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THE ECONOMIC CRISIS IN AMERICA – THE "GLORY" & THE GRIEF OF GLOBALIZATION

Abstract: *The current economic crisis that is shaking the United States and threatening the stability of the entire world with the prospect of economic collapse did not come as a great surprise to careful analysts of socio-financial tendencies in the world's leading economies. The crisis that has appeared at the beginning of this millennium is greatly reminiscent of the Great Economic Crisis of 1929. Paul Krugman, this year's Nobel Prize laureate in Economics, has pointed this out, among others.*

Using Keynesian methodology in analyzing the period preceding the Great Economic Crisis, between 1923 and 1929, one notes conspicuous similarities with the economic habits in banking and financial operations, and the loss of control over the financial system, mostly in the US, in the period at the beginning of the 21st century. What has, in fact, happened, and on what basis does Krugman draw his parallels between the Great Economic Crisis of 1929 and 1930 and the economic crisis of 2007 and 2008?

Does this not confirm yet again the "glory" and the grief of globalization as an (in)corrigible and universal phenomenon of historicity?

Key words: *economic crisis, globalization, deregulation of financial markets, state intervention, economic neoliberalism.*

JEL classification: F02, F4, G21

1. Introduction

Truly, like a "bolt from the sky," the news about the financial and economic crisis in the US have started to pour in, primarily through the print media[1] and from America itself. Some are even comparing the crisis with

[1] Truth be told, economists, professors and scholars are still hesitant to write more serious articles about the current events, for numerous reasons. It is certainly difficult to obtain sound data, but many are also confused by the newly developed situation and are reluctant

the Great Economic Crisis of 1929, among them this year's Nobel Prize winner for Economics, Paul Krugman.[2]

It seems as though Krugman is reminding us of Hegel's maxim, i.e., that we have forgotten what happened during the 1930s and, by refusing to learn from history, are making the same mistakes again. In that context, Krugman is warning us that, contrary to popular opinion, the stock market crash of 1929 was not the key moment in the Great Depression. The key moment in the Great Depression, which ***turned an ordinary recession into a collapse with civilizational ramifications, was the wave of "bank runs" in America during 1930 and 1931. The banking crisis of the 1930s showed that unregulated and unsupervised financial markets are overly prone to catastrophic meltdowns***. Nevertheless, with the passage of decades, this lesson has been forgotten and we are now learning it once more, in a harder way – concludes Krugman.

2. What happened in 1930 and 1931?

Banks seek to reconcile the opposing interests of savers and borrowers. Savers desire free access to their money, within a short period of time. The borrower seeks confidence: he does not wish to risk a sudden demand for repayment in full. Banks usually satisfy the wishes of both sides: depositors have access to their money whenever they wish, while the largest portion of the money entrusted to banks goes into long-term credits. This functions because new deposits, meaning that the bank needs only modest reserves of money on hand in order to fulfill its promises, more-or-less replace the money that is withdrawn. However, sometimes – often on the basis of mere rumors – a large number of depositors tries to withdraw money from one or more banks at the same time. Thus, the bank from which depositors want to withdraw money is left without the cash needed to meet the demand, and may fail even if the rumor turns out to be false. To make matters even worse, a "bank run" may be contagious. If depositors in one bank lose money, it is probable that depositors of a second bank will become nervous, which starts a chain reaction. And the economic ramifications may become even broader: while the surviving banks are attempting to hoard cash by stopping credit approval, a vicious circle forms, in which bank runs result in a meltdown of the credit market, causing other firms to fail, which in turn creates new problems for the banks, and so on. Briefly, that is what happened in 1930 and 1931, and that is why the Great Depression was dramatic.

to engage in more serious analyses, using the scientific methodological method, of the causes and effects of the newly occurring economic crisis.

2 P. Krugman, "Partying Like It's 1929", *New York Times*, March 21, 2008

3. What happened in 2007 and 2008?

The basis of the present-day crisis of the financial markets lies in the inadequate conditions under which loans were given and the debts that resulted from unsound credit policies. Of course, the real estate crisis is not affecting only banks. Builders and investors are also suffering large losses. The superior status of the world's leading economy, the US, began to be shaken in the summer of 2007, when the crash of the American mortgage market was announced on Wall Street. Betting that home values in America never fall, at the beginning of the millennium US bankers developed a system of high-risk credits, better known as "subprime" mortgages, which were bringing investors substantial returns – on the condition that the debtors paid off their housing credits one day. The basic characteristic of subprime mortgages is that a housing credit is offered and approved without an adequate check of the applicant's financial status. Attracted by the low initial interest rates on subprime credits, lower-class Americas were able to gain "keys to the house" with incredible ease at the beginning of the millennium. The poor but proud new homeowners usually did not pay attention to the small print in the credit contracts. Yet it was precisely there, in the barely noticeable clauses, that the fuse of the present-day financial quake was set. Namely, in order to secure themselves from losses in case of irregular mortgage payments, the American mortgage banks would exponentially raise their credit customers' interest rates. On the other hand, American lenders went ahead and repackaged mortgages into complex financial arrangements for resale to interested investors all over the world. For a long time, many of the world's central banks had almost no insight whatsoever into the rules governing the buying and selling of these credits. Even today, no one knows for certain how much money is "tied into" the risky mortgage credit scheme in the US: experts are mentioning figures of trillions of US dollars. Also, no one knows for certain as to how many commercial banks and hedge funds throughout the world have invested in the sustaining of the failed American dream of owning one's own home. Generally speaking, a great problem lies in the huge loans and home credits taken by Americans over the past 7 years, which exceed debts taken on during the 1990s by more than 3 trillion dollars, a huge figure even by today's economic standards. This led to a certain saturation of the real estate market, which meant that supply in most American states started to greatly exceed demand, except in attractive locations such as New York, Las Vegas or San Francisco, where real estate prices continue to grow due to increased demand, but are still much more affordable than those of European real estate. Testimony to that lies in the fact that, for example, a $120m^2$ house with a same-sized yard and a swimming pool at an attractive location in Miami Beach can be bought for less than 300,000 dollars.

"The financial crisis that began on the American home mortgage market is far more serious than it first seemed. The crisis is taking on increasingly serious global proportions. The current economic shock on Wall Street will, in the short term, affect Asia and Europe more than America itself but, in the long term, the US will fall into a long-term stagnation, which will last 10 to 15 years," predicts Erich Streisler, a prominent economic professor at Vienna University, for the Austrian paper *Der Standard*.[3]

"The risks and dangers for the global financial market are extremely high. The parameters of global financial business are worsening. American economic problems will affect other economies in the world, the situation requires a global response," warns Strauss-Khan.[4]

The unusual decision by the American Central Bank (FED) to directly intervene in the saving of the Bear Stearns investment bank and many other banks from bankruptcy due to losses on the US home construction market astounded stock markets throughout the world, as well as American public opinion. The FED has dished out hundreds of billions of dollars of credit to all the main Wall Street brokers, which has never happened in the history of America or its stock market. That is a clear indicator that the state has intervened in the market and that the FED is pulling out all stops in trying to prevent financial catastrophe.

Whose interests is the US central bank protecting? Of the powerful American investment banks that expected huge profits from the resale of risky mortgage credits, or the hundreds of thousands of Americans who, no longer able to repay their loans, are faced with the forced repossession of the "American Dream"?

Economics students are also confused. They are asking their professors how it was possible for a crisis of such proportions to occur in spite of the presence of so many famous economists and Nobel Prize winners, in the spite of the great advancements made by economics as a science and, especially, its mathematical and economic methods and models. They ask: is it possible that there is no formula for solving the crisis?

Stock market participants throughout the world do not understand the basis for American president George Bush's stubborn optimism regarding the strength of the US economic and financial system. President Bush's words about the healthy foundations of the American economy sound like the words of Herbert Hoover during the great Wall Street crash in 1930.

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[3] E. Streisler, "Austrian Expert: US Faced with 10 to 15 Years of Stagnation" (*Serbian translation:* "Austrijski ekspert: SAD očekuje 10 do 15 godina stagnacije"), *Der Standard*, Vienna, September 17, 2008. http://www.kim.sr.gov.yu/cms/item/news/rs.html?view=story&id=6003&sectionId=8

[4] D. Strauss-Khan, *Associated Press*, Paris, March 2008

4. The economic crisis in America and globalization

"The key word – globalization, is basically capitalism's uninterrupted and self-renewing tendency, ever since the 15th century, to establish and maintain its mastery, to spatially expand it to the entire world and to, on the basis of endless accumulation of capital, make it eternal. For the "great hegemons," it represents a continuum of the fight for survival, which brings scientific and human progress, but also hegemony and the rule of power and force. Not much new has happened during these five centuries – since the 15th century – ever since capitalism established itself and imposed its global domination, colonial or, presently, post-colonial."[5]

Today, one can write about a new "bogeyman" circulating around the planet at the end of the 20th and the beginning of the 21st century – the "bogeyman" of globalization. And this "bogeyman," like the one about which Marx and Engels wrote, is eliciting different reactions among almost all the more important scientific, ideological, cultural, social and political currents and movements in Europe and throughout the world.

Globalization has dramatically shaken the current civilizational order. This word has dramatically marked the spirit of the time at the beginning of the new millennium. Globalization does not leave anyone indifferent.

The present is symbolized by the word "globalization." Globalistic shifts are extremely powerful; they are redrawing the map of the world and resemble the movement of a speeding machine. However, the directions of the machine's movement are unpredictable, as though guided by some invisible film director who, in directing the drama of today's epoch, is pulling the many strings of our everyday lives. Still, in spite of all this, the answer to the question: what is globalization continues to be a great enigma. The answer to this question is the subject of numerous disputes, in which diametrically opposing viewpoints are being expressed.

The previously mentioned as well as the coming divisions connected with globalization are expressed in Held's famous classification into "hyperglobalists," "skeptics," and "transformationalists,"[6] as well as in the works of Z. Bauman,[7] M. Castells,[8] U. Beck[9] and A. Giddens.[10]

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5 M. Jakšić, *Globalizacija i povlačenje države*, Dom kulture "Studentski grad", Beograd, 2003, p. 97

6 D. Held, *Demokratija i globalni poredak,* "Filip Višnjić", 1997, p. 67

7 Z. Bauman, *Globalization, the Human Consequences*, Columbia University Press, New York, 1998; *In Search of Politics*, Cambridge Polity Press, 1999, p. 265

8 M. Castells, *End of Millenium,* Blackwell, Oxford, 2000, p. 45

9 U. Beck, *World Risk Society,* Cambridge Polity Press, 1999; *What is Globalization*, Cambridge Polity Press, 2000, p. 89

10 A. Giddens, *The Third Way,* Cambridge Polity Press, 1998, p. 60

At one pole are those who see in it new horizons for humanity and the finally found path to earthly paradise. Globalization is like a river, which nothing and no one can stop.

"Within the framework of the present-day institutionalization of international economic relations, the basic method and instrument of globalization is represented by the agreements signed at the Monetary and Financial Conference held in Bretton Woods in July 1944."[11]

At this conference the decision was made to establish the International Monetary Fund and the International Bank for Reconstruction and Development. These two institutions were supposed to secure international monetary and financial cooperation: the former in the field of international payments, the latter in the area of mid-term and long-term financing. The IMF and the World Bank are the most important institutions due to the fact that they have been in the center of major economic events in the world over the past two decades, including financial crises and the transition of the former socialist countries to market-based economies.

Those who convened the conference in Bretton Woods had on their minds the previously mentioned global depression of the 1930s. British economist John Maynard Keynes, who would become the key participant in Bretton Woods, offered an explanation of the crisis and an appropriate package of recipes for coming out of it. According to Keynes, the absence of sufficient aggregate demand explains the causes of economic decline. In cases when monetary policy proves ineffective, governments rely on fiscal policy, either through increased spending or tax reduction.

After the Great Economic Crisis and the Second World War, the US Congress made sure that mistakes from the times of the Great Crisis would not be repeated. A system of regulations and guarantees that provided a safety net for the financial system was adopted. And everything functioned reasonably well.

During the 1990s, Alan Greenspan, the Governor of the American Central Bank (FED), thought that, by way of a technological revolution (especially the development of the Internet), the economy had stepped into a zone of productivity in which it was possible to avoid cyclical crises.

All the usual signs of an overheating economy – a big rise in real estate prices, stocks, raw materials and a huge current accounts deficit, found a new explanation and stopped being seen as a problem. In such a "universe," it is up to the monetary authorities to secure sufficient money so that credit can continue to flow uninterruptedly to consumers. At the center of this model is the citizen who is taking on more and more debt and spending more and more. The finan-

11 I. Stojanović, "Globalizacija i strukturne promene u privredi", Proceedings from the international academic conference *Radical Changes in Companies and the Economy under the Conditions of Globalization* (Radikalne promene u preduzećima i privredi u uslovima globalizacije), Megatrend univerzitet primenjenih nauka, Beograd, 2003, p. 366

cial sector openly embraced these new ideas and, with the help of cheap money, the boundaries of greed were moved once more – ***now mortgages were being approved to uncreditworthy debtors***.

The basic initial orientation of the IMF was based on the realization that markets often do not function well. When markets do not function well, that might lead to huge unemployment. The IMF was established with the belief that collective action was needed on the global level in order to sustain economic stability.

During the years of its existence, the IMF has undergone substantial changes. Founded on the original belief that markets have often malfunctioned, the IMF has fundamentally changed and is now propagating the idea of market perfection with ideological fervor. The IMF was also founded on the belief that international pressure needed to be applied to countries so that they would conduct more expansive economic policies, such as increased spending, tax reduction or lowering interest rates in order to stimulate the economy – but the opposite is the case today. The IMF extends money from its funds only for countries who adopt policies such as deficit reduction, tax increases or raising interest rates, which are policies that lead to recession.

The most dramatic changes in these institutions occurred during the early 1980s, when Ronald Regan in the US and Margaret Thatcher in the United Kingdom were propagating the free market ideology. The IMF and the World Bank became new missionary institutions through which the ideas and ideology of the free market and market fundamentalism were imposed on poor countries, which most often had a great need for loans and donators. Finance ministers from poor countries were prepared to make various concessions in order to receive financial funds.

The said changes during the time of Ronald Regan and Margaret Thatcher gained their theoretical, practical and even ideological grounding in the "Washington Consensus," which was formulated in 1990, in the form of ten recommendations from Washington, from the IMF and the World Bank, actually intended for Latin American countries: fiscal discipline, the reallocation of public spending, tax reform, ***liberalization of financial markets***, a single exchange rate set on the basis of competitive relations, ***foreign trade liberalization, openness to foreign investment, privatization, general deregulation of all social and state flows, especially economic flows and financial markets*** and clear ownership rights. The most important recommendations were concerned with fiscal and monetary discipline, liberalization of foreign trade and investment, and all-encompassing privatization and deregulation.

Both the contents and the name of the concept became controversial. John Williamson[12] pointed out that its recommendations did not contain the free movement of capital investments, monetarism, "supply-side eco-

12 J. Williamson, *The Economic Opening of Eastern Europe*, Institute for International Economics, Washington DC, May 1991

nomics," minimal taxes and the concept of the so-called minimal state. Such a supplemented development concept, according to Williamson, was an outgrowth of the neoconservative programs of Margaret Thatcher and Ronald Regan. On the other hand, macroeconomic discipline, stability, privatization, a market economy and free trade were elements congruent with the neoliberal economists gathered around the Mont Pelerin Society and the ideas of Milton Friedman and Friedrich von Hayek.

Fiscal austerity, privatization and market liberalization[13] ***are the three carrier "pillars" of the Washington Consensus and the main economic determinants of contemporary globalization during the 1980s and 1990s.***

According to the Washington Consensus, growth is achieved through liberalization, i.e., the "liberation" of the market. Privatization, liberalization and macroeconomic stability should create a climate conducive to attracting investments, including those from abroad. Those investments generate growth. Foreign business brings technical expertise and access to foreign markets, creating new employment possibilities.

4.1. Foreign trade liberalization

The liberalization of foreign trade represents a process of reducing the role of the state in foreign economic relations and the removal of external trade barriers.

The most frequent consequence of foreign trade liberalization in underdeveloped countries is the inflow of cheap products from countries with highly productive economies. As a result, domestic industry rapidly deteriorates and jobs are eliminated. Inefficient industries are compelled to stop working, under pressure from foreign competition. The IMF viewpoint in connection with structural adjustment is that new, more productive jobs will be created parallel with the elimination of old, inefficient jobs created behind protectionist walls. However, this is not possible even theoretically, let alone in practice. The IMF has made matters even worse in many countries, as its programs of fiscal severity and restrictive credit-monetary policies have often produced high interest rates, sometimes above 20%, above 50%, and sometimes even above 100%. In such circumstances, job creation and the opening of new companies are impossible. The capital needed for economic growth simply becomes too expensive.

For developed countries, free trade means access to foreign markets, without limitation, without export barriers for their goods, and without barriers for the purchasing of the foreign goods essential for their own economies, in the first place raw materials and the use of cheap labor. The documents of almost every global and regional international organization emphasize the need to remove interference and obstacles to free trade, especially in the raw materials for which developed

[13] J.E. Stiglitz, *Globalization and Its Discontents* (Serbian translation: *Protivurečnosti globalizacije*), SBM-x, Beograd, 2004, p. 170

countries are interested. The developed countries have "forgotten" how, with what and for how long they themselves once defended the development of their own industries, agriculture and other economic segments from competition from other countries. For example, after suffering great destruction during World War II, it was not until 1957, after reconstruction and the implementation of the Marshall Plan, that Western European countries liberalized 88.8% of their imports. Now that they have become powerful, developed countries, they are denying underdeveloped countries the right to defend their own economies and development.

In a report entitled "Rigged Rules and Double Standards,"[14] Oxfam, an organization encompassing an international confederation of 12 non-governmental organizations devoted to fighting global poverty, analyzes the Western countries' position regarding global trade and reports that the US and the European Union are the most flagrant violators of established world trade rules. The author of the report, Kevin Watkins, claims: "Governments of rich countries constantly stress their commitment to poverty reduction. Yet the same governments use their trade policy to conduct what amounts to robbery against the world's poor. Rich countries are fierce advocates of liberalisation in developing countries, while retaining high trade barriers against exports from the same countries. Developing countries and transition countries have suffered huge damages as a result of inequalities in the global trade system. Countries that have an interest and benefit from preventing access of goods produced in developing countries and transition countries are hypocritical when they claim they are helping developing countries by making them open their markets for products from developed industrial countries while at the same time protecting their own markets."[15]

Oxfam ranks Europe first according to an index which measures protectionism by the world's biggest trading powers, followed by the US, Canada and Japan. They impose the highest trade barriers against the industries of most importance to poor countries: agriculture and textiles. The Report especially emphasizes that, through their control of the World Bank and the IMF, the rich countries are forcing the poor countries to open their markets to Western goods. At the same time, while representing themselves as free traders, the only thing they have in mind is the protection of their own industries. The poor countries that take loans from the IMF and the World Bank are forced to reduce their tariffs and end subsidies to their producers as a condition for obtaining credits from these two institutions. "'Poor countries have been opening up their economies much more rapidly than rich countries,' Oxfam says. 'Average import tariffs have been halved in sub-Saharan Africa and south Asia, and cut by two thirds in Latin America and east Asia. In many cases, it says, rapid liber-

[14] *Guardian*, London, April 17, 2002

[15] See: J.E. Stiglitz, *Globalization and its Disconents*, pp. 1-15

alisation has harmed poor countries by exposing their industries to competition before they are ready to take on more efficient producers.'"[16]

Hand in hand, the following "malign pair" is circling the planet – ***an ever-more rapid hoarding of fabulous riches on the part of a narrow elite and a globalization of poverty of gigantic proportions; there is an ever-deepening abyss within and between societies, which is turning the global arena into a rumbling volcano. "Inequalities are acquiring astounding proportions. One half of humanity is living in poverty, more than one-third in destitution. About 800 million people are suffering from malnutrition. Almost a billion are illiterate. A billion and a half do not have potable water, and at least two billion people still do not have electricity."[17] The gap between rich and poor is growing more and more rapidly: during the past two-and-a-half decades, it has risen from 1:60 to 1:84. Two decades ago, the wealthiest ten percent had an income 77 times greater than the poorest 10 percent; today, that figure is 124 times greater. Just 254 billionaires have an income greater than one half on the world's populace. "Globalization is too harsh, too intrusive, too unjust toward too many people, it is too dehumanizing."[18]***

Today, new markets are mostly not being forced to open up under the threat of military power[19] but through economic pressure, the threat of

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16 I. Stojanović, "Globalizacija i strukturne promene u privredi", ibid, p. 368.

17 *Le Mond Diplomatique,* Serbian edition, November, 2002

18 T. Friedman, *The Lexus and Olive Tree, Understanding Globalization*, Farrar Straus, Giroux, New York, 1999

19 However, there are other opinions as well: "America's military forces serve to guard the unstoppable expansion of American capital. When Yugoslavia resisted the control of American-controlled financial institutions, the IMF and the World Bank, the American Air Force attacked it. Iraq was bombed because, with its strong nationalized oil reserves, it could potentially become a powerful and independent economic center in the region, while Panama earned Wall Street's enmity by becoming the banking center of Latin America. Corporate America could not even stand a country such as Sudan having a strong and independent pharmaceutical industry, so it destroyed it with rockets." (Speech by Michel Chossudovskyi, Professor of Economics at Ottawa University, at a conference held in New York on August 1, 1999, on the occasion of the presentation of an indictment against the US and NATO for their aggression against FR Yugoslavia, *New York Times,* August 8, 1999. Of a similar opinion is Noam Chomsky, world-famous linguist, political analyst, philosopher and activist, whom the *New York Times* referred to as probably "the leading living intellectual. The Belgrade daily *Politika*, published an interview with Chomsky, in which he said: "… the real goal of that war (NATO's aggression against FR Yugoslavia in 1999, author's note) was not in any way connected with concern for the Kosovo Albanians. The real cause lay in the fact that Serbia was not carrying out the social and economic reforms that were being demanded of it, which means that this was the last corner of Europe, which had not submitted to neoliberal programs under the control of the US, so this had to be eliminated. That is the view of the leadership itself." (*Politika*, May 7, 2006, interview with Chomsky conducted by Danilo Mandić).

sanctions or the withholding of needed aid in times of crisis. While the World Trade Organization was a forum within which international trade agreements were being negotiated, negotiators from the United States and the IMF would often insist on an accelerated tempo of trade liberalization. The IMF insists on this faster tempo of liberalization as a condition for aid and, thus, countries facing crises do not have a choice but to agree to the demands of the IMF.

4.2. ***Deregulation of financial markets***

The wave of the deregulation of financial markets of the 1980s has raised the issue of the structure of the financial system. The financial system is traditionally a national category, but some universal characteristics can be found relatively easily. The classic structure of contemporary financial systems includes: 1) a central monetary instruction, 2) a banking system (various types of banks and other depositary intermediaries), 3) financial markets and 4) financial instruments. All these components have common theoretical characteristics even though they are usually variously defined in various financial systems. Thus, different financial institutions and markets compete for a limited amount of savings by offering various financial instruments and services and, especially, a large variety of securities.

The capital market is based on information. In an imagined situation of an ideally functioning market, all the participants have access to the same information at the same time, and it is up to them as to how they will use this information. In reality, the situation is different. ***More and less informed participants, who possess more and less knowledge and skills, populate the market. Thus, we have situations in which one side in a transaction is more informed than the other. This informational inequality ultimately compromises the market functioning of the system, which results in the loss of confidence in the market on the part of other market participants, and the market begins to carry out its function less efficiently. Another consequence of participants' unequal knowledge and skills on the market are situations where the activities of one, typically stronger or superior participant (e.g. a bank) which is pursuing its own interests, influence the activities of another, typically weaker participant (e.g. individual investor), who does not have the ability to influence the situation.***

Deregulation is an economic policy program that reduces state-imposed limitations or control measures, with the goal of stimulating competition in an economic branch, i.e., on the market. Financial market deregulation is oriented toward reducing the influence of the state and strengthening competition between various forms of financial institutions connected through the activity of the capital market. Confidence in the market and its mechanisms is the key factor of success of every financial market. Investors benefit from the normal functioning of the market environment, especially from lower prices, increased investment possibilities, research and innovations.

