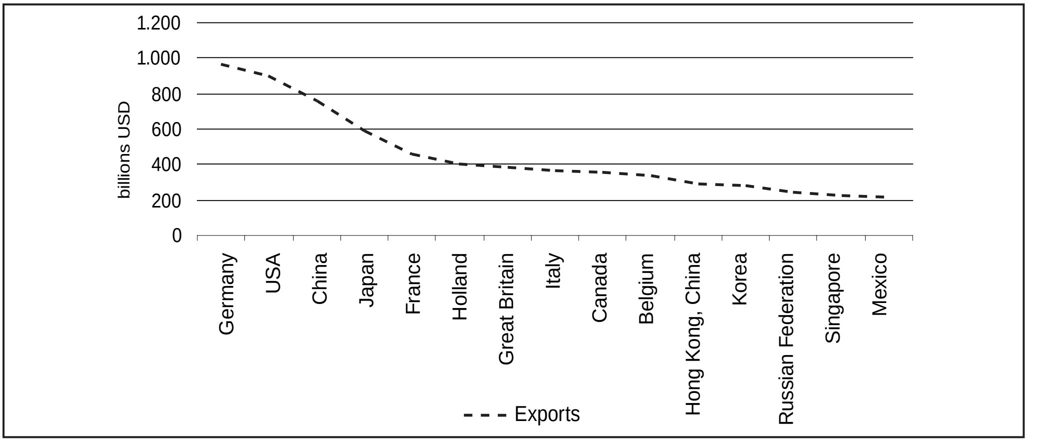
The opposite conclusion comes out of the analysis of import coefficients (Graph 9). The U.S. has relatively small imports in comparison with other developed countries, which shows that the large deficit is a result of low exports, not overly large imports.

Graph 9: *Import coefficients for select countries, 2005*



Source: Calculated on the basis of: *International Trade Statistics 2006,* pp. 199-203 and web.worldbank.org.

Graph 10: *The leading exporting countries in 2005*

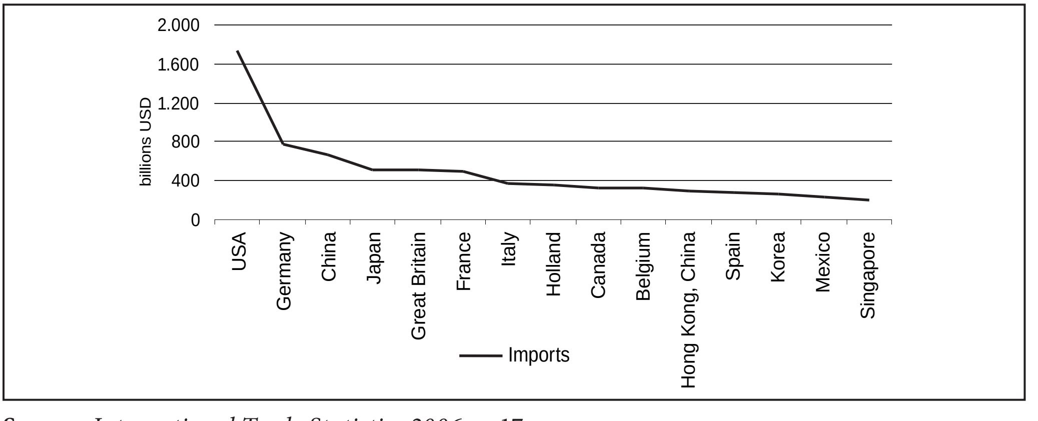


Source: *International Trade Statistics 2006*, p. 17.

Even though, as we have seen, the U.S. export coefficient is low, primarily due to the size and strength of the U.S. economy, we must also emphasize that the U.S. is the world's second-ranked exporter, after Germany (Graph 10). Other countries, including China, with its two-digit economic growth, as well as the Russian Federation, whose exports are most certainly helped by the jump in the price of oil on the global market, export significantly less than the U.S.

The situation is the same on the side of commodity imports (Graph 11). The U.S. economy is the world's leading importer. Also, the steep slope of the import curve from the U.S. to Germany shows that the U.S. is quite a bit ahead of Germany and other developed countries in this respect, which cannot be said when it comes to exports.

Graph 11: *The leading importing countries in 2005*

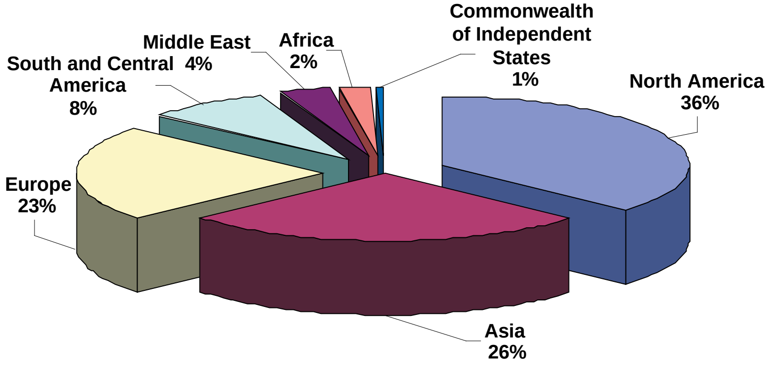


Source: *International Trade Statistics 2006*, p. 17.

3.3. Geographical structure of U.S. foreign trade

In addition to the above demonstrated characteristics of U.S. foreign trade, it is interesting to see which are the regions and countries with which the U.S. trades the most (Graph 12). There is no doubt whatsoever that the North American region is the most significant U.S. export destination, which confirms the long-known view that this is a region with pronounced intraregional trade.[12] North America is followed by the Asian and European regions. These three leading regions absorb about 85% of total U.S. commodity exports.

Graph 12: *Regional structure of U.S. commodity exports, 2005*



Source: *International Trade Statistics 2006*, p. 48.

Such a regional structure breeds the import structure by country (Graph 13). We see that Canada and Mexico are highly significant export destinations, which is in accordance with the pronounced intraregional trade. Also, the significance of the European region indicates the significance of the European Union, which absorbs 21% of U.S. commodity exports. Finally, the significance of the Asian region is reflected in the cases of Japan, China, the Korean Republic and Taipei.

The situation is similar on the imports side, except that the North American and Asian regions have switched places (Graph 14). In other words, the most important region from which the U.S. imports is Asia, followed by North America and Europe. These three regions account for about 84% of total commodity imports.

As far as countries are concerned, their significance is a reflection of the regional structure of commodity imports (Graph 15). The great significance of China, Japan, Republic of Korea and Taipei coincides with the importance of the Asian region. At the same time, Canada and Mexico, from which 27% of total commodity imports come, confirm the important role of the North American region. Also, the European Union (25) absorbs almost the entire imports from the European region.

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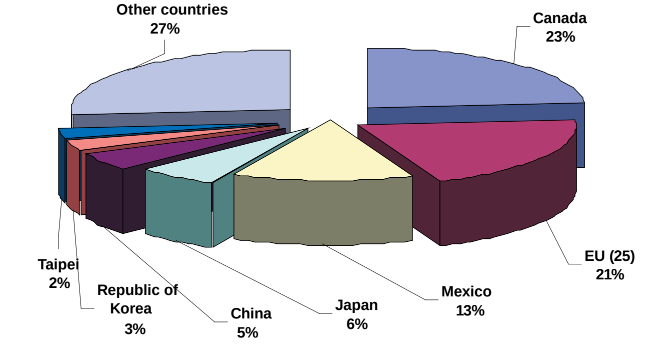
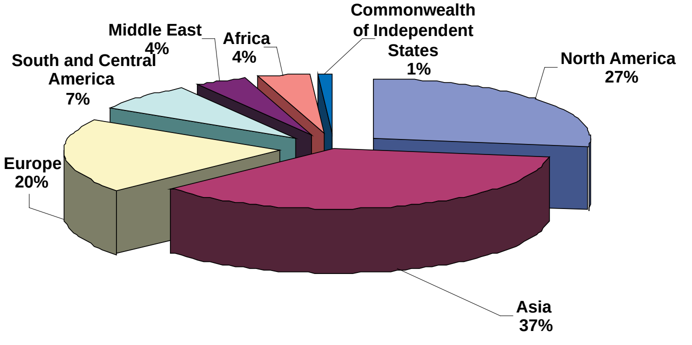
12 Kovačević (2002).

Graph 13: *Structure of U.S. commodity exports by countries, 2005*



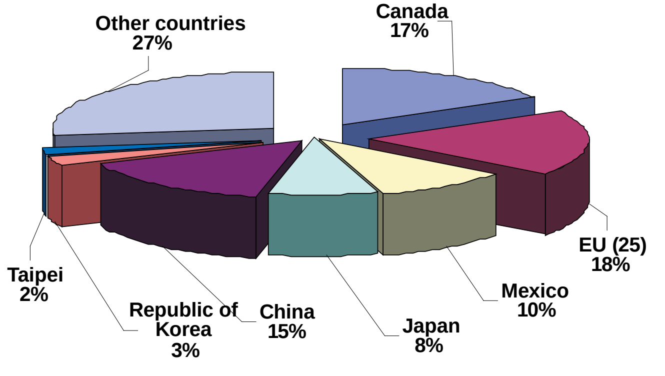
Source: International Trade Statistics 2006, p. 48.

Graph 14: *Regional structure of U.S. commodity imports, 2005*



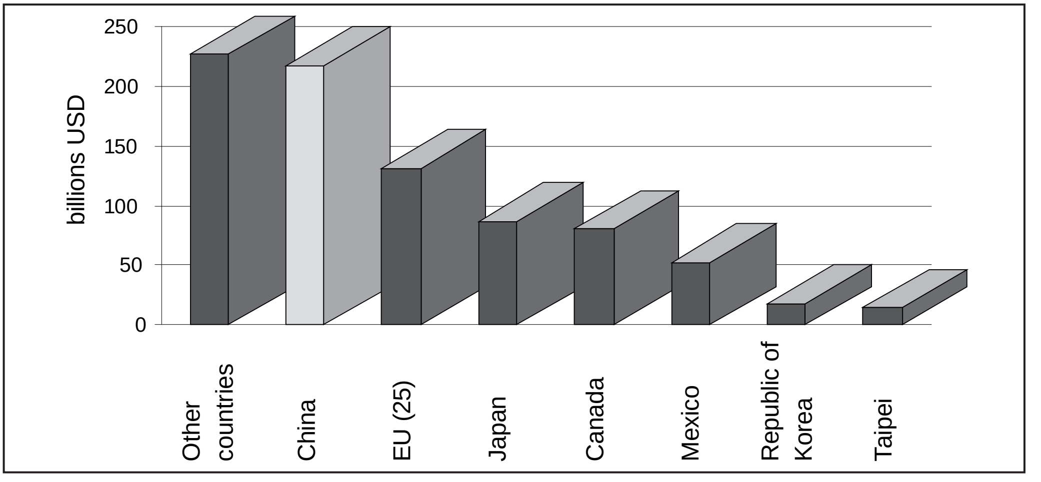
Source: *International Trade Statistics 2006*, p. 48.

Graph 15: *Structure of U.S. commodity imports by country, 2005*



Source: *International Trade Statistics 2006*, p. 48.

Graph 16: *Structure of the U.S. foreign trade deficit by country, 2005*



Source: Calculated on the basis of: *International Trade Statistics 2006,* p. 48.

Since an important characteristic of U.S. foreign trade is the large and growing foreign trade deficit, it would be useful to examine its structure by country (Graph 16).

It is generally known that one of the more sensitive issues of U.S. foreign trade, and one of the most sensitive political issues of all, is America's extremely high foreign trade deficit with China. Our analysis shows that, out of the total U.S. foreign trade deficit of 828 billion dollars in 2005, 26%, or 218 billion dollars was with China.

The U.S. foreign trade deficit with China attracts the attention of numerous scholars and officials, both in the U.S. and throughout the world. The results of one research indicate that the causes of the U.S. deficit with China are diverse.[13] Thus, numerous American businessmen, labor unions and creators of policy think that the foreign trade deficit with China is costing the U.S. jobs, since American companies are forced to face competition from Chinese imports. At the same time, there are those who think that this segment of the foreign trade deficit is a consequence of the Chinese unwillingness to accept all the demands of the World Trade Organization (WTO). Finally, some economic policy creators hold the view that the Chinese yuan is underpriced against the U.S. dollar, which reduces that price competitiveness of imports from the U.S. while increasing the price competitiveness of exports into the U.S. However, the reasons for the expansion of the American deficit with China are pretty complex and tied to macroeconomic and fiscal policies in both countries. This may be illustrated by saying that, under conditions of a growing fiscal deficit and growing total consumption without growth in domestic savings, a current accounts deficit becomes inevitable.

13 Wang and Phippen (2006), pp. 1-11.

Still, we think that it is perhaps exaggerated to say that Chinese foreign trade policy is unfair. Its accession to the WTO was quite complex and lasted about 15 years. This meant a further opening and liberalization of the economy, and the establishment of a more secure and dependable environment for trade and investments. Like the other WTO member states, China gradually removed or lowered tariff and non-tariff barriers for a large number of goods and services such as agricultural products, raw materials, automobiles. Thanks to this many American companies profited.

A common view in academic circles is that the obligations related to dumping, the undervalued Chinese Yuan and respect for intellectual property rights have yet to be fulfilled, which explains the reasons for the high U.S. deficit.[14]

The question of the undervalued Yuan is a very current question in regard to the high U.S. foreign trade deficit. From 1994 to 2005, the Chinese authorities maintained the Yuan at a fixed rate of 8.3 Yuan to the U.S. dollar.[15] In July 2005, the Yuan was allowed to appreciate by 2.1% against the dollar and it was announced that the Yuan would be tied to a basket of the leading convertible currencies, instead of just the dollar. Since then, the Yuan has appreciated by an additional 1%. However, the exchange rate continued to be a target of equally intense criticism. Numerous researchers, as well as officials from the U.S. Congress, are of the opinion that the Chinese monetary authorities are keeping the value of the Yuan at a significantly lower level than the one that would be formed in the case of a freely floating rate. Such an exchange rate policy cheapens American imports from China while, at the same time, making American exports to China more expensive, increasing the U.S. foreign trade deficit, suffocating U.S. economic activity and eliminating jobs. Economists also think that the appreciation of the Chinese Yuan would stimulate other Asian countries such as Japan, South Korea and Taiwan to a stronger appreciation of their national currencies and a reorientation to a more flexible exchange rate policy. That would have positive implications for the American economy. However, the said countries are not prepared to take such steps without the appropriate Chinese measures.

According to some estimates,[16] the Yuan is underestimated by 15-40%, which means that the U.S. would need to impose tariffs equal to the average of these two figures, or 27.5%, in order to prevent a future artificial inflation of Chinese goods' price competitiveness. There are also other views, favoring mild sanctions and a more aggressive exchange rate policy, as it is an important cause of the imbalance in trade with China. Sanctions should include refusal of certain guarantees for federal investment credits, as well as opposition to increased voting rights within the International Monetary Fund.

14 Ibidem, pp. 3-7.

15 Ibidem, pp. 7-9.

16 Ibidem, p. 8.

At the same time, there are economists both in and out of China who think that a more flexible foreign exchange policy is in accordance with China's long-term interests. If China were to focus on allowing a freer floating regime, it would gain the ability of conducting a more independent monetary policy. In that way, it could engage in a long-term stimulation of economic growth or conduct a low inflation policy. Also, the Chinese National Bank would no longer have to frequently, sometimes even intensely, intervene on the foreign currency market in order to sustain the level of the Yuan. Finally, a more free-floating rate would allow a gradual and smooth adjustment of the Chinese economy to external and internal shocks.