Depending on which component of the financial system has greater relative importance, financial systems are classified into different groups. In general, theory knows two types of financial systems: 1) bank-based and 2) securities market-based.

The former is linked with Germany and Japan, while the latter is linked with Anglo-American practice. The Anglo-American market-based financial system model represents a way of internalizing risk in the absence of close relations between bank and company.

With the deregulation of the financial sector, new financial institutions (non-banking financial intermediaries) entered the banking market, i.e., started to engage in work previously reserved for banks only. This brought an increased competition of systemic risk. On the other hand, banks began to engage in operations on the capital markets.

Deregulation of financial markets assumes the removal of state regulations introduced in order to control the flow of "hot" money into and out of the country.

"During the current processes of economic globalization and transition in the former socialist countries, the globalization of contemporary financial markets has become highly dynamic. Financial market regulation has changed form and has taken on new characteristics. One of the most significant characteristics of the new forms of financial market regulation is the deregulated flow of contemporary financial markets."[20]

If the banks in a given country have favorable interest rates, they will attract so-called hot money from abroad, which will, however, be withdrawn from the country should interest rates elsewhere become more favorable. Or, if a company in a given country needs a short-term loan, it will take one out without seeking permission from the state, even under unfavorable conditions. Governments are usually cautious on the issue of relatively improving their current accounts balance and strengthening their currency's exchange rate on the basis of "hot" money inflows, since such inflows are mostly temporary. In fact, "hot" money represents short-term loans, which any economic entity can take without the permission of the state. The state simply does not have insight into which economic entities are taking short-term loans and for what purposes. Among other things, "hot" money represents gambling on expected exchange rate movements. This speculative money cannot be used to build factories and increase employment. Companies do not engage in long-term investments using money that might be withdrawn at a moment's notice.

20 I. Stojanović, M. Kulić, *Deregulation of financial markets as an instrument of economic globalization – the example of newly-industrialized countries and lessons for transition countries* (Serbian translation: *Deregulacija finansijskih tržišta kao instrument ekonomske globalizacije – primer novoindustrijalizovanih zemalja i pouke za zemlje u tranziciji*), Donetsk National University, Donetsk, Ukraine, 2005, p. 56

In an economy, which has deregulated its financial markets, a company can take out a short-term dollar-denominated loan from an American bank, for example, without the approval of the state. The company then transfers the dollar amount of the credit to its central bank in exchange for the same amount in the domestic currency. This means the following: suppose that a company from a small developing country has taken out a short-term loan of 100 million dollars from an American bank, with an interest rate of 18%. The company turns these 100 million dollars over to the central bank's foreign reserves, getting the same amount of money in the national currency in return. Usually, small countries invest their foreign reserves in short-term securities issued by the US Treasury, for which they draw an interest rate of about 4%. Hence, the country is taking a loan from the United States at 18% interest while, at the same time, crediting the United States to the tune of 4% interest. The American bank takes a clean net profit of 14 million dollars.[21]

When at the beginning of the 1990s the IMF and the US Treasury insisted on the full deregulation of the markets of newly industrialized countries, international bankers and politicians were certain that a new era was dawning. However, full deregulation of financial markets went against the interests of the newly industrialized countries because they did not need additional capital, as their savings rates were quite high. Hence, full deregulation of financial markets was something that was imposed on them during the 1980s and the beginning of the 1990s. And that was the most important factor that caused the crisis of 1997.

At the annual conference of the IMF and the World Bank held in September 1997 in Hong Kong – a couple of months after the crisis broke out in Thailand, IMF officials asked for changes to be made in the IMF Charter, which would allow them to exert greater pressure on developing countries to deregulate their financial markets.

Thus, at the very beginning of the crisis, the IMF and the US Treasury propagated even greater deregulation of financial markets. Economic theory and practice are overflowing with evidence and examples that, in a situation when a crisis is just starting, it is totally wrong to insist on further deregulation of financial markets because this stimulates capital flight during a recession, when it is most needed. It was not only the IMF that insisted on the deregulation of financial markets. The US Treasury, which, as the biggest IMF shareholder also wields sole veto power, and has a large role in shaping IMF policy, also insisted on deregulation.

21 J.E. Stiglitz, ibid., p. 79

5. Concluding remarks – the "glory" and the grief of globalization

So, what actually happened and on what basis does Krugman make a parallel between the Great Economic Crisis of 1929 and 1930 and the economic crisis of 2007 and 2008? Krugman draws a very firm conclusion and observes: "…we were partying like it was 1929 — and now it's 1930. The financial crisis currently under way is basically an updated version of the wave of bank runs that swept the nation three generations ago."[22]

After World War I, a "new era" began. The state's functions in the economy were limited. Taxes were reduced, while the role of the state was reduced to protecting private property. The high economic activity was a result of the transition from wartime to a peacetime economy. However, representatives of private enterprise thought that such economic activity was a result of the "new era," i.e., a return to conditions of free competition and a limited state role. The Great Economic Crisis that began in 1929 negated their evaluation.

In the period between 1923 and 1929, the average hourly wage of an industrial worker in the US increased by 8%. At the same time, corporation profits rose by 62%, and paid dividends by 64%, together with a general rise in national income of 21%. The increased national income was disproportionately used for private accumulation. Consumption lagged. As a result, instead of production, accumulation was being directed to the stock market***, setting off a speculative race of ballooning stock values and easy enrichment***. Share values were growing on all the exchanges, especially on the biggest of them all, the New York Stock Exchange. There was a veritable rush to buy stocks for the purposes of enrichment. The majority of these purchases were on credit, which means that at the time of making a purchase contract, the buyer was paying only a part of the purchased security (about 10-15 percent), with the rest being a credit from a bank or a stockbroker, and the stock itself being used as security for the credit. When the credit came due, if the price of the securities was higher than the purchase price, the buyer was able to sell the securities and return the credit, and make a profit on the price difference as well, while if the price was lower, then he would leave the securities to the creditor to sell them and cover his outstanding loan. All this took off to such an extent that stocks were being bought at prices significantly above their actual value at the time of purchase. This resulted in the creation of "financial bubbles" causing a speculative boom on the stock market due to rising stock prices fed by the unrealistic expectations of their buyers that they would be able to take a profit on the difference between the buying and selling price once they sold the stock and returned the credit – and not on the basis of the actual profits of the companies that issued the stock.

In the first half of the 1920s in the US, buyers were profiting on the difference between the buying and selling price, but not because of high current profits but because of the high profits from World War I. When the profits from

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22 P. Krugman, "Partying Like It's 1929", *New York Times*, March 21, 2008

World War I were spent and new ones were not produced because money was not being invested in production but into savings and end consumption – such investments not only failed to bring new profits but also reduced the previous, wartime profits – forcing companies into losses.

There were more and more cases in which, when the credit would come due, the selling price of the stocks would be lower, forcing the creditor to sell them at a price lower than the purchase price, in order to at least partially cover his loan. An absurd, economically unrealistic and unhealthy situation ensued. At the same time, the large investments into stocks led to a nominal rise in company values, even as losses mounted. Once this was understood, genuine panic broke out among stockholders and the stock market crashed. The market for stocks collapsed. This led to the so-called Black October of 1929. Almost all the participants in the stock market, including professionals (like John Rockefeller) and experts (such as Irving Fisher, the famous Yale economics professor) suffered huge losses. The climax was reached in 1933, by when the indexes had lost about 85 percent of their value relative to 1929. All the illusions of the missionaries of the "new era" were shattered.

The Great Economic Crisis shook the existing economic dogmas, based on the starting premise of total competition, giving rise to the theory of monopoly and imperfect competition. However, the authors of monopoly and imperfect competition, Srafa, Joan Robinson, Chamberlain, etc., analyzed monopolies exclusively from the standpoint of the process of exchange and explained their appearance as market imperfection. They did not understand that Adam Smith's "invisible hand," by way of economic liberalism and technological development represented the civilizational spiritus movens of the historical necessity of monopoly formation and imperfect competition as an external manifestation of the internal logic of the development of such a mode of production. This necessity realized John Maynard Keynes (1883-1946). He writes: "Whilst, therefore, the enlargement of the functions of government, involved in the task of adjusting to one another the propensity to consume and the inducement to invest, would seem to a nineteenth-century publicist or to a contemporary American financier to be a terrific encroachment on individualism. I defend it, on the contrary, both as the only practicable means of avoiding the destruction of existing economic forms in their entirety and as the condition of the successful functioning of individual initiative."[23] The state acquired a qualitatively new, directing role in the national economy. It became an active actor in the initiation and maintenance of productive processes. Economic liberalism and the liberal state were transformed into state interventionism and state capitalism.

[23] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, 1936. Translated into Serbian under the title, *Opšta teorija zaposlenosti, kamate i novca*, Kultura, Beograd, 1956, p. 401

In analyzing the period between 1923 and 1929, the period preceding the Great Economic Crisis, Keynes came to the conclusion that the mutual influence between consumption tendencies and investment stimuli gave rise to an incomplete use of accumulation and falling rates of spontaneous investment. Since consumption tendencies cannot be significantly altered, the vicious circle can be overcome only through state intervention, while public spending supplements insufficient private investment, thus ensuring economic activity at the level of full production capacities. All this caused President Roosevelt to, within his New Deal policy, initiate the passage of numerous laws in Congress, which had a preventive and controlling function. These are the famous Securities Act (1933) and Securities Exchange Act (1934).

And we all lived happily for a while, as Paul Krugman would say,[24] but not forever after. Wall Street complained about the regulations that limited risk – but also potential profits. And, bit-by-bit, it got its way – partly by convincing politicians to loosen the rules, but mostly by creating a "shadow banking system," which relied on complex financial arrangements through which the safety regulations of the banking industry were avoided. For example, in the old system, savers had federally insured deposits that were strictly regulated by law, while the banks used their money to extend mortgages. With time, however, this was replaced by a less secure system. As the years passed, shadow banking was taking over more and more business because the "players" in this unregulated system offered, it seemed, a better deal than the conventional banks.

Then the 1980s arrived, the time when Ronald Regan in the US and Margaret Thatcher in the United Kingdom were propagating the free market ideology. Their economic neoliberalism gained its theoretical, practical and even ideological basis in the Washington Consensus, in the role of new methods and instruments of globalization (foreign trade liberalization, financial markets deregulation and privatization).

Thanks to globalization, by using cheap labor throughout the world through multinational companies and cheap raw materials, the American economy earned high profits but, at the same time, restructured itself. It moved its industries to underdeveloped countries with a cheap labor force and cheaper raw materials, leaving the US to develop chiefly service industries.

Just as after World War I, the high profits were to be found on the deregulated banking and financial market. In this way, according to Streisler,[25] the basis of the present-day crisis of the financial markets was set since, after 2000, savings have outstripped investment throughout the

24 P. Krugman, "Partying Like It's 1929", *New York Times*, March 21, 2008

25 E. Streisler, "Austrian Expert: US Faced with 10 to 15 Years of Stagnation," *Der Standard*, Vienna, September 17, 2008. http://www.kim.sr.gov.yu/cms/item/news/rs.html?view=story&id=6003&sectionId=8

world. "American banks are holding 65 to 75 percent of global financial surpluses in the form of savings. And what do they do with these savings? They speculate on the financial markets, which, among other things, means the pursuit of profits at the expense of others because nothing is really being produced," underlines Streisler.[26]

At the same time, the problem has been significantly compounded by the fact that the latest technological revolution in the area of computers, software and the Internet was not especially demanding in terms of investment, plus the fact that, during the past 4 to 5 years, there have been no significant advances in computer technology in terms of new solutions that would find application in mass production and sales. On the other hand, predictions by American financial analysts say that ***end consumption has already fallen***, along with employment. Corporations are cutting their losses but that is certainly leading into a still deeper recession.

Loans were given under inadequate conditions and, ***in the summer of 2007, the crash of the American mortgage market was announced on Wall Street.***

Thus, it is now becoming perfectly clear why Krugman said that, during 2007, it was partied as though it was 1929, while now, in 2008, 1930 has arrived. In a true sense, continues Krugman, the current financial crisis is an "updated" version of the bank run of three generations ago. Only now people are not withdrawing money from banks in order to put it under the mattress but are performing today's equivalent – withdrawing money from the shadow banking system in order to turn it into treasury bills. And now, as then, the result is a vicious circle of financial constriction.

It is time that we all finally learn the lessons of the 1930s and reestablish control over the financial system. Otherwise, as far as the "glory" and the grief of globalization are concerned, in accordance with the principle of historicalness, which has universal meaning, the following question can be posed: "Does globalization lie on this civilization's final crossroads? Perhaps some sort of 'globalization' also lay on the final crossroads of some earlier civilizations. And perhaps those earlier civilizations disappeared because, on that final crossroads, they took the wrong path?"[27]

[26] Ibidem

[27] I. Stojanović, *Globalizacija kao civilizacijski izazov*, Megatrend univerzitet, Beograd, 2007, p. 95

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INTEREST RATE CHANGES – A POTENTIAL RISK FOR INVESTORS AND BANKS UNDER THE CONDITIONS OF THE FINANCIAL CRISIS[1]

Abstract: *No problem today is attracting such attention as the crisis on the global financial market. The role of interest rates and inflation in the present-day world is in the focus of efforts to resolve the problem. The main reason why we need to devote special attention to these problems lies in the constant battle between interest rates and inflation, as well as the risk attached to interest rates when it comes to placements on the financial markets.*

Key words: *interest rate, inflation, investors, financial market*
JEL classification: G21, E31, E43

1. Introduction

This country's economic reality is being reflected in the numerous problems on the financial market. For years, the business sector in Serbia has been transferring the burden to the financial sector. Even though economic restructuring started back in 2000, significant changes in the internal structure have yet to occur. The restructuring of the banking sector has been almost completed, that is, foreign banks have established domination over Serbia's financial market – but that still does not mean

1 This paper is a part of the research on the project *Serbia and Europe – Economic Analyses and Predictions,* ev. No. 149038, and the project *Strategic Options for Integrating Serbia into Global Financial Flows,* Ev. No. 149060, financed by the Ministry of Science and Technological Development of the Republic of Serbia.

that the financial system is consistent. And under the conditions of its inconsistency, disruptions in the monetary system are inevitable. In other words, all visible and invisible problems are being transferred to the domain of monetary policy.

An inadequate monetary policy within an inefficient system results in a situation in which a surplus in the money supply does not bring an increase in investment and reduced interest rates. On the contrary, an oversupply of money brings an increase in demand for goods but also an increase in the dinar's exchange rate, which brings falling production and higher prices.

In spite of the existence of exogenous problems related to the global financial crisis, the central bank has a key role in regulating all that is happening on the money market. The central bank has at its disposal instruments for both "rough" and "fine" regulation of the financial market. It is necessary to emphasize that this money-issuing institution controls the entire liquidity of the system but that, however, the available supply of liquid funds is distributed through the market.

The policy of the central bank regarding its activities on changing the bank rates and discount rates, the rediscounted contingent and the minimal reserve level, has a direct influence on changes on the money market. Without going into a detailed analysis of the activity of certain instruments (direct and indirect) and their effects on occurrences on the financial market, we shall focus our attention on the interest rate – an instrument of fine regulation of the money market.

However, it is fairly difficult to concisely present all the problems faced by investors, issuers and financial middlemen regarding the security and liquidity of their placements, since placements are a factor of interest rate risk. Therefore, in this work we shall think from the aspect of how to manage interest rate risk. The goal is to shed light on the effects of interest rate changes, i.e., to explain the exposure of investors and banks to interest rate risk.

2. Protecting investors from interest rate risk

Risk management is a highly complex activity, since it includes a broad array of assets and liabilities, whose value is subjected to change but also, at the same time, mutually in correlation. The motivation of investors, issuers and professional middlemen to protect themselves from an unstable environment and the numerous techniques, measures and models[2] for managing risk available to them, have expanded the structure and diversity of highly efficient instruments[3] for a more frequent rebalancing of assets and liabilities with which to dynamically respond to changed circumstances.

2 See: S. Grk, "Poznavanjem modela do uspešnog investiranja u vrednosne papire", *Ekonomski signali*, No. 76, Beograd, October 2000

3 Instruments such as futures, options, swapts, etc. are most often used for the purposes of distributing and diversifying interest rate and currency risk.

Especially under the circumstances of rising inflation and variable interest rates, interest rate risk and currency risk carry the possibilities of profit loss and the "melting away" of capital. Under such conditions, and in order to minimize risk on the financial markets, a hedging investment strategy is the one most frequently used.[4]

The behavior of investors under specific circumstances of financial instrument price changes depends on their readiness to accept or not accept risk. Let us explain.

The financial market is made up of a number of submarkets or segments, within which, depending on supply and demand for financial funds, the appropriate interest rate structure is formed. Seeking to protect themselves from risk, investors seek to minimize investment risk, i.e., choose investments that carry the lowest risk of interest rate changes. In order to protect themselves from risk, some investors will not cross the bounds of the segments in which they are investing, despite the existence of higher interest rates in other segments. Investors seek to tie the choice of term structure of the instruments into which they are investing with the term structure of the sources from which they are financing their investments. And, especially, financial middlemen seek to balance the structure of their assets with the structure of their liabilities.

However, there are investors who will opt for the theory of preferential segments. In other words, these investors will opt for the term segment that most closely matches their risk tendencies, i.e., their expected profits. Investors, i.e., financial middlemen, seek to avoid the risk of reinvesting, i.e., of price changes, opting instead for the financial instrument that matches the term preference of deferred consumption and fixing the term of that instrument. However, if the movement of interest rates in other segments allows more profitable investment opportunities, which can compensate for the risk of investing outside the bounds of the chosen segment and the interest rate risk, investors will buy instruments of various maturities. According to this theory, the movement of interest rates on the financial market allows investors all types of returns.

In order to manage risk more efficiently, investors need to know the profile of the financial instrument's return. Namely, the return profile of any financial instrument can be either "symmetrical" or "asymmetrical." A symmetrical return is one that moves in proportion to movements on the market, i.e., movements of interest rates, exchange rates or stock and bond prices. Thus, fixed income stocks and bonds have a symmetrical return profile. An asymmetrical

[4] The essence of this strategy is a combination of transactions with financial instruments that diverge with changes in the exchange rate (currency hedging) and in reaction to changes in the interest rate (interest hedging). A hedging strategy has the goal of: minimizing potential losses in case of unfavorable interest rate movements; maximizing potential profit in the case of favorable interest rates; minimizing sliding (degree of uninsured risk) between hedging instruments and risk that should be covered; minimizing reselling costs; minimizing the complexity of the strategy.

return profile comes about when an instrument does not reflect changes in the value of the base instrument or risk factor in general in a linear way.

The use of options[5] is a more predominant alternative in relation to the continued rebalancing of positions with assets of a "symmetrical" return structure. Differently from the price of a stock, the price of a stock option contains implicit information regarding the instability of the stock price expected by the market. High options prices usually indicate instability of the base market in the time interval that matches the option's maturity. Information regarding future price instability is on the level of importance of information on the expected future price.

If there is a significant difference between the information of the participants "in the game" and those "outside the game" regarding the development plans of a corporation or bank (especially in the case of a smaller corporation), it is to be expected that the stock will be sold at a discount. In combination with other unfavorable circumstances, including tax treatment, this makes one's own capital into an exceptionally expensive source of financing business activities.

Since impulses regarding the future prices of basic assets are constantly coming from financial markets, the investors' main task is to monitor these impulses in order to secure timely possession of relevant information necessary for making decisions on the allocation of their capital.

Since participants on the financial market have complex risk position, consisting of various kinds of risk (interest rate, exchange rate, etc.), investment decisions must essentially be based on quantitative analysis. That means that each investor or financial intermediary, in addition to using analytical methods, must:

- analyze the description of total assets in terms of expected return and expected risk;
- make decisions regarding asset allocation, i.e., determine how assets will be distributed between groups of investments, such as stocks and bonds;
- measure risk performance, i.e., the distribution of (risk) performance for each stock and group connected with systems risk (market risk – inflation, recession, high interest rates) and each group connected with total risk (attached to the operations of a specific company or bank).

5 An option is a contract between a buyer and a seller containing the right, but not the obligation of the buyer to buy or sell some financial instrument within a specified period of time or at a specified future time, at a price determined at the time the contract was made.
Interest rate options are managed with interest rate risk, foreign currency options with foreign currency risk, while, for the purposes of managing stock risk, there is an options market for individual stocks, as well as a market for stock index options, which, together with index futures, are the best instruments for managing the systemic risk of the stock markets.

3. Interest rate changes – a potential risk for banks[6]

Since banks are market financial institutions primarily engaged in financial intermediation of money by way of credit relations, this means that each change in the structure and levels of interest rates is of particular importance to them. Each change in interest rate level and structure has a direct influence on the bank's decision to invest in securities, as well as on the market price of its stock.

Generally speaking, in their operations banks follow a certain policy in order to gain profits, without becoming insolvent or illiquid in the process. Banks seek to gain solvency by keeping only quality securities in their portfolios, although it may be observed that even long-term quality securities – such as state-issued bonds – fluctuate in price, in accordance with changes in market interest rates. Cash is certainly secure property, but banks do not like to hold large amounts of cash because it offers no returns. Thus a bank has to compromise. Some risk must be accepted in return for expected profits. A bank that does not suffer losses usually follows a conservative credit policy. However, banks that make compromises gain security and profits by carefully analyzing the credit value of loan applicants before approving credit to them, and by adhering to accepted investment principles, such as diversification. Still, the fear of failure remains. Risk analysis includes a degree of subjective evaluation, which is why it is not entirely secure. Sometimes the desire for profit can overcome soundness of judgment.

For banks, investments in first-class securities represent secure and liquid placements. However, these placements carry a factor of interest rate risk, precisely because the price of securities is in a negative correlation to interest rate changes. This risk is referred to as a market or price risk of financial instruments and is characteristic both of credit instruments (debt securities) and of placements in stocks (equities). In fact, the price of securities, i.e., bonds and other debt securities on the secondary market is the sum of the discount value of interest coupons and the discount nominal value of bonds.

Thus, prices of securities fluctuate depending on interest rate changes. Securities prices on the secondary market fall when interest rates rise, while, on the contrary, a fall in interest rates on the secondary market means a rise in the price of securities. The same applies to securities that do not bring periodic returns. It is important to note that the effect of interest rate changes is greater with bonds with longer maturities and a smaller coupon value.

It is important to make a distinction between an ordinary term of maturity and a weighted term of maturity. Namely, an ordinary term of maturity shows average cash-flow time span, while a weighted term maturity shows average cash-flow time spans while also taking into account term preference.

6 For more on this, see: S. Grk, "Efekat promena kamatne stope na tržištu vrednosnih papira", *Berza*, *Tržište novca*, Beograd, No. 8, 1995, pp. 64-72

Securities with more weighted payouts, i.e., coupons, are analyzed in the same way as securities with a single payout, i.e., without coupons, but their weighted term of maturity is always shorter than an ordinary term.

The evaluation of market risk for securities and markets for financial instruments for paper transfers and reallocation depend on their type – either a stock exchange on which totally standardized contracts are traded, or on an OTC (over-the-counter) market where contracts whose price, risk and other essential elements are separately negotiated are traded.

4. A bank's interest rate – sensitive assets and liabilities

Each change in interest rate levels on the financial market causes potential interest rate risk for all banks. Theoretically speaking, this problem would not exist only on the condition that, on the basis of credit and deposit contracts, banks applied flexible interest rates that would be automatically adjusted. However, in market-oriented banking, interest rates are set as fixed rates, just as in the case of bonds. Of course, in practice there are also bonds and bank credits with flexible interest rates, but those instruments are much less represented than instruments with a fixed interest rate.

With slight adjustment, the "life span"[7] analysis is used to measure a bank's exposure to interest rate risk. Actually, this adjustment has to do with the calculation of the life span of all balance positions of the bank's assets and liabilities, in order to understand the influence of interest rate changes on their values. Analogously to the analysis of securities, the value of a bank's balance positions is inversely proportional to their life span and interest rate changes.

The method of analyzing and regulating interest rate risk is known as funds gap analysis. The essence of this analysis is a disaggregation of the balance of the bank's assets and liabilities into at least two sub-balances. In the first sub-balance, positions sensitive to interest rate changes are on the side of assets and liabilities, while in the second are the positions that are not sensitive to changes in market interest rates.

The first group of instruments on the side of bank's assets and liabilities is made up of short-term loans with a fixed interest rate. Since a fixed interest rate has a short maturity, it is formed again quite quickly. The second group sub-balances of assets and liabilities is made up of long-term instruments.

The life span is shorter than the maturity for all the bank's balance positions characterized by a larger number of payouts. Each change in the interest rate creates a sensitivity gap, which is the difference between the life span of the bank's assets and its liabilities. The gap may be positive, negative or equal to zero. The

7 The "life span" of a security, i.e., bond, is the current value of the weighted average number of securities during which payouts are made.

gap is positive when the assets have a longer life span, i.e., when they are more sensitive than the liabilities to interest rate changes. Conversely, a bank whose liabilities have a longer life span will register a negative gap. And, finally if the life spans of the bank's assets and liabilities are equal, there is no gap, i.e., it is equal to zero.

What are a bank's sensitive assets and liabilities?

These are a bank's short-term claims and obligations. There are, however, various definitions when it comes to the time limits by which interest rates will be re-formed. Thus, according to one definition, interest rate-sensitive balance positions are those where the interest rate will be formed within 90 days while, according to another definition, the term can be up to a year. But there is also a definition according to which one should observe several time intervals within which the maturities of the bank's assets and liabilities are analyzed, with the proviso that the maturities of assets and liabilities as well as cumulative maturity can be calculated for each time interval. The essence of this definition is that short-term assets and liabilities have to be liquidated in the shortest possible periods. After that, the bank is once again ready to approve credits, either to the same or to new customers. But, in either case, credit approval is done according to new market interest rates. The situation is identical when it comes to the bank's liabilities. Namely, mature deposits are calculated according to the agreed interest rate, while any extension is accompanied by a revision of the market interest rate.

If there is a gap between interest-sensitive assets and liabilities in the bank's balance, then interest rate movements on the financial market have a certain effect on net interest income. That is why each bank should have a balance gap policy that follows two pieces of information: its existing balance structure and expected interest rate changes. In other words, the rise or fall of market interest rates has either positive or negative effects on the bank's net interest income with the presence of a positive or a negative gap.

The existence of a positive gap, i.e., assets surplus, with variable interest rates relative to liabilities, brings positive effects to net interest income. However, if the bank should register a negative balance gap, as market interest rates rise, the effect of rising interest rates becomes evident more quickly on the liabilities side than on the assets side, which produces a negative effect on net interest income. Under the assumption that interest-sensitive assets and liabilities are absolutely equal, the change in the market interest rate would have zero effect on the bank's net interest income, i.e., its profitability. Banks that do not wish to expose themselves to interest rate risk will sooner opt for achieving a zero balance gap, i.e., maintaining a balance between interest-sensitive assets and liabilities.

5. Positive real interest rates

As all prices, interest rates have significant functions – redistributive, allocation and informative. In order to achieve the said functions, interest rates have to be real when it comes to approving credit to businesses and individuals for fixed-term money deposits or savings. Real interest rates allow the issuing institution to supply the economy with the necessary sums of money, without any pressure. Under normal circumstances (where there is trust in the banking system), as savings increase, interest rates reduce current consumption in the process of income distribution or in the course of purchasing durable consumer goods. In this way the need to borrow money abroad is reduced. By eliminating deficit financing, real interest rates prevent rises in prices of goods, regardless of the fact that all interest rates have to be calculated into the price of goods (or otherwise costs would not be economically valued). Real interest rates allow greater earnings through increases in production and work productivity, quality improvement, cost reduction, and aid the selection process among producers by removing incapable and favoring capable organizations. Thus, positive real interest rate must protect invested funds and prevent further capital "ruination."

The experience of both developed and developing countries shows that the implementation of a restrictive monetary policy is always accompanied by higher interest rates, which in fact establishes monetary balance under conditions of a limited money supply (credit or volume of money).

The implementation of a fixed exchange rate policy prevents the process of balancing money supply and demand from being carried out through changes in the volume of money. Under such conditions, the balancing mechanism is transferred onto interest rates. In other words, the central bank does not respond to increased money demand (as its goal is to protect certain exchange rate relationships) but, rather, the given money supply is adjusted to the demand by way of interest rates.

In Serbia, the costs of the banking system's operations per unit of realized transactions (i.e., banking services) are high, which is another factor responsible for high interest rates.

The economy is forced to accept credits at a high interest rate. Under the present circumstances of a high price of money, no investment – whether real or financial – rejects a profit rate that would be higher than the interest rate. In other words, despite the financial balance – which is achieved by way of a high interest rate – investment growth will be quite slow, with all the accompanying effects on the dynamics of economic growth, and shifts in productivity and employment.

6. Interest rates and inflation

When analyzing the role of interest rates in the contemporary world, it is noticeable that the "clash" between raising prices and raising interest rates under conditions of numerous inflationary "accelerations" has, as a rule, resulted in the victory of inflation over interest rates. In developed economies, real interest rates have become significantly positive, which has improved business conditions and even lowered the inflation rate.

The internal economy and the rate of mobilization of working assets depend on real factors, such as an insufficiently developed market, imports as a limiting factor of supply, removal of price disparities, etc. Still, real interest rates can do much to accelerate the circulation of working capital.

The mechanism of setting interest rates conceals a trap, which, along with rising inflation and attempts to maintain a positive real interest rate by adjusting the normal interest rate to inflation, results in interest rates that are always higher than the inflation rate. It is an unsustainable thesis that the problem can be solved if the nominal interest rate slightly lags, since a more rapid rise in interest rates is unavoidable. Actually, the problem does not lie in a positive real interest rate but in the securing of sources for financing working capital through inadequate credit arrangements.

In the case when we are financing business operations with credit, while wholly counting interest rates as running business expenses, all increases in the inflation rate as well as increases in nominal interest rates lead to increases in interest rates that are more rapid than increases in the inflation rate.

Prices of raw and production materials, along with high fiscal burdens placed upon companies have the greatest influence on business expenses and final product prices. Another significant inflation factor are energy prices and unused installed production capacities. Also, prices are greatly influenced by expensive sources of financing, i.e., credits, the inability to collect debts, tariffs and non-tariff charges and surplus employees.

In case of a growing rise in uncollected mutual debts and claims among business entities, this will lead to increasing loss of confidence on the money market and an inability to conduct monetary policy in its essential segment.

It may be expected that a clumsy economic policy, and especially a clumsy monetary and fiscal policy, aided by an inadequate moderation of the intensity of factors that influence price pressure, would multiply initial inflationary impulses.

Inflation can be controlled only through radical intervention in the very tissue of economic flows and through changes in the behavior of economic actors and individuals. As long as there are no serious radical interventions in the economic tissue – which requires great financial means and the will of the main structures of government – inflation will be this country's destiny.

We should be aware of the fact that a "clash" between price and interest rate rises would exist even with the presence of much less inflationary elements because of the way in which business is financed. Actually when business is financed in the traditional way, i.e., with credits that match the rate of inflation, then, as a rule the nominal rise in interest rates must be greater than the rate of inflation. Compensation for price increases lies in the constitutive element of the price of money.

Undoubtedly, the message is that if inflation remains in the zone characterized by business actors and the public, normal interest rates will have to be high. Thus, respecting all the complexity of economic laws, the monetary authorities need to continue with the implementation of more active measures in the area of interest rate policy.

7. The global financial crisis and interest rates

Generally speaking, the world is entering a period of so-called stagflation. This means that an environment has been formed in which prices are rising while economic growth and employment are stagnating or even falling.

For now it is unclear how Serbia will defend itself from the negative impulses coming from the global economic scene, i.e., external factors, when it is known that the negative internal factors that directly imperil the country's already fragile macroeconomic stability have already been activated.

Even before the outbreak of the global financial crisis, Serbia's macroeconomic indicators were worrisome, before all because Serbia's economy is founded on credits, huge public consumption, a huge foreign balance of payments deficit and debt, an overvalued dinar and a large rise in real estate prices. Such a model of economic functioning is unsustainable.

In fact, the current model is sustainable only in the very short term, and that only as long as foreign investors continue to finance unrestrained domestic consumption, judging that their high investment risk can be compensated with huge returns on interest.

As interest rates and spreads in Serbia are among the highest in Europe, it is understandable why foreign banks as well as individual investors or import lobbies had an interest in establishing domination here. In other words, they were motivated by high profits, i.e., the high returns they were enjoying thanks to the enormous interest rates

The fact that money throughout the world has become more expensive due to the crisis on the global financial market has also been felt on the Serbian market, by way of rising interest rates on credits. The crisis has already contributed to the growth of the benchmark interest rate and a reduction in the total amount of credit as well as on the ability to borrow on the international financial market. Still, at the beginning of October 2008, the Monetary Committee of the National

Bank of Serbia decided to keep the benchmark interest rate at 15.75%, but, on the last day of October, further restricted monetary policy by raising the benchmark interest rate to 17.75%. This adjustment of the benchmark rate was made in order to prevent the exchange rate from going further out of control.

The influence of the global financial crisis on the United States and the European Union will also reflect on other economic determinants that affect macroeconomic movements in Serbia. Inflation in 2008 is huge, probably winding up at about 13% on the annual level.

The most efficient and quickest instrument in the battle against inflation is raising interest rates. In fact, rising interest rates bring reduced demand and price stabilization, less borrowing and more expensive credits. However, an economy in recession needs lower interest rates. Central banks can soften the current crisis through the instrument of the interest rate.

It is certain that the moment will come when even enormous interest rates will not be able to cover the increased investment risk, or secure the necessary inflow of foreign currency for a normal functioning of the financial system. Serbia's economy, despite it weaknesses, is a part of the global world and the economic crisis simply cannot be avoided.

Foreign currency reserves will continue to melt away since they will be needed to defend price stability and the rate of the dinar as well as to repay foreign debts. The effects of the global economic crisis are already being felt in Serbia when it comes to investments, namely in the reduced interest in the privatization of companies. For their part, potential foreign buyers are making significantly lower offers.

The country's foreign reserves, which have begun to shrink, are not a sufficient guarantee against significant tremors on Serbia's financial market, regardless of claims by leading figures from the National Bank of Serbia to the effect that foreign reserves are being held mostly in the form of deposits at other central banks or invested in state securities issued by the world's most development countries with AAA ratings (such as Germany, Canada, Great Britain, etc.), as well as securities issued by international financial institutions (the European Investment Bank, the World Bank, EBRD…).

8. The effect of the global financial crisis on falling stock prices on the Belgrade Stock Exchange

The regulation of the financial markets has remained under the jurisdiction of national institutions, which decide how taxpayer money is spent. In fact, no citizen of any of the European Union member states would acquiesce in Brussels spending his money on saving a failed bank in another country, especially in a country that is not a member of the European Union.

The securities or, more precisely, the stocks of the big European banks have been under pressure due to the crisis, which has drastically reduced their prices. Even the stock of the second-largest German bank, Kommerzbank, has seen a drastic reduction in trade volume and price after confidence in the financial system of Europe's leading economy was shaken. However, stock prices have also fallen on the leading Asian stock markets as well as on the Australian and New Zealand markets.

Thus, it should not come as a surprise that the Belgrade Stock Exchange has been shaken after everything that has happened on the global financial scene. The negative events on the inter-bank securities market reflected quite quickly on this stock exchange.

According to information from representatives of the Belgrade Stock Exchange, the domestic capital market lost 3.1 billion euros in value between January and the beginning of October 2008. In addition, the fall in monthly stock capitalization is as high as nine percent, while falling prices of Republic of Serbia old savings bonds in September have brought a reduction in the total value as well as in the capitalization of those securities by more than two percent.

The decisive cause for the fall of capitalization lay in the reduced demand for securities due to the withdrawal of a large number of foreign investors.

This caused an imbalance that brought a significant fall in the price of securities. Thus, while the average monthly share of foreign investors in trading volume on the stock exchange equaled 50.4% at the beginning of the year, by September 2008 the share of foreign investors had fallen all the way to 33.5%.

Such a decline is a result of investor fear and panic, as they are now avoiding trading even in shares of good companies whose business has not been affected. As the crisis has a psychological effect on investors, it is understandable that the domestic investors are fearful, while the professional foreign investors are having their own problems both on the big markets and on their own domestic ones, so the Serbian stock exchange does not interest them a great deal.

In addition, some companies believe that, under the present circumstances, financial derivatives are being used exclusively for speculative purposes. This can be understood in a situation where credits are being realized according to a variable interest rate, which is actually a speculative position that exposes a company to potential losses.

The conditions that have been created on the little Belgrade Stock Exchange should serve as a warning signal, as the effects of the global crisis will be felt by everyone, especially very successful companies whose stock has been traded for a longer period of time, but which has now become practically worthless.

There is another not at all insignificant problem as well. Namely, people who have placed their funds in voluntary pension and investment funds are now faced with great uncertainty and are living in a state of fear accompanied by lack of confidence in new investment possibilities. As a result, this will slow the reform of the pension system.

Since Serbia does not have a vision of the development of the domestic capital market, it is to be expected that a large number of participants on the Belgrade Stock Exchange will turn to possibilities of investing in real estate or gold, until the global crisis finally subsides.

9. Conclusion

Of all the risks that exist in contemporary banking, i.e., exchange rate risk, credit risk, liquidity risk, the risk of a decline in the market value of the bank's stock, interest rate risk is among the most important. Namely, interest rate risk may be passed on, by way of changes in interest income, to the bank's rate of profitability, with corresponding effects on its solvency and the market value of its stock.

At a time when the currency is depreciating and the central bank is raising interest rates, property values and, thus, bank property values are falling. If the banks try to sell it in order to finance their obligations, i.e., secure their liquidity; this could deflate their value even more. In other words, sales revenues cover due obligations to an even lesser extent, making banks insolvent.

Banks can solve their liquidity problems by selling securities from their assets on the secondary market. However, the situation in which banks have the problem of interest rate risk is much more uncomfortable. Namely, if assets have been placed at fixed interest rates and longer maturity periods while the bank has mainly deposits i.e. liabilities that also have fixed interest rates, but with shorter maturity periods, there develops an asymmetry between the length of the intervals of re-forming agreed interest rates on the sides of the bank's liabilities and assets. The revision of interest rates on the liabilities side must be faster, due to shorter agreed due dates, depending on movements in market interest rates.

By introducing more order into debtor-creditor relations on the global level, but first of all here, the pattern of demand for money as a liquid form of assets would change as well, allowing for lower interest rates under the given scope of supply. In addition, besides a decrease in the degree of investment risk, i.e., the removal of an inadequate legal system of investor-creditor protection, the elimination of other problems that burden the interest rate regime, such as reducing bank operation costs and resolving bad debts in the financial system as well as in the business sector, would do much to push down interest rates.

In the preceding period on the Serbian financial market, the rise in the total amount of foreign currency was, among other things, the result of huge interest rates on dinars. In other words, the difference between domestic, dinar-linked interest rates and foreign currency interest rates encouraged the entry of speculative capital into the country, which was the basic generator of surplus foreign currency and money in circulation.

The money that entered Serbia, which represents the capital surplus, did not go into the economy but was immobilized, invested into National Bank of Serbia securities. However, due to the interest rates that it has to pay out, the central bank will suffer huge losses. At the same time, that money represents a constant threat to the financial system. While it is in the country – inflationary pressure is constant; when it leaves the country – this increases demand for foreign currency and causes great problems on the foreign exchange market.

Until now, artificial stability has been maintained in Serbia thanks to constant borrowing abroad and sales of state property. Now such a policy has become unsustainable, due to the current global crisis. Namely, as already mentioned, high interest rates were the reason why money was being invested in Serbia up to now. With the onset of the global financial crisis, the situation has changed in the sense that the priority is no longer profit but safety of placements. This means that the hard currency outflow has been increasing while the inflow has decreased. As capital is now leaving Serbia, the pressure on the exchange rate is high. Thus, despite the central bank's interventions, the fall of the dinar cannot be prevented. In other words, in trying to prevent the outflow of capital from the country and reduce pressure on the dinar, the National Bank of Serbia has resorted to removing reserve requirements in order to increase bank liquidity. Still, that has the same effect on banks as a rise in active interest rates.

Generally speaking, the dinar will eventually have to be devalued, as its rate will not be able to be defended with the kind of policy currently that is currently led by the central bank. Thus, it would be better if this happened as quickly as possible, so as not to give too much time to the owners of speculative capital to take their money out of Serbia – with hefty profits, of course.

In that case, the effects of such a disastrous policy of maintaining the exchange rate at any cost would be born exclusively by the people of this country. If the central bank continues to insist on an unsustainable exchange rate – Serbia's economy will be ruined, without a chance of recovery for a longer period of time.

The coming tine will be quite hard for Serbia, since the crisis will move from the financial sector to the real sector, i.e., the real economy.

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THE PERCEPTION OF THE YUGOSLAV ECONOMIC SPACE IN SLOVENIA

Abstract: *Viewing from a historical perspective, we can say the perception of the Yugoslav economic space was not one-sided but ambivalent in Slovenia. There was a tension present between the two clashing viewpoints, which were common to both the time between the two world wars and the time of the communist Yugoslav state. It was a question of establishing balance between the two complex and structurally different choices. On one side, there was a notion of self-sufficiency and comfort of the virtually non-demanding and, in terms of developmental dynamics, also non-stimulating market. But on the other side, there were tensions for decentralisation in the political and economic field and the notions that Slovenians would create the adequate economic politics of competitive advantage that would be beneficial for the Slovenian economy and consequently preserve the Yugoslav market by increasing competitiveness in enterprises to be present both at home and on foreign markets. At the same time, this would also diversify the area of trading and, in this way, reduce dependence on the Yugoslav market. In practice, Slovenia first needed to leave the Yugoslav economic space in order to reform and restructure its own.*

Key words: *Yugoslav economic space, economic policy, Slovenia*
JEL classification: O52, P21, N14

1. Introduction

It does not appear exceptionally resourceful to state at the very beginning of this paper that the Yugoslav state was, from the moment when it was first established, extensively unequal, to put it mildly. Historical differences, or, in other words, different national communities, traditions as well as cultural and civic environments set to cause conflicts, if not even rupture, as early as the nations started to live together in the newly-formed state. Some geographical areas showed different levels in their social-economic development, therefore their behaviour was hardly understood by people in other regions. While some areas had already been integrated into the broader economic environment and expanded their economic activities to the entire Yugoslav state, others, on the other hand, remained limited to their local borders, still mainly featuring the simplest forms of economic trading. While some regions already extensively embraced industrial development and established the adequate conditions in terms of infrastructure, other regions remained deeply devoted to traditional economic structure. While in some areas, values typical of an industrial society were already more prevailing due to a more classified social structure, other areas still cherished the values of traditional, agrarian society. While economic initiative in some regions was limited to predictable risks, in other areas it was hindered due to an exceptionally high level of uncertainty. While certain areas recorded small differences in formal and informal types of behaviour in the economy, other regions were faced with a much deeper gap between these two categories. This series of features could be continued for quite some time and we still wouldn't exhaust all social-economic contrasts in Yugoslavia. Following all these diversions, we should keep in mind the fact that a line in these contrasts and differences, which were extending from north-west to south-east, was more than obviously dependent upon the geographical position of a certain area within the Yugoslav state. North-eastern areas deviated in the upper direction, while south-eastern regions deviated downwards from the Yugoslav average.[1]

These significant differences need to be considered when discussing the topic of the perception of the Yugoslav economic space in Slovenes. At the very beginning, it needs to be embedded in the basic and elementary statement, which represents a conceptualising framework within which we interpret dynamicity in perceptions within a historical perspective. The truth is that every time we try to define problems in respect of the said question, we should not and cannot avoid the complete social, political and also economic context. Of course, this also means that it is extremely difficult or maybe even impossible to draw a clear line between the attitude shown towards the economic environment as such and the same attitude conceptualisation in case of the national economic policy that marked the events in this region. In light of these cause-consequence categories, a long-term studying of this environment has emerged in the process. In any other case we would risk missing out the whole picture of the problem, since it was precisely this viewpoint that determined the perception of the Yugoslav economic space with a historical dimension in Slovenes. Different entering positions also defined relativity in the economic situations in individual Yugoslav regions embedded within the Yugoslav national-economic environment. This means we are establishing a correlation between the relative economic status and the prevailing perception(s) of Yugoslav economy in time and space. At this point, it would definitely be wise to mention that the economic aspect of Slovenia becoming part of the Yugoslav state had no particularly important role. Of course, this does not suggest the case was not the opposite later on.

1 Ž. Lazarević, "Gospodarski vidiki slovenskega življenja v Jugoslaviji do druge svetovne vojne", *Slovenci in Makedonci v Jugoslaviji,* Ljubljana-Skopje, 1999, p. 56

2. Economic Relations of South Slovene Territories before Foundation of Yugoslavia

By saying that, I certainly do not wish to deny that Slovene economic circles were interested in cooperating with the areas that later became part of the Yugoslav state. As early as the turn from the 19th into the 20th century, there was an increase in interest in what was referred to as the "Yugoslav economic space" on the Slovene part. Of course, this reference was not meant in the sense of events occurring after 1918 but in terms of trialistic "Yugoslavism", namely south Slavic territories inside the Austrian-Hungarian Empire. This is the point when Slovene investments in Croatia and Bosnia began, with the most heavily represented area in this field being that of banking[2] as a predecessor or herald to the subsequently large number of enterprises dealing in other businesses. It was also no surprise that these investments were taking place in the first decade of the 20th century, since they followed important economic changes occurring in Slovenia in the last twenty years of the 19th century, when economic development within general conjuncture acquired greater acceleration[3]. By greater concentration of capital, some strong banking and industrial joint-stock companies that were able to expand their economic environment, especially to Croatia, were established. In principle, in other regions those enterprises stayed limited to the Slovene ethnic environment due to highly competitive markets and their own lack of competitiveness. Croatian and Bosnian markets were offering opportunities in economic growth. This economic motive was followed by political influences. In assessing these processes, we namely should not miss the fact that political circles were very cooperative in both Croatia and Bosnia.

This way, elementary economic relations had been established even before the establishment of Yugoslavia itself. Croatia, as an important market for the Slovene economy, presented an important complimentary approach to mutual political inclinations that these two states showed for each other. It was as early as that point when the subsequent typical phenomenon of Slovenia viewing its cooperation with Croatia as cooperation with Yugoslavia was established. Through Croatia, Slovenia indirectly operated in the rest of the Yugoslav regions. In terms of politics, this was most evident at the time before WW I, and also later, when Slovenia became included into the Yugoslav national-economic environment as well.

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[2] Ž. Lazarević, Oris razvoja slovenskega bančništva do prve svetovne vojne. *Prispevki za novejšo zgodovino*, 2/1999, pp. 75-90

[3] Ž. Lazarević, "Od regionalnega k slovenskemu narodnemu gospodarstvu", *Slovenija 1848-1998,* Ljubljana, 1998, pp. 273-277

3. Change in the Position of Different Regions in "The First Yugoslavia"

As already mentioned, the economic aspect was not prevailing when Slovenia became part of the Yugoslav state. But once the decision had been adopted, there was a need for its detailed justification. The attitude towards this newly created environment was presented by Milko Brezigar. In is book titled "Osnutek Slovenskega narodnega gospodarstva" [4] (An Concept of Slovene National Economy), which was published right before Slovenia became one of the Yugoslav countries, he presented his perception of economic relations with Croatia (based on his own experience) that needs to be perceived as the Yugoslav space – if we consider the subsequent historical context. In principle, the author exposed the supplementing economic structure. He viewed the quite significant agrarian character of Croatia/Yugoslavia as complimentary to a higher relative industrial share in Slovenia. In Brezigar's opinion, Slovenia could have been completely open towards the import of agricultural crops and products without consequences for its own agriculture. What is more, Brezigar was convinced that Yugoslav competition would encourage Slovene farmers to catch up with the competition, especially with farmers from Slavonia and Vojvodina, and even surpass it by updating their farming and subsequently also increasing their economic efficiency in production and processing. Similarly, he was convinced that the division of labour would take place in agriculture – crop processing on higher levels would be performed in Slovenia due to the more advanced industrial sector. With this, Brezigar presented the other side of the future economic relations and exposed the belief that internal economic progress will act as an accelerator of Slovene industrialisation. His basic presumption was that mutual trading and closer cooperation would invoke a faster economic development of the new country.