A debate is being waged in academic circles about whether a more flexible exchange policy for the Yuan would in any way contribute to an improvement in the U.S. foreign trade and current accounts balances. The first reason for this are doubts about whether a freer-floating rate would be the equivalent of an appreciation. If this was accompanied by a liberalization of the capital account, Chinese companies might decide to invest substantial sums of money into the American economy, which would increase demand for the dollar and annul any appreciation that might occur as a result of a freer-floating rate, perhaps even causing depreciation. The second reason is reflected in the fact that an appreciation of the Yuan does not necessarily have to result in higher prices of Chinese goods on the American market, provided that Chinese manufacturers lowered their prices in Yuan at the expense of their profits, thereby offsetting the effects of appreciation. At the same time, the appreciation of the Yuan would reduce the costs of the use of imported raw material, components and energy resources, which would compensate for the reduction in export profits and allow Chinese manufacturers to continue profitable business operations. At the end, it should also be emphasized that it is a big question as to whether the American import demand is price-elastic. Namely, it is possible that the growth in dollar prices of Chinese goods on the American market caused by an appreciation of the Yuan would not be compensated with a proportional decrease in demand, which would increase the value of U.S. imports.

Still, the U.S. should encourage Chinese reorientation toward a more flexible exchange rate regime, which is certainly more productive than threats of foreign trade sanctions.

3.4. Analysis of the U.S. balance of payments

An especially important issue is the financing of the U.S. foreign trade and current accounts deficits. Toward this end it is useful to review U.S. balance of payments data for the 2000-2005 period. The basic characteristic of the U.S. balance of payments is the growing foreign trade and current accounts deficit, which equaled about 6.3% of the GDP in 2005 (Table 2).[17] It is also interesting that the

[17] Data shown in the balance of payments related to visible trade differ from the data previously shown, due to the different covered area in the balance of payments and the statistical evidence.

current accounts deficit in 2004 equaled and in 2005 overtook the trade deficit, since the surplus in income-based transactions and commercial service trade could not finance the deficit of one-sided transfers. The commercial services trade and income-based transfers had a constant surplus and exhibited obvious fluctuations in the observed period. According to the methodology of the IMF, an income account includes collections and payments on the basis of interests on short-term and long-term credits and loans, salaries and employee compensations, and data on paid off and collected revenues from foreign direct and portfolio investments. Also, one-sided transfers are a deficit item and have a stable growth trend.

As far as the capital and the financial balances are concerned, capital transactions (net) are a negligible item, while the financial balance is very important and shows a substantial surplus. In the structure of the financial balance, far and away the most important item are private investments in securities, which have a growth trend.[18] Foreign direct investments and the bank and non-bank financial flow, whose value changes from year to year, have an incomparably smaller significance. Finally, it should be noted that foreign reserves are divided into two parts. The U.S. reserve assets (item IV) include stocks of monetary gold (excluding earmarked gold held at the Federal Reserve Bank for foreign parties), special drawing rights (SDR), reserve positions with the IMF and foreign currencies.[19] A second component of foreign reserves are foreign assets (row V), held at the Federal Reserve Bank, consisting of foreign deposits, U.S. Treasury securities and earmarked stocks of monetary gold for foreign parties, which were not previously included in the U.S. reserve assets. Also, it should be said that deposits and securities do not include deposits and securities of international and regional organizations.

If we add up the positions of the balance of payments for the 2000-2005 period and set aside all the deficit items, we see that the foreign commodity trade deficit (88.3%) makes up the essence of such a conceived external deficit (Graph 17). This is followed by one-way transfers (10.8%), among which private transfers account for a deficit more than twice the size of state transfers. The remaining items (net capital transactions and statistical discrepancies) contribute negligibly to the total cumulative deficit.

Also, the balance of payments shown in this work differs from the balance shown in the original source since, for clarity's sake, we excluded foreign reserves from the financial balance, showing them in the form of the total balance, which in fact represents a change in the foreign reserves. Thus, the negative value of the foreign reserves represents their reduction as a result of the covering of the total balance of payments deficit.

18 The position of a security also holds within itself portfolio investments in stocks as proprietary securities; however, we assume here that the greatest part of this position has to do with debt securities. Such a conclusion is founded on the view that prevails in professional circles, that foreign investments in American securities (mostly debt securities) ensure the inflows of foreign accumulations that finance the current deficit and allow its growth. For more on this see: Edwards (2005), pp. 5-9; Cohen (2005), pp. 2-4; Karczmar (2004), pp. 5-7, and Greenspan (www.dawn.com/2007/11/12/ebr14.htm).

19 www.federalreserve.gov/releases/bulletin.

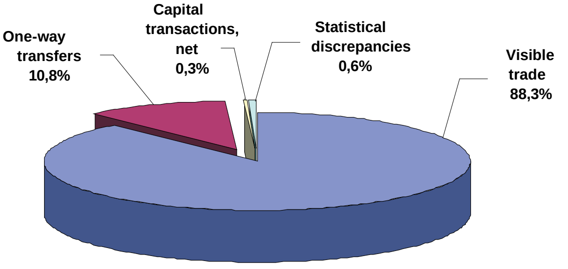
Table 2: *U.S. balance of payments, 2000-2005*

	2000	2001	2002	2003	2004	2005
	In billions of dollars					
I Current balance	-415	-389	-472	-528	-665	-792
% of GDP	-4,2	-3,8	-4,5	-4,8	-5,7	-6,3
A Balance of goods and services	-378	-363	-421	-495	-611	-717
Visible trade	-452	-427	-482	-547	-665	-783
Exports	772	719	682	713	808	895
Imports	-1.224	-1.146	-1.165	-1.261	-1.473	-1.677
Trade in services	75	64	61	52	54	66
Service exports	299	286	292	303	344	381
Service imports	-224	-222	-231	-250	-290	-315
B Earnings	21	25	12	37	28	11
Revenues	351	288	271	303	375	475
Expenditures	-330	-263	-258	-266	-347	-463
C One-way transfers	-59	-51	-64	-69	-82	-86
State	-17	-12	-17	-22	-23	-31
Private	-42	-40	-46	-47	-58	-55
II Capital transactions, net	-1	-1	-1	-3	-2	-4
III Financial transactions	443	377	391	258	191	572
A Private capital	445	378	391	258	190	566
Foreign direct investments	162	25	-70	-86	-111	101
Outflow	-159	-142	-154	-150	-244	-9
Inflow	321	167	84	64	133	110
Securities	267	313	357	182	353	513
Outflow	-128	-91	-49	-147	-147	-180
Inflow	395	403	405	329	499	693
U.S. banks net flow	-16	-17	58	84	-25	-33
Non-banking capital flow	32	58	46	78	-27	-14
B Other	-1	0	0	1	2	6
IV U.S. Official foreign reserves	0	5	4	-2	-3	-14
V Foreign assets	-43	-28	-116	-278	-388	-199
VI Total foreign reserves (IV+V)	-43	-23	-112	-280	-391	-213
VII Statistical indiscrepancies	-70	-10	-29	-8	85	10

Source: *United States: 2006 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion, IMF Country Report No. 06/279,* p. 27.

The financing of the external imbalance during the observed six-year period was performed primarily through borrowing abroad (Graph 18). About 52.2% of the external deficit was financed by the net issuance of securities in which foreign private capital was invested. The second most important item are total foreign reserves, whose reduction financed 27.9% of the external imbalance. The share of the U.S. reserve assets in the deficit's financing is less than one-half of a percent, while the rest is taken up by foreign assets held at the Federal Reserve Bank, of which about 99% are U.S. Treasury securities. The rest of the external deficit is covered by the surplus in the balance of services (9.8%) and all other remaining transactions (10.2%).

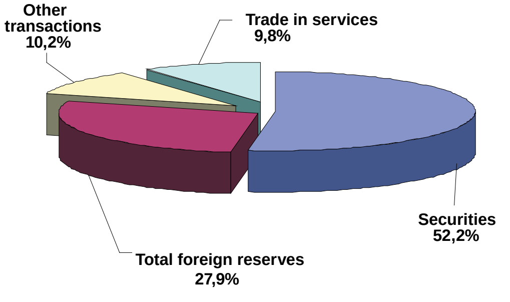
Graph 17: *Structure of the cummulatives of the total U.S. external deficit*



Source: Calculated on the basis of *IMF Country Report No. 06/279,* p. 27.

Therefore, this analysis shows that the foreign trade deficit is by far the most important component of the total external deficit, and that it is dominantly financed by borrowing from abroad, either in the form of foreign private investments in residential securities or by the emission of U.S. Treasury securities, the revenues of which are held at the Federal Reserve Bank.

Graph 18: *The financing of the U.S. external deficit*



Source: *calculated on the basis of IMF Country Report No. 06/279, p. 27.*

4. Conclusion

Several important conclusions can be drawn from the above analysis. The first is that the U.S. is either the best-ranked or at the very top of the ranking list of countries according to competitiveness of economy while, at the same time, the competitiveness of its exports has fallen significantly in the 1948-2005 period. The second conclusion has to do with the fact that the 1995-2005 period registered a slowing of growth in commodity exports and an accelerated growth in commodity imports, which resulted in an accelerated growth of the foreign trade deficit. Thus, the basic characteristic of the U.S. balance of payments is the large and growing foreign trade and current accounts deficit, whose growth was partly influenced by a greater increase in the prices of imported articles than of exported ones, in the essential sense, and the nominal depreciation of the U.S. dollar, in the accounting sense. The American economy is, as expected, fairly closed, while the size of its foreign trade deficit is confirmed by a comparison with countries at a similar level of development. Slightly more than one fourth of the U.S. deficit comes from trade with China, and it is a consequence of low exports rather than high imports. Also, of the total external deficit, which was conceived as the sum of all the deficit items of the balance of payments, about 88% is taken up by the foreign trade deficit while, of the total foreign trade deficit, about 97% is the current balance deficit. The U.S. external deficit is primarily financed by the investment of foreign savings into U.S. securities, mostly debt securities.

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THE ROLE OF CORPORATE SOCIAL RESPONSIBILITY IN CONTEMPORARY BUSINESS*

Abstract: *The contemporary business environment is making increasing demands on companies to take full moral and legal responsibility for their activities, especially when it comes to the protection of consumer interests and environmental protection. Contemporary business philosophy assumes that an organization has to be responsible for its actions and deeds vis-à-vis all the actors in its environment. An organization's achievement of business excellence requires a fully developed corporative social responsibility. In order for domestic enterprises to become competitive on the international level, it is necessary to change ways of thinking and to adopt contemporary global standards in the area of organization management. The application of the concept of corporate social responsibility is one of the basic prerequisites for the achievement of business excellence on the part of domestic enterprises.*

Key words: *social responsibility, competitiveness, quality, excellence, knowledge*
JEL classification: L51, K32

1. A new understanding of organization

In the global economy, consumers are becoming more and more educated and informed, and, in the last ten or so years, are even becoming media owners, as the computer connected to the Internet has become a super-medium. Partners in the chain of production are also becoming ever more demanding in terms of securing development goals – the achievement of growth on the basis of building fair and partnership relations. For almost three decades, the state administrations of the world's most developed countries have been developing legal frameworks designed to stop the degradation of the human environment and natural resources, as well as improve and protect the natural environment. In the global

* According to reviewers' suggestions the paper has undergone a revision.

context, sustainable development guidelines are being defined in order to establish a balance between the goals of economic development on one side and social development on the other, while taking consideration of the need to improve and protect the natural environment. All this influences businesses to devote themselves more seriously to satisfying an ever-increasing number of interest groups in their own surroundings. Contemporary society makes more and more demands upon companies in the direction of defining their social responsibility. On the other hand, companies are absolutely aware of the fact that they have to take an affirmative attitude toward these demands.

Corporate ethics has become the supreme demand in all business undertakings, from the boardrooms of the world's biggest firms to the classrooms in business schools and colleges the world over. Ethical considerations and demands for preserving the environment will have an even greater future influence on the demand for companies' products and services. The world's biggest companies are already being faced with growing formal demands to preserve the environment and, as a result, their business thinking has become founded in consideration for these demands. Modern society demands responsibility and contribution. According to Drucker,[1] a knowledge-based organization demands that everyone take responsibility for the organization's set goals, its contributions and its behavior. All members of the organization must completely review and reconsider their achievements and contributions.

There are several definitions of corporate social responsibility. According to the World Business Council for Sustainable Development, it represents a company's devotion to contributing to the sustainability of economic development, in cooperation with the unemployed, their families, the local community and society in general, toward the goal of improving the quality of their lives. In its "Green Book," the European Union has stated that being socially responsible does not solely mean the fulfillment of legal obligations but going beyond mere law abidance and making additional investments into human capital, the environment and relations with stakeholders.[2]

Social responsibility in business is related to the obligation of companies and other business organizations to increase their positive influence and reduce their negative activity toward society. In that sense, while ethics is a matter for each individual in the business field, social responsibility is related to the influence of an organization's business decisions on society. One of the most significant principles on which modern business is based is that of an organization based on responsibility. Organizations must take responsibility for their role in society. An organization based on responsibility means that all the members of the

1 P. Drucker, *Postkapitalističko društvo*, PS Grmeč – Privredni pregled, Beograd, 1995, p. 110.

2 Savet za borbu protiv korupcije, *Korporativna odgovornost u borbi protiv korupcije*, 4/27/2006, p. 1

organization must comprehensively review and consider all their tasked achievements and contributions, and take responsibility for both.[3]

It used to be enough for companies to satisfy their basic economic goals – profit, as the basis for achieving growth and development goals. Since the 1970s, satisfying consumer demands has become an increasingly important business goal – informed consumers have become the first and the last links in the economic chain. A company must first identify consumer demands and then define ways of satisfying them. The 1990s brought the necessity of satisfying general social interests – hence, in addition to consumers and the owners of capital, in modern business a company must also satisfy a broader spectrum of ruling interests in its social environment.

There is more and more talk today about corporate social responsibility. It represents a commitment to advancing the well being of society by way of discretionary business practices and contributions at the expense of company resources.[4] The key word in this definition is *discretionary.* This is a voluntary commitment on the part of an organization and its decision to choose and apply contribution-making business practices. Some of the reasons for applying and developing social responsibility are: increase in market share, strengthening brand position, strengthening the corporate image, improving capacities for attracting and motivating employees, reducing business costs, increasing attractiveness for investors.

According to some views, we can presently observe six social initiatives acting in the domain of corporate social responsibility:

- Promoting social goals;
- Marketing tied to social goals;
- Corporate social marketing;
- Corporate philanthropy;
- Volunteer community work;
- Socially responsible business practice.[5]

The promotion of social goals assumes that companies secure financial resources, in-kind donations or other resources, for the purpose of developing consciousness about some social goal or of collecting means toward the fulfillment of that social goal. Marketing connected to social goals assumes that a company obligates itself to set aside a percentage of profits from sales of products or services in favor of a specific social goal. Corporate social marketing assumes that a company aids the development and/or execution of a campaign to change

3 D. Đorđević, Ž. Anđić, *Uvod u poslovnu etiku i pravo*, TF "Mihajlo Pupin", Zrenjanin, 2004, p. 9.

4 F. Kotler, *Korporativna društvena odgovornost*, Adižes, Novi Sad, 2007, p. 3.

5 F. Kotler, op. cit., p. 28.

behavior in order to improve health, security, the environment or the well being of society. Corporate philanthropy is a practice by which a company gives direct donations for some charitable or social cause, most often as non-repayable aid in cash or in-kind donations. Volunteer community work assumes that a company supports and stimulates its employees, as well as those employed in partner organizations, to help local social organizations and actions through volunteer work. Socially responsible business practice is a situation in which a company unilaterally adopts and implements a business practice that supports some social goal, which is supposed to improve life in the community and protect the environment.

In relation to the above, companies need to accept an advanced market philosophy, known as *social marketing*. The concept of social marketing assumes company efforts to determine the needs of the targeted market and to satisfy consumer needs more effectively and efficiently than the competition, in a way that preserves or improves the benefit of both consumers and society as a whole.