The creation of the Yugoslav state caused changes in the relativity of positions held by regions that once belonged to the Austrian-Hungarian Empire[5]. Slovenia and Croatia immediately progressed and became the most advanced part of the entire country, both economically and technologically, with places and people being the most prosperous in all Yugoslavia. Despite the fact that, internationally speaking, Slovenian and Croatian economic achievements in the former Empire[5], or later, in the 20th century, had been quite modest. [6] It is only natural that these events would have some effect on national pride, especially in

[4] M. Brezigar, *Osnutek slovenskega narodnega gospodarstva*, Omladina,Celje, 1918

[5] The conflict is clearly reflected in the fact that in 1910, for instance, Slovene gross national product per citizen exceeded the Yugoslavian average by three times. In 1910, the Slovene gross product per citizen amounted to 220 dolars, while in southern Yugoslav regions it was only 70 to 80 dolars. T. Hočevar, *The Structure of the Slovenian Economy 1848-1963,* New York, 1965, p. 114

[6] D. Good and T. Ma, "The Economic Growth of Central and Eastern Europe in Comparative Perspective 1870-1989", *European Review of Economic History* no. 2/1999, pp. 103-137, and A. Maddison, *The World Economy. Historical Statistics*, Paris, 2003

terms of politics. Changes in the relativity of the position in what was an extraordinary diverse country in terms of politics, culture and economy had multi-faced consequences, especially in the fiscal field. Slovenia and Croatia became net contributors in Yugoslavia, which was a constant source of political conflict. The source of these confrontations was political as well as the economic imbalance found in the whole state, regardless of the type of economic policy, both prior to WW II and in the Communist Yugoslavia established after 1945. The political power was concentrated in Belgrade, while economic power was the strongest in Slovenia and Croatia. This means the main agents in political supremacy could not establish economic dominance. In comparison with the Austrian-Hungarian Empire, a new order occurred, where the less developed forces had the power to tailor the principles of economy. The Serbian side attempted to balance the uneven economic competition by controlling the state-governed mechanisms. On the outside, this clash took the form of a conflict between the centralistic and autonomous or decentralised conceptualisation of the state mechanism.

Change in relative prices, equally after 1918 and with their distortion in 1945 under the condition of socialist economy, affected the relative position of individual regions/republics within Yugoslav national economy. Effects, which were by no means single-layered, strongly affected the Slovene perception of the Yugoslav economic space. Effects in the economic area were both positive and negative. They were positive for the non-agrarian and negative for agrarian activities. Brezigar's expectations in the agrarian field did not entirely come true and Slovenes were well aware of that. Between the two world wars it would have been difficult to find anyone who would not have recognised the importance the Yugoslav market had for the Slovene economy.[7] Likewise, there were no words of criticism heard about economic nationalism. On the contrary, many praised and welcomed it since it was only grist to the mill of domestic entrepreneurialism. Of course, this image should not be idealised, since there was also a great feeling of dissatisfaction present. The fiscal area was one of them, accompanied by the sense of depravation in share of state investments. Even though people could sense that net capital outflow from Slovenia was increasing in the 1930s, they deemed the final balance sheet was still in their favour. This is why Slovenia did not witness such a stormy response to Yugoslav economic reality as was the case in Croatia with the well-known book entitled "Ekonomska podloga hrvat-

[7] Typically arguments were: "In the course of 10 years, there has been a great change taking place in Slovenia that the requirements for industrialisation or crucial changes have prevailed in our country. The reasons for this sudden change are many. First, we have been detached from the former Austria that had mostly been staking us with industrial products and there was a new hope that domestic industry goods would be heartily welcomed. Secondly, the structure of the new state, which features a prevailingly agrarian character, encouraged industrialisation." J. Jovan, "Glavne produktivne sile v gospodarstvu Slovenije", *Slovenci v desetletju 1918-1928*, Ljubljana, 1928, p. 485

skog pitanja", (The Economic Basis of the Croatian Question) even though similar questions would emerge in the Slovene media as well. [8]

Rudolf Bićanić, the author of this publication, tried to "establish" the economic aspect of demands for rearranging the political relationship in Yugoslavia. The fundamental Bićanić's position in this case, which he attempts to support with arguments throughout the book, is that the Serbian authorities have established a subordinate position for Croatia, and also Slovenia, Bosnia and Vojvodina, by politically controlling the state mechanisms and enhancing the role of the government in the economic environment. Controlling state mechanisms with various measures, especially those in the financial field, was supposed to encourage the tendency to transfer the economic power to Belgrade, which was also the political centre of the country. [9]

Similarly, the Serbian answer to Rudolf Bićanić received no extensive response in Slovenia. On the Serbian side, his book provoked a number of answers, replicas, and arguments against it, which were published under the title "Istina o ekonomskoj podlozi hrvatskog pitanja" (The Truth about the Economic Base of the Croatian Question) in 1940, with a very clear subtitle: "An answer to Mr Bićanić". Numerous articles could be commonly denominated as indignation expressed on the part of Serbia with the argument that, upon entering Yugoslavia, Croatia (and Slovenia as well) supposedly acquired new market and also the possibility of a quicker economic development. In the environment of a protectionist economic policy, Croatia (and Slovenia) was claimed to enhance its competitive advantages before Serbia due to its more balanced economic structure. While Croatia (and Slovenia) was partly industrialised, Serbia was still mainly a typical agrarian country. The Serbian side also argues that, upon entering the new state, most benefits would go for the northern part of Yugoslavia. In different conditions that changed after 1918, the Serbian economy supposedly did not have a chance to compete against its Croatian/Slovene competition and could not entirely use all system-levelled initiatives – in an economic sense of a paternalistic country with a clear tendency to secure national economic interests or, in other words, consolidate domestic entrepreneurialism in the industrial sector.[10]

In the context of time, different arguments expressed in both books, even though diametrical contradictive, were made very clear. The said disputation was only small surprise in terms of its contents, since it reflected the current condition in the country. This polemic proved that perceptions of the reality were largely diverse as well as was the diversity in the reality of perception. A detailed comparison of the two contradicting viewpoints shows that contradictions and

8 See: Ž. Lazarević, "Dojemanje stvarnosti – stvarnost dojemanja", *Prispevki za novejšo zgodovino*, no. 1/2006, pp. 145-154

9 R. Bićanić, *Ekonomska podloga hrvatskog nacionalnog pitanja*. Zagreb, 1938

10 S. Drašković, *Istina o ekonomskoj podlozi hrvatskog pitanja. Odgovor g. Bićaniću*, Beograd, 1940

disputes grew their roots as early as the very beginning of the new state. They reflect different views and perceptions of the newly established country, while at the same time testifying to great changes in the relativity of position held by the regions of the Yugoslav state. This is precisely the key to understanding these so extensively contradicting viewpoints. The conflict was all about questions that had a strong political charge, especially in such a multinational country that also featured extreme regional differences while at the same time facing an unbalanced economic structure. The said debates were a common occurrence in political and economic life ever since Yugoslavia had been established. Due to the size and economic power of Croatia, political circles in this region attempted to reach dominance or at least shared power with the Serbian side, in which they succeeded by founding the "Banovina Hrvatska", special Croatian unit within Yugoslavia. Slovenian politicians had no ambitions in regard with dominance since they were well aware of Slovenia's relatively limited power and were satisfied with the role of a mediator between Serbian-Croatian unbalanced proportions and initiatives emerging in the Yugoslav market.

Therefore, the question of the Yugoslav economic space was formed differently in Slovenia, which did not exclude manifestations of discontent. Slovenia, too, was against centralism and state intervention. This is where the desires for a greater decentralization of the state originated in. This was mostly evident when a special Croatian unit, the Banovina Hrvatska was established. At that time, Slovenia also established a project for a special Slovenian unit, so called Banovina Slovenija.[11] Its economic foundations were laid by Andrej Gosar, who vigorously refused concerns that changes should not be requested for fear of losing the market and these types of warnings were also put forward by some business circles. Gosar made it clear that the short-term economic benefits or possible losses cannot serve as a basis to reject a priori the demands to decentralize the country. The interests of Slovene nation as a whole have always been more important than the interests of individual companies or businessmen. Gosar made a further step forward and unequivocally claimed that the only way to maintain and increase the Slovenian share of the Yugoslav market in the long term, was to reform the country in order to achieve greater decentralization, including the economic sector. He believed that the Yugoslav unitarily designed economic and social policy did not sufficiently take into account Slovenian interests, needs and specific features. Therefore, a new Slovenian economic and social policy was needed,[12] but it was only possible if a clear line in power would be drawn between the political centre and the regions. Gosar was convinced that the centralized institutional arrangement of the state provided significantly more opportunities to facilitate

[11] J. Perovšek, "Srbi vladajo, Hrvati razpravljajo, Slovenci plačujejo: (Mit in resničnost prve Jugoslavije)" *Časopis za zgodovino in narodopisje*, no. 2-3 /2004, pp. 405-427

[12] A. Gosar, *Osnovna narodnogospodarska in socialna vprašanja Slovenije*, Bohinjski teden, Ljubljana, 1940, pp. 89-102

industrialization in other parts of the country than would be possible if a more balanced division of political and financial power across all regions were applied. Gosar did not oppose industrialization of other parts of the country – on the contrary, he welcomed it. In fact, he was convinced this was the only way to solve the increasing economic and social shortcomings of the population. At the same time, however, he claimed that by decentralization, Slovenia would acquire governance mechanisms in order to be able to adapt to newly emerging circumstances. This would enable Slovenia to use economic policy measures in order to facilitate the competitive advantages of Slovenian companies and thus maintain its share of the Yugoslav market.[13]

4. Economic Position of Federal Units in "The Second Yugoslavia"

However, the political centre showed no significant interest in making any thorough reforms of the Yugoslav state in the sense of further decentralisation.[14] Nevertheless, the issue of centralism and powers of individual Yugoslav regions or, after WW II, republics, still remained one of the key factors that determined the Slovenian perception of the Yugoslav economic area. Although a different economic and political context was in place after WW II, concerns remained practically the same. Gosar's ideas from the end of the 1930s proved to be true. This goes especially for the claims he made in 1940 that the centralized political arrangement enabled disproportionate rapid industrialization in other Yugoslav regions. In the context of the centrally planned economy, which the Yugoslav communists practiced throughout the decade after 1945, problems that Gosar had been warning people about began to emerge both in principle and practice.

The national issue was the key program point of the Communist Party of Yugoslavia. The Communist Party promised to reorganize the country into a community of equally treated nations. At that time, equality meant not only political equality – it was meant as the possibility of bringing decisions on the common level and independently on the local level. The new authority elevated the definition of national equality to a higher level. The definition of national equality was expanded or, better yet, conditioned by economic and social equality.[15] In practice, this viewpoint resulted in a tendency to balance the levels of economic and social development in the country. This tendency manifested itself in a flow of resources through the political centre, which was even greater than before WW II. [16] This

13 A. Gosar, *Banovina Slovenija. Politična, finančna in gospodarska vprašanja*, Dejanje, Ljubljana, 1940

14 J. Perovšek, see above, pp. 405-427

15 K. Mihailović, *Regionalna stvarnost Jugoslavije*. Belgrade, 1990, p. 22

16 Approximate calculations show that, in 1938, the outflow of resources from Slovenia was approximately 3 % of national income. This figure is based on the assumption that

fact was in political circles as well as in the public perceived as a factor that was inhibiting the faster economic and social development Slovenia.[17]

This viewpoint was a commonly prevailing opinion and was justified in various ways. For the sake of illustration, let us have a look at the definition given by Stane Kavčič. This selection is not coincidental, as he was an important figure in Slovenian political life after WW II, and especially in the 1960s and at the beginning of the 1970s. In August 1964, Kavčič published a brochure in which he presented Slovenian viewpoints with regard to the current economic policy in the country and therefore also with regard to the Slovenian position in it. His viewpoint was clear: political differences are most evident in the area of the economy and the economy was becoming the most important political subject. He believed this diversity and, consequently, also the source of this conflict of interests should inevitably be taken into account in any kind of discussion relating to economic policy. The conflict of interest originated in the differences in the economic and social structure found among the Yugoslav regions. He firmly believed that current problems could not be solved by application of the old methods (centralization!). Therefore, Kavčič demanded a change to be made in the economic policy, but in demanding a transition into "intensive management" he saw no obstacles for progress from other regions in the country. Furthermore, he explicitly stated that development of less-developed republics was

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the share of Slovenia in the Yugoslav national income was approximately 15 %, by analogy with conditions in 1952. In 1938, the Yugoslav national income amounted to nearly 48 billion dinars (*Yugoslavija 1918-1988*, p. 95), thus the Slovenian share (15 %) would amount to over 7 billion dinars. According to Gosar, the net outflow of resources from Slovenia amounted to 210 million dinars, accounting for nearly 3 % of the Slovenian national income in 1938. (A. Gosar, *Banovina Slovenija, Politična, finančna in gospodarska vprašanja*, Dejanje, Ljubljana, 1940). To illustrate the increase of the load, let us state the figures from the end of the 1980s. In 1986, the net outflow of resources was 8.8%, in 1987 6.8%, in 1988 9.8%, and in 1989 6.4%. These data were acquired using an appropriate calculation method, whereby the net outflow was compared with the data on national income, all expressed in current prices. The data on the net outflow of resources and on the national income can be found in the *Statistical Yearbook of the Republic of Slovenia* for the Year 1991, pp. 167 and 174.

17 This standpoint was strengthened by the information showing that Slovenia was falling behind in the growth of the gross national product in comparison with other countries. Furthermore, it was expected that Slovenia would fall below the national average in terms of the production volume growth. They felt they were being left out in terms of investment. In the period from the end of the war to the end of the 1950s, only 14% of investments were made in Slovenia, regardless of the fact that over 40% of the so-called "investment goods" were being used. Especially worrying was the fact that in terms of usage, processing industry, which established most of its trade on the Yugoslav market, was in the lead (Arhiv Republike Slovenije. Republiški izvršni svet, Kabinet Viktorja Avblja, fasc. 1; quoted according to J. Prinčič, *V začaranem krogu*, *Slovensko gospodarstvo od nove ekonomske politike do velike reforme (1955-1970)*, Ljubljana, 1999, pp. 165-175

in the interest of the developed republics as well. However, it was his belief that the contribution to this cause had to be used more transparently.[18]

Kavčič too, much like Gosar before the war, argued that economic and social peculiarities featuring in individual republics should be taken into account when creating the economic policy on the federal level. Kavčič went even further with his viewpoints when he served as the Slovenian prime minister. In the 1960s, he became the most exposed Slovenian advocate of ideas on how necessary the reform of the economic system was; he believed the solution was in the introduction of trading elements. The following ideas came forward: the importance of increasing the productivity of labour, market, demand, technological innovation, processing industry, export and the service sector as well as closer integration with Western economies. In the context of the Yugoslav economic space, Slovenia was perceived as a driving force that could, on the basis of a restructured and successful economy, also more effectively contribute to development of the less-developed regions in the country. At first, however, Slovenian contributions to the less-developed republics would have to be somewhat reduced. The Yugoslav economic integration was to take place without pressure on the part of the political centre, stemming from the economic initiative.[19]

This concept was based on the desire to optimize Slovenian advantages within the Yugoslav economic area. Kavčič's idea was to combine technological surplus and a higher level of economic efficiency with the advatages of geographical locations in terms of transport logistics. Due to its relative significance, Slovenia's tensions were, of course, limited when it came to implementing them in practice. Slovenia could not highlight its central position like Croatia or Serbia. These two republics were able to implement their more central position into their economic concepts. From this standpoint, and based on their own dominant economic structure, they wanted to transfer the country's economic centre of gravity to themselves and thus to determine the direction and dynamics of the country's development. Thus in Serbia, the so-called "Danube development concept" was widely accepted, whereas in Croatia the "Adriatic development concept" was a common notion. In the Danube development concept, the following factors were expressed as priorities or comparative advantages: metallurgy, raw chemical industry and, of course, agriculture and the food-processing industry. On the other hand, the Adriatic development concept included a re-orientation towards the West and substantially less declaratively defined sectors as development priorities. The concept was primarily based on Croatian needs, its needs for economic and transport integration, but because of its specific position it had to include Bosnia and Herzegovina as well.[20]

18 J. Prinčič, see above, p. 270; S. Kavčič, Komunisti danes, Ljubljana, 1964, pp. 44-54

19 B. Repe, *Liberalizem v Sloveniji*, Ljubljana, 1992, pp. 40-46; N. Borak, *Ekonomski vidiki delovanja in razpada Jugoslavije*, Ljubljana, 2002, pp. 24-35

20 Borak, see above, pp 24-35

According to the Kavčič circle, Yugoslavia and its market were Slovenia's habitat; this, however, did not prevent them from placing self-confident demands to change the relations within the country. The powers of the federal state would have to be transferred to the republics if Slovenia would want to be given the opportunity to regulate its economic development with a greater degree of independence.[21] Although in different words, this message was astonishingly similar to the one Gosar made before WW II.

The demand for partial transition of the Slovenian economic exchange to Western markets and a subsequent restructuring of the Slovenian economy was greatly upsetting for the more dogmatic circles embedded within the communist organization. In their critical response, the designers of the different development vision of Slovenia, who demanded that relations within the Yugoslav economic area be changed, were accused of deviating from the previous policy of supporting the development of the less-developed countries. The path suggested by the designers of the new strategy was described as too unpredictable and, also, harmful for the current government system. They claimed too much emphasis was given to specific Slovenian interests in comparison to the common ones. There was also a reproach that the designers of this idea were not aware of the advantages offered by the uniform Yugoslav market (Kardelj). They were especially keen on proving the "actual" amount of outflow of resources from Slovenia that was, so it was argued, at least 50 % lower than the one proclaimed. They were pointing out that Yugoslavia was a vital market for the Slovenian industry, because Slovenia "will not be able to sell its goods at such favourable (i.e. high) prices elsewhere" (Popit). Based on the above arguments, the conclusion was drawn by stating that the "deficit" in Slovenia's relations with the rest of Yugoslavia is even lower. The idea was that the deficit as presented by Kavčič did not include inflows resulting from the differences in relative prices between the internal and external markets.[22]

The outflow of financial resources from Slovenia through the fiscal system or by avoiding it was a very sensitive political issue and the public took great interest in it. The generally accepted perception of the public was clear. The public believed that the net outflow of resources from Slovenia was too large and that it presented an important barrier in Slovenia's economic development. Politicians, who claimed otherwise, were not popular with the public. In 1972, Kavčič's government was removed from the position and its plans gradually disappeared from official documents, either in parts or altogether. Nevertheless, their efforts were in some way realized. With the great constitutional reform in 1974, numerous powers were transferred to the republican levels and "economic sovereignty" of the republics was increasingly stronger. In order to balance the

21 J. Prinčič, N. Borak. *Iz reforme v reformo, Slovensko gospodarstvo 1970 – 1991*, Ljubljana, 2006, p. 189

22 J. Prinčič and N. Borak, see above, pp. 170-174

decentralization process, legislators introduced numerous decrees on the unity of the Yugoslav market to both the constitution and a number of laws. Control over the operation of this unified market was entrusted to the central government in Belgrade and its bodies. [23]

The 1970s were therefore characterized by the process of establishing the so-called "republic/national economies". In practice, the process resulted in the tendency to enclose economic life within republic borders, which lead to a decrease in the inter-republic trade of goods and services. The objective was to establish a self-sufficient economic system, both in the administrative and production sense. Party authorities started to introduce a protectionist development model within their respective republics, directed not only against foreign countries but also against other Yugoslav republics and they started to operate as independent national and economic regions.

This is exactly how the republic governments or rather their Executive Councils started to act. Trading activities carried out among the republics became a matter of agreements, negotiations almost. This is the reason why, in the 1970s and 80s, it was not surprising that the republics representatives held gatherings and discussed the procedures of economic cooperation. For instance, they were discussing the possibilities of cooperation in certain branches and industries, joint investments or even joint appearance on third markets – at that time they were thinking of foreign country markets. The media seemed to be interested in inter-republic meetings therefore it was no surprise the main feature shown at the working meetings held by the leaderships of Yugoslav republics was that they were representing the interests of their own republics, which were, in principle, hard to be brought in line altogether.[24]

To present the whole picture, it is important to mention the fact that the Yugoslav republics directed only a small share of their "national" product to trade with other republics or export. Slovenia, for instance, as the most industrialised Yugoslav republic, was one of the most open regions in this respect, though even there, over 60% of the product was spent within its borders. Only 20 to 50% was directed into inter-republic trading. Figures in certain periods deviated from the average, yet not to such an extent that would have made any important changes to this fact. Larger republics were less dependent on the inter-republic trading and had a greater share of product spent at home. [25]

Thoughts and inquiries about the Yugoslav economy or about the role Slovenia played in the Yugoslav market were not put aside. On the contrary, in the

[23] J. Mencinger argues that the operation of the unified Yugoslav market was, besides with the constitution, also regulated by 103 Articles contained in 16 federal laws. J. Mencinger, "Slovensko gospodarstvo med centralizmom in neodvisnostjo", *Nova Revija*, no. 95, Marec 1990, p. 492

[24] J. Prinčič and N. Borak, see above, pp. 79-80, 99, 103, 326-327, 357

[25] F. Kuzmin, *Medrepubliške blagovne menjave kot faktor razvoja razvitejših oziroma manj razvitih republic*, Ljubljana, 1973

1980s, they were becoming increasingly important due to the economic crisis which was increasingly showing that Slovenia, although parting from the rest of Yugoslavia in terms of development, was very much behind its neighbouring countries – namely Austria and Italy, both in relative as well as absolute terms.[26] This fact was undoubtedly frustrating. Moreover, frustration was not on the rise only in Slovenia – it occurred in other Yugoslav republics as well. In the non-developed regions, frustrations were founded on the low level of economic and social development, the prevailing one-sided economic structure, and insufficient competition in domestic as well as external markets. In fact, this was the continuous flow which could be seen both at the time before WW II and after it. [27]

5. Breakdown of Unified Yugoslav Economoc Spase

Viewing from a historical perspective, we can say the perception of the Yugoslav economic space in Slovenes was not one-sided but ambivalent. There was a tension present between the two clashing viewpoints, which were common to both the time between the two world wars and the time of the communist Yugoslav state. It was a question of establishing balance between the two complex and structurally different choices. On one side, there was a notion of self-sufficiency and comfort of the virtually non-demanding and, in terms of developmental dynamics, also non-stimulating market. But on the other side, there were tensions for decentralisation in the political and economic field and the notions that Slovenians would create the adequate economic politics of competitive advantage that would be beneficial for the Slovenian economy[28] and consequently preserve the Yugoslav market by increasing competitiveness in enterprises to be present both at home and on foreign markets. At the same time, this would also diversify the area of trading and, in this way, reduce dependence on the Yugoslav market.

This dilemma was resolved in the late 1980s. In circumstances where the state and the economic system were practically falling apart, the choice was more than obvious. However it will not be too much to mention another two events that symbolically represent two milestones in this process. One of them was symbolic for the intellectual circles, while the other was much more evident to the public eye. The first was the text written by the Serbian Academy of Science and Arts in the mid 1980s, which presented arguments on Serbian dissatisfaction with Yugoslavia as it was after WW II, including the field of eco-

26 P. Sicherl, *Slovenija zdaj. Primerjava indikatorjev razvitosti*, Ljubljana, 1990

27 Ž. Lazarević, "Razkorak med razvitimi in nerazvitimi – zaviralni dejavnik modernizacije Jugoslavije?", *Prispevki za novejšo zgodovino*, no. 2/2002, pp. 77–88

28 In terms of the Yugoslav environment, we are referring to the higher technological level, capital productivity or effectiveness, management and organisation of industrial and logistic processes, raised average level of education, an increase in labour productivity, inclusion into international economic flows, a well-balanced economic and social structure …

nomics. In this respect, the text basically derived from viewpoints that had been heard before, since was is drawn from and developed the argumentative instruments contained in the answer which Serbian intellectuals[29] had once directed to Rudolf Bićanić and his book on the economic position of Croatians[30] in Yugoslavia before WW II. The constant nature of the mind flow was more than evident. According to this opinion, Yugoslav politics after WW II as well as the one practiced before supposedly caused Serbia to relatively regress in terms of its economy, especially if compared to Slovenia and Croatia. The alleged reason for that was due to its less fractioned economic structure and subsequent competitive inferiority in the Yugoslav market that was supposedly controlled by Slovenia and Croatia. Economic policy and the system, which were, so it was argued, inflicted by Slovenia and Croatia, were preventing balance in this unevenness. Allegedly, all these factors were obstacles that could be removed by a centralised regime that would significantly consider the interests of the Serbian economy.[31] The notion of transferring these principles into Serbian political reality had a disruptive effect in Yugoslav politics as well as in the field of economy.

The other symptomatic event, which extensively resounded in Slovene public and political life, goes back to 1989. At the time of extremely conflicting political tendencies in Yugoslavia, Serbian politicians introduced an economic boycott against Slovenia, Slovene products, and Slovene enterprises located in Serbia. However, the boycott was selective in order not to inflict too much damage on the part of Serbian interests and was supervised by political bodies. [32] The whole country was appalled since this was an unprecedented event in Yugoslavia. This obviuslly form of nationalism in the economy, which basically disrupted the idea and practice of a unified Yugoslav market, had yet not been seen. The cause of this boycott, which represented a climax to Serbian economic nationalism, was quite simple. Slovene politicians were, alongside the silent consensus on the part of other republics, the main obstacle standing in the way to the restoration of the centralistic and economically paternalistic state model. However, the effect of this obstruction, which was expected to decrease the Slovene "national" product by 14%[33], was quite the opposite from what was expected, since it only accelarated the disintegration of Yugoslavia.

29 S. Drašković, *Istina o ekonomskoj podlozi hrvatskog pitanja, Odgovor g. Bićaniću*, Belgrade 1940

30 R. Bićanić, *Ekonomska podloga hrvatskog nacionalnog pitanja*, Zagreb, 1938 It is interesting that, in the early 1990s, Jakov Sirotković, a former highly-positioned Yugoslav politician from Croatia, under the impression of war in Croatia, wrote a so-called "spiritual sequel" to the Bičanić book, titled *The Croatian Economy from 1945 to 1992*. Zagreb, 1993

31 Group of SANU academicians: *Memorandum SANU* (undone document in Serbian), Belgrade, 1986: *Duga,* jun 1989

32 B. Repe, *Jutri je nov dan. Slovenci in razpad Jugoslavije*, Ljubljana, 2002, pp. 141-142

33 J. Mencinger, see above, p. 495

The final deviation from the Yugoslav economic policy was defined in 1990 by the economist Jože Mencinger, who presented it in a clear and unbiased manner. Later on, Mencinger became vice president to the Slovene Government, who was responsible for economic issues, where he, in the scope of his power, left a deep mark in economic policy within the first two years of the independent Slovene country. At the beginning of his thesis, Mencinger claimed there was no serious attention given to the economic development in the then anticipated Slovene state, which was, in his opinion, a natural occurrence. The decision to form an independent state was the result of a political will, while the economy was forced to adapt to it. On this level, Mencinger defined what became obvious as early as the time when Slovenia entered Yugoslavia. The economy was in the second plan, while the feelings in national depravation were pushed forward. Moreover, Mencinger drew attention to two extreme delusions. According to the first, Slovenia was to become a country close to Switzerland only by leaving the Yugoslav economic environment and turning into a synonym for rich and well-organised country. On the other side, independence was considered no less than a national suicide. In Mencinger's opinion, both illusions had no firm grounds and he clearly expressed his basic standpoint. The fact that Yugoslavia and its market fell apart was the consequence of the socialist state system. In this way, the path out of socialism also meant the path that lead out of Yugoslavia (Neven Borak). The crisis, which had only been deteriorating since the early 1980s, revealed the incapability of the socialist economic system to secure long-term economic success and stability.

The author also clearly stated that the argument of the Yugoslav market being irreplaceable for the Slovene economy, this leading counter-argument for Slovene demands to decentralise Yugoslavia ever since its foundation, was nothing but a fearful myth. In his opinion, the size of the national economy in the case of internationally-oriented policy, which was expected to take place in the case of the Slovenian economy once the state would become independent, was not a key factor at all. When the Yugoslav market would finally fall apart, Mencinger expected short-term negative and long-term positive side effects. Being embedded into the Yugoslav economic frame, being insufficiently open towards the rest of the world in the economic sense, and the flood of less qualitative products in trading, which could hardly have been sold anywhere else, almost definitely invoked negative effects. In his thesis, Mencinger even found sensible grounds for the Serbian boycott of Slovenian products. As an economist, he had the opportunity to calculate what would have been the actual effects of the terminated economic flows. In the long run, he could only see the benefits of this for the Slovenian national-economic environment. However, he was not too sure whether prices would lower in the newly formed state, but he was not denying that a break in outflows through a fiscal and parafiscal system would have a beneficial effect. Moreover, Mencinger was firm in his belief that an independent

Slovenia could develop "a faster introduction of normal trading economics and better state intervention in the economy due to a more thorough understanding of our own economy, which would also be a more balanced one in terms of development.[34]

6. Conclusion

Today, as we have learnt from the past experience, it can only be said that Jože Mencinger was right. And it is also in other respects that we are now given the chance to wrap up the presentation of problems occurring in the perception of the Yugoslav economic environment in Slovenes through a historical perspective. Slovenia first needed to leave the Yugoslav economic environment in order to reform and restructure its own. The consolidated economy in terms of competitiveness enabled Slovenia to "re-conquer" the markets of former Yugoslav republics, which are now independent states. However, this time it is on different foundations, not on paroles and principles of "brotherhood and unity" but on the trading principles of mutual economic interest. The thesis that had been so clearly defined by Andrej Gosar before WW II and has not died even after 1945, as is evident from the Kavčič's case, was confirmed only after Yugoslavia had fallen apart.

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THE MONETARY-FINANCIAL ORGANS OF THE EUROPEAN UNION

Abstract: *The knowledge of and adequate adjustment to the work of the monetary and financial organs of the European Union is of particular significance for states that are not members of the European Union, especially if, as is the case with the Republic of Serbia, they are expressing a dominant political and economic interest in joining this, certainly one of the most important international regional organizations. Connected with this are both the rights and the obligations attached to this membership, which are especially strictly laid down in the monetary and financial spheres, meaning that their anticipation and incorporation into measures of current economic policy is not something that is dependent, at least for the most part, on the political will of the current holders of political power, but is a fact that must be counted on in actual reality. In that sense, the task of this paper is to shed light on the state of affairs in the area of the European Union's monetary and financial organs, without going into the actual usefulness of their work and existence, either from the aspect of communitarian interests or from the aspect of the interests of individual states, regardless of whether they are member of the European Union or only have the intention of becoming its members.*

Key words: *European Union, "eurozone," Central European Bank, euro, organs of the European Union*

JEL classification: E58, F33

1. Introductory remarks

Parallel with the development of integrative processes within the European Union, which were based on the implementation of the fundamental principles on which the common market of the European Union is based, financial mechanisms and institutions for the support of these integrative processes were also being created and developed together with the establishment of an economic space without internal borders.[1]

[1] V. Ognjanović, *Međunarodno bankarstvo*, Beograd, 2003, p. 267

The normative bases for the realization of those processes are found in Article 2, line 1 of the Treaty on European Union, in accordance with which "the establishment of economic and monetary union, which shall in due time contain a common currency" is set as one of the European Union's primary goals.

However, having in mind the fact that economic integrations in the European Union should be observed only as a process, not as a given state, it follows that the financial institutions that were in the function of supporting these integrative process also manifested themselves in various forms. In that sense, it is necessary to make a distinction between institutions that were in the function of realizing joint development programs, such as, for example, the European Investment Bank, from institutions that came about with the aim of securing conditions for the definition and implementation of a common monetary and currency policy, such as, for example, the European Monetary Institute, the European Central Bank and, emanating out of that, the European System of Central Banks.

2. The European Investment Bank – EIB

The European Investment Bank was established in 1957, through the Treaty on the establishment of the European Economic Community (the European Community since 1992). According to then Article 198b (now Article 266, following amendments and additions to the original text), in part five, which regulates the organs of the European Community, the European Investment Bank is provided for as a separate organ, in Chapter 5. It can, thereby, be clearly and indisputably concluded that the European Investment Bank has the properties of a communitarian organ, with a precisely defined status and functions that it must carry out as an organ of the European Union. Connected with this is a basic contradiction that careful analysis reveals. This contradiction comes out, on the one hand, from its autonomy as an independent financial institution and, on the other, from its connection to contributing to the achievement of the economic policy defined and implemented by other organs of the earlier European Community – the present-day European Union. In that context, our attention is drawn to the opinion of the European Court of Justice, given in Judgment 85/86 of March 3, 1988, which recognized the functional and institutional autonomy of the European Investment Bank, but which also underlined that this "does not have as a consequence the total separation of this financial institution from the framework of the organs of the Community."[2] According to the above-cited Article 266 of the Treaty on the European Community, the European Investment bank has the properties of a legal entity, with its members being the mem-

[2] Cited judgment of the European Court of Justice, according to: Jean-Claude Zarka, *The Essentials of the Institutions of the European Union* (Serbian translation: *Osnovi institucija Evropske unije*), Beograd, 2004, p. 103

ber states of the former European Community, now the European Union. The seat of this bank is in Luxembourg.

As a legal entity, the European Investment Bank has its organs of governance, among whose competencies are competencies for adopting decisions through which the functions of this financial institution are realized. The basic organs of the European Investment Bank are: Board of Governors, Administrative Council (Board of Directors), Management Committee and Audit (Verification) Committee.

The **Board of Governors** consists of ranking ministers (as a rule, ministers in the areas of economics or finance), with each member state delegating one minister to the Board of Governors. In reviewing the competencies that have been transferred to this organ, it can be concluded that the Board of Governors has a dominant position within the European Investment Bank. Its competencies include setting the general guidelines of the bank's credit policies, especially regarding the goals that have been set in accordance with the development of the common market.

In that sense, the Board of Governors is specifically authorized to:

- set the bank's general and credit policies;
- approve the bank's activities outside the territory of the European Union;
- review the report of the Audit Committee, as well as review the financial state of the bank, including operating profits and losses, and adopt the annual report;
- name the members of the Administrative Council (Board of Directors), the Management Committee and the Audit Committee.

In addition to the above, the Board of Governors of the European Investment Bank oversees the implementation of its decisions.

The Administrative Council (Board of Directors) is made up of 25 members and 13 deputies named by the Board of Governors. Of the said number, 24 members and 12 deputies are proposed by member states, while the European Commission proposes one member and one deputy. The members of this organ are persons of professional competence and personal independence. In their work, the members of the Administrative Council are responsible only to the European Investment Bank. In case their function ends, members of the Administrative Council can be replaced for the remainder of their mandate.

The Administrative Council is exclusively responsible for financial operations and decisions on granting loans and credits, and for approving borrowings. In addition, this organ is authorized for the following tasks:

- ensuring the execution of the Bank's functions in accordance with the founding acts, the Bank's statute and the guidelines set by the Board of Governors;
- approving loans;
- approving conclusions regarding guarantees and borrowings;
- proposing credit policy changes to the Board of Governors.

Each member of the Administrative Council has one vote. As a general rule, decisions are adopted through a simple majority of members with voting rights. More detailed provisions on the working quorum and decision-making within this organ are contained in the Statute of the European Investment Bank.

The **Management Committee** is the executive organ of the European Investment Bank, charged with managing the Bank's daily operations.

The Management Committee is made up of the president and six vice-presidents, named to a six-year term by the Board of Governors on the recommendation of the Administrative Council. The president or, in case he is prevented, the vice-president of the Managing Committee, represents the European Investment Bank in relations with third persons.

The basic function of the Management Committee is to propose and execute the decisions of the Administrative Council. In addition, its functions include controlling the accuracy of accounting data significant for the operations of the European Investment Bank.

The Audit or Verification Committee is the basic internal organ for controlling the work and operations of the European Investment Bank. This organ, made up of three members named by the Board of Governors, has the task of producing a yearly report on the legality of operations and accuracy of the Bank's accounting data. Besides the Audit Committee, also significant for controlling the operations of the European Investment Bank are special forms of control carried out through external and internal auditing controls, as well as by way of a separate Financial Control Board within the organizational structure of the European Investment Bank, whose competencies also include the monitoring of the Bank's financial results.[3]

From the fact that the organization of the operations of the European Investment Bank is directly connected with the economic policy of the European Union arises the obligation of informing the organs of the European Union about the work of the European Investment Bank. Namely, even though the organs of the European Investment Bank enjoy full autonomy in making decisions within the scope of their competencies, as defined by the founding acts and the Bank's Statute, the European Investment Bank is obligated to inform

[3] Z. Stefanović, *Pravo Evropske unije*, Beograd, 2003, p. 122

the organs of the European Union regularly and wholly regarding the execution of these decisions. Toward that end, the Bank submits an Annual Report, which is very detailed and encompasses all operations that make up the entire balance of the Bank's activities. In addition, the Bank submits a list of all its financial projects and their characteristics. This report is separately reviewed at the Council of the European Union and in the European Parliament. Also, at the invitation of the European Parliament, representatives of the European Investment Bank participate in the work of certain parliamentary commissions, which debate problems either directly or indirectly connected with investment activities within the European Union.[4]

The basic function and task of the European Investment bank is to contribute through its activity to a balanced and harmonious development of a common market in the interest of the European Union. Toward that end, it helps the financing of development projects in all sectors of the economy on a non-profit basis, and especially:

- programs for the development of less developed regions;
- programs for the modernization or restructuring of companies, or for starting new businesses in the function of the gradual establishment of a common market, which, by their scale or nature, cannot be wholly covered by various forms of financing available at the member state level;
- projects of joint interest to several member states, which by their scope or nature cannot be wholly covered by various modes of financing available at member state level.

It may be concluded from the above that the activities of the European Investment Bank are primarily oriented toward three basic goals. The first is the development of insufficiently developed regions within member states. The second is the adjustment of existing economic entities to the changes brought on by the establishment and functioning of a common market without borders within the European Union. And third are projects of European significance, of joint interest for several member states, which by their character surpass the interests and financial potentials of each individual interested state.

In addition, the European Investment Bank helps the financing of investment programs with the participation of structural funds and the community's other financial instruments. Toward that end, in June 2000, the European Investment Bank and the European Investment Fund jointly formed the European Investment Bank Group, with the European Investment Bank as the majority stockholder of the European Investment Fund.[5]

4 V. Ognjenović, ibid., p. 269

5 Jean-Claude Zarka, *Osnovi institucija Evropske unije*, Beograd, 2004, p. 106

The business policy of the European Investment Bank is founded on the following criteria, which are in the function of realizing the goals of its founding, and which especially apply to:

- securing the most favorable means of placing financial funds for financing projects that promote the increased competitiveness of economic entities from the area of the European Union;
- providing aid to and advancing the activity of small and medium enterprises;
- enabling the creation (construction) and maintenance of trans-European networks (transport, telecommunications, long-distance electric grid, and similar);
- creating the conditions for increasing the employment rate of the working-age population;
- contributing to the protection of the environment and the improvement of urban living, etc.

This policy of the European Investment Bank is primarily applied to activities within the member states of the European Union, where about 90% of the total available financial funds are placed. In addition, the bank strives to financially stimulate the creation of conditions for sustainable development in states and regions where member states of the European Union have a pronounced joint interest, such as the Mediterranean states, the West African states, the Caribbean and the Pacific region, and especially overseas territories that have special relations with European Union member states.[6]

The financial means at the disposal of the European Investment Bank are secured on the basis of the following two sources. The Bank's own funds, contributed by the member states as a share of their capital in the Bank. Here, a principled distinction must be made between the subscribed capital of the member states, which equals almost 100 billion euros, and the paid-in capital equaling about 6 billion euros. The second source is funds raised on the financial market, totaling more than 150 billion euros. In addition to this, the European Investment bank can, under certain conditions, draw financial resources from the budget of the European Union.

Recipients of European Investment Bank funds, in the form of direct credits and approved guarantees, can be all public and private legal entities, or international business actors under the additional condition that the Bank's crediting share in the financing of a particular project does not exceed 50% of the project's estimated value.

[6] V. Ognjenović, ibid., p. 208-209

3. Economic and Monetary Union

3.1. History of the creation of the Economic and Monetary Union

The monetary cooperation of European states has a long tradition, but was especially intensified after the end of World War II. The result of that cooperation, among other things, allowed the convertibility of the main European currencies and contributed to the expansion and stabilization of the European economy, i.e., allowed the recovery of the European countries' war-torn economies. The cooperation of European states in the monetary sphere in that period was characterized by unbridled initiative, which was then mutually coordinated within the framework of international financial organizations of a global character, before all the International Monetary Fund.[7]

Thus, the first European integrative acts, in the first place the Treaty on the creation of the European Coal and Steel Community, did not contain provisions either for the creation of a monetary union or even for the cooperation of member states in that area. This subject matter started to be considered during negotiations on the formation of the European Economic Community, as an important economic regional integration of a supranational character. As common-market relations were being established within the framework of this community, together with respect for the proclaimed principles regarding the free flow of goods, services, capital and people, it was necessary to construct an appropriate monetary mechanism that would be in the function of the realization of these goals.

In that context, the Treaty on the creation of the European Economic Community (Paragraph 2, Article 105) states that the European Economic Community, by way of its organs, secures the setting and implementation of the community's monetary policy. In other to achieve these goals, an advisory organ at the Community level, the Monetary Committee, was to be formed.

The task of the Monetary Committee, in accordance with the provisions of Article 114 of the Treaty on the creation of the European Economic Community, was:

- to monitor the monetary and financial situation of the member states and the Community, as well as the general system of payments, and to regularly inform the Council and the Commission about this;
- to provide opinions, either upon request of the Council or the Commission or self-initiatively, for the purposes of these institutions;
- to inquire into the state of affairs in the areas of capital movements and freedom of payment at least once per year, as provided for by the founding documents and measures brought by the Council and, accordingly, to make appropriate proposals.

7 V. Ognjanović, ibid., p. 241

The Statute of the Monetary Committee laid out the tasks of this organ in greater detail, giving it authority to investigate the monetary and financial situation of member states in order to anticipate eventual problems. The results of investigations could serve as cause for limiting payment operations, which was provided for by the founding acts.

In accordance with the existing provisions of the Treaty on the creation of the European Community, i.e., the European Union, for the purpose of establishing a common market, as well as the Economic and Monetary Union, which are highlighted in Article 2 as one of the basic goals of establishing the European Community, i.e., the European Union, the functions of carrying out economic and monetary policy have been transferred to the Community, i.e., its organs. The establishment of an economic and monetary union is mentioned in that context, since the Community organs have exclusive competence in this area.

Economic and monetary union are closely connected and, thus, the measures of one significantly influence the other. Economic union would be difficult to achieve without monetary union, i.e., the authority of communitarian organs to carry out monetary policy. Hence, the development of the Monetary Union was directly connected and conditioned upon the development of the common market institutions as an economic environment in which the functions of economic union would be realized.[8]

In connection with this, generally speaking, three periods of mutual harmonization of economic and monetary union within the framework of the European Economic Community can be observed.

The first period encompasses the beginning of the work and functioning of communitarian organs and institutions, and lasted until the 1970s. In that period, monetary cooperation between economic states was also taking place at the level of the International Monetary System (Committee).

The second period is linked to the beginning of the 1970s when, once the dollar's peg to gold was ended, the European Economic Community began seeking its own solutions, particular to the member states themselves. Toward that end, on the basis of the conclusions of the Community Council of 1969, a report (known as the Werner Report) was issued, recommending the creation of an economic and monetary union in three successive phases, whose ultimate result would be the creation of a common market, characterized by the free movement of goods, services, capital and labor. Toward that end, the creation of a single currency was proposed, or at least the achievement of the total convertibility of European currencies and a fixed rate of exchange between them.

It was anticipated that these goals would be dynamically realized in three phases. The first phase was to begin on January 1, 1971, and last for three years. An important feature of this phase was supposed to be the establishment of direct cooperation in the process of defining mid-term economic policy, as well

8 Z. Stefanović, ibid., p. 123

as closer cooperation between states and central banks in the fields of credit and monetary policy. However, changes that occur on the global level at that time, especially the abandonment of the gold standard on the part of the dollar, the dominant global currency at that time, forced certain adjustments in the monetary policy of the European Economic Community's member states. The end of the dollar's convertibility brought an end to its trading at a fixed exchange rate, which was set within the IMF on the basis of the Smithsonian Agreement of 1971. The bounds of currency oscillation were set at ±2.25%, including the dollar. Due to the specific nature of the economies of the member states, this system of correcting currency values for European Economic Community member states was set in 1972, on the basis of the Basel Agreement, within the range of ±2.5%, with possibility of fluctuation in special cases of ±6%. This system of exchange-rate fluctuation, popularly known as the "snake in the tunnel,"[9] did not produce the expected results and was totally abandoned after the first devastating monetary effects caused by the oil crisis of 1973. As a result, the next two phases of the program of establishing economic and monetary union were not even activated. Instead, it was concluded in 1975, on the basis of the so-called Majolin Report, that the Werner Plan of 1970 had failed.[10]

The third period of establishing the Monetary Union began in 1978, with the adoption of the plan on forming a European monetary union, which began to be implemented in March 1979, with an agreement on operative procedures on the part of the central banks of the European Economic Community member states.

The idea about the creation of the Monetary Union was not basically changed but the measures that were to be applied in order to secure its achievement were. Namely, the mechanism of determining the currencies' parity with the dollar was finally abandoned and a new settlement currency of the European Economic Community states was established. This was, thus, a redefinition of the European Monetary System, whose base now became the European Currency Unit (ECU).

The goals of the European Monetary System were:

- the establishment of a higher degree of monetary stability within the European Economic Community;
- support for lasting and stable economic growth of the member states' economies;
- a faster return to full employment;
- equalization and growth of the standard of living, and
- the reduction of regional differences within the European Economic Community.

9 V. Ognjenović, ibid., p. 141

10 Z. Stefanović, ibid., p. 127

In addition to the above, the European Monetary System had the goal of facilitating the convergence of economic growth and fostering the development and the formation of the European Union.

The mechanism of establishing parity of the currencies of the European Economic Community member states through the introduction of the European Monetary System was changed, so that currency values were not set against the dollar but against the ECU. In that context, each state participating in the European Monetary System would set the median value of its currency, denominated in the European Currency Unit – the ECU, on the basis of fixed exchange rates.

The median value of the thus set exchange rates was formed with certain allowed fluctuations, ranging between ±2.25% to ±6%. Interventions of member state central banks in order to maintain the thus set exchange rates were mandatory and were not limited by any special measures. Moreover, in order to sustain the established exchange rate values, the practice of mutual borrowings between the member states' central banks was established. The debts and claims created on the basis of these interventions were liquidated in ECUs.

However, differences in the development conceptions of individual European Monetary system member states, along with imperfections in the functioning of the ECU, created the need for giving a new impulse to the development of the Monetary Union within the framework of the European Community.

Of special significance for the development of the Monetary Union was the passage of the Single European Act, which, although it does not explicitly contain provisions on the establishment of the European Union, creates the necessary economic as well as political environment for the implementation of this plan. Toward that end, at a meeting of the Council of the European Union, held in Hanover in 1988, a special committee was formed as a working body of the Council, with the task of considering and recommending the necessary measures and means for the final establishment of the Economic and Monetary Union. This committee was presided over by Jacques Delors, then president of the Commission. This committee proceeded to submit a report (known as the Delors Report) in 1989, in which the formation of a European and a monetary union was once again recommended, only this time with a concrete program of measures adapted to the given conditions.

In the report of the Delors Commission, the Monetary Union was defined as a "currency zone in which a common policy toward the adoption of common macroeconomic goals is conducted." Such a conceived Monetary Union assumed:

- the securing of total and irreversible convertibility of national currencies;
- the total liberalization of capital transactions;
- the full integration of the banking and other markets, so that all transactions would be performed on a communitarian basis;

- the removal of the existing margins of fluctuation of the national currencies and a definite setting of currency parities.

This report anticipated the realization of these goals in three phases, whose final result was supposed be a single European currency and a system of European central banks, headed by the European Central Bank.