Table 1: *Differences between the concept of marketing and the concept of social marketing*

Elements / Concept	Starting point	Focus	Means	Result
Marketing concept	Market	Consumer needs	Integral marketing	Profit through satisfying consumer needs
Concept of social marketing	Macro-environment	Society's needs	Global marketing approach	Profit by achieving benefit for society as a whole

Source: *D. Đorđević, D. Ćoćkalo, Osnove marketinga, TF "Mihajlo Pupin", Zrenjanin, 2004*

The accent is placed on the macro-environment. The focus of observation is not only the consumer but society as a whole. This concept is founded on three basic elements:

- The well being of the entire society,
- Satisfying consumer needs and
- Achieving profit for the company.

Modern business conditions carry within themselves an implicit need for a global marketing approach. The end result of applying the concept of social marketing is the satisfaction of the needs of both the consumer and society as a whole, along with achieving profit for the company and increasing society's well being.

2. Corporate social responsibility

Corporate social responsibility represents *one of the pillars of an organization's business excellence*. The other two pillars of business excellence are satisfying user demands and improving business productivity. These two pillars contribute to the making of profit, but without the application of the principle of social responsibility, there is no business excellence. Business excellence assumes the development of market-oriented operations with the user being at the center of the organization's attention, constant improvements in business operations based on improving knowledge and work productivity and, finally, business operations adjusted to the demands of various local interest groups towards the goal of advancing the public interest. In that sense, the company is obligated to satisfy all the demands of the consumers, society, partners, workers and stockholders. These are, at the same time, the basic tenets of the philosophy of Total Quality Management (TQP). This concept assumes the satisfaction of consumer needs, developing the quality of business operations, employee safety, environmental protection, employee education and the creation of an organization's corporate culture. The final goal of applying the TQM concept is to improve quality of life. Viewed in this way, the entire system rests on the individual, who must become a "responsible individual," who with his work and actions contributes to increased productivity and, thus, the general well being.

A company should build and advance its relationship with the environment in which it operates. This means:

- That the public interest is the primary interest for every company;
- That the public interest is expressed through company policy;
- That company policy must be realized;
- That public relations are communication.[6]

The concept of corporate social responsibility has been standardized and today represents an integral part of integrated management systems.

The principles connected with existing definitions of corporate social responsibility consist of the following: taking part in community life, accountability, sustainability, transparency, ethical behavior (without corruption), honesty and inclusion. Socially responsible companies adhere to the "triple result" approach, keeping in mind the social, economic and environmental influence of their business operations.[7]

In place of a long-term building of the TQM concept, goals of political excellence can be achieved in a shorter time period on the basis of applying successive integrated

6 B. Mitrović, *O+P+P = Priručnik za upravljanje propagandom*, Beograd, 1988, p. 192.

7 Savet za borbu protiv korupcije, *Korporativna odgovornost u borbi protiv korupcije*, 4/27/2006, pp. 1-2.

management system modules, based on respect for the international standards ISO 9001, ISO 14001, ISO 18001 and SA 8000. Each of these standards contains some of the tenets of the concept of corporate social responsibility, with the SA 8000 standard being directly connected with the development of this principle.

The principles of SA 8000 (Social Accountability 8000) can be applied by all companies, regardless of their size and structure, who want to have a socially responsible workplace anywhere in the world. Companies may certify all their locations, or choose separate, specific plants for certification. By implementing SA 8000, a company can maintain respectable work conditions throughout the supply chain.

Table 2: *Standardized management system*

Nº	Name	Designation	Interested party
1.	QMS (**Q**uality **M**anagement **S**ystem)	ISO 9001:2000	User
2.	EMS (**E**nvironmental **M**anagement **S**ystem)	ISO 14001:1996	Community
3.	OH&SMS (**O**ccupational **H**ealth and **S**afety **M**anagement **S**ystem)	OHSAS 18001:1999	Employees
4.	CSRMS (**C**orporate **S**ocial **R**esponsibility **M**anagement **S**ystem)	SA 8000	Society

Social Accountability 8000 (SA 8000) is an international standard for social responsibility, created by CEPAA (Council on Economic Priority Accreditation Agency) with the goal of securing an ethical source of products and services. This standard is of a voluntary character and can be applied to any company, regardless of size and branch of operations. Also, the standard can either replace or be a supplement to companies or industries with a specific code of social responsibility. The international SA 8000 standard was created in 1997, and revised in 2001. The SA 8000 standard is based on ISO 9000, but its goal is the improvement of work conditions in factories throughout the world. These standards differ in that the SA 8000 also includes the characteristics of demands supplementary to the system. Namely SA 8000 requires the employer to secure employee wages that are sufficient for their needs, to secure a safe work environment, to refrain from employing children or forced labor, and to refrain from requiring employees to work more than 48 hours per week. SA 8000 is based on nine elements:

- Child labor
- Forced labor
- Health and safety
- Freedom of association and collective bargaining rights
- Discrimination
- Working hours
- Compensation
- System of management

Also, a company in the process of implementing SA 8000 must subsequently implement an SMS (Social Management System) in order to secure concurrence and permanent improvement in the delivery of both the above aspects. The requirements of the standard are based solely on serious conventions and recommendations of the International Labor Organization (ILO) and the Universal Declaration on Human Rights and the Convention on Rights of Children of the United Nations.

The implementation of SA 8000 standards is important for all market actors: workers, labor unions, non-governmental organizations, buyers and investors, as well as for the company itself. The implementation of the SA 8000 standard can bring a company advantages in two segments – buyer and supply. From the buyer's standpoint, advantages are related to the following segments.

- The implementation of standards leads to greater confidence in the purchased products and services, which have been produced in an attractive and safe work environment. Demands for continual improvement, the need for a regular third audit member, and certification represent a basis for improving company reputation and securing a better corporate image.
- In case the company already has its own control procedure at the place where sold products are secured, under the mane of the company or its brand, and which are produced in a way expected by today's buyers, the standard will bring them substantial reductions in the cost of control.

In the area of supply, the following benefits may be expected:

- The implementation of SA 8000 can totally reduce the costs of managing different social demands. The SA 8000 standard allows a company to get everything in one place.
- SA 8000 can also secure a better position in the labor market for the company. Genuine adherence to social and ethical standards will help companies attract well trained personnel, which is a key element of success in today's business.
- Company commitment to employee health will increase their loyalty to the company. This does not only result in increased productivity but also in better buyer relations, which in the long run leads to their greater loyalty.

In speaking about the implementation of SA 8000, it is necessary to say that its biggest users are companies in the fields of textiles, footwear, clothing, food, toys, cosmetics, and electronic products. The service and agricultural sectors are still learning about the advantages of its implementation, especially in the fields of retail sales, fast food, export agencies and high-level crop production.

According to the data of Social Accountability International, as of June 30, 2007, 1,373 plants in 64 countries had received certification. These plants encompass 66 industries with 680,903 employers. As we can see from the following table, the number of certified plants increases each year, which is an indication of employers' raised consciousness regarding the importance of creating an adequate work environment as a prerequisite of successful business operations.

Table 3: *Number of certified plants by year*

Number of certified plants by year		(%) yearly growth
2007*	1375	15
2006	1200	36
2005	881	54
2004	572	67
2003	342	79
2002	191	68
2001	114	54
2000	74	95
1999	38	375
1998	8	

* Includes only two quarters up to June 2007

Source: *www.sasaccreditation.org/certification.htm*

Looking at tables 4 and 5, it can be concluded that, at present, the implementation of SA 8000 is more prevalent in companies with up to 250 workers, whose business orientation is textiles, footwear, clothing or other forms of light industry. This is especially true for countries such as Italy, India, China, as well as Pakistan, Vietnam, Thailand. The reason for the under representation of companies from economically developed countries can be found in the insufficiently developed consciousness of their employers about the advantages of applying this concept. Also, in the majority of those countries, a significant role is played by big corporations who are not sufficiently interested in certain segments of SA 8000, such as child labor, forced labor, overtime labor, discrimination.

Table 4. *Certified plants by size*

Employed workers	Number of plants	Percent participation
> 1,000	167	12.1
251-1,000	319	23.2
51-250	418	34.3
1-50	471	34.3

Source: *www.sasaccreditation.org/certification.htm*

Table 5. *Countries with the largest number of certified plants*

Country	Number of plants
Italy	626
India	217
China	159
Brazil	91
France	8
Greece	8
Great Britain	4

Source: *www.sasaccreditation.org/certification.htm*

The principles of SA 8000 can be applied to all companies – regardless of size and structure. Companies can certify all their locations, or they can choose separate, specific plants for certification. By implementing SA 8000, a company can retain respectable work conditions throughout the supply chain.

There are two main groups that encompass the challenges of social responsibility (SR): understanding social expectations and the application of activities in the process of fulfilling those expectations. Standards can play a significant role in the promotion of these two main goals, although it is not certain whether a single standard can serve both goals equally. We can say for standardization that it creates rules, which can lead to a situation where regulations must be respected as rules, while standards as regulations within an organization are accepted voluntarily. Standardization is also used in the private sector in such a way that it becomes a business imperative. In a recent strategic document, "ISO Horizon 2010 – Standards for a Sustainable World," the ISO Central Secretariat identifies the following key elements: urgency in the development of social responsibility, encompassing economic, social and environmental aspects, where all the social participants have a role while companies and other organizations create a new orientation. Globalization and the growth of mutual linkage between countries and regions lead to a growth in the significance of international standards. However, it is important to emphasize that sustainable development is an entirely different field of action from the one with which the International Standard Organization has dealt thus far.

The International Standard Organization is working on the development of a future ISO 26000 standard, setting down guidelines for SR. The ISO 26000 standard will be intended for companies of all types, in the public and the private sector, in developed and developing countries. ISO 26000 represents an added value of the existing SR initiative, ensuring harmonization and appropriate global guidelines based on the international consensus of the main representatives of stakeholder expert groups, thus stimulating the application of SR best practices worldwide. This standard is important not only because of its relation to company products and services, and customer satisfaction, but also for doing business in a socially responsible way.

3. Corporate social responsibilities and improving the competitiveness of domestic companies

Viewed from the aspect of developing the competitiveness of domestic companies, corporate social responsibility is a business imperative in the transition process. One practical way of applying this business principle is the implementation of integrated management systems. The implementation of integrated management systems shortens the time necessary for building TQM, which opens the way for companies from less developed countries, by respecting the demands of international standards, to build business systems that would allow the creation of world-class products and the realization of business excellence goals.

It is perfectly justified for a company that wishes to achieve business excellence goals at its current level of development to choose to integrate certain management systems that are defined by individual standards.

The preparation of the IMS (Integrated Management System) concept can prove to be of great importance for companies in transition countries. Namely, since those companies need to improve their competitive abilities in the global market in a short time period, the implementation of IMS is one of the means for achieving that goal.

Speaking about the application of IMS to domestic companies, we may conclude that the process is still insufficiently developed, which has a significant bearing on their competitiveness. According to data of the International Standard Organization, of all the standards that make up IMS, the ones most represented in domestic companies are ISO 9000:2000 and ISO 14001 with 1551 companies and 84 companies, respectively. Unfortunately, this number of certified companies in the Republic of Serbia is still insufficient, especially when compared to related data for countries in the region.

One of the most frequently cited reasons for the bad situation in the application of international standards is business people's low level of knowledge about their contribution to successful business operations. It should, therefore, not be a surprise that the issue of social responsibility, i.e. the application of SA 8000 in domestic companies, is still not being adequately addressed. Namely, the economy of the Republic of Serbia is still in the process of transformation to a market economy, which means that there are still certain obstacles present, which are normal for this period of adjustment. Directors of non-privatized companies do not have a desire to introduce new concepts for improving business operations, which is a consequence of their fear for their positions. Also, the owners of privatized companies are currently more focused on profits than on long-term planning. These companies most frequently base their business strategies on a cheap labor force, which is a winning combination only in the initial period, after which other elements of the company's operations come into the foreground.

However, it is necessary to mention individual domestic companies that have accepted corporate social responsibility as one of the key directions of company operations. “Telekom Srbija” is one of the most profitable domestic companies in its field, while its social engagement is composed of the following segments: culture, sports, charity, youth, science and education. Their interest is to devote themselves to their mission in a maximally responsible way: “Creating values for all of society, while creating value for ourselves.” The financial resources they set aside are a part of their business approach. They believe that their responsibility is not only to their customers but toward society as a whole.

Toward the end of developing the implementation of SA 8000, it is, thus, necessary, for the state to actively involve itself in the initial phase, through its ministries and economic services, labor representatives and the non-governmental sector, by way of the permanent education of all the participants in the economy. Since the companies that apply the SA 8000 standard are more oriented toward textiles, footwear, clothing and other light industries, a great problem for domestic industry is caused by the unfair competition of producers of cheap textile products of Chinese origin. Namely, due to the low product price being offered to buyers, domestic companies are still not able to apply new management concepts, which is why the issue of the implementation of SA 8000 is still not being adequately addressed.

Differently from most of the domestic companies, foreign company representatives are contributing to the introduction of new business concepts in the economy of the Republic of Serbia. The foreign employers’ relationship with domestic labor unions is different from that of domestic businessmen. The examples of the privatizations of “US Steel,” and the “Beočin” and “Popovac” cement plants have shown that, even in our conditions, care can be taken regarding the workers, work conditions and environment in which the company operates, while at the same time turning a significant profit. Some companies have begun to form their own scholarship funds for students, as well as finance certain cultural activities for the promotion of specific cultural values. This is why the role of foreign company representatives is significant in the further popularization of social responsibility, since they can help develop a consciousness about the usefulness of its application through their domestic partners.

According to the data in Table 6, we can see that the countries in the region, which have finished the transition process, have succeeded in developing a series of SA 8000 standards. It can be concluded from these data that, as part of the process of Serbia’s accession to the European Union, domestic companies will be obligated to develop the concept of social responsibility.

Table 6: *Number of certified plants*

Country	Number of plants
Romania	4
Bulgaria	2
Croatia	2
Hungary	1
Slovenia	1

Source: *www.sasaccreditation.org/certification.htm*

This serves to indicate that – if the Republic of Serbia wants to be competitive with neighboring countries – it has to work much more on the solution of problems that are slowing down the implementation of IMS in the domestic economy. Thus, the following directions of activity appear to be necessary:

- Acquainting local government representatives with the significance that the application of SA 8000 will have for their economy;
- Creating a strategy for the successful promotion of the need to implement SA 8000 among domestic businessmen;
- The cooperation of domestic economic services (Serbian chamber of commerce), labor unions, and non-governmental organizations as a key factor in the development of this concept.
- Cooperation with representatives of countries that have successfully applied this concept in their economy (i.e. Italy, India, China, etc.).

Serbia used to have a great tradition of legacies, which fell into neglect with time, for various reasons. According to data from 2004, more than 70% of citizens think that philanthropy is less developed in Serbia than in EU countries. The following were listed as the reasons for this insufficient activity on the part of domestic companies:

- The bad economic situation,
- Lack of trust among the population,
- Lack of consciousness and
- The legal environment does not encourage philanthropy.

As a way of promoting and stimulating this social initiative in the domestic economy, an annual corporate philanthropy prize, the “Virtus,” has been inaugurated, in six categories: the prize for a contribution at the national level, the prize for contributing to the local community in which the company operates, the prize for a small and medium company, the prize for supporting the most innovative project of the year, as well as two separate prizes - for long-term partnership between the business and the non-profit sector and a special prize of media contribution. Most domestic businessmen have not yet succeeded in developing an appropriate relationship with other sectors of society and to take responsibility in relation to society and the community. Also, it should not be overlooked that companies in Serbia generally do not have a defined view regarding numerous social issues.

In order to better promote this concept, the Open Society Fund, Smart Kolektiv and the Chamber of Commerce of Serbia have launched the Responsible Business Initiative (RBI) project, with the aim of stimulating and institutionalizing the social responsibility of companies in Serbia. Several additional projects have also been established within the RBI project:[8] the standardization of socially responsible business operations as a recognizable framework for development through the introduction of generally accepted European/global standards of behavior; the stimulation and development of inter-sectoral cooperation between the public, for-profit and civil sectors; opening up prospects for sustainable community development and civic initiatives of civil society through a permanent and self-sustainable cooperation of the for-profit and non-profit sectors.

It is important to emphasize that, within the RBI project, a Strategy for socially responsible business and an Action Plan for its realization are to be initiated, along with the constitution of a Forum for Responsible Business in Serbia. These plans connected with the RBI project show that much will be done in the coming period on creating an environment necessary for the development of a process of implementing corporate social responsibility.

Institutions are one of the key elements in the process of creating an adequate environment for the implementation of corporate social responsibility. Stable institutions represent a basis for the further development of the remaining elements that make up an environment: regulations, strategies and the participants themselves (companies, NGOs and local governments). However, according to data from the research project "Socially Responsible Business in Serbia" of 2005, people have the most confidence in local government (21%) and the republic government (18%), and the least confidence in large multinational companies (66%), the NGO sector and business associations (56%). These data indicate that business associations are still not active and concrete enough to gain companies' trust. The usual problems connected with multinational companies in transition countries are additionally magnified in Serbia by the fact that they are the least trusted segment. However, most of the surveyed companies (43% and 41%, respectively) believe that multinational companies and NGOs work in the best interests of society, while government and parliament (18% and 12%) are the least trusted. On the subject of the general welfare, the surveyed companies place the government and parliament at the head of the list (96%), which is an indication of just how important the role of the state and its organs is in the development of the Corporate Social Responsibility (CSR) concept.[9]

8 "Inicijativa za odgovorno poslovanje Srbije", *RBI Newsletter*, no. 1, April 2005, pp. 3-4

9 "Društveno odgovorno poslovanje u Srbiji", *RBI*, Beograd, October 2005.

Most of the representatives of the surveyed companies give as their main motive for the implementation of CSR the creation of a positive image for a company, i.e. the company's successful positioning on the market. Interestingly, the following are the most frequently mentioned as the key elements of CSR: consumers (84%), employees (76%) and the local community (61%). However, the problem in the said research is the fact that only 14% of the surveyed companies view society as a whole as being the main actor of CSR. The reason for such a stance on the part of companies toward society as a whole can be found in their insufficient understanding of CSR, since everything is still being reduced to concentration on the short-term interests of the company. Since the main CSR activities of domestic companies are in the domain of philanthropy (53%), there is a disharmony with the conclusion that the primary factors in companies' CSR are consumers and employees.

Also, the disharmony between company activities and the needs of the state in the CSR domain is evident from the fact that the thrust of companies' activities lies in philanthropic actions, while the themes most needed by Serbia are philanthropic only in the most general sense: business ethics (90%), dialogue on the laws (88%) and product safety (84%). The problem lies in the lack of actors who would initiate the said themes, since companies are oriented toward their own interests. Despite the consciousness on the usefulness of applying CSR, domestic companies (slightly more than one half) feel that doing business according to the CSR code should be regulated by law, rather than being voluntary.

It is interesting to see the data related to the way in which people view the services that companies provide to them, as well as the reasons for their employment. Namely, according to the research **60% of those surveyed think that the most important element in forming an opinion about a company is quality of products and services,** followed by health protection and worker safety (48%) and respect for the law (34%). However, when seeking employment, those surveyed pay most attention to salary size (79%), health protection (53%) and fair employee treatment. Thus, it can be seen that the views of those surveyed differ depending on whether they are employees or consumers. When speaking as employees, those surveyed place less priority on quality of products and services, business ethics, and environmental protection and give greater weight to wages and work conditions. It is normal that wages and work conditions are important for employees, but problems arise when there is a large gap between these and other factors. This only shows the low development of people's consciousness about the importance that corporate social responsibility has for society, which points to a need to constantly inform them about the importance of this concept, both for society and for the people themselves.

4. Conclusion

Under modern business conditions, companies are increasingly challenged to retain their market positions. There are several reasons for this, the most serious being that the consumers themselves have changed in the sense that they have become much more demanding. The growing number of companies in the marketplace has made competition a more complex affair. As a result, companies must adjust their operations to the demands of the market, as well as constantly introduce novelties in order to retain their competitiveness. In order to build the best possible relations with both consumers and the local community, many companies have incorporated social responsibility into their business concepts. Social responsibility is becoming more and more important for companies, since this concept has brought very good results to those companies that have applied it. The end of the 1990s saw the creation of the SA 8000 standard, whose goal is to improve the employee work environment and the work process, and to open up the possibilities of free association and collective bargaining. This standard has brought an increase in the cooperation between employers and labor unions, greater care for the employee work environment as well as for health and safety at work. It is difficult for transition countries to start applying this standard, since in the majority of cases many segments are still unresolved, such as rights of association and collective work, problems of discrimination, health, safety, working hours, etc.

In the domestic economy, no company has implemented SA 8000 thus far, as opposed to other countries in the region – which says enough about these companies' competitiveness. That is why a more active role on the part of the state is needed in the promotion and implementation of this concept, through its economic services and ministries. In addition, the role of labor unions and non-governmental organizations is also important, due to the need for these bodies to educate their members about the role and significance of SA 8000 for company operations and for the economy as a whole.

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CRISIS AND CRISIS MANAGEMENT – A CONTRIBUTION TO A CONCEPTUAL & TERMINOLOGICAL DELIMITATION

Abstract: *Crisis and crisis management are relatively new concepts in Serbia, both in theory and in practice. Their implementation is accompanied by terminological confusion regarding basic phenomena – emergency situations, crises, conflicts and catastrophes, as well as various kinds of attempts at managing uncertainties and hazards. This work is an attempt at a contribution to a conceptual and terminological delimitation in this field.*

Key words: *crisis, emergency situation, conflict, catastrophe, crisis management, risk management, security management, managing area hazards, managing operation continuity*

JEL classification: D74, L29

1. Introduction

Crisis management is a relatively new concept here, both in the theoretical sense as a scientific-educational discipline and research field, and as a practical activity in private corporations, state administration, state-owned companies and organizations in the non-profit sector. Its, relative to global tendencies, belated and slow entry into the academic and practical-management sphere is accompanied by terminological confusion about basic phenomena – emergency situations, crises, conflicts and catastrophes, as well as various kinds of attempts at managing, either proactively or reactively, various kinds of hazards and uncertainties that threaten society and individual organizations and groups. Concepts are often translated literally or inadequately from the English language, and then inappropriately used, without a clear awareness of their meaning and scope. The following text does not aspire to a total elimination of unclearness,[1] but to at least a partial contribution to a conceptual and terminological delimitation in this field, as this is a prerequisite for adequate communications and understanding between theoreticians and practitioners. Toward that end we shall identify the basic concepts – crisis and crisis management and related concepts: emergency, conflict and catastrophe, i.e. environmental hazard management, risk management, emergency situation management, security management, catastrophe management and business continuity management.

2. The concept of crisis

Today, the word *crisis* is probably one of the most frequently used words in everyday speech. It is used to describe personal, i.e. private situations but, more frequently, it is used to describe a state in which society as a whole or individual organizations and systems within it find themselves, with potentially negative consequences. Still, in spite of its frequent use, the term "crisis" does not have a clear or uniform conceptual content. Instead, there are numerous and often mutually divergent interpretations.

Etymologically speaking, the word crisis comes from the Greek language. In ancient Greece the word crisis (κριςις) meant "judgment" or "decision," i.e. the decisive moment that determines the further positive or negative development of a thing or a situation. The essence of crisis is that one must decide, but that no decision has yet been made.

A misconception often appears in literature, by which the symbol for crisis in the Chinese (Mandarin) language (wei-ji) includes characters that mean "danger" (wei) and "opportunity" (ji), which results in an interpretation by which crisis is equally good and bad. Sinologists, experts in the Chinese language, point out that only the first part is true, i.e. that the logograph *wei* truly means "danger," but that the other one – *ji*, means change or turning point, and they emphasize that a much more accurate translation of this Chinese symbol is: "opportunity for danger to occur."

In present times, crisis primarily signifies discrimination or the ability to discriminate, choice, judgment, decision, but also exit, conflict resolution, clarification.[2]

The modern concept of crisis comes from medical literature, in which it designates a dangerous state of an organism's health, from which it cannot recover

1 This is, in fact, impossible to do in its entirety. The famous American sociologist of catastrophe, Enrico Quarantelli says that he spent almost forty years struggling with the attempt to conceptualize the concept of catastrophe. E.L. Quarantelli, ed., *What Is a Disaster?*, Routledge, NY/London, 1998, p. 1

2 A. Krummenacher, *Krisnmanagement*, Industrielle Organisation, Zürich, 1981, p. 3

without permanent damage, outside intervention or a fundamental restructuring, since the defense (immunological) mechanisms of the organism are not sufficient to pull it out of the crisis. Social scientists have borrowed this basic medical metaphor in order to describe crises in economic, political, social and cultural systems.

Although there is no consensus regarding its meaning, crisis is a quite popular and widely used term. It is even said that its popularity makes it more difficult to define it. This is not surprising, since the researchers who study the phenomenon of crises do not consider themselves to be crisis researchers. The crisis field is poorly defined, sort of like a confused jumble of scientists from various disciplines (sociology of catastrophe, public administration, the political sciences and international relations, political and organizational psychology, along with technical specialists such as computer scientists or epidemiologists). As to who is on the inside and who on the outside – that depends on the person defining the field. The issue is further complicated by the fact that the following terms are used for various kinds of negative or dangerous events simultaneously and often without a clear awareness about their mutual relations and delimitations of meanings or, especially in the English language, even as full synonyms for the concept of crisis:

- adversity, i.e. an emergency event caused by factors that are not under control, which endangers the lives or health of people or animals, and results in material damage;
- contingency, i.e. an event that was not predictable;
- accident, denoting a mishap caused by the human factor, including technology, which extends outside the bounds of the technical-technological plant in which it occurred;
- major incident, i.e. a state of emergency representing any event that may cause death, injuries, property damage, environmental changes, disruptions in the normal functioning of society, whose activity and consequences cannot be prevented, alleviated or remedied by available community means and capacities, and especially the terms:
    1) catastrophe (disaster) – denoting a calamity caused by natural factors, and
    2) emergency situation.

However, the meaning of these terms and the kind of response (reaction) they require, remains problematic.

There is a large body of literature dealing with crisis and, thus, many partly matching or partly divergent definitions. Crisis is much too complex a phenomenon to be easily defined. Calamity (adversity) disrupts normal conditions and creates confusion, while specialized organizations (agencies) are assigned the task of restoring everything to a normal state. However, when adversity goes beyond normal boundaries, we enter the world of crisis.

Since the phenomenon of crises has attracted the attention of a number of researchers from different scientific disciplines and fields (economics, history, politics, medicine, ecology, psychology, etc.), this means that the concept of crisis, in addition to certain general characteristics (a situation that has reached a critical point and a turning point, either toward something better or something worse), is often used in quite specific meanings characteristic for different fields of research. Thus, psychology talks about crisis of personality, medicine about crisis as the culmination of serious disease (or crisis in a country's health system), while ecology thinks about a critical threat to the environment. Even within the bounds of the same science, such as economics, there are differences regarding the use of the concept; thus, macroeconomics talks about crisis as a turn in a previously regular market cycle, and microeconomics about crisis as a condition that threatens a company, i.e. an individual economic actor.

In our efforts to harmonize various perspectives, the term *crisis* is usually used as a "universal box," i.e. as a concept that encompasses all types of negative events. In an even broader perspective, the term crisis is applied to situations that are unwanted, unexpected, unpredictable and almost unthinkable, which cause disbelief and uncertainty.

Referring to the numerous definitions in the International Encyclopedia of Social Sciences, James Robinson concludes that they are either overly precise and specific and, thus, not broadly applicable to different situations, organizations and actors or, on the other hand, that they are overly broad, i.e. unbounded in their meanings, which, in that case, makes difficult to distinguish crisis from non-crisis.

Kathleen Fearn-Banks defines crisis as a "larger event with potentially negative consequences affecting an organization, company or industry, as well as its target public, products, services or good name."[3] For Hamblin, crisis is an "urgent situation in which all the members of a group are faced with a common threat,"[4] while Pauchant and Mitroff see it as a "disruption that physically affects the system as a whole and imperils its fundamental premises, its autonomy and essence."[5] Fink claims that crisis is any event that can escalate in intensity, become the focus of attention of the media and the government, obstruct normal business operations and negatively affect a company's image and profit.[6] Barton sees crisis as a "larger and unpredictable event with potentially negative consequences. This event and its consequences may cause significant damage to a company, its employees, products, services, financial state and reputation."[7]

3 K. Fearn-Banks, *Crisis Communications: A Casebook Approach*, Lawrence Erlbaum Associates Publishers:Mahwah, NJ, 1966, p. 1

4 R.L. Hamblin, "Leadership and Crisis", *Sociometry* 21, 1958, p. 322

5 Ibid

6 S. Fink, *Crisis Management: Planning for the Inevitable*, Amacom, New York, 1986

7 L. Barton, *Crisis in Organizations: Managing and Communicating in the Heat of Chaos*, South-Western Publishing Company:Cincinnati, OH, 1993, p. 2

Finally, Pearson and Clair define crisis as an "event of small probability and great consequences, which imperils the life of an organization, being characterized by unclear causes, effects and means of solution, as well as a conviction that decisions must be made quickly.[8]"

Paul t'Hart has given a contemporary definition of crisis, describing it as an "unpleasant event that represents a challenge for decision-makers, tempts them to act under conditions of imperilment, time constraint and unpreparedness." Crisis is a "serious threat to the basic structures or fundamental values and norms of a social system, which, under conditions of time pressure and very uncertain circumstances, demands the bringing of critical decisions." This definition has two important characteristics. Its significant advantage lies in the fact that it can be applied to all types of disruptions (ecological threats, breakdowns of informational-communications systems, economic crisis, intrastate conflicts, jail mutinies, regional wars, factory explosions and natural catastrophes). This very characteristic demands a multidisciplinary approach in understanding crises. Secondly, this definition directs our attention toward decision-making: crises are seen as an opportunity to make critical decisions.

Even though the suggested definition is relatively the most acceptable, it is, nevertheless, not totally unquestionable. Namely, thus understood, crisis is in a certain sense an elitist construction. Whoever holds authority or power decides whether a certain process or event represents an advance in the normal state of things or, on the other hand, its disruption. Going along with this definition, we can talk about crisis only if the participants of the event in question view a given situation as a crisis (the so-called Thomas Theorem). If, for instance, citizens or state authorities proclaim the hard position they are in as a crisis, that will decisively influence the future course of events. This subjective understanding of crisis makes it impossible to precisely demarcate its beginning and its end, since different participants perceive a given situation as a crisis in different points in time. For example, a serious chemical accident is first identified as a crisis at the plant, then on the local level and the finally on the state level. So long as the authorities charged with taking emergency measures in times of a crisis situation are not aware of the situation, the analyst cannot define such a situation by the term "crisis." Thus, the essence of things lies in the fact that crisis is not just an event per se but an event for us (Ding-fur-uns), i.e. that it assumes a subject-object relationship.

8 C.M. Pearson, J.A. Clair, "Reafirming Crisis Management", *Academy of Management Review* 23, 1998, p. 60

3. Crisis and related concepts

Crisis is often mixed up with catastrophe, conflict and emergency situation, which is why it's necessary to delimit the terms and concepts that they denote.