In accordance with the plan and program contained in the Delors Commission report, as well as the practically implemented measures and the appropriate amendments and supplements to the founding acts, the creation and development of the European Economic and Monetary Union has three clearly differentiated phases.

The first phase began on July 1, 1990, and lasted until December 31, 1993. The basic goal to be achieved within this phase was the formation of an internal market, within which all measures limiting the movement of capital and payments were abolished, together with ensuring the greater cohesion of member states through the harmonization of economic and monetary policy within the given normative framework. An addition goal was the harmonization of monetary policies and a more adequate coordination of national central bank measures.

Toward the realization of these goals, the member states were required to:

- remove all restrictions on the movement of capital in their internal relations as well as vis-à-vis third states, non-members of the European Community;
- review regulations so as to prevent the European Investment Bank and the central banks from approving negative balances or any other form of credit to Community institutions or organs, central directorates, regional or other local organs of authority and other public organizations and companies, and to forbid all measures not based on estimates of a financial character and which allow Community institutions or organs, regional or local organs and other public organs or bodies privileged access to financial institutions;
- coordinate their economic policies with the Council toward the establishment of common goals;
- adopt the necessary multi-year programs with the aim of achieving lasting convertibility, which is necessary for the achievement of economic and monetary union, especially in the area of price stability and securing a sound financial situation in the public sector.

Actually, it was expected that the necessary platform for the succeeding phases would be created in this phase, within which a single market, sound budgetary discipline and a coordinated economic policy and exchange rate policy would established.[11]

[11] R. Vukadinović, *Pravo Evropske unije*, Beograd, 2001, p. 242

The second phase began on January 1, 1994 and, contrary to initial plans, lasted until 1999 instead of January 1, 1997. The basic goal to be achieved in this phase of building the Monetary Union was the further harmonization and convergence of the member states' monetary policies, as well as the establishment of the appropriate monetary institutions with the goal of eventually transferring monetary authority to the communitarian organs.

A specific feature of this phase of building the Monetary Union was the establishment of the European Monetary Institute, whose seat was in Frankfurt am Main. Its basic function was to coordinate the monetary function of the member states and conduct preparations for transition to the third phase, in which the European System of Central Banks and the European Central Bank as the base organs of the Monetary Union were to be established.

The European Monetary Institute was established on January 1, 1994, as a legal entity with the right of disposal of its own financial means formed from contributions by member state central banks. The Institute was governed by only one organ – the Council, composed of the governors of the national central banks and the president of the Institute, who was named by the Council on the basis of a jointly agreed proposal by the chiefs of state or government and the central bank governors of the member states. The president of the European Monetary Institute was named for a term of three years, with right of reelection to his function.

The members of the Institute Council were independent in the execution of their functions, both in relation to the member states and to other Community organs. Only the Court of Justice of the European Union could decide on the dismissal of the president of the European Monetary Institute.

The European Monetary Institute, which was in a way the predecessor of the European Central Bank, was particularly charged with the following tasks:

- strengthening cooperation between national central banks;
- strengthening the harmonization of the member states' monetary policies, in order to ensure price stability;
- controlling the functioning of the European Monetary System;
- conducting consultations regarding questions under the jurisdiction of the national central banks, which influence the stability of financial institutions and markets;
- taking over the functions of the European Fund for Monetary Cooperation within the European Monetary System;
- facilitating the use of the ECU and supervising its development, including the successful functioning of compensations in that currency;
- preparing the necessary instruments and procedures for implementing a single monetary policy in the course of the third phase;

- fostering, if needed, the harmonization of rules and practices regulating the collection, processing and dispersion of statistical data in the area of its competency;
- setting down the rules for regulating the work of national banks within the European System of Central Banks;
- fostering the efficiency of cross-border payments;
- supervising the technical preparation of ECU bank notes.[12]

The European Monetary Institute also had significant consultative functions, especially when it came to giving opinions and recommendations regarding the general guidelines of currency and monetary policy, as well as regarding measures brought in relation to those questions by the national organs of the member states.

The European Monetary Institute had the authority of bringing appropriate acts, in the form of opinions and recommendations, in the area of monetary policies conducted by the member states, and the Council was obliged to consult with it before adopting acts from the area of the Institute's competencies.

At the end of 1996, the European Commission and the European Monetary Institute defined the criteria which the member states must fulfill in order to secure the conditions for transition to the next phase of development of the Monetary Union, i.e., a zone of forming a single European currency. At that time, four criteria of harmonization were set down:

1) strict respect of the currency fluctuation margins of +/-2.25% of the current European Monetary System, for a period of two years;
2) the rate of inflation must not exceed by more than 1.5% the average rate of inflation of the three member states with the lowest inflation rate;
3) the budget deficit must be less than 3% of the gross domestic product, while the public debt must not exceed 60% of the gross domestic product;
4) long-term interest rates must not exceed by more than 2% the average interest rate of the three member states with the lowest interest rate.

On May 3, 1998, taking into consideration the said harmonization criteria, and on the basis of the joint report of the European Commission and the European Monetary Institute on the achieved progress of the member states and the fulfillment of the conditions from the second phase, the Council of the European Union adopted a decision according to which 11 member states had fulfilled the necessary conditions for transition into the third phase, which was to start on January 1, 1999 and last until January 1, 2002.

The member states that remained outside the so-called eurozone were Greece (which had not fulfilled the majority of the criteria at that time), Sweden (which

12 J-K. Zarka, ibid., p. 89

had not completed the harmonization of its laws), and Great Britain and Denmark (which, as before, wanted to "wait and see" how things were developing and decide accordingly at a later time). In the meantime, in 2000, the Council determined that Greece had fulfilled the prescribed conditions and that it could join the so-called eurozone on January 1, 2001.[13]

The European Monetary Institute played an essential role in the choice of the design of the bank notes and coins to be used for the Euro-currency.

The third phase of the development of the Monetary Union began on January 1, 1999. The basic goal to be achieved within it was the ending of the transition to the Monetary Union, on two bases: first, by releasing into circulation the common currency – the euro, and, second, by the foundation and the beginning of the work of supranational monetary institutions of a communitarian character, i.e., the European System of Central Banks and the European Central Bank.

One of the features of this phase was that the currency of the member states, based on Council decision number 2866/98 of December 31, 1998, were irreversibly fixed to the new common currency – the euro, on the basis of the inter-currency relations that existed in the European Monetary System on that date. The exchange rates of the member states that had fulfilled the conditions for transition into the third phase were formed in accordance with the following reference values:

1 euro	= 40.3399 Belgian francs
	= 1.95583 German marks
	= 166.386 Spanish pesetas
	= 6.55957 French francs
	= 1936.27 Italian liras
	= 40.3399 Luxemburg francs
	= 2.20371 Dutch guldens
	= 13.7603 Austrian schillings
	= 200.482 Portuguese escudos
	= 5.94573 Finnish marks
	= 340.750 Greek drachmas

Such a formed exchange rate was irrevocably set, which meant that, in the period from its coming into force to the moment when the member states exchanged their currencies for the euro as the new currency, it was not possible to change it according to the usual procedure. In this way, the euro became a full-fledged currency, and the currencies of the member states could be exchanged for the euro or mutually only according to these irrevocably fixed exchange rates.

In that context, by its Decision (protocol) no. 974/98, the European Council provided that, beginning with January 1, 1999, the euro would be introduced

13 On January 1, 2008, Slovenia was admitted into the "eurozone" club of states, as the first among the 12 newly-admitted members of the European Union.

as the currency of all the member states of the European Union. In connection with this, a transition period was provided for, during which the euro would be used as an accounting unit and a means of cashless payments. In the period from January 1, 1999, to December 31, 1999, it was possible to make payments both in euros and in the national currencies of the member states, according to the irrevocably fixed exchange rate. From January 1, 2002, euro bank notes and coins were released into circulation, with the member states of the so-called eurozone being obligated to exchange their national currencies into the euro within six months at the most. After the expiry of that term (June 30, 2002), the euro would become the only official means of payment in all the member states of the so-called eurozone.

Besides the monetary currency aspect, at the beginning of the third phase of establishing the Economic and Monetary Union all the member states completely transferred their competencies for conducting monetary policy to the communitarian organs, in the first place the European System of Central Banks and the European Central Bank as the single and supreme monetary authority within the European Union.

Parallel with the establishment of the monetary organs in the European Union, with the transition to the third phase of forming the Economic and Monetary Union, the Economic and Financial Committee was also formed, substituting the position and functions of the former Monetary Committee. The Economic-Financial Committee is not an organ of either the European System of Central Banks or the European Central Bank but has its own operative independence in the system of communitarian organs. Its basic function is to analyze the free movement of capital and the freedom of payment between the European Union member states and send its findings to the Council of the European Union and the European Commission.

3.2. European Central Bank – ECB

The European Central Bank was established on June 1, 1998, with its seat in Frankfurt am Main (Germany), and represents continuity in the work of the institutions of the Economic and Monetary Union, having wholly substituted the functions of the European Monetary Institute, which ended its work on January 1, 1999.

With the project of the Monetary Union, a new currency, the euro, was born, along with a new central bank, whose primary function was to devote itself to that new currency – the euro, i.e., to be the guardian of its value as well as an unconditional, indisputable and independent protagonist of its powerful use.[14]

Pursuant to Article 107 of the Treaty on the creation of the European Community (in the final text) the European Central Bank is a legal entity. In accord-

[14] V. Ognjanović, ibid., p. 295

ance with that status, in each member state the European central Bank has the broadest possible legal authority that is granted by the national legislature to legal entities. In that context, the European Central Bank can acquire or sell movable or real property, and can be a party in any legal dispute. This ensured this financial institution's necessary independence, which was an essential prerequisite for a successful and unhindered execution of its functions.

In that sense, it was explicitly defined that, in the course of exercising its powers and executing the goals and tasks coming out of the founding acts and the Statute of the European Central Bank, neither the bank itself nor the national central banks or any member of their decision-making organs may request or accept instructions from Community organs or bodies, member state governments or any other organ. In connection with this, the organs and bodies of the Community, as well as the governments of the member states, obligate themselves to accept this principle, in the sense that they shall not try to influence members of the decision-making organs of the European Central Bank or the national central banks in the execution of their tasks.[15]

In addition, each member state is obliged to ensure the harmonization of its national laws, including the statute of its national central bank, with all the provisions of the founding acts and the Statute of the European System of Central Banks.

Thus were created the conditions for the full legal and operational independence of the organs and institutions of the Monetary Union, both in relations with other Community organs and, specifically, in relations with the monetary organs of the member states.

The basic functions of the European Central Bank are:

5) defining and implementing monetary policy in the zone of the euro;
6) carrying out exchange rate operations, maintaining and managing the official currency reserves of the states in the euro zone;
7) issuing bank notes in the euro zone;
8) promoting and improving the system of payments in the euro zone.

The execution of these functions is oriented toward the realization of the dominant goal which as defined by the founding acts, i.e., preserving price stability.

Of course, the realization of this goal does not contradict the basic principles on which the economy of the European Union member states rests, such as the principle of an open market economy based on free competition, along with support for a more efficient distribution of resources and respect for a basic com-

15 *The Founding Act of the European Union* (Serbian translation: *Osnivački ugovori Evropske unije*) edited by D. Lopandić, PhD, Beograd, 2003, p. 103

mitment to sound public finances, favorable monetary conditions and a stable balance of payments.

Since, other than a proclamation on "preserving price stability," the founding acts did not provide for quantitative indicators according to which the achievement of this goal would be defined, the European Central Bank has adopted a precise quantitative benchmark for measuring price stability. According to that benchmark, it is considered that prices in the euro zone are stable if the yearly growth of harmonized consumer prices is less than 2%.

In the achievement of these goals, the European Central Bank is responsible for setting the interest rates in the euro zone, as well as for the daily management of exchange operations with the goal of avoiding inflation.

The European Central Bank is solely authorized to approve the issuing of bank notes in the member states of the eurozone. On that basis, the European Central Bank and the national banks can issue such bank notes. Only bank notes issued by the European Central Bank and the national banks, as approved by the European Central Bank, will be treated as legal tender. The member states can only issue coin in the amount approved by the European Central Bank, to the extent necessary for ensuring their normal circulation.

In carrying out its functions, the European Central Bank is authorized to adopt: rules (acts) necessary for carrying out its tasks; decisions necessary for carrying out concrete operations; recommendations and opinions. Rules (acts) have a general function and each of their elements is bindingly applied with direct effect in each member state. A decision is binding in all elements, but only for those subjects to which it applies. Recommendations and opinions do not have binding power. The European Central Bank may decide to publish its rules (acts), decisions, recommendations and opinions in the Official Gazette of the European Union.

In addition to the said operation, in cooperation with the national central banks the European Central Bank collects the necessary statistical data, either through authorized national organs or directly from economic entities, for the purposes of carrying out its tasks. Toward that end, it cooperates with the Community institutions or organs, with the authorities of the member states, as well as with third countries and international organizations.

The European Central Bank owns its own capital and assets. The founding capital of the European Central bank equals 5 billion euros. This capital was subscribed and paid in by the national central banks of the member states, according to a predetermined key, taking into consideration the size of the gross national product and population of each member state. However, only the national central banks of the eurozone states were obliged to pay their portions in their entirety, which they have done, while the national central banks of the other states were obliged to pay 5% of the subscribed amount. As a result, the total paid-in capital of the European Central Bank equals about 4 billion euros, and not the 5 billion that was subscribed. In addition to the subscription and depositing of the founding capital, the eurozone member states also have the obligation of keeping their foreign currency reserves with the European Central Bank. According to some estimates, these reserves amount to 40 billion euros.[16]

Since the European Central Bank came about with the introduction of the euro as the means of settlement, and that it exercises its competencies only vis-à-vis the states in which the euro is legal tender, this necessitated a specific structure for the management of this financial institution. The basic organs of management of the European Central Bank are the Board of Governors and the Executive Board (Directorium).

The **Board of Governors** is the highest decision-making organ in the European Central Bank.

The basic function of the Board of Governors is to define and implement monetary policy in the euro zone. Additionally, it has the sole authority of determining the interest rate according to which commercial banks can draw money from the central national bank. This organ also adopts decisions related to the implementation of the set monetary policy. The Board of Governors is made up of the Executive Board (Directorium) and the governors of the national central banks.

The Board of Governors meets at least ten times a year. A quorum of two-thirds of Board members is necessary in order to adopt decisions. In case of a lack of quorum, the president of the Board of Governors may convene an extraordinary session, at which decisions can be made without a quorum.

In principle, each Board member has the right to a single vote (the exception being when, in accordance with the Statute, members of the Board of Governors are deciding on the share of their national central banks in the subscribed capital of the European Central Bank). The Board of Governors makes its decisions by way of a simple majority, unless provided differently by a separate act. In case of an equal number of votes, the vote of the president of the Board of Governors is decisive.

The meetings of the Board of Governors are closed to the public and confidential, but the Board has the right to decide to inform the public about the results of its work.

The Rules of Procedure of the Board of Governors provide for the possibility that a member of the Board of Governors who will be prevented from voting for an extended period of time can authorize someone else to represent him in the capacity of member of the Board of Governors.

The Executive Board is the executive organ of the European Central Bank and, as such, is changed with implementing the monetary policy adopted by the Board of Governors and, within that framework, gives the necessary orders and instructions to the national central banks. The Executive Board prepares the

[16] Z. Stefanović, ibid., p. 129

sessions of the Board of Governors, but the Board may also transfer additional competencies to the Board.

The Executive Board is composed of a president, vice-president and four members. The members of the Executive Board are jointly named by the governments of the member states, being chosen from the ranks of personalities with known and recognized expert authority and experience in the monetary, i.e. budgetary sphere. The decision on naming is made at the level of chiefs of state or government, at the recommendation of the Council of the European Union, after consultations with the European Parliament and the Board of Governors.

Only citizens of European Union member states can be members of the Executive Board. Their mandate lasts eight years and cannot be renewed. The members of the Executive Board carry out their functions professionally during full working hours, and no member may professionally engage in any other work, with or without compensation, except upon exceptional approval of the Board of Governors.

Each member of the Executive Board present at a session has voting rights and represents a single vote. Unless otherwise provided for, the Executive Board makes its decisions by way of a simple majority. In case of an equal number of votes, the vote of the president is decisive.

The Executive Board is responsible for the running operations of the European Central Bank.

If a member of the Executive Board no longer fulfills the conditions for carrying out his functions or if he has committed a serious error in his work, the Court of Justice of the European Union can, upon request of the Board of Governors or the Executive Board, dismiss him from his function. In case of dismissal of a member of the Executive Board, a new member is named according to the procedure for electing Executive Board members.

In addition to these two basic organs, the European Central Bank also contains *General Council* of the European Central Bank, which was established as a transitional organ, since not all the European Union member states necessarily participate in the single currency, or at the same time. This organ is made up of the president and vice-president of the Executive Board and the governors of the central banks all the European Union member states. The other members of the Executive Board have the right, without voting rights, to attend sessions of the General Council. The basic function of the General Council of the European Central Bank is to contribute to the quality of consultations and the coordination of the work of the European Central Bank, as well as to prepare for eventual future expansion of the euro zone, i.e., the accession of new member states to the zone.[17]

[17] J-C. Zarka, ibid., p. 95

3.3. European System of Central Banks – ESCD

Since, having transferred monetary and financial authority to the Community organs, the European Union member states have not totally renounced their influence in the field of monetary policy, the issue of the coordination of these policies from the communitarian level, as well as the maintenance of the legal and operational independence of the national central banks, has come up as a separate question. The establishment of a new sui generis organ – the European System of Central Banks, resolved this.

The European System of Central Banks is made up of the European Central Bank and the central banks of the member states (national central banks and the Luxembourg Monetary Institute, which has the status of the Luxembourg central bank).

The organs of the European Central Bank manage the European System of Central Banks. Its basic function is to: define and implement the monetary policy of the European Union; carry out foreign exchange-currency operations; manage the common foreign currency reserves of the member states and foster the smooth functioning of the payment system between the member states. In addition, the European System of Central Banks contributes to a more successful realization of the policy of the competent organs having to do with the quality control of credit institutions and contributes to the stability of the financial system. In that context, the European System of Central Banks has significant advisory-consultative functions. Namely, this organ is authorized to provide opinions to Community institutions or organs, as well as to national organs, in the domain of its competencies.

The establishment of such a centralized system, with elements of decentralization (since the national banks of the member states have retained their status of legal entities, with their own autochthonous organs of management), has secured the functional unity that exists within the European Monetary Union. In that way, along with securing the execution of the policy of the European Central Bank and the necessity of harmonizing the national legislatures with Community regulations, the European Central Bank is still obliged to consult the national central banks regarding certain issues, although the need and usefulness of such consultations is at the sole discretion of the European Central bank.

4. Concluding remarks

The monetary-financial organs of the European Union, as is the case with the other organs and institutions of the earlier European Community, now the European Union, did not have a clear normative basis and a harmonious path of development. A pronounced pragmatism, which is one of the essential features of the development of the European Union, was manifested in this segment in the taking of varying, often opposing viewpoints on the issue of the status features and functional characteristics of the monetary and financial organs. Nevertheless, by monitoring the achieved level of the economic integration of the economies of the European Union member states, which is currently manifested in the single market, without internal borders, the vision of the monetary and financial organs that exist today within the European Union has developed and crystallized.

The task being placed before these organs is of an essentially twofold nature. The first segment of obligations is connected with ensuring the harmonious development of all the member states, and especially the regions within these states, which have differing economic and development potentials. Parallel with this comes the need for financing so-called European development projects, which express the common economic-developmental interest of several European Union member states but which, at the same time, exceed the financial capacities of each of them individually. This segment of operations has been delegated to the European Investment Bank, as an autochthonous financial institution that was created together with the European Economic Community during the mid 1950s.

The second segment has to do with the establishment of the Economic and Monetary Union and has been manifested in the existence of the European System of Central Banks and the European Central Bank. The foundation of these financial institutions and the basic tasks with which they are charged has been determined by the euro as the common currency of a certain number of European Union member states (the so-called eurozone). The fact that the majority of the European Union member states are still not members of the eurozone (12 member states are effectively members of the eurozone) does not reduce but, rather, raises the significance of these organs, placing them in a specific, heretofore relatively unfamiliar position of supranational organs in a segment (currency operations) long considered as one of the basic features of the national sovereignty of every independent state.

A knowledge of and adequate adjustment to the work of the monetary and financial organs of the European Union is of special significance for states which are not members of the Union, especially if they, like the Republic of Serbia, demonstrate a prevailing political and economic interest in accession to this, today certainly one of the most significant international regional organizations. Connected with that are both rights and obligations stemming out of such membership, which are especially strictly set in the monetary and financial spheres; thus, their anticipation and integration into current economic policy measures is not something that depends, or at least mostly depends, on the political will of the current carriers of political power, but a fact that should be realistically taken into account. In that context, the task of this paper is to give insight into the current state of affairs within the sphere of the monetary and financial organs of the European Union, without delving into the usefulness of their work and existence, both from the aspect of Community interests and the aspect of the interests of individual states, regardless of whether they are members of the European Union or only have the intention of joining it.

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CREATIVITY AS ONE OF THE FACTORS OF MANAGEMENT DEVELOPMENT

Abstract: *The paper examines the significance, influence and effects of creativity on the development of society and management.*
Key words: *creative work, creativity, management*
JEL classification: O31, J24

I

> *Of all the schools of patience and lucidity, creation is the most beneficial. It serves, as well, as exciting testimony of man's sole dignity: a tenacious revolt against his own life, perseverance in an effort that seems meaningless. It demands everyday effort, power over one's own self, an accurate estimation of the boundaries of the truthful, measure and strength.*
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> Albert Camus:
> *The Myth of Sisyphus*

Each new age in society's development and advancement, and all spheres and areas of social life are necessarily and inevitably influenced by creativity. Each new world in the making, as well as the one that disappeared, has changed and is changing creativity's relationship towards the actually existing and towards the fictitious, or virtual, towards that which is still in its inception. Thus, before the man of the past, present and future, before the creator of this new world, always lie some new social demands, general or specific demands that provoke him, inspire him and propel him toward creating the values upon which the further development of civilization, man's own development and a more quality way of life undoubtedly depend. Because it is precisely these values, both material and spiritual, that cause the new world, otherwise full of contradictions and conflicts, to move much more rapidly towards its total technological, economic, cultural, civilizational and social advancement and development, towards a more humane society.

Creativity is manifested in all areas of human individuality, in all areas of man's social existence as well as of his particular emancipation, appearing as the material and spiritual wealth of all humanity. Of course, precisely as such, creativity has become the key factor of social development. The achieved level of human creativity is never the ultimate level, creativity is never a finished process, cannot carry the mark of finality, even though its definitions changes its content and meaning, both its internal and external impulses – with each new culture and civilization, with each new time. That is why the meaning of creativity and man's creative sense for the ever-newer and improved endlessly changes, expands and adjusts to new areas and forms of life. The areas that especially dominate here are those connected with technique and technology, new technology, language and symbolism, with politics in its broader meaning, various forms of innovation and areas of inventions, with work, the organization of work and management, with upbringing, human communication, technical communication, with the creative industry as the decisive source of advantage on the market. [1]

Naturally, creativity also extends to the totality of shapes and contents in which man's multidimensional talent for creativity and originality is manifested in the best possible way, in which imagination and fancy are consummated. Thus, through his mental activity, man comes to new and original solutions, to solutions that could also have a universal social value, expressed and realized through scientific discoveries, technical discoveries, and works of art.[2]

Each period of society's historical development is marked by characteristic human creativity. The century behind us is recognizable by its very rapid and exceptionally contradictory changes, as well as by the uneven development of certain areas of social life. Once highly valued, collectivism and similar orientations are losing significance today and pretty much lack any practical application. Now there is a reorientation from social to individual values, from concern for others and the desire to secure their welfare to concern about personal needs and desires. The twenty-first century, which has inherited many of the features of its predecessor, is already seeking now paths, stimuli and inspirations on the path of creating something new, especially in areas connected with learning and with mastering the methodology and techniques of creativity, which encompass new ways of producing and valuing creativity, but also of realistically evaluating the characteristics of the creators themselves, as creativity itself will, to a great extent, be dependent on them. Thus, care must be taken to find the right way to measure all human activity in a quality and correct way. For, the loss of a sense of true measure can imperil the future itself.