3.1. Emergency situation

An ***emergency situation*** is still not a crisis, although it makes extraordinary demands upon the traditional structures.[9] What matters here is that the institutional components of the system set up to battle hazardous situations are able to meet these extraordinary demands with the aid of already established mechanisms. These are perfectly understandable (comprehensible) operative situations that, if allowed to develop, can result in a serious degradation of capacities and loss of resources and/or human lives. In such situations emergency services (police, firemen, ambulance, etc.) are able to react with traditional means. During such situations, other components of the system are not disturbed to a greater extent. Thus, the distinction between the concepts of crisis and emergency situation is relatively precise and logical. The key distinctive elements are the clarity of the nature, character and dimensions of the events that exist in the case of an emergency situation but not in the case of a crisis. Differently from a crisis, an emergency situation is mainly solved by routine operative procedures within the framework of an organization's existing capacities. A second distinction is the sufficiency (availability) of resources for solving an emergency situation, as distinct from a crisis.

An emergency situation is a concept broader than that of crisis, since each crisis is at the same time a distinct situation, while each emergency situation does not necessarily have to be a crisis. Something that is merely an emergency situation (large fire, serious traffic accident) for a given social group or geographic community may be a great crisis or catastrophe for the immediate actors.

3.2. Catastrophe

The word *catastrophe* comes from the Greek word *katastrefo* (καταστρεφο), which means to turn, spin, tip over. It is most often used in the sense of disaster,

9 A distinction should be made between an emergency situation and a state of emergency – which assumes a special legal regime relatively precisely regulated by law, which is most often introduced by a special decision of the relevant state organ (government, president or parliament), which suspends the normal functioning of the government and the state administration, while citizens are warned to change their accustomed way of life or behavior in order to protect their lives and property, while state agencies are given orders to act according to plans for emergency situations, and certain citizens' liberties and rights may be limited. Reasons for the introduction of a state of emergency are usually natural catastrophes, mass civil unrest or declaration or beginning of war, in which case the expression state of war is also used.

breakdown, sudden great calamity with very serious consequences in terms of human lives and material damage.

Lay people, politicians, journalists and practitioners often confuse the terms crisis and catastrophe and/or use them as synonyms. In the world of theory, however, there is a constant striving to establish and maintain the most precise possible demarcation line between these concepts that broadly encompass all kinds of previous and future calamities. The field of catastrophes is a well demarcated research field of a group of researchers (mostly sociologists and geologists), certain institutions (or individuals) that determine and execute policy (e.g. FEMA – Federal Emergency Management Agency – the U.S. federal agency for managing emergency situations) and people – practitioners – who work directly in the field. It includes academic study programs, professional magazines, gatherings and conferences. However, it must not be forgotten that crisis and catastrophe are two distinct but mutually tightly related concepts. As noted by A. Boin, "one cannot formulate a useful definition of catastrophe without an appropriate definition of crisis, since the two concepts are inseparably connected."

In order to demonstrate this, we shall present attempts at defining and contemplating catastrophe distinctly and independently from the concept of crisis. Just as in the case of crisis, there is no universal definition of catastrophe, since it is also dependent on the discipline within which it is being used. Sometimes, great human casualties, material destruction and environmental devastation, which overwhelm the abilities of the affected community to solve them, are referred to as *differentia specifica* catastrophes.

On the general level, the concept of catastrophe can be approached from four main angles:

- according to source, or original root (natural or technological),
- according to consequences (degree of loss and damage, intensity and length of time),
- according to course of events (interventions of different actors, response, organization and community capacities),
- according to degree of risk involved.

Dennis defines catastrophe as a "sudden event of small probability that, if it occurs, has important consequences in the sense of loss (human, material, financial, etc.) for a given collective and causes tensions in its social structure." A cause-and-effect link between a catastrophic event and its effects is important for the concept. Thus, a catastrophic event such as a devastating earthquake is not a catastrophe if it occurs on uninhabited Aleutian islands, but if it hits a densely populated city center – it is.

A classic definition of catastrophe with which Quarantelli dealt the most revolves around four key elements:

- description of source,
- physical damage,
- social disruption and
- negative evaluation.

Older varieties of the definition insist on sources and damage, while the newer ones insist on socially construed dimensions and social disturbances that characterize or accompany a catastrophe.

However, a question arises as to whether even a definition that combines the said elements is adequate to encompass the essence of catastrophe in today's "risk society" (Ulrich Beck), which is more characterized by an obsessive fear for security than by threat of annihilation. In modern Western societies, namely, people are so accustomed to physical security that they are disturbed by even the smallest sign of vulnerability. In a risk society even small errors or defects can cause great problems that, in the context of "invulnerability," are additionally magnified. For example, a power outage of only a few hours in a large city represents a risky situation, as most people practically have no idea about how to behave in such circumstances. The extent to which criteria and views are conditioned upon social circumstances is evidenced by the fact that events such as the crash of an "El Al" "Boeing" in an Amsterdam suburb, the explosion in Enschede in 2000 and the incident in the Wollendam disco in 2001, which had a total death toll of less than a hundred people, have been identified as catastrophes that have marked the modern history of Holland. This does not match the criteria and definitions of modern catastrophe sociologists in the US, while Chinese journalists would mark these events as something just a bit more than ordinary accidents. Similarly, scientists, politicians, journalists, the public, victims, and social activists use different terms for a single event, such as the chemical poisoning tragedy in Bhopal; thus, the responsible company, "Union Carbide" calls it an incident, the Indian government an accident, the victims a catastrophe, while social activists refer to it as a tragedy, massacre, even an industrial genocide.

Since the nature of modern catastrophes changes, increasingly becoming a product of collective reasoning instead of an exogenous agent, the definition of catastrophe must be adjusted in order to match the phenomenon it is describing. This is why present-day authors are abandoning definitions oriented toward the agents of catastrophe and, faced with modern catastrophes, shift the focus of research toward the "social construction of catastrophes" – a mysterious process through which people mark certain segments of time or collective experience as catastrophes. A shift from the objective to the subjective dimensions of catastrophe is a special challenge. It is not sufficient to say "I know a catastrophe when I see one," which is a specific version of the Thomas Theorem. Scientific reasoning demands the objectification of the subjective. Theorists of catastrophe want to know when and under what conditions do a certain percent of people agree on the characterization of certain conditions, events or time period as a catastrophe. Such an undertaking requires that theorists examine how politicians, the media, corporations, social organizations, scientists and certain social groups reach consensus (which lasts a certain amount of time) that “something” is a catastrophe. The undertaking is not at all easy, as interpretations of catastrophe change through space and time. Still, in any case, a “legalistic” definition that would objectify a catastrophe according to legal criteria is not adequate. Defining catastrophe in absolute terms (number of dead, wounded, those left without homes, water, and such) leaves too much space for endless discussions stirred by various interpretations and cultural differences. An absolute definition also negates what happens in practice. As far as public administration is concerned, a declaration about a catastrophe is more a product of politics than of an absolute measure of the number of dead and the magnitude of destruction. Moreover, a legalistic definition of catastrophe with “objective” indicators, percentages and scope cannot encompass the subjective sense of loss.

While the objective portion of the definition of catastrophe directs our attention to an undoubted and undeniable calamity (earthquake, hurricane, tsunami, flood), the subjective meaning directs us to concern ourselves with all kinds of collective reasoning and assigning of meanings to an event. The challenge is to harmonize these perspectives on collectively defined undesirable system breakdowns.

According to Perry and Quarantelli, the only solution to the said problems is the linking of the concept of catastrophe with the concept of crisis. Namely, the concept of crisis helps solve at least one problem that characterizes classical definitions of catastrophe: it does not cover only events that are clearly and undoubtedly catastrophes but also a wide array of various events, processes and time periods that cannot fit within the definition of catastrophe but whose nature certainly deserves the attention of catastrophe researchers. Since it alleviates the prerequisite of collective evaluation and, thus, opens the way for threatening situations and the problems of successfully battling hazardous events, it is applied to all processes of disturbance that demand remedial action. Of course, all the previously mentioned problems tied to denoting the concept of crisis must not be forgotten.

If we place the concepts of crisis and catastrophe under a common roof, we allow the making of distinctions between objectified processes of disturbance and subjective processes of collective reasoning, without the researcher being compelled to focus exclusively on natural catastrophes or turning into a mere observer of social trends. In such a divided concept, crisis refers to the process of observing disturbances, and catastrophe to the time when the collective evaluates that process in negative terms. In such a perspective, crisis is a “catastrophe with a bad outcome." It may be said that catastrophe represents a sub-category of the generic concept of crisis. This is a semantic reconstruction which liberates catastrophe sociologists from their objective armor and invites them to share their findings and insights with an increasing number of practitioners (including managers of profit and non-profit organizations) and scientists (political scientists, social psychologists, organization engineers, etc.) who study various types of calamities and negative events and think about the ways of battling them and of dealing with them. Catastrophe sociologists can return to the study of causes, conditions and consequences of social disturbances without worrying about questions regarding collective marking, i.e. labeling. The new paradigm only demands that they reserve the term catastrophe for a specific type of crisis, without preventing them from studying all other types of crises.

Such a common perspective leads to a more dynamic approach. Crisis does not have a clear beginning. The root of the process of disturbance represents a combination of exogenous and endogenous factors. The consequences of crisis are felt in the future; long after it was thought that the crisis has been extinguished, it could rekindle. The processes of reasoning and definition have quite different dynamics. It sometimes overlaps with the dynamics of the crisis itself, creating a widespread sense of catastrophe, which Barton describes with the concept of collective stress. Much more frequently, this process follows different time paths fragmented through space and time. Crisis is sometimes declared without clear signs of disturbance, creating an *ipso facto* crisis (or even a catastrophe) by its consequences. Or a crisis may be formally ended even though, as far as some actors are concerned, it is only at its beginning. Crisis dynamics and processes of reasoning and definition influence each other in countless ways.

This newly presented perspective demands a multidisciplinary approach. By linking the concepts of crisis and catastrophe we can encompass and classify numerous different events and processes that were long a subject of various fields of expertise. The category of catastrophe has been broadened to include all types of crises with a bad outcome.

Catastrophe is not a crisis in the traditional meaning of the word (a situation that includes within itself both threat and possibility and in which an important decision must be made within a short period of time); rather, it more likely includes managerial procedures and problems under conditions of larger emergency situations that include threats, injuries and loss of life.

Differently from crisis, which contains an ambivalent possibility of development, catastrophe is seen as a decisive turn for the worse with a destructive (lethal) outcome, whose activities are oriented toward those affected by the catastrophe and are neither predictable nor removable. They can be understood as the ultimate (extreme) expression of crisis.

In any case, a crisis that is not efficiently resolved may lead to a catastrophe. On the other hand, the same event can be a catastrophe for some actors, while having the marks of crisis for others. Thus, for example, the devastating hurricane "Katrina" (2005), which took many lives and caused significant material damage, was a catastrophe for the affected populace, while for FEMA and the US government it was a crisis, as they were faced with serious criticism and a fall in legitimacy due to their inadequate reaction to this event.

The following represent the common characteristics of catastrophes:

- a large number of victims,
- destruction and damage of material resources also affecting those employed in emergency intervention services and other response services,
- a disproportion between needs and abilities to remove and remedy the consequences,
- the appearance of various psychological reactions that may negatively influence protection and rescue activities,
- the urgency of interventions, which are automatically performed,
- the stimulation of positive human reactions in unaffected and distant areas in extending aid and solidarity.[10]

3.3. (Im)possibility of delimitation

As can be seen from the above, in practice it is often quite difficult, if not impossible to distinguish between an emergency situation, a crisis and a catastrophe. When a large-scale incident occurs, it places varying demands on certain agencies in certain time intervals. What one agency defines as a catastrophe another will define as an ongoing crisis or emergency situation. For example, in case of an airplane crash, once the casualties are taken care of, the police, the organs of investigation and the civil aviation authorities are included in the recovery operation. However, for certain social services such a situation will continue to represent an ongoing crisis in terms of resource management (reception and care of the injured, damage repairs, reestablishment of normal traffic, etc.). This illustration indicates that the nature of the ties established between social workers, ambulance services, other emergency services and volunteer organizations engaged in remedying the consequences of large incidents is dynamic and in a state of mutual construction. It is not uniformly given in advance within highly structured crisis response plans; instead, each crisis represents a unique event that requires a unique combination of needs and demands in terms of providing an adequate response.

Besides, crises occur in totally differing contexts, which makes attempts at comparison extremely difficult. Is it possible to identically make a model of a terrorist act, an epidemic of a dangerous infectious disease, or of an economic or

[10] I. Toth, "Upravljanje zaštitom i spašavanjem u katastrofama", in: *Mjere i sredstva za zaštitu od terorizma*, IPROZ, Zagreb, 2001

a political crisis? Obviously, the establishment of a comparable level of decision-making between different highly structured organizations and agencies represents a problem, especially if the hierarchy and the points at which decisions are made within them differ. If such sort of comparison was attempted between commercial and political organizations, it could turn out that an all-encompassing crisis model is practically unattainable.

In an attempt at distinguishing the concepts of emergency situation, crisis and catastrophe, Borodžić suggests the modeling of these concepts on the basis of response. Thus, emergency situations could be defined as situations that demand an urgent and highly structured response, in which risks tied to making critical decisions can be relatively precisely defined. In the conceptualization (mental modeling) of such events, the authorities are clear about what is happening (scope and nature of the incident) and what they are supposed to do (effective strategy). In an organizational sense, an emergency situation represents a hazardous situation that can be responded to with available resources and in accordance with procedures outlined in appropriate plans. For example, in case of fire in a building, the staff is evacuated and moved to a previously determined safe location. If the response to an emergency situation overwhelms the institutional capacity of the said organization to the extent that the newly emerged situation might cause irreversible, serious damages in essential sectors, an emergency situation transforms into a crisis.

Crises are also situations that demand an urgent response, but it is much more difficult to define the risks faced by the makers of critical decisions due to the lack of clarity and/or the complexity of the situation itself. Typical for these situations is that the effects of responses to it are unclear or become evident only after the fact. Namely, it is not clear whether the measures taken have an effect on easing the crisis. The first example, fire, can be used once again as an illustration of a crisis, but with an additional complicating (social or physical) factor that interferes with a structured response or even makes its implementation hazardous. For example, a fire has spread to a vital plant of crucial significance for the production of all the products the company produces; or to buildings containing dangerous chemicals, or explosive materials; or a fire was set by a deranged person threatening to kill the people in the burning building or the firemen.

Catastrophes are irreversible and disastrous results of badly managed emergency situations or crises. As Dombrovski says, “catastrophes do not cause effects, effects are that which we refer to as catastrophes.” In this sense they are indeed a social construction, i.e. a cultural myth granted the status of a physical phenomenon.[11] If we return once more to our example, a catastrophe would be a consequence of a fire that has completely destroyed a vital factory plant, disabled further production and the fulfillment of contracted obligations, thus bringing in question its survival and causing great material damage and a number of human casualties.

[11] Borodzicz, ibid., pp. 78-82

In fact, the definition of all the said concepts bears in mind primarily their static portion, while the dynamic component has been neglected. From the standpoint of practical action, it is quite difficult to draw clear and precise bounds between calamity, greater calamity, accident, incident, emergency situation, crisis and catastrophe, since these are states and forms of action that are dynamic, flexible, permeating interactive, which quickly change and transform from one shape into another.

4. The concept of crisis management

The concept of crisis, as a departure from a normal order of things, came about relatively late in history, only once people realized that order and lawfulness, i.e. cosmos instead of chaos, exist in nature and society. Crisis as a departure form normalcy, i.e. the deterioration of usual functioning, was long seen as a product of a higher power or the result of divine will,[12] which means that human activities in cases of crisis came down to magic rituals (mystical attempts at taming or commanding higher powers) or religious ceremonies (sacrifice or prayer in order to appease the absolute and mystical power or to extend gratitude to it). With the onset of a rational worldview and scientific development came the first attempts of people to describe, classify, understand and explain crises and construct the most adequate ways of managing crises. Still, crisis management as a scientific-theoretical discipline and rationally conceived practice made a serious appearance on the historical scene only in the second half of the 20th century.

The origin of the term *crisis management* can be found in the political sphere. Namely, it is claimed that American president J.F. Kennedy first used this expression during the Cuban Missile Crisis of 1962, when the US-USSR confrontation caused by the installation of Soviet nuclear missiles in Cuba brought the world to the brink of World War III. It was thus that Kennedy described the managing of a serious, emergency situation.

Crisis management as a function, that is, the activities of crisis management are older than the term itself. The management of emergency situations as a formal responsibility of the US government came about through its efforts to respond to the growing fire threat in large cities during the 19th century.

Crisis management is a kind of applied management, as is, in fact, management as a whole; it is not an exact science but, rather, more of a practice guided by theory. There are numerous definitions of crisis management. Thus Gigliotti and Ronald define it as an organization's ability to act quickly, efficiently and effectively

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12 Thus, in his copious work "De Civitate Dei," St. Augustine interprets the greatest crisis of the ancient world – the fall of the Roman Empire, as the result of divine will, i.e. the fact that Rome was a *civitas terrena* (an earthly state that was the work of the devil), and not a *civitas Dei* (state of God).

in possible operations aimed at reducing threats to human health and security, reducing damage to public or corporate property and reducing negative influences on the continuation of normal business or other operations.[13] Similar conceptual approaches have been recommended by other researchers as well,[14] equalizing crisis management with responses to unpredictable situations (contingency operations). Although such approaches seem satisfactory when the crisis is initially identified, they can also be ineffective because they do not take into consideration many other important aspects of an integrated crisis management plan.

Crisis management can be defined as a set of functions or processes whose goal it is to identify, examine and forecast possible crisis situations and establish special means that would enable an organization to prevent a crisis or to deal with it and overcome it with minimal consequences and the fastest possible return to a normal state. Thus, crisis management is a stenographical name for all kinds of activities directed at dealing with a system in a state of disruption: prevention, preparation, alleviation, and recovery. It is a matter of modeling actions, agreements and decisions that influence the course of the crisis and encompasses organization, preparations, measures and distribution of resources for the purposes of overcoming it. Crisis management usually takes place under conditions of organizational chaos, under the pressure of numerous media, in stressful circumstances and without precise information.[15]

Crisis management is not a unique calling or profession but a theoretical concept that encompasses, in the research sense, a specific group of events (crises) that possess certain common regularities but also great mutual differences. Different professions deal with monetary crises, military tensions, terrorism, natural disasters, etc. and could hardly act efficiently in areas in which they lack expertise. However, on a certain abstract level, they can exchange experiences. The term crisis management, therefore, is not a synonym for protection and rescue, or for protection from natural and other disasters, or for civil defense, or for all these together. It encompasses a much broader social reality that exists as a theoretical concept in science and research, rather than in the real world as a system, institution or center for mastering all possible crisis events.

13 R. Gigliotti, J. Ronald, *Emergency Planning for Maximum Potection*, Butterworth-Heinemann, New York, NY, 1991

14 B. J. Varcoe, "Not us surely? Disaster recovery planning for premise," *Property Management*, vol. 11, no. 1, 1993, pp. 11-16; A.A. Alexander, R.F. Muhlebach, J. Phelps, "Emergency procedures for commercial buildings," *Journal of Property Management*, Institute of Real Estate Management, Chicago, Illinois, USA, vol. 49, no. 3, 1984, pp. 20-5; D. T. Berge, *The First 24 Hours: a Comprehensive Guide to Successful Crisis Communications*, Basil Blackwell, London, 1990

15 A. Boin, P. t'Hart, "Public Leadership in Times of Crisis: Mission Impossible," working paper at Leiden University, 2001

5. Crisis management and similar concepts

It is necessary to distinguish crisis management from linked concepts, such as environmental hazards management, emergency situation management, risk management, security management, catastrophe management, civil defense and business continuity management.

Issues management[16] refers to management of hazards in the environment, i.e. in an organization's social environment. In today's highly dynamic societies, each organization in normal (non-crisis) circumstances follows and monitors events in its environment, analyzes and evaluates all changes, deciding about what could be used as a potential advantage and what should be avoided. The concept actually came about as a result of economic corporations' strivings to deal with the pressures imposed by their critics (activists for the protection of the human environment, gender equality, consumers, etc.). It is a product of social activism and increased internal and external pressures on corporations to define and implement the concept of corporative social responsibility. It is a tool used by companies to identify, analyze and manage problems, i.e. to respond to them in their initial and development phase, before they attract public attention and become a part of public awareness. In case the organization does not react proactively to newly formed topics and problems, it will be forced to passively submit and accept new rules and guidelines brought by the government, its regulatory bodies or by professional associations. These regulations may place companies into either privileged or inferior positions. If the goal of corporate management is profit maximization and loss minimization, in a socially responsible way, issues management should be seen as a key element of an organization's entire management and planning. There are many similarities between issues management and crisis management, but there is also a difference. Issues management is less oriented toward action and more toward anticipation. Issues management is proactive in its strivings to identify the potential for change and influences the bringing of appropriate decisions before the coming changes can exert a negative influence upon the corporation. It includes looking into the future in order to spot potential trends and events that might negatively reflect on the organization's functioning without, however, the presence of acute real danger or sense of urgency characteristic of a crisis. Since the problem has the possibility of developing into a serious crisis, thinking is oriented toward *how to avoid* rather than how to solve a crisis, by scanning for problems that might arise during a specific

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16 Issue is most often defined as a "gap between corporation practice and stakeholder expectations." This has to do with a circumstance or event within or outside the organization that, if it lasts, can have a significant effect on the organization's functioning or performance and its future interests. It appears when an organization or a group assign significance to a perceived problem (or opportunity) that is a result of political, legal, economic or social trends (i.e. an increase in the number of people infected by a disease or research that uncovers a medicine's side effects).

period – problem consideration. On the other hand, crisis management is more of a reactive discipline that deals with situations and problems when they have already reached the public agenda and have affected the organization.[17]

Risk management is one of the oldest recorded human activities. Aristotle himself used to say that one should "always expect the unexpected," while the Chinese Book of Changes (*Yi-Jing*) represents one of the oldest decision-making tools still in use today. In the contemporary sense, risk management is a process of measuring or evaluating risk[18] and of developing strategies for dealing with risk. It is a matter of identifying the degree to which an organization is exposed to potential losses and choosing the most adequate way of dealing with such exposures. Generally, some of the applied strategies involve shifting risk to others, risk avoidance, reducing the negative effects of risk, or accepting some or all the consequences of a certain risk. Traditional risk management is focused on risks emanating from physical or legal sources (natural catastrophes, fires, accidents, death, judicial processes, etc.). On the other hand, financial risk management focuses on risks that can be managed by way of exchanging financial instruments. Regardless of the type of risk, all large corporations have teams and small groups for risk management and practice it both informally and formally.

In a broader sense, risk management is a part of a proactive crisis management. Depending on the angle, it might also be said that crisis management is part of a broader system of organizational risk management. It is said that risk management is the management of uncertainties. At the other extreme are certainty and activities of ongoing management, while risks are in the middle. As one moves from certainty toward uncertainty, potential risks grow. To the extent that they are not managed (since there is no such thing as bad risk management), uncertainties manage us, bringing us to the field of crisis management, followed by catastrophe management.

Catastrophe management (disaster management) involves taking measures in order to reduce or remedy the consequences that came about as a result of natural and other disasters of catastrophic proportions. It differs from risk management to the extent that catastrophe, as an event that, in principle, cannot be managed, differs from crisis. Thus, catastrophe management does not encompass the management of the event that caused the catastrophe but the minimization of its destructive consequences, i.e. the reduction of human casualties (killed and injured) and material damage. It encompasses activities before, during and

[17] M. Regester, J. Larkin, *Risk Issues and Crisis Management / A Casebook of Best Practice*, 3rd edition, Chartered Institute of Public Relations: London/Sterling, VA, 2005, pp. 40-43

[18] Risk is the measure of a possible unfavorable outcome of an event. It is a combination of an event's probability and its consequences. The difference between risk and uncertainty according to Frank Knight is the following: If you are not certain about what will happen but know the probability, that is risk. However, if you don't even know the probability, then this is uncertainty. Frank Knight in: "Risk, Uncertainty and Profit," according to: D. Keitsch, *Risikomanagement*, Schäffer-Poeschel, Stuttgart, 2000, p. 10

after a catastrophe.[19] Most often it includes rescue activities and "picking up the pieces" left behind the undesirable event. Often, and – as Borodžić points out – probably wrongly, the term emergency management (or planning) is used as a synonym. The closest concepts are probably the concepts of civil defense and of a defense and rescue system. Namely, the concept of *civil defense* (civil protection) is used with two basic meanings: a) an activity having to do with the protection and rescue of people and material goods from wartime destruction, natural and other disasters and catastrophes, and b) a system (organization) that carries out protection and rescue. A concept quite close to that of civil defense is that of societal security, which deals with the establishment and improvement of the capacities of public and private stakeholders for preparing for and responding to a wide spectrum of threats and hazards.[20] By its nature it acknowledges and integrates an entire series of related disciplines such as: resource protection (physical, environmental protection, financial, informational and human), emergency situation management, risk management, crisis management, business continuity management and recovery management. A *protection and rescue system* is a form of subject preparation and participation in responding to catastrophes and larger disasters, along with the organization, preparation and cooperation of operative protection and rescue forces in preventing, anticipating and reacting to catastrophes and the removal of possible causes and effects of catastrophes.

Security management involves making decisions about the security aims of an organizational system, about the ways and means of avoiding unfavorable security influences coming from the environment or the organizational system itself, or of lessening their harmful influence. According to traditional thinking, the role of the security manager was limited to preventing the loss of an organization's property, primarily by way of various forms of internal and external crime. The simplified concept that reduces security to the control of physical access to an organization and the monitoring of property movements has recently started to broaden to include issues of health and safety, and components of risk evaluation and management, paying attention to a broader array of risks (forgeries, terrorism, emergency situations).[21]

The management of every organization devotes special attention to security as a basic precondition of survival and prosperity. An organization's general goals, various challenges, risks and threats to which it is exposed, as well as its responsibility to the environment in terms of security, have a decisive influence

[19] It should be pointed out that an incident that is labeled as a catastrophe may carry within itself ongoing crises and emergency situations. This is because the social actors involved in responding to the catastrophe might be in a situation where they will be responding to various problems and challenges at the same time.

[20] Differently from civil protection, which treated citizens as mere objects in the concept of societal security, they are both an object and a subject who actively participates in protection.

[21] Borodzicz, E. *Risk, Crisis and Security Management*, John Wiley&Sons Ltd.:Chichester, West Sussex, 2005, p. 68

on security management, i.e. the way in which decisions tied to security will be made. We can, thus, distinguish between security management in organizations whose basic mission is the providing of security services to other users, and security management in organizations engaged in economic or social activities, where security management is in the function of the organization's preservation and growth. In addition, there are economic enterprises that have great significance for the security of the community in which they operate, either due to the significance of their products and services for the normal life of the inner or broader community, or due to the dangerous forces contained in their plants, whose damage would cause large catastrophes. In organizations engaged in offering security services to other users (state security services, etc.), security management represents a basic but not the only form of management, since such organizations also perform a series of other functions (financial, planning, personnel, developmental, etc.). Security-related tasks, at least within the corporate context, are often fragmented: the financial sector deals with financial risks, maintenance personnel deal with the organization's physical structure, a special service deals with fire protection, while the security service is charged only with dealing with what comes into or out of the organization. In case of major incidents, such fragmented responsibility has negative effects on the organization's ability to return to normal and draw lessons from the crisis. It is as though everyone is reasoning according to the principle "don't tell me what's happening because, if I know, I'll be responsible." Today, the traditional view of the security manager as the person charged solely with property loss prevention is being increasingly abandoned in favor of a significantly more all-encompassing understanding of this function.

Business continuity management (BCM)[22] is a new field of professional activity and academic studies and research, whose aim is to facilitate the relief of emergency situations, crises and catastrophes in an organization. According to Gwynne, it deals with thinking about the unthinkable or about its alleviation.[23] BCM is a holistic management process that identifies potential influences that have negative effects upon an organization and secures a framework for building capacities for recovery and an effective response that protects the interests of key stakeholders, the reputation and brand and value-building activities. BCM secures the availability of processes and resources toward the aim of securing the continued realization of an organization's key goals.

22 In the non-profit sector, the term operations continuity management is also used.

23 Borodzicz, p. 85.

6. Final note

The presented concepts of various types of actually or potentially hazardous situations and of human attempts to influence these events are labeled by different terms. We highlighted the key characteristics of each of these concepts, conscious of the fact that it is often impossible, both in theory and in practice, to draw a clear line of demarcation between them, since these are dynamic phenomena that change and transform from one into another and which, besides an objective, have a subjective side as well, having to do with human perception, regardless of whether we are dealing with direct actors, a broader circle of stakeholders, media or with public opinion as a whole. Finally, the use of certain terms is partly a matter of convention, as well as the scientific discipline, a given organization's mandate, political interests and the overall socio-cultural context from which the phenomenon is approached.

With the ending of the privatization process, the further stabilization of democratic institutions and the construction of a system of responsible public authority, along with advances in the process of Serbia's European integrations, crisis management – along with the other said concepts of managing uncertainties and hazards – will become a part of everyday life in both the public and the for-profit sectors. Bearing in mind the ancient principle "nomen est omen," it is necessary for the academic community to make an effort to develop, accept and establish the appropriate terminology. Both for the sake of clearer insights and a more adequate division of labor and because, as Saint-Exupéry's Little Prince says, "language is the source of all misunderstandings between people."

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OPENNESS OF THE WORK OF ECONOMIC ACTORS AND THE BUSINESS SECRET

Abstract: *Business operations of economic entities (companies, enterprises, entrepreneurs, etc.) under the conditions of globalization and the "rule" of the market require that various persons, both internally (owners and employees) and externally (creditors, organs of state, etc)., be adequately (totally) informed). This is a general requirement for the functioning of individual economic entities, or the economic systems to which they belong, but, more broadly, a requirement for conducting business on the international economic level. Nevertheless, the openness of economic actors is not "boundless" - it is limited by the bounds of the institution of the business secret, which protects the "intimacy" of economic actors, allowing them to maintain their competitive position in the marketplace.*

The subject of this paper is the way in which the relationship between openness and the business secret is established normatively and practically.

Key words: *economic actors, business principles, providing information, openness, business secret*

JEL classification: L15, L21

1. Legal actors in the legal system

The current domestic legal system is made up of a large number of legal actors who are organized in different ways and whose legal position is not uniformly regulated. Even a superficial analysis indicates that the greatest number of legal actors are companies whose business operations are regulated by special law.[1]

However, in addition to legal forms of business enterprises, there are also other forms of economic organization to be found in the legal system. These are enterprises formed by special law, which is provided for by the Law on Business Enterprises (ZOPD), Article 2, Paragraph 3. Also, a portion of economic activities takes place within the framework of company branches, even though these

1 Law on Business Enterprises (ZOPD in further text), "Official Gazette of RS," no. 125-04.

are not independent economic actors but parts of business enterprises that conduct their business in the "…name of and for the benefit of the company."[2]

Thus, even though various organizational forms can be recognized within the economic system, each of them is obligated to conform to certain generally applicable rules and principles in their business activity, so that the economic system may function as a coherent whole. Of course, each legal system has its own specific characteristics in accordance with that society's level of development (civilizational and economic). However, there are also some universal principles and rules whose respect is a prerequisite for the mutual connectedness and compatibility of economic systems, and whose respect, or lack thereof, can be recognized at the level of basic economic actors.

Under the conditions of globalization, which is a planetary process,[3] certain principles and rules regarding the operations of economic actors are especially emphasized. One of these is undoubtedly openness – transparency of work and operations.

2. Basic work principles of economic actors

The principle of the openness of the work of business enterprises, i.e. of economic actors in general, is emphasized along with respect for other general principles of conducting business, such as: the free exchange of labor and services, prohibition of unfair competition, respect for consumer interests, respect for business ethics. Each of the said principles has its own role and significance, but our attention is here focused on two principles: openness of work and the protection of the business secret.