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1 J. Hartley: *Creative Industries* (*Serbian translation - Kreativne industrije*), KLIO, 2007, p. 5

2 R. Kvaščev: *Psihologija stvaralaštva*, Zavod za udžbenike i nastavna sredstva, Beograd, 1981, p. 23

Creativity attains its true sense, measure and meaning only if it contributes to the maintaining of society and man and to their constant and continual advancement and development,[3] to a greater degree of man's freedom in relation to society, nature and other men, relative to his own activity, in the first place material but also spiritual. Man's freedom and the humanization of his life bring a new quality to his life, a quality appropriate to his social being, as well as contribute to society's advancement in the technical-technological, economic, social, cultural and civilizational sense. Thus, the present tells us that strength and inspiration for achieving changes are the qualities important for the future, and that these changes shall be achieved through creative human abilities and their inexhaustible ideas.[4]

Changing present reality and creating a new one are certainly not possible without creativity. That mutual, multidimensional flow of influence between society and creativity is quite complex; however, creativity always exerts a more significant influence on future society, which is a departure from the previous period, in which the influence of society upon creativity was more pronounced. This complexity of creativity's influence on society is manifested through numerous mutually connected and complex social processes even though such influence is, to an important degree, socially determined. Namely, society exerts influence upon itself through material and spiritual creativity. Of course, in such circumstances, the creator himself is influenced by creativity in a certain way. Such influences have their origin in previous creative activity and assume a modern approach to creativity, but are also connected to the creativity that is yet to come, to future creative activity.

The contemporary approach to creative activity is being strongly influenced by new and growing scientific knowledge and the unfathomable scope of technological achievement. Thus, to the extent that it is nurtured and improved, it is also, to the same degree, reexamined due to its frightening potential consequences, especially ethical – but also, increasingly, ecological – which may greatly imperil the world and man's existence in it. That is why management must also adjust to such changes, must adjust its creative potential and its creativity to new circumstances dominated by a virtual market, virtual capital, virtual corporations. That is why it is important for creativity in the field of management to achieve humanistic goals and preserve the dignity of the man who is working in that new world, but also to preserve the world for future generations.

Creative freedom is a necessary precondition for the development of human potentials, which are the starting premise for general social development, for a humane social development that secures uninterrupted growth and its proper distribution, which satisfies basic human needs, as well as those needs that have

3 M. Ilić: *Sociologija kulture i umetnosti*, Institut društvenih nauka, Beograd, 1966, p. 19

4 F. Mayor: *Tomorrow is Always Too Late* (Serbian translation: "Sutra je uvek kasno"), *Jugoslovenska revija*, Beograd, 1991, p. 19

come about in accordance with the realized conditions of society's contemporary development.[5] Of course, creative freedom has different meanings in different periods of societal development and in different areas of social life. However, in order for a creator to be truly free, in all times and places, he has to have multiple offered possibilities at his disposal, an awareness of alternative possibilities, that he can achieve his own choice without compulsion, pressure and control, and that he can create accordingly.

In any case, in order to be free, a man must fulfill numerous and various conditions. Namely, true human freedom assumes a conscious cognition of rational necessity, as Hegel pointed out. However, that is not enough. For, man is not just a cognizant being, man is also a being that feels, that carries within itself a world of conscious and unconscious experiences, interests, tendencies. Since such a rich psychological reality always has its own individual physiognomy, different subjects will react in psychologically different ways to the same necessity that manifests itself in a given situation. And if this necessity appears as an opposition to a man's desires and tendencies and is unavoidable, and then necessity becomes compulsion and, as such, prevents him from satisfying his tendency or from expressing any one of his potencies. Of course, when a given necessity and an individual's psychological stance overlap, then it becomes possible for that individual to achieve his given need or desire, or develop a given potency. Thus, a man should subjectively accept a given necessity in a given situation and, in order to be concretely free, he needs the objectivity to be able to do what he desires and the subjectivity to desire what he can actually do, to be able to refuse what is being imposed on him against his will.[6]

As a conscious, but also a creative being, man is conscious of being limited and bounded by his natural surroundings, by the fragility and finality of his existence, of the fact that powerful natural and social forces are constantly and unconditionally molding his own life – along with tradition, customs, habits, and moral as well as social norms. And current ideologies impose a specific kind of suppression and limitation upon him, and play a significant role in his freedom of expression and self-manifestation, just as they, quite certainly, condition and decisively influence his desires, motives, tendencies, criteria, and – in accordance with this – value system, and this precisely at the moment of his existence that appears to him as an experience of his own individuality and freedom of choice.[7] However, man is aware of the fact that freedom of creativity has not been given once and for all, that it is not a momentary condition but a process, new and unrepeatable, a permanent process. That is why freedom of creativity is the starting premise for the development of higher levels of creativity. That develop-

5 F. Fukuyama: *The Clash of Cultures* (Serbian translation: *Sudar kultura*), Zavod za izdavanje udžbenika, Beograd, 1997, pp. 35-36

6 S. Rakas: *Uvod u poslovnu etiku*, Megatrend univerzitet, Beograd, 2006, p. 31

7 M. Marković: *Sloboda i praksa*, Zavod za udžbenike, Beograd, 1997, p. 11

ment encompasses numerous preconditions that must be fulfilled in the name of that goal and within which the creator must realize himself in a creative and original way.

Man's goal in life, in the humanist sense, is not to have but to be. His goal is to fulfill his entire human potential within the framework of various needs and life's manifestations. And the basic and the most needed life's meaning is creation, activity in any area and sphere of social life, in a way that allows freedom of innovation and the greatest possible spiritual wealth.[8]

II

Creation is the essence of life.

Shakespeare

Creativity is an essential human characteristic, one that is unique to man. This characteristic enables him to create something new, something previously nonexistent, and something that he realizes according to a previous conception.[9] However, there are disagreements and disputes even regarding this characteristic: whether the new also has to be socially valuable, or whether it is sufficient for it to be merely new, but new only for the creator. For creation is, after all, an individual act, but one closely and unbreakably connected with the creator's own nature, his psyche, interest, intuition, ambitions and knowledge of the essence of things, even though this is related to the biological, psychological, social, cultural and philosophical aspect and is dependent on socio-historical and cultural conditions.

As an exceptionally complex and nuanced phenomenon, creativity has marked the onset of human civilization; it has ennobled man and uncovered that specific essence of his internal necessity and his being, it gave culture its overtly familiar and recognizable stamp; it uncovered that wonderful game of the contemplative and the scientific; creativity has become an inseparable and integral part of everyday life. Philosophers have debated it, scientists have tried to uncover its meaning and essence, psychologists have tried to interpret it, legal and ethical scholars have dealt with it.

Creativity, as one of man's greatest ambitions and challenges, but also as one of his undoubted needs, has been the subject of many theories and approaches; it has generated numerous viewpoints and explanations characterized by a historical consciousness and a memoirist spirit, or in the form of cultural reviews and cognitive comparisons. All theories and approaches, understandings and

[8] Ibid, p. 246

[9] S. Rakas: *Psihološko-etički problemi u pravu*, Megatrend univerzitet, Beograd, 2007, pp. 29-32

explanations mutually intertwine and connect, or exclude and negate each other. Many theories on creativity that have come about as a result of man's intellectual activity have a firm internal logic and a strong structure but do not have – at least in the beginning – almost any connection with practice, for they have not grown out of practice and cannot be applied in practice.

In spite of the fact that "the most incomprehensible thing about the world is that it is comprehensible," as Albert Einstein wrote, creativity has still not been conceptually defined, being mainly considered through the very elements and categories that make it such a complex phenomenon in the first place.[10] The situation is similar when it comes to creative powers, of which the most frequently mentioned are: imagination, intuition, the subconscious, inventiveness, originality, exceptionalness, mystique, mobility, creativity, learning and similar human powers. However, even these are not clearly understood and are, thus, often conceptually equalized or used as synonyms. This applies, before all, to originality and creativity. There is somewhat less imprecision regarding the ability for creative thinking, where, once again, originality and creativity are the most frequently mentioned, along with fantasy and imagination, flexibility, tolerance toward vagueness, fluency of ideas, experience.[11] However, the greatest amount of agreement, in spite of necessary and understandable disputes regarding the understanding of the essence and definition of creativity, has been achieved concerning the phases of the creative cycle. Thus, in that sense, creativity encompasses: creative potential, the creative personality, the creative process, the creative product and the creative situation.

Despite creativity's complexity and the accompanying and necessary differences in approaches to it, knowledge about creativity is becoming ever greater and deeper, especially in psychology, in the areas of creative thought and creative abilities, as well creative intelligence. Namely, the significance and role of cognitive and motivational process in creativity is increasingly a subject of study; the close mutual connectedness and conditionality of intelligence and creativity is increasingly being emphasized; the creative personality is coming into the focus of research, along with its characteristics and the factors that contribute to the development, slowing or stopping of creativity; all attention is being directed toward possible choices and possible ways of systematically developing creativity.

The complexity of creativity as a specific phenomenon, its nuances and multidimensional character, has brought numerous contradictions not only in the understanding but also in the explanation of the relationships that it creates. Namely, in the unceasing battle between man and the world, the idea of creativity encompasses a broad spectrum of highly contradictory and opposing phenomena.[12] For, creativity is subject to change, which is necessary; it develops

[10] M. Ilić: *Teorija i filozofija stvaralaštva*, Gradina, Niš, 1979, p. 9

[11] R. Kvaščev: *Psihologija stvaralaštva*, p. 23

[12] N. Milošević: *Ideologija, psihologija i stvaralaštvo,* Beograd, 1972, p.7

into something new, something other, which is inevitable. Hence, creativity is a developing phenomenon. And man is a creative being.

In that sense, creativity is man's permanent battle against boundaries and limitations, against contradictions, as well as taboos imposed by the world that surrounds him and in which he lives, imposed by his own internal characteristics, which define him as such in an essential way. In this conflict, man fights to defeat both the world and his own self. In this conflict, man seeks to overcome all limitations being placed before him and those he places in front of his own self – in which he succeeds or, sometimes, doesn't succeed. Man's conflict with his own self also encompasses his battle against his own unlimited possibilities, but also against those that are limited. The former he tries to realize while the latter he seeks to overcome. Since this striving is always present, it should be satisfied, for its delay, or the impossibility of satisfying some needs, only serves to heighten the tension between them. And, out of that tension between man's natural spontaneity and his rebellion against the boundaries and limits being placed in the path of this spontaneity – comes creativity in all areas. That is why creativity is challenge and achievement, meaning and meaninglessness, fantasy and fiction, improvisation and unrepeatable, criticism and no criticism, ability, creativity, talent and genius.[13]

As a creative being, man expresses himself in all areas of social life. His creative powers and potentials are unsurpassed and unpredictable; as a result, he is often faced with the consequences of his ingenious ideas and even more ingenious acts in all areas, including management. For, as the creator of a new world, one that is always and constantly new, as the one who is managing that world, man is constantly exposed to new challenges, which he either succeeds or does not succeed in meeting. Thus, the creator in the total management process is faced with a significant task: to find new techniques, methods and means of management, in order to make that virtual world in the making a better place for living and working for all the planet's inhabitants, to secure, besides digital integration, the social integration of the still quite disunited, essentially divided and highly mutually opposed humanity, a humanity dominated by conflicts, clashes, rivalries, crises. In that sense, as a creator, as a manager, man needs to discover new technologies or protect the existing ones from possible abuse, as well as to refrain from using them in the function or as a means of establishing domination of some over others, of the powerful over those who are not.

Due to these reasons, management in the present time, and certainly in the future, is highly complex, demanding from the creator of that new virtual world and new technologies, much knowledge and even more responsibility. Especially if it is known that we live in an era of telecommunications and global information networks, which still connect the world only virtually and not in reality; in the microelectronic phase of the development of electronics and microelectronics, and

[13] S. Rakas: *Psihološko-etički problemi u pravu*, p. 32

even nano-electronics, under the domination of biochips, photo-chips and other known and unknown chips; in an era of computers that will possess so-called artificial intelligence and even have the ability of self-reproduction, and which will be made of protein materials, which are in nature responsible for the most subtle functions of perception and learning, functions characteristic only for man; under the domination of new materials that are making new technological inroads into nature's essential potentials; in an era when biotechnology is entering the phase of application, of genetic, protein and hormone engineering, which is, however, the most dangerous area of technological development as a whole because, in spite of the satisfaction in the application of all the possibilities possessed by biotechnology, the fear of possible abuse of this, the most powerful technology so far, is becoming increasingly widespread because it tampers with the very essence of life, enters the secrets of the heritable characteristics of living beings, including man; in the sphere of robotization, which significantly influences the working world, in the sense of its humanization, the substitution of living work, but also of new forms of organization and management that are, before all, creating a new reality: factories without people; in an era of genetic engineering which has already mastered the most delicate methods and means of manipulating heritable characteristics, thus opening up the question of historical responsibility for the further development and, especially, application of this technology; in a time marked by informatization, sophistication, medicalization and other known technologisms. Thus, the management of new technologies and virtual technologies is becoming especially complex, but also creatively challenging.

Concluding remarks

All new knowledge can either serve or harm man.

Federico Mayor:
Tomorrow Is Always too Late

The development of contemporary society, which is being defined as the digital era, as a society of risk or a civilization of knowledge,[14] demands new ideas and solutions, other forms of inspiration and interest, creative curiosity, demands and imposes essentially new sources of creativity, creative activity, originality, new talents. The new time also imposes and demands new values, both individual and social values that encompass the psychological states and experiences of the self, that apply to social groups and to societies in general.

14 S. Rakas: *Sociologija menadžmenta,* Megatrend univerzitet primenjenih nauka, Beograd, 2004, p. 150

Those new values are the foundation of all of man's activities, his behavior, decisions, needs and interests. In accordance with the development of a new society, these values take on new features, which are manifested either as universal, as in the case of freedom, or as individual values, such as justice and knowledge.

In contemporary theory, the thesis on the connection between economic and cultural values is being increasingly propagated; thus, economic development is so significant that it cannot be left to economic values alone, which are pragmatic and rational, but can also be short-term; instead, economic development should be understood precisely as a cultural process.[15] In that sense, economics and management favor those cultural values which work and creation place in the very center of the value system – providing that the new challenges of the time, such as competition and incentives for long-term goals and short-term interests, also possess value. However, in economics as well as in management, those values that emphasize the significance of creativity and creative activity and, what is especially important, emphasize the significance of knowledge and education, are also significant. Namely, creativity as an economic value defines a new, better, wealthier, more productive and more progressive society,[16] as well as a more humane society, in which culture develops and nurtures creativity as a value, as an essential feature of business and management. Thus, creativity and work represent the basis of contemporary economic development, because creativity as a value stimulates the individual, the group and the organization to create, to achieve business success within that creative process, to, as free actors, achieve innovations, new undertakings, new ideas, new inventions, new solutions, to have confidence in themselves and others, as well as to inspire the confidence of others. Hence, creativity and creative activity stimulate both the individual and society to something qualitatively better, stimulate and direct management itself as an encompassing and complex process of the contemporary method of oversight in the direction of success and justice.

The nurturing of creativity in the management process will be much more significant and creativity will be a much greater concern in the future than is the case now. Of course, both today and tomorrow, more than ever before, it makes sense to ask what kind of technology one desires, can, should and is allowed to develop. For, in the world of business, a constant battle of ideas is being waged, in which only those creators who can offer new, more original and better solutions can survive. Those who cannot either stagnate or simply fail. In any case, creativity in business is not a topic that has drawn too much attention, it is a topic that has not been especially analyzed as a separate phenomenon; hence the lack of more serious studies on this topic, which would either define or discover

15 G. Mariano: "The Cultural Typology of Economic Development" (Serbian translation: "Kulturna tipologija ekonomskog razvoja"), in: L.E. Harrison, S.P. Huntington: *Culture Is Important* (Serbian translation: *Kultura je važna*), Plato, Beograd, 2004, p. 8

16 E. Mouland, M. Nowlan: *Creating an Enterprise Culture,* Breakwater Books JTD, 1995, p. 43

the essential characteristics of creativity in business. Here it is also especially important to raise the justified question regarding the control of human creativity, which might take off in an undesirable direction and, thus, void or bring into question all previous civilizational achievements. That is a great problem for the new society in the making and a great problem that may arise at the moment when, if it should happen, human creativity is brought under control and starts being managed. That would give rise to the question of justifying the existence of management and all its facets. Nevertheless, the need for creative solutions in general, especially in contemporary management, is quite certainly evident and needed, necessary and inevitable. In that context, numerous creativity development programs have been initiated, giving added significance to the issue of creativity control.

All current programs are striving to resolve some basic dilemmas connected with creativity in business. One of the most frequent dilemmas in this area is the following: is creativity a merciful gift endowed upon rare individuals or is it a gift possessed by many, or even all people? This dilemma has yet to be resolved in the existing literature, as there are proponents of both or even a third, combined option. Nor has the dilemma regarding the domination of group or individual creativity received a genuine answer. However, there are more proponents of the thesis that problems in work, as well as the process of management, can be resolved better and more easily within the framework of a group. Arguments in favor of such a view can be found in the view that problems in business can be more easily resolved within a group, which can produce more ideas and correct, ennoble or improve each new idea. Another frequently asked question that truly deserves attention has to do with seeking the following answer: is creativity a spontaneous process or a process done under pressure? For, creative ideas often come unexpectedly, at a time when the creator least expects them. That is why pressure is not applied on creators to find concrete solutions at a specific moment. Of course, there are opposing views as well.

In addition to programs for developing and training creativity, contemporary management is also aware of numerous strategies for improving and developing creativity in business. The most often used is Crutchfield's system of creativity development, founded on the theory of associations, Gestalt theory and Line Theory, whose basic goal is to develop an ability to formulate problems, new, unusual ideas, and the discovery of implicit facts. Also, Torrance's method of creativity development contains a discovery of the multiple meaning of given facts, and concerns the development of strategies of creative learning by way of discovery, the development of creativity's motivational components, the synthesis of empirical research and theoretical generalization, as well as the nurturing of a creative atmosphere in a group. Also used for improving creativity in business is Britt and White's decision-making method, as well as Osborn's creativity method, which is designed to simulate a situation which will significantly facilitate the production of creative ideas.[17] However, this method cannot absolutely guarantee the production of new and applicable ideas, but can only increase the probability of arriving at creative ideas.

Despite the fact that programs and strategies for creativity development are an inevitable result of contemporary society and business, an essential question is posed: can creativity be trained in any way? Even though creativity is being trained in many developed countries, in many areas, those projects, nevertheless, are not giving significant results. Namely, what such training programs are missing are a starting recognition of the features and characteristics that enable an individual to create new values, to create something new, something that did not previously exist, just as they are missing the internal motivational component of creativity. For, man has a need to model and remodel the world in which he lives and creates, has a need and desire to establish power over it, to stand out, to be better and more successful than others. In contemporary business, this means that man has a need to survive, gain advantage, defeat the competition and achieve victory on the global market.

The contemporary development of civilization and the new time before us demand creators who will be creative, gifted, and talented, in all areas of social life, including, of course, management.

It is not hard to recognize creative personalities, since they possess personal characteristics and features that set them apart from other people and which are clearly dominant. These are curious people, with a pronounced psycho-motoric activity, who possess the ability to concentrate and maintain attention, have the ability for independent work, and possess developed linguistic interests. Creative personalities are courageous in their convictions, have a pioneering spirit, and pronounced intuition, independence of judgment, and they are visionaries.[18] These are successful people, motivated by a need to work, dominant and aggressive, who reject pressure, have almost no inhibitions, are less formal and conventional, stubborn, self-disciplined, constructive; these persons are open to feelings and sentiments, they are esthetics in their personal feelings, adaptable to the appropriate values of their environment, have a need to be active in their social environment,[19] possess communicational and other necessary skills. A special quality of creative personalities is their desire for knowledge, while no less significant is their connectedness with emotional and moral development of a higher order.[20] Along with all this, it is also necessary for creators to have a strong motivation for creation, an ability to think originally and productively, to

17 D. Hellriegel, J. Slocum: *Management*, Massachusets, Addison-Wesley Publ. Co, 1989, p. 13

18 E. P. Torrance: *Rewarding Creative Behavior*, Prentice Hall, Englewood Clifts, New Jersey, 1965, pp. 230-232

19 M. J. Stein: *Making the Point*, The Mawa Press, Amagansett, New York, 1984, p. 14

20 Dabrowski: *Positive Disintegration*, Little Brown, London, 1964, p. 11

have the necessary skills for a creative execution of a creative act, in which case they possess creative talent.[21]

Namely, these are personalities who see problems somewhat differently from others, they are characterized by divergent thinking about possible solutions, by the use of a selective process of insight; they possess all-encompassing knowledge about the subject of their interest; they have a tendency toward making their own rules and working on problems that are unique; they have the ability to be tolerant; they are ready to overcome ambiguity, to take risks and possess a strong desire to overcome hardship when they encounter it and go on with their work; they are interested in all the work in which they are engaged.[22] Creative and gifted persons create a great number of ideas and have solutions for the given problems; they always pose numerous questions about various matters; very often, they offer unusual, original and humorous answers; they are individualists and are not afraid of being different from others; they display a pronounced sense of humor; they do not accept the positions and solutions of authorities without critical reexamination; they are intellectually disciplined persons and superior in relation to others.

In acting in a creative way, each creative personality contributes to the development of society, while a society that nurtures and develops the creativity and creative work of individuals attains a quality human existence and develops more rapidly. That is the imperative of each civilized society and of each individual. In that sense, creativity is a significant motive force in the development of management, which is experiencing a mild crisis in today's time, but which will experience a significant rise in the time to come.

21 E. Necka: *On the Nature of Creative Ttalent,* Trillium Press, New York, 1986, pp. 131-132

22 R.J. Sternberg: *Investing in Creativity*: Many Happy Returns, Educational Learship, 1996, pp. 80-84

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JAPANESE MANAGEMENT: A SYNTHESIS OF DOMESTIC HERITAGE AND FOREIGN EXPERIENCES

Abstract: *During the 1970s and 1980s, Japanese management became a topic of research and of numerous papers and books, which examined the secrets of the Japanese economy's success in various ways. Numerous authors agree that the two main forces behind the power of the Japanese economy are:*

1. A specific way of managing companies and 2. Japanese culture and national history.

The main goal of this paper is to present the basic characteristics of Japanese management and their explanation, along with a historical overview of this phenomenon, and a differentiation of the above.

Key words: *Japan, management, history, culture*
JEL classification: N85, L23

1. Working hypothesis

Unique Japanese management is one of the key factors of Japan's economic rise. It came about as a creative synthesis of domestic heritage – spiritual and sociological – and the business experience of the most developed Western countries.

2. Theoretical overview

2.1. The concept of management

The majority of authors engaged in the study of management define it as a process of planning, organization, motivation and control, through which a company's basic goals are achieved.[1] According to M. Jovanović, "*Planning* is the phase in which an organization's basic goals are defined, and in which preparations are made in order for those goals to be fulfilled. *Organization* is a phase of the management process in which the allocation of tasks and responsibilities for the execution of the plan are carried out. In this phase, the harmonization of individual and group activities directed toward the achievement of the set goals takes place. *Motivation* is the phase of connecting the social, material and psychological needs of employees with the realization of the organization's goals. *Control* is the monitoring and evaluation of the activities of individuals and groups in a company. This phase has to contain certain corrective measures."[2]

2.2. The main theories of management

Management as a separate scientific discipline was established at the end of the 19th century. The main pioneers of this discipline were Henri Fayol and Frederick Taylor,[3] a mining engineer and a factory supervisor, respectively, who, at almost the same time but in different places, came to very similar conclusions about what management should be and what it encompasses.

Henri Fayol is known for his work *General and Industrial Management*, which has seen more than one hundred editions up to the present day. Fayol defines management as a process of forecasting, planning, command, coordination and control.[4] In the said book he also identified the basic entrepreneurial activities within a company and what they encompass.