When it comes to openness of the work of economic actors, the implementation of this principle became especially relevant following the "return" of companies to domestic business practice, after the long years of an economy organized according to self-management principles, as the dominant form in the economic system. The company was, thus, legally promoted as a form of economic organization, which was the result of the passing of the Law on Companies in 1988.

3. Characteristics of the principle of economic actors' openness of work

The work and the results of economic actors are the subject of various people's attentions. In the first place, these are their owners, employees and creditors. Of course, this is the first, but also the most important, circle of actors. No less of an interest exists on the part of the state and other actors. The specter of

2 Law on Business Enterprises, Article 3, Paragraph 2.

3 M. Pečujlić, *Globalizacija (dva lika sveta)*, Gutenbergova galaksija, Beograd, 2002.

interests of those interested in the work of economic actors is quite diverse, but interests of a material nature undoubtedly predominate.

The law is often, if not exclusively, a measure of various interests. In this sense, the articulation of an interest in the openness of the work of economic actors in concrete legal texts is quite justified. As an illustration, the earlier Law on Companies (1996) explicitly stated in Article 87 that the work of a company is public, specifying that the openness of a company's work is regulated by the company's statute and other general acts. It should be emphasized that the openness of a company's work is also exercised in other ways not directly and exclusively devoted to the achievement of this principle, but which confirm the need for its existence in the work of the economic actor.

Of course, an economic actor's openness of work is not and cannot be unlimited. This is a result of the fact that the economic actor has its own interests which need to be protected even from the above-mentioned people, such as owners, employees, etc. The ways in which the interests of the economic actor are protected are a matter of internal regulation within specific organs charged with running and managing the said economic actor.

In the most general sense, the limit of the economic actor's interest, which sets the bounds of the openness of its work, is the business secret, which protects the sphere of common interests within the economic actor. We shall try to explain the relationship between an economic actor's openness of work and the business secret at an appropriate place in this work. However, before that, we will shed light on the economic actor's work openness towards certain categories of people interested in its work.

3.1. An economic actor's openness of work toward the owners

An economic actor's openness of work first and foremost has to do with its owners, who cannot enjoy their essential proprietal right to oversee the economic actor without real and complete information about its work. If we examine this through the example of company owners, then it is easy to conclude that the stockholders have a right to be informed about the company's state and operations, and especially about the contents of the company's financial report.[4]

The breadth of the owner's right to be informed is not uniform. In theory and law there are two basic concepts when it comes to informing the owner: absolute and limited, and both are encountered in comparative law.

Within the framework of the absolute concept, the owner (stockholder) can at any time demand any data having to do with the operations of the economic actor. The second concept has a restrictive character, providing the owner with a limited right of being informed only about issues on the agenda of the economic actor's shareholder meeting.

[4] Law on Companies (ZOPD), Article 289, "RS Official Gazette," no. 125-04.

The domestic legal system expresses a compromise view that, in regard to certain questions, gravitates toward either one or the other concept. Namely, in Article 208, Paragraph 1, Item 1 of the ZOPD, the lawmaker grants stockholders "…the right of access to legal acts and other company documents and information." Such a broadly conceived stockholder right to (general) information regarding the work of economic actors also has a second form, expressed as "…the special information of stockholders," which covers data on the company's state and operations (the company's special financial state), the acquisition of own shares (their number and nominal value) and all the company's activities in connection with this.[5] The law has set down a general framework of the owners' rights to be informed, while its detailed elaboration has been transferred to other law sources, before all to the comany's autonomous acts.

A specific form of company work openness, i.e. of providing information to the owners, is the right to inspect certain books with data on shares and shareholders. The shareholder has the right to inspect the shareholder books and photocopy them (Article 206, Item 8 ZOPD).

Just how significant the owner's (shareholder's) right to information is can be seen in the way in which it is protected. Namely, if the owner was denied his rights to certain information concerning questions within the scope of the work of the shareholder meeting, he can demand that this be evidenced in the minutes of the meeting, along with the reasons for withholding. The owner can realize his denied right to information on certain questions judicially, within 15 days from the day of the company shareholder meeting in which the providing of the requested information was denied. It is interesting, however, that the ZOPD does not anticipate how the courts will react in the case of persons who are denied their right to information – which is certainly a shortcoming of this provision, which needs to be remedied in a future amendment to the Law.

An economic actor's work openness is especially reflected in access to its acts. It is the legal obligation of a company to make available all its acts, ranging from the founding act, to the acts of registration and operation, to acts on acquiring and keeping evidence of shares, etc., which is provided by Article 342 of the ZOPD, covering all present or former stockholders (for the period in which they were stockholders) for the purposes of photocopying and right of inspection. Shareholders can realize this right during the company's working hours, on company premises. The only condition for utilizing this right would be the identification of persons requesting inspection and providing proof of shareholder status, which depends on whether this is demanded by the company whose acts are being requested for inspection.[6]

Earlier regulations in this field, recent and less recent, also provided for the information of company stockholders. Thus, the Law on Companies (ZOP – 1996), which preceded the ZOPD, provided for the right of shareholders or their

5 The previous Law on Companies had similar provisions, Article 86, Paragraphs 1 and 2.

6 For more detail, see: Article 343, Paragraph 1 and 2 ZOPD.

agents to inspect company books and documents, in a way that would not interfere with the company's operations. This regulation provided that information of this kind was to be more closely defined by the company statute.[7]

As a rule, as empirical data shows, there is no problem between the company and the shareholder when it comes to exercising the right of access to company acts, which forms the essence of the right to information about a company's work. However, if the company, or a member of its board of directors or another responsible organ within the company, refuses to make available to a shareholder an act from ZOPD Article 342, then the shareholder, i.e. the person with the right of access can ask in out-of-court proceedings, within five days of submitting a written request to the company, for a court order allowing him to exercise his right. Court action in this case is considered as urgent, and the court is obligated to make a decision within three days of the request submission.

The information about company operations gained by the owner (shareholder) obligates him to handle it in such a way that will not be damaging for the company. Before all, this means that he cannot make it public or present it in any other way that might harm company interests.

As far as publicizing acts and confidential information about company operations, there are exceptions regulated by law, in accordance with a strict application of the principle of legality. The publicizing of the said data and information is allowed exceptionally if such an option is provided by law. Thus, the possibility of arbitrary evaluation in this sphere is excluded. The law delineates the framework within which the possessor of the said data can move.

3.2. Company openness toward employees

A separate segment of company openness is reflected in its treatment of employees, i.e. their right to being informed. This right is in the function of exercising a broader employee right, the labor right.

In practice, there are various ways in which employees are informed on matters of significance for their position within the company. The way in which they are informed depends on the character of data presented to them. Data related to employees' social position (company development plans, salary trends, work safety and security, measures for improving work conditions, changes in status, changes in company form and the founding of new companies, etc.) can be announced to them in a general way, through internal company publications (company newspapers, bulletins, etc.). Employees can also be informed about other issues provided for by the statute (Article 89 ZOPD).

A special form of employee information is carried out through the employee council, in case such an organ is formed within a given company. The employee council can demand from company management the disclosure of informa-

7 A similar solution existed in the Yugoslavian Law on Trade of 1937, §330 and further.

tion related to labor-related employee rights. Also, the employee council, after acquainting employees with facts related to concrete questions and soliciting their views, relates its own views to the company management.[8]

One way of employee information is carried out through their representatives in the company organization (board of directors, supervisory board, etc.).

3.3. Company openness toward creditors

The company forwards a certain amount of business information to interested creditors and third parties. The reasons for having an interest in this kind of information may vary; most often, these have to do with business relations that are based on this kind of data.

4. Limits of company openness

The openness of company operations is not, as we pointed out earlier, limitless. In each company's work and operations, some data are not covered by the concept of openness. More exactly, the openness of company operations is bounded by data that cannot by definition be publicized, since this would be harmful to company interests. In other words, public openness does not cover data that can be classified as a given company's business secret.

4.1. Some solutions regarding public openness from older laws and comparative legal solutions

Some solutions regarding company openness existed in earlier regulations, and can also be found in comparative law.

Thus, the Yugoslav Law on Trade of 1937 (§ 278-280) stipulated that, in case shareholders were denied information at a shareholder assembly or if they were not satisfied with the information, the assembly could bring a decision (despite opposition from dissatisfied shareholders), but that the said decision could not be executed if this was demanded by shareholders possessing at least one-tenth of the basic capital. This shareholder minority could demand within 15 days that the president of the court in which the company was registered form a special council (consisting of one judge, a senior state prosecutor and three experts from the relevant field), which would rule on whether the provided information is adequate or not. If the council were to decide that the information was satisfactory, or that it was justifiably withheld, the minority of shareholders that demanded that the execution of the assembly's decision be halted would be jointly liable for any damages the company may have suffered as a result.

8 For more detail, see ZOPD, Article 89, Paragraph 3.

This regulation also stipulated that information could be withheld in case company or public interest overrode the interest of the shareholders to receive an answer.

When it comes to third parties showing an interest for certain company data, the Law stipulated that the registry court could allow an examination of yearly accounting reports of a given company, if such persons were able to show a credible legal interest in this. Company interests were also protected by the Serbian Civil Code (SGZ), which stipulated that "a partner cannot engage in any business that would be harmful to the interests of the partnership."[9] By extension the SGZ denied the possibility of disclosing data representing the business secret of a given partnership company.

4.1.1. Company openness in English and French law

The institution of company openness is present in Anglo-Saxon as well as continental law. Thus, English law stipulates that minority shareholders within a company have the right to demand its liquidation in the case that majority shareholders denigrate their right to information in a "rough manner."

The openness of a company's work to shareholders also includes rights of shareholders who possess or represent one tenth of the company's basic capital, or a smaller portion as provided by the statute, to demand that the final accounting statements or investment decisions from the previous two years be examined by an appropriate expert. If the shareholder assembly denies this proposal or fails to bring a decision within 60 days from the day the proposal was submitted to the assembly, then the court will, upon the request of the said shareholders, appoint an expert. Once it receives the expert's report, the shareholder assembly can reconsider its stance regarding relations with company management.

Also, English law contains solutions that allow at least 200 shareholders or shareholders holding a tenth of company shares to request the trade ministry to name a court expert who will examine the company's business operations. An especially significant solution in English law is one by which the trade ministry may name a court expert to examine a stock company's business operations if there are grounds for suspicion that it is conducting business with the intention of defrauding its creditors.

In French law there are legal solutions that allow shareholders to request at any time disclosure of minutes from the three previous shareholder assemblies, along with lists of attending shareholders. Also, shareholders can examine or ask to receive annual accounts, business reports, auditing reports, certified total salaries paid, the 10 or 15 highest paid company employees. According to French law, company management must deny data disclosure if this is necessary for protecting company or public interests.

9 For further details, see the Serbian Civil Code (SGZ), §731.

As for the circle of actors with the right of requesting disclosure of data on company operations, French law equates the position of shareholders with that of bearers of commercial paper (certificats d´investissement), since it is considered that they too, even if only temporarily, have a participation in company capital.

As for informing employees, according to French law this is separately carried out by way of the company council, made up of employee representatives. Through company councils, employees are informed about questions that might be related to their position, such as, for example, the introduction of new technologies, bonuses, questions of work conditions. Also, every three months, company management informs the council about the execution of production programs, the company's financial position, and furnishes data regarding needs for new workers.

Council members also receive materials for the company shareholder assembly, leaving them sufficient time to take a position and then inform management about it, which, in turn, informs the company board of directors.

It is interesting that regulations regarding, among other things, the openness of company operations, were brought during the earliest period of the creation of European Union law. Thus, the first directive of the EEC[10] obligates a company to publish its balance sheet and income statement for each business year, along with data on persons who authorized them. In case these were not published, the EEC member-states had to provide for appropriate penalties. On the other hand, in its relations with creditors and third parties, the company had the right of safekeeping data that could be harmful to company interests and which represented business secrets.

4.2. History and contemporary understanding of the concept of the business secret

The first forms of the business secret appeared back in ancient times in the field of crafts, but this institution acquired its full meaning in capitalism, with the development of competition in the marketplace. Through this institution capitalist trading companies protected their advantages in their competitive relations with other trading companies.

With the strengthening of state intervention in economic relations, the business secret began to protect not just the individual interests of the trading companies but also the interests of the national economy as a whole, which meant that the degree of responsibility of various persons for its eventual revelation also differed.

The business secret protects not just production and other technical advantages, but also the commercial and financial advantages of a company against the competition in the marketplace. In this sense, the concept of the business secret is broader than similar concepts, such as the protection of patents and

[10] First directive of the European Economic Community (EEC), March 9, 1968, "Official Journal" No. L. 065.

other forms of industrial property. The business secret is similar to the plant (production) secret or the professional (banking, lawyer's, doctor's, etc.) secret.

The banking secret is a special kind of business secret, which protects the interests of customers, but through which the banking organization acquires economic advantages against competing banking organizations. The secrecy of savings deposits and customer accounts is guaranteed by domestic law, which best illustrates the significance of this kind of business secret.

In the post-World War II period, the institute of "know-how" began to appear in European countries, having been taken over from Anglo-Saxon law. This institution is a complex business secret, incorporating within itself a set of production, commercial, financial and other company experiences, which have a significant property value and can be transferred to others contractually, with or without compensation.

The concept of the business secret in its contemporary interpretation is and has always been a subject of legal regulation. Of course, in defining this concept the lawmaker starts from the fact that all the numerous existing companies also have differing needs for protecting some of their business operations data. For this reason the lawmakers came up with a highly flexible approach when they defined the business secret as an information "…for which it is obvious that it would cause extensive harm to the company if it were to come into the possession of a third party."[11]

The term "obvious", which was used in the said legal formulation is imprecise and leaves space for various interpretations, and that is the main shortcoming of this legal solution. In general, the legal concept of the business secret is very broadly set and requires a detailed elaboration in other autonomous acts mentioned in the law; these are the founding act, the contract between partners or company members, and the company statute (Article 38, Item 1 ZOPD).

Also, in defining the business secret, the lawmaker did not specify the kind of data in question: are these production data (production secret) or service-related data (trading secret).

By way of an earlier solution contained in the Law on Companies of 1996 (Article 90 and 91), the business secret referred to data and documents defined as business secrets by the statute, the rules and other general company acts and whose disclosure to unauthorized persons would be contrary to company operations and would bring harm to its interests and business reputation. The insufficiently precise part in this definition is the one that refers to things contrary to company operations, as it is nuclear what this essentially referred to.

For the sake of a better understanding of the concept, it should be pointed out that the domestic legal literature does not have a uniform definition of the business secret. Instead, certain elements that this concept incorporates within itself have crystallized. Most generally, this is information used with the purpose of advancing or preserving the competitive position of a given company. As such, the business

11 See Article 38, Paragraph 1 ZOPD.

secret represents a right derived from the right to engage in economic activity that cannot be revoked, since it falls into the category of personal rights. In addition to this dominant view, in our legal scholarship the business secret is also defined as a legal situation that, under stipulated conditions, enjoys legal protection.

Also present is the view that the business secret is a subjective right that excludes another's right to use the same data.

5. Departure from the obligation of protecting a business secret

We have said that the business secret is the boundary at which the openness of a company's work stops. However, there are situations in which some broader social interests require removal of the obligation to protect data that make up a business secret. In the first place, this pertains to data that are in the function of connecting and technologically advancing a company. Also, innovations that contribute to general social advancement (and are already protected as patents or inventions) cannot be treated as business secrets.

Protection of the public interest, in certain cases, requires the disclosure of information that would be considered a business secret in other situations. According to the legal definition, this pertains to the disclosure of information whose disclosure is in accordance with the law or represents a violation of the law, i.e. a violation of good business practice or principles of business ethics, or information for which there are grounds for suspecting that it represents corruption.[12] Persons who disclose data related to corruption to authorized persons or make them public in some other legal way, are not only not held responsible but "…the company is obligated to provide full protection to a person who, acting conscientiously and in good faith, reports the existence of corruption to the proper authorities."[13]

Also, it is not considered a breech of the business secret when data from a business secret are announced at sessions of a company's organ of management; however, in such a case, the authorized person is obliged to inform those present about the nature of the said data and how it should be handled.

Sometimes, although very rarely, disclosure of certain elements of a business secret may occur within the context of exercising an employee right, which is also not a violation of the business secret.

In all other cases, all employees are obliged to protect business secrets, regardless of the way in which they came into possession of the data. The obligation of keeping a business secret applies even after employment termination in the company that possesses the business secret. This obligation can be further defined in individual work contracts that the company signs with its employees.

12 Law on Companies, Article 38 Paragraph 2.

13 Law on Companies, Article 38 Paragraph 4.

Persons who have at their disposal data from a business secret and who violate the provisions about its safekeeping are responsible for the damages inflicted on the company as a result of their actions. The type and character of responsibility depend on the nature of the business secret, which is determined by relevant acts, ranging from laws to individual autonomous company acts.

In some cases, the disclosure of a business secret (having the character of a military secret) may encompass elements of certain criminal acts provided for in the Criminal Code of the Republic of Serbia.

6. Instead of a conclusion

This text attempted to explain the relationship between the institution of company work openness and the business secret, which are correlational and necessary in contemporary business and work conditions. Company work openness is undoubtedly a *causa sine qua non* of business operations. This is especially the case under conditions when a large number of companies have the need to, through transparency of work, establish an appropriate position in the marketplace, which is increasingly becoming the place where the quality of a company's work is tested and proved. Also, companies often change their organizational forms by way of mergers, which is another reason why it is necessary to become previously acquainted with their work, which is impossible if their work is not publicly open.

At the same time, we have shown that the protection of business secrets is an inevitability and a way to protect the interest and the integrity of a given company.

It is obvious, however, that, de *lege ferenda*, fewer and fewer business secrets will be so characterized and that the space for the publicly open work of companies will continue to expand, this being a result and a consequence of the globalization of business, which is becoming an unavoidable civilizational reality.

When it comes to company work openness and the business secret, the normative aspect of regulating the relations between these institutions is highly significant. A greater degree of precision in defining the contents of each of these institutions is necessary, since legal and other normative solutions – if they are imprecise – might cause unneeded confusion in their interpretation and implementation. In that case, as previously explained, it would be necessary to make needed improvements in the existing legal regulations related to the definition of the business secret (Article 38 ZOPD) and its protection (Article 451, Paragraph 1, Item 4 and Paragraph 2 of the same article), as well as the issue of information (Article 208, 209 ZOPD).

When it comes to the openness of company work, it seems that it would be necessary to define as a violation the withholding of necessary information about company operations on the part of persons charged with this duty. In any case, the Law on Companies of 1996 included such solutions, and we think that they were unjustifiably abandoned in the present Law on Business Enterprises.

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Book review
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MEDIA ADVERTISING

An essay on the book "Media Advertising"
by Professor Milivoje Pavlović, PhD, Marija Aleksić, M.A., Danica Šiljeg,
Megatrend University, 2008

Megatrend University's publishing activity, unusually dynamic and productive in the domestic university milieu, has been visibly enriched in the past several years by a new library made up of publications dealing with the most diverse aspects of cultural-artistic and media activity. Clearly, this novelty in the publishing program is a result of the efforts and strivings of the professors of the Faculty for Culture and Media, as well as of Megatrend's other institutions, to prepare relevant textbooks for their students in the shortest possible time period.

At the beginning of this year, a new title has been added to this library – "Media Advertising," written by a group of authors led by Prof. Milivoje Pavlović, Dean of the Faculty for Media and Culture. In addition to gaining a needed textbook, with this volume our academic community, as well as our broader educational and specialized public, have gained a comprehensive work written by domestic authors, one that systematically examines the phenomena of an all-important segment of media practice. The fact that it comes in the form of a textbook gives it additional value, since this will ensure its being in the service of those whose knowledge about media advertising must be clear and fundamental – primarily future media professionals, but also those whose future work will require the use of media services.

How did the phenomenon of media advertising move to the center of theoretical interests and why is the study of it important?

All media phenomena represent a significant field of interest for contemporary theoretical thought. From Benjamin, through the Frankfurt School and McLuhan, to Bodriard, the media have taken up a central spot in the ruling social theory. During the previous century, the current of social life shifted from the production sphere to the communications sphere – which is dominated by the media. Does this mean that contemporary society is no longer interested in the economic profit generated in the field of production and is now more interested in the ideological and related influences achieved through the media? Or is it the case that direct production is no longer the only, nor a very dependable and efficient field of profit-making?

The up-until-recently ruling industrial concept of economic growth is, by all estimates, obsolete and no longer produces satisfactory results. Production in and of itself no longer secures sufficient development capacities, being forced to search ever more intensely for such possibilities in the marketplace. Only market consumption and its growth can secure the sustainability of production or its further growth. Never in history have production, and the social economy as a whole, been more dependent on consumption than they are today. Thus, in a society that is more consumption than production-oriented (since those that produce also consume), the decisive battle for profit is being waged in the field of consumption, which is at the same time the dominant form of social behavior. Everything that can be placed in the service of consumption and its strengthening is desirable and welcome. In past times, the mere existence of certain products was sufficient for their immediate use in consumption. In the next stage, with the development of industrial production and market competition, the marketplace had to be offered more information about various products. Finally, once industrialization reached a high level, the introduction of goods to a highly competitive and demanding market is no longer possible without additional activities that can make a product more attractive than another in the marketplace and form a need for its consumption.

Are there better, more influential and more efficient tools for such intermediation between production and the marketplace than the mass media?

Thus we come to the reasons that explain the all-encompassing integration of the media as means of communication with the consumption sphere; as well as the use of media in marketing communications that aim to strengthen consumption, through which, conversely, production potentials are activated. The central field of this newly established practice is media advertising, which has become not only the key pillar of the media economy but has developed into that segment of media activity through which the main questions regarding the total contemporary social role of the media are filtered.

The study "Media Advertising" introduces us to these issues by offering an understanding of the essential questions regarding the use of media in advertising. Understanding the true nature of media advertising is very important, since this kind of media practice often manifests itself as a field for serious abuse of media power and influence. Nevertheless, just as media by themselves are neither good nor bad, being defined in their character and influence by the ways in which they are used, neither is advertising by itself necessarily and by definition a field for media manipulations. This circumstance brings into focus the need for a moral standpoint as the centerpiece of all media activity and, in the context of the subject at hand – of the practice of advertising itself. The pages of this study, whose purpose is to instruct future media professionals, are brimming with this explicit demand. Aware of the fact that advertising does not represent the mere use of the media toward commercial ends, but that it may be "entrusted with commercial, communicational, political, socio-cultural and other tasks," the authors do not approve of the possibility that, in the field of the free market and the liberal economy, in which ethics are often reduced to the principle of "business is business to business," some other intentions, aims and influences might be disguised by commercial motives.

The media sphere is diverse and, in this sense, the very practice of advertising assumes a diversity conditioned upon technological factors and each individual medium's potentials of expression. In their study the authors are oriented toward the so-called mass media – print, radio, television and the Internet, striving to individually highlight the specificities of each medium as far as its use in advertising is concerned.

This sort of approach has defined the study's ultimate structure, which, in addition to an introduction, contains four parts, each devoted to one of the above-mentioned mass media.

The first part is devoted to advertising in the oldest medium – print. Not only has the media sphere significantly expanded, it has, as the authors point out, fundamentally changed, which has, understandably, exposed the print media to merciless and, seemingly, unequal competition. Nevertheless, instead of confirming McLuhan's predictions about "the end of print," we are instead getting a reaffirmation of the rule by which each new medium, while doubtlessly threatening the old, also brings, according to the dialectical principle, an impulse that moves forward the processes of technological development within the existing media and, especially, their more practical and creative use. It seems that, with time, the print media have managed to strengthen their position in the newly established media context, proving themselves to be a media alternative for a continuous and more direct critical and analytical reexamination and consideration of social phenomena. Of course, print has definitely lost its previous primacy in the advertising field but, despite competition from new media and all the objective shortcomings accompanying the use of print in advertising, print media continue to base their business viability precisely on advertising revenues. This makes it all the more surprising that, in a small media marketplace such as ours, in which total daily newspaper circulation does not surpass 800,000, there is enough space for the profitable operation of such a large number of daily newspapers.

The second and third parts of the study are devoted to advertising by way of radio-diffusive media. With time, thanks to program, technological (digitalization) and organizational improvements, radio, just like print, has preserved a portion of its existing positions in the media space, and has even captured new ones.

The authors demonstrate that, by way of diverse formatting, radio has developed into a "medium that establishes dialogue", thus reserving for itself a specific niche within the framework of overall media practice – including advertising.

The authors rightly claim that television is undoubtedly "the most influential and the most popular means of mass communication," which they go on to prove by way of statistical indicators regarding the share held by this medium within the total media auditorium. The share of television in Serbia's media auditorium is 63%. According to the rules of the media's twofold economics, i.e. that the media do not just sell "words and images" to their readers, listeners and viewers but also sell their audience to advertisers, it turns out that television's share in advertising must be the largest, along with the achieved revenues. Still, the question of whether television will always be the best choice for advertisers depends on many circumstances, especially on the amount of available money. Thus, the authors are not satisfied with only a theoretical elaboration of various phenomena characteristic for the television medium and its audience. In some parts, the study transforms into a practical guide through all the procedures of television advertising.

Although in a significantly smaller scope, the study does not leave out the Internet, "the medium of all media." Along with parts dealing with the history and the way of functioning of this integration technology, the study also emphasizes this medium's increasing penetration into the field of media advertising. Nevertheless, the authors think that the use of the Internet in advertising is still modest and significantly disproportional to the number of users, which they explain by a still insufficient awareness of the possibilities that this network offers in the field of advertising.

In accordance with the good principles of advertising and sales their book affirms, the author and the publisher did not neglect to make their book-product attractive as well. The cover decorated by a Jugoslav Vlahović illustration is an attention-grabber, while also sending the following message: what may have seemed unimportant and harmless only yesterday might turn into something quite important, even dangerous. Is this not the case with advertising itself, which has evolved from a once marginal media activity into an economically powerful media field? Moreover, the broader social influences of advertising are themselves no longer considered unimportant or harmless.

The more demanding reader will not fail to note that the study abounds with linguistically and stylistically inspired passages, revealing the literary pen of Prof. Milivoje Pavlović, a long-time cultural and media professional.

Book review
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A NEW ECONOMY IN A CHANGING WORLD

Essay on the book "A New Economy in a Changing World"
by Professor Nataša Cvetković, PhD and Professor Slobodan Kotlica, PhD,
Megatrend University, 2007

Improvements and new solutions within the framework of the information-communications sector open up new possibilities for the use of the potentials of information-commuications technologies as the primary developmental movers of economic and overall social development. Technological innovations, especially wireless telephony and web-based Internet support reforms, are making information-communications potentials accessible to all the world's peoples. Globally, the information-communications sector is not only the second largest sector of the global economy but the main generator of new employment and new business undertakings, as well as the basis of a new, "knowledge-based" global economy, i.e. its basic developmental lever.

In the present-day phase of development there are few activities in which information-communications technologies do not play a direct or indirect role, transforming contemporary ways of doing business, trade and the organization of the markets themselves. Prof. Nataša Cvetković and Prof. Slobodan Kotlica undertook the writing of the monograph "A New Economy in a Changing World," precisely with this state of affairs in mind.The monograph offers an overview of the complete problematics of the new business environment and the advantages of using contemporary forms of e-business as a way of survival in an increasingly global and dynamic global marketplace. The monograph is a result of work on the project "Strategic Options of Integrating Serbia's Economy into Global Economic Flows – the Influence of Electronic Business on the Restructuring of the Domestic Market," financed by the Ministry of Science of the Republic of Serbia,, which confirms the correct choice and current relevance of the research topics financed by the Government of the Republic of Serbia.

The monograph is divided into two parts. The first, entitled "Structural Changes in a Changing World," comes from the pen of an experienced author, Prof. Nataša Cvetković, who analyzes the contemporary networked society based on the creation of profitable business networks as a basis for the creation of a national economy's future competitive advantages. The author starts from the fact that the process of globalization has interlinked countries into a multi-dimensional network of economic, social and political flows, when the markets of individual countries are becoming insufficient for the formation of optimally sized companies. It is precisely for this reason that Dr. Cvetković elaborates categories of strategic e-business options as a response to the possibility that a company will adjust to such a changed business environment, which will ultimately result in a new structure of both the national and the overall global economy.

An especially challenging research challenge for Prof. Cvetković is the successful linking of developing and transitional nations' economies into global economic flows through the method of creating profitable business networks as the fundamental means of companies' competitive advantages. These experiences are important for the author, since they can be a useful basis for the transformation of domestic companies and the overall restructuring of the Serbian economy, in line with the demands of the new, knowledge-based global economy.

Emphasis is placed on the special role of knowledge and its technological application as the only path for the integration of developing transition countries into the global economic competition. Technological advances, knowledge, education, professional training, the free flows of labor and capital, and other factors of quality are today becoming generators of growth and the creators of competitive advantages that these countries must also apply. Other paths lead to marginalization and very low possibilities for meeting the demands of increasingly selective global consumers. According to Prof. Cvetković, domestic companies must be oriented toward a permanent ability to learn as well as the fact they must base their competitive advantages on intangible property made up of experience, information and the ability to process it, know-how, management abilities, brands, image, reputation, organizational culture, loyalty, trust and consumer preference. Of course, companies can behave in such a manner only if the state creates an adequate environment that will put an accent on a development strategy calling for a permanent upgrading of the skills and knowledge of its economic organizations and its populace, and if the state concentrates economic development on "creative industries" no longer based on the collection and conversion of raw materials but on an exchange of goods that contain ideas, knowledge and information.

The author of the monograph's second part is Prof. Slobodan Kotlica, who directed his research creativity toward the study of the influence of the Internet on contemporary business models and processes, the entrepreneurial process in Internet business, the structure of the Internet business model and the dynamics and classification of the Internet business model. According to Prof. Kotlica, the success of a modern company depends on the measure in which it has adjusted its business model to the application of the Internet in all segments of its business activity. Toward that end, the author provides a description of the basic Internet business models and their characteristics. Each company that uses the Internet in its business must have its own Internet business model, i.e. the way in which it plans to achieve long-term competitive advantages and profit by using the Internet. A firm's business model is successful to the extent that it enables it to achieve greater profits relative to its competitors in its field of business. Familiarity with the said business models is an important segment of business knowledge, one that domestic company managers also must possess in order to adequately set their business strategies in accordance with the advantages offered by new IT tools and the demands made by the contemporary network economy.

The authors, Professor Nataša Cvetković and Professor Slobodan Kotlica, have very broadly encompassed and presented a series of relevant questions regarding the new and quite current issues of the e-economy, whose development is important for the work and operations of the entire domestic economy. Characterized by a clear style of presentation and interpretations grounded in references to a rich body of literature, this book can, in the first place, be of great use to the student population, as well as to managers, business people and all those who are following the processes and demands of modern competitive business.

The fact that the available domestic literature offers very few materials that explain the use and implications of contemporary IT tools in a relevant way, both in terms of greater efficiency and business profitability, as well as implications for users, who receive more quality, up-to-date and cheaper products and services – makes the contribution made by the monograph "A New Economy in a Changing World" all the more special. In this sense, its publication is a useful undertaking toward the enrichment of domestic literature dealing with the implementation of e-business in various domains of work and action, as well as an important effort in the conext of promoting the need to accept information-communications technologies as a factor of the domestic economy's success, as well as a prerequisite for the competitiveness of domestic enterprises in the European and the global marketplace.

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