This kind of concrete distribution of tasks within a company became universally accepted in the years that followed. Fayol lists the following entrepreneurial activities:

1) technical activities (production),
2) commercial activities (buying and selling),
3) financial activity (capital),
4) security (guarding property),
5) accounting activities (financial information),
6) managerial activities (planning and organization).[5]

In the formulation of his own theory, Frederick Taylor began from the practical problems in the Midvale Steel Works, primarily related to increasing production efficiency. On the basis of experiments he was conducting, Taylor arrived at conclusions upon which he founded his *theory of scientific management*, which

1 M. Jovanović, *Interkulturni menadžment,* Megatrend univerzitet, Beograd, 2004, p. 92

2 M. Jovanović, ibid., p. 158

3 M. Jovanović, ibid., pp. 97 and 100

4 Ibid., p. 97

5 Ibid., pp. 97-98

was in the first place oriented toward determining optimum daily production and the principles and methodology of scientific management. Taylor held that it was only through the determination of daily achievement that employees could plan and control the production process, decrease production costs and increase employee productivity. This theory gained a circle of followers among company owners and managers but encountered much resistance among workers. In the first place, Taylor championed so-called scientific company management, in which the accent was placed on worker productivity, while the task of management was to guide the workers along that path.

The theories that subsequently appeared took into account the needs, motives and desires of employees in order to attain company, i.e., management goals, which itself changed the definition of management. In that context it is necessary to mention *Maslow's* (Abraham Maslow) *theory of the hierarchy of motives and needs*, which took motives and needs as the main prime movers that shape man's behavior. Douglas McGregor formulated the *X and Y Theory*, according to which people are not lazy or unambitious by nature but, actually, quite the opposite, and that it is the task of company management to enable employees to realize their goals and ambitions through appropriate management.

In defining management, newer literature and practice cannot overlook Peter Drucker, best known for his book *The Practice of Management* (1954), which he, in his own words, wrote because at that moment there was no book that explained the concept of management in a good way. Drucker holds that management is the activating element of a company as a business system, and that the task of management is to first make the desirable possible and then real.[6] Drucker also thought that the people within the company are its most important resource and that a company's success depends on the kind of relationship that is established with the employees. On the basis of this observation, he formulated the concept of Management by Objectives, according to which the manager's individual goals must be harmonized with the goals of the company, i.e., management by objectives is a means of integrating organizational goals (profit, growth) with managers' individual needs (salary, advancement).[7]

During the decades that followed, the concept was changed in many ways, both by Drucker and other authors, but the basic premise remained the same – that if employee motives are understood correctly, it is possible, through proper motivation, to secure a company's greater success and advancement.

6 M. Milisavljević, *Savremeni strategijski menadžment*, Megatrend univerzitet, 2005, Beograd, p. 4

7 M. Jovanović, ibid, p. 177

3. Types of management

Two basic types of management are studied in economic science: European and Asian. Actually, all written history, including economic history, has occurred in the Eurasian space. Asia and Europe have alternated in the role of the world's economic center. It is thus understandable why this geographical space has given birth to managerial skills that subsequently spread to the rest of the world. Significant differences exist between the European and the Asian type of management.

3.1. European management

Modern European management came about in the city-states of Renaissance Italy, where the modern market economy first took root ("European-type development").[8] As the cradle of the industrial revolution, England gradually crystallized its own, Anglo-Saxon way of management. This way of doing business exerted a powerful influence on the entire European continent but, nevertheless, did not wipe away the uniqueness of continental-type business. In large part, it was Christianity[9] that shaped the European way of doing business, and, thereby, management.

According to M. Jovanović, the characteristics of European management, i.e. its postulates, which also took root in the US, are:

- Individualism – independent problem-solving;
- striving for a fast career – it starts as early as high school, and continues at university and then on the job itself;
- specialization – training and advancement within a narrow field of work;
- pronounced personal interest – the individual places his interest above the interests of the company;
- material motivation above moral – money is the most important motivator;
- lack of identification with the company – one of the characteristics in total opposition to the Asian style of management, which means that, for Europeans, a company is a mere place of work and not a place with which they identify and because of which they work; the company is only a means for realizing individual goals, and the company's welfare is not necessarily their own;
- respect for hierarchy in the decision-making process – superiors and subordinates are clearly and precisely defined along with the appropriate rules of behavior.[10]

8 B. Babić, *Ekonomija Azije,* Megatrend univerzitet, Beograd, 2007, p. 22

9 That is, its various forms – Catholicism, Orthodoxy, Protestantism, Judaism...

10 M. Jovanović, ibid., pp. 124-126

3.2. Asian management

As in Europe, management in Asia is not uniform. In the Asian economic space, three basic ways of doing business have crystallized: Chinese, Japanese and Indian, Modern Indian management has developed under Anglo-Saxon influence. Chinese management is doubly authentic: it combines the preservation of the heritage of domestic business skills and the ability to assimilate foreign experiences by way of an “open door” policy. Japanese management differs from both Indian and Chinese management.

4. Origins of the specificities of Japanese management

The Japanese economic rise has attracted researchers’ attention to the specificities of Japanese management. So far, research has identified three main factors that form this specificity:

a) spiritual heritage, b) the sociological evolution of Japanese society, c) the origins of modern entrepreneurship.

4.1. Spiritual heritage

The three essential spiritual bases of the Japanese people are: Confucianism, Buddhism and Shintoism. These three teachings have shaped the Japanese people’s way of thinking and behavior.

Confucianism was more of a code of behavior or a general approach to life than a religion. The basic postulates of Confucianism, which have also influenced the way of doing business, are reflected in the following basic relationships.

- Relationship toward the ruler – the ruler expects absolute loyalty and obedience from his subjects. Subjects must never doubt his decisions; in return, he has to take into account their needs and desires, and work on providing a better life for them.
- Relationship between husband and wife – the husband rules his wife, akin to a god who rules over people. The wife must be faithful and obedient, and has the obligation of serving her husband’s sons. In return, the husband has the obligation of providing his wife with everything she needs for life.
- Relationship between parents and children – children must be obedient and obey their parents without complaint. Parents must raise and educate their children, while children must care for their parents in their old age, love them and respect them.

- Relationship between the young and the elderly – the younger generations must respect the elderly because of their years and age, and this postulate is the key element of Confucian ethics.
- Relationship between friends – this is the only relationship within Confucianism characterized by equality. Friends should be sincere with each other, loyal and ready to help each other. Insincerity among friends is not allowed and, if it exists, demands punishment.[11]

Shintoism is the religion adopted by the state, according to which the emperor is, on the one hand, the embodiment of the state and, on the other, the Son of God.[12] According to Shintoism, the Japanese are the children of god and, as such, different from other nations. One of Shintoism's most important beliefs are that harmony must exist between everything and everyone: in nature, in society, in the family, the company, and the state. The maintaining of this harmony is of essential importance for the good functioning of Japanese society.

Even though Shintoism is little practiced today, its guidelines are still important for the Japanese people, especially the part related to the functioning of harmony.

Buddhism, like Confucianism, arrived from China. The most widely accepted version of this teaching in Japan is Zen Buddhism, which was practiced by warriors – the samurai, in order to better prepare for battle. The essence of this method was the practice of meditation and concentration. Since in today's Japan managers are often compared to samurai, because they fight for the welfare of their company, many practice Buddhism as a technique that allows them to think better and make decisions.

These three teachings first influenced the formation of the state, and then the formation and the work of companies. Readiness to sacrifice for the company, obedience toward the elderly and the emperor, a striving for harmonization with nature and other people, have contributed to the formation of the spiritual basis of Japanese society. After World War II, this increased Japan's ability to face the challenges of the modern age.

4.2. Sociological evolution of Japanese society

Japan was the first Asian country that raised itself from the ocean of poverty. From the historical viewpoint, it was the country best prepared for "European-type development," i.e., the type development based on transforming product surpluses into capital:

[11] S. El Kahal, *Business in Asia Pacific*, Oxford University Press, 2001, pp. 128-129

[12] M. Jovanović, ibid, p. 15

a) Japan is the only Asian country that had a “completed feudalism,” akin to Europe. Thus, just as in Europe, the preconditions for the process of capital accumulation, i.e., the establishment of a market economy, were already set in feudal Japan.
b) Japan is the only Asian country that has never been either a colony or a semi-colony, which is why its populace accepted the more modern aspects of technology and business skills without resistance.

4.3. Origins of modern entrepreneurship

The feudal time in Japan produced a caste of merchants, usurers and tradesmen, the kind that produced the modern entrepreneurial caste in Europe. This caste could not affirm itself in Japan in the same way as in Europe since, until its forced opening, Japan did not possess an appropriate organization of government that would protect business conditions.

After Japan’s forced opening, thanks to reforms, a political system that allowed the establishment of a modern market economy was created. Under conditions of increased personal and proprietary security, merchants and tradesmen gradually transformed into entrepreneurs.

The samurai held an especially important place in the establishment of modern entrepreneurship in Japan. In exchange for loss of their samurai titles, which were abolished by reforms, they received sizeable buyout sums. Out of these funds they established the first modern banks, as well as, in many cases, industrial and trading companies. Therein lie the origins of one of the important specificities of Japanese entrepreneurship and management. Samurai were the most educated and the most entrepreneurial segment of Japanese society, with a strong adherence to Confucian ethics and a readiness to sacrifice for the community. That had a large influence on the way in which entrepreneurship was understood. It is not important whether a company is private or public, since they all work for Japan. Such an understanding of business is one of the factors of the “economic miracle.”

5. Japan's path of economic and social transformation

5.1. From sakoku to kaikoku

Two factors had an especially important role in the shaping of the Japanese path of economic development: a) the country's position as an island and b) its scarcity of natural wealth. For these reasons, Japan was isolated from the outside world for centuries, mired in poverty just like the rest of the Asian continent. Thanks to historical circumstances, Japan turned these two drawbacks into virtues. From an extremely poor country, it became one of the richest countries in the world.

In the socio-economic evolution that prepared Japan for modern business, an especially imported role was played by the era of the shogun rule of the Tokugawa family (1603-1867).[13] The most important features of Japanese society in that era, in which traditional Japanese entrepreneurship and management were established, were:

a) A hierarchical organization of society. The highest caste were the warriors – samurai. The next most important caste were the farmers, followed by merchants and then craftsmen. Thus, the classes from which sprung the entrepreneurial class in Europe, merchants and craftsmen, were the lowest classes in Japan. There was no security of property or contract. Thus, in the given political system, this caste could not develop market entrepreneurship in the way it could in Europe during feudalism.
b) However, since Japanese society was feudal, conditions for the initial accumulation of capital gradually began to form in its pores as well, thanks to the existence of trade, usury and craftsmanship. The only thing missing was a political framework in which all these conditions could be transformed into a flow of initial capital accumulation.
c) The country's self-imposed isolation (*sakoku*). For two hundred years, the Tokugawa shogun kept the country almost completely isolated from the outside world.[14] Neither were the Japanese allowed to exit the country, nor were foreigners allowed to enter Japan. The exceptions were the Chinese and the Dutch, whose merchants had permission to enter only the Nagasaki port and do their trading there.

The preconditions for the development of a process of initial capital accumulation were merged into the process of capital accumulation after Japan's forced "opening" (*kaikoku*) in 1867. Through the coup, better known as the Meiji Restoration, which brought to power the juvenile emperor Mutsuhita (posthumously named Meiji – "enlightened rule") in 1868, Japan initiated a series of reforms

[13] B. Babić, ibid., p. 477

[14] Ibid., p. 481

whose result, among other things, was the creation of a strong central government and the transformation of Japan into a single market. Security of business was ensured.

It was in such a social milieu that Japan's modern entrepreneurship was established, recruited from the ranks of former samurai, merchants and craftsmen. The borrowing of foreign technology and foreign business experiences followed the opening toward the outside world. Thus began the synthesis of the authentic Japanese way of doing business with the business skills borrowed from Western countries, among which the Japanese also counted Russia.

The ideal of the Japanese elite is a "rich country and a strong military." The achievement of this ideal was to be reflected in the development of industry. In the first phase, the decisive role in that regard was played by the state, followed by private entrepreneurs, among whom, in that phase, former members of the samurai order took the leading role. In the space of only a few decades, Japan joined the ranks of the great powers.

There is general agreement among scholars that the basis for the rise of the Japanese economy was set down during Emperor Meiji's rule.

5.2. From military defeat to "economic miracle"

Japan came out of World War II as a loser. Yet, within a few decades, it joined the ranks of the world's greatest economic powers. A series of factors contributed to this, the most fundamental being the collective consciousness of the people about the need to sacrifice for the renewal and development of the country. Paradoxically, the occupation authorities also acted in that direction, imposing a series of fundamental reforms that contributed to the creation of an environment conducive for the rise of the Japanese economy.[15] The reform program conceived by the occupation forces was defined by Japanese writer Shinichi Ichimura as the "*Three D* policy: demilitarization, democratization and de-monopolization"[16] of Japanese society. In addition, conditions on the global market were also favorable for the Japanese economy, especially the low price of oil (2 dollars per barrel).

In the space of 15 years, from 1956 to 1970, Japan's annual economic growth rate was about 10%, creating the "economic miracle" that surprised both Japan itself and the world.

With the oil crisis of the early 1970s came the end of the "economic miracle." Still, Japan's reaction to this crisis was more successful than that of other developed economies. However, at the beginning of the 1990s, Japan's economy began to slow, its economic growth rate falling below the rates in other industrial countries. It remains to be seen whether Japan will be able to return to the old

[15] Ibid., p. 488

[16] Ibid., p. 492

path of success. Nevertheless, it is indisputable that Japan has been and remains a "classroom of development" for most of the world's countries.

6. Schools of Japanese management – *zaibatsu and keiretsu*

The main carriers of the rise of the Japanese economy were the unique, complex gigantic companies – *zaibatsu*[17] and *keiretsu* – in which the skill of doing business known as "Japanese management' reached the highest levels.

6.1. Zaibatsu

Zaibatsu companies operated on the basis of three principles that make up the main features of Japanese management:

- first principle – family management;
- second principle – company ownership and management belong to one family;
- third principle – the maintenance of a broad network of family companies was accomplished by way of family financial resources and business connection.[18]

It was precisely through the family ties that characterized these companies that four great families (Mitsui, Mitsubishi, Sumitomo and Yasuda) exercised their great influence over the Japanese economy, controlling one fourth of all business in Japan before World War II.[19] With time, with an increase in the number of companies operating within their conglomerate and the diversification of the scope of the family business, zaibatsu owners gradually began to employ genuine managers, who were schooled for this type of work.

These managers, i.e., clerks, were called *banto*. They were schooled for managing the zaibatsu from childhood, with only the most successful being offered positions as company managers.[20] They were completely responsible in their work to the company owners. In return, the company owners married the bantos to their eldest daughters, in order to tie them to the company and stimulate

[17] In practice it is very difficult to set a legal definition of zaibatsu companies. According to some authors, zaibatsu is an unlimited liability company, while, according to others, it is a holding. Since holdings were abolished by law in post-World War II Japan (as a reaction to the existence of the zaibatsu), in further text, the term "holding" will be used to denote a zaibatsu.

[18] www.unu.edu, The Japanese Experience in Tehnology, 1990, part 13. The devolopment of Japanese-style management

[19] R. A. Inman, D. A. Victor, *Japanise Management*, www. referenceforbusiness.com; S. el Kahal, ibid., p. 147

[20] www.unu.edu, ibidem

them to devoted work. In this way, the best managers permanently stayed in one company, i.e., one family. There was no danger of bantos joining another company. The family environment was considered sacred.

The zaibatsu had the support of the state and, in return, they were its main economic pillars. That was the main reasons why they were abolished after World War II.

After the end of World War II, the occupation authorities ordered the abolishment of the zaibatsu. The true reason was political – abolishing the pillars of Japanese militarism. The ideological explanation was that this was an abolishment of monopoly companies in order to develop competition on the domestic market and, thus, increase company efficiency.

The main objection to the zaibatsu way of doing business was that everything (good and bad) remained within the family, i.e., the company, making it easy to conceal both good and bad business, depending on what was judged useful in the given circumstances.

It is a fact that the Japanese market was an oligopoly. A small number of large companies colluded to maintain the prices of certain kinds of goods above market prices. The occupation authorities tried to end that way of doing business. The official reason was the protection of Japanese consumers, while the unofficial reason was making it easier for American companies to do business on the Japanese market.

6.2. Keiretsu

The zaibatsu showed themselves more resistant than the occupation authorities expected. The Japanese authorities were not prepared to renounce the main "engines of development" of the domestic economy. Having no choice, they accepted the formal-legal abolition of the zaibatsu. In their place, under the guise of new legal norms, a new type of conglomerate – *keiretsu*, was created. Their name is best translated as a group of companies linked around one main company, which partly owns the shares of the other united companies.

Many students of Japanese company organization agree that the keiretsu are only a technically but not an essentially different form of zaibatsu. Today, there are 6 great keiretsu: Fuyo/Fuji Group, Sumitomo, Sanwa, Mitsui, Mitsubishi and Daiichi-Kangyo Ginko. These companies belong to the group of so-called classical keiretsu. This means that the companies that form it have ownership shares in each other, which is the opposite of a zaibatsu, in which a so-called hierarchical system existed, where one company owned a second, the second owned a third and so on. In a keiretsu, one company has at least 20-30% of its resources invested in the other companies.[21]

[21] S. El Kahal, ibid, p. 147

In literature, a distinction is usually made between two types of keiretsu: classical (horizontal) and vertical (pyramidal),[22] although two more kinds are often added: bank-centered and non-bank-centered keiretsu.[23]

A classical or horizontal keiretsu (*yoko*) is a group of large companies mutually linked through their organs of management, i.e., boards of directors, managing boards or presidents, depending on the system of management in the given company. Even though the companies within the group are, legally speaking, mutually independent, the boards of directors of each of these companies are mostly made up of the same people. Examples of classical keiretsu are Mitsubishi Group or Sumitomo although, strictly speaking, Sumitomo also belongs to the group of bank-centered companies.

Vertical or pyramidal keiretsu (*tate*) are made up of a number of companies. It is customary for such a group to be headed by one large company, which has several hundred smaller companies that deal with it. A true example of a pyramidal keiretsu is Toyota, which has three vertical keiretsu within itself: Hitachi, NEC and Toshiba, with one pyramid engaged in producing goods and the other in their distribution and sale.

It should be pointed out that, due to the Japanese companies' complex relationships and size, it is hard to determine which type of keiretsu they belong to; for example, Toyota includes within itself companies that it does not control directly, which is also typical of a vertical keiretsu. The difference lies in the way their business is indirectly influenced; namely, within a classical keiretsu, control is usually exerted through the granting of bank guarantees while, in the case of a pyramidal keiretsu, control is exerted on the basis of production-purchasing dependence.

Bank-centered keiretsu (*kinyu keiretsu*) are, in a way, the true successors of the zaibatsu, with Sumitomo and Mitsui being the prime examples. Namely, these are financial groups in which a large bank usually stands at the head of the group. By way of complex financial transactions and ownership, this bank links up with horizontally oriented industries (keiretsu) and, through crediting, influences the companies' business policy.

Non-bank-centered keiretsu (*kigyo keiretsu*) are connected with the previously mentioned pyramidal keiretsu, in which one big company has a large number of affiliates, i.e., subsidiaries, which it controls not through financing but through business dependence, i.e., conditionality through production, purchasing, sales or distribution. It is interesting to note, however, that these affiliates have less decision-making freedom than do affiliates within a classical keiretsu. It is usually considered much more difficult to negotiate with a bank than a company that is practically a part of the group, but the situation here is quite different. Toyota and Matsushita are true examples of non-bank-centered keiretsu.

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22 www.unu.edu, ibidem

23 S. El Kahal, ibid, p. 148

This way of doing business, which sprung out of Japanese tradition, resulted in the development of an entire series of specific features that grace Japanese management, which came about as an outgrowth of the tradition and culture of the Japanese people, but also of contemporary business conditions.

7. Japanese management before the court of time

There is no doubt that the key to Japan's economic success lies in the human factor. What attracts the attention of researchers is the question of how Japan managed to use its human potential more efficiently than other countries.

One of the factors of this efficiency is rooted in the successful synthesis of domestic cultural heritage and the most successful foreign business experiences. Researchers devote particular attention to Confucianism as a feature of Japanese management. In what way has Confucianism shaped the Japanese business environment? In their monograph, The *Intercultural Challenges of Globalization*, Mića Jovanović and Ana Langović-Milićević write: "The basis of the Confucian humanist learning and the essence of its moral creed is reflected in the following principles. In the first place, harmony in social relations, **collectivism** and cooperation in interpersonal relations, a **desire for learning and knowledge**, based on: cultivating a model of behavior founded in **humanism** – *zhen,* a sense of duty and obligation – *yi*, **respect for older people** – *xiao*, **devotion** – *chung*, **a feeling for joint and family life** – *li*."[24]

It was precisely these cultural legacies that, through solidarity, self-improvement and respect for hierarchical structure (of the family or the state), aided the relatively easy and successful implementation of the development strategy of the Japanese economy, based, in the first place, on the training and improvement of the labor force.

According to Shinichi Ichimura, one of Japan's most prominent economists, only a portion of the former characteristics of Japanese-style management has survived the judgment of time. According to his research, which considered 12 characteristics of Japanese management, only 6 are still being applied in more than 50% of the observed companies.[25]

Ichimura considered the following twelve characteristics of Japanese management.

a) *Employment stability.* According to Ichimura, employment stability in fact means constancy of employment, i.e., that workers tend to seek to stay in one company as long as possible. This is one of the 6 characteristics that have remained in the Japanese system of business.

[24] M. Jovanović, A. Langović-Milićević, *Interkulturni izazovi globalizacije,* Megatrend univerzitet, 2006, Beograd, p. 149

[25] B. Babić, ibid, pp. 584-585

b) *Dependency of salary on length of working service.* Salary size is proportional to the length of working service.
c) *Advancement according to length of working service.*
d) *Rotation between tasks.* The rotation of workers at the work place reduces the one great problem of today's robotized and modern way of production – boredom at work. Of course, the companies that apply this labor technique must employ multi-qualified workers, i.e., workers who are not specialized for only one task but who possess the knowledge and skills that allow them to perform a number of different jobs.
e) *An accent on ideals.* The philosophy and the goals of the company are the concern of both management and employees. This principle is based on the old Confucian tradition according to which moral motives are above material ones and that certain things are done for the common good, regardless of whether it is a question of state, company or family.
f) *Flexible management.* There is no strictly defined job description.
g) *Group-based decision-making.* This is a legacy of old family enterprises in Japan, which were much smaller than they are now. In the multinational companies that are the main pillars of Japan's economy, the need for efficient decision-making has narrowed the possibilities of applying this principle.
h) *Group responsibility.* Here, too, Confucianism had an influence. Differently from Christianity, which puts a greater accent on individuality and individual responsibility, Confucianism insists on community.
i) *Accent on interpersonal relations.* Japanese workers and their superiors have a specific system of relations. Supervisors or managers feel that they are directly responsible for each success or failure of the group in their change. In order for the group to be successful, in addition to good interpersonal relations, it is necessary for them to support the status of their workers. In that way, their subordinates will follow them in the execution of their work assignments and mutual respect is achieved, since all are aware that the end results are dependent on their harmony and joint work. Also, the supervisor or manager who comes into a situation where he has to dismiss one of his workers sees this as his own personal shame and it is not rare for a manager to submit a resignation himself in such a situation.
j) *Ringi system.* This is a centuries-old legacy, used in former local communities when decisions of importance to the entire community were being brought, which later found its application in business as well.

The word *ringi* itself is a compound word, consisting of the word *rin* – which denotes the submission of a proposal to a superior for approval, and the word *gi* – which evokes deliberation or discussion.[26] Within such a system, making a decision about a solution to some problem begins with the lowest level within

26 B. Babić, ibid., p. 582

the organization, i.e., with a small group of workers. Once a proposal or decision is extensively deliberated upon at a council of this small group, they are then transferred to the next level of hierarchy, all the way to the end of the company's organizational structure. It is thought that, in this way, a detailed consideration of the problem will produce the best possible decision. This form of decision-making subsequently spread to the other countries of the Confucian tradition.

k) *Minimal differences*. This characteristic means that no distinctions are made between superiors and workers, i.e., that, in situations where this is possible, they perform certain tasks in an equal way, such as having joint meals at the company canteen.

l) *Small-group-level activities.* This is a newer legacy of Japanese-style management, primarily related to product quality control. Worldwide, Japanese products are known for their high degree of quality. That is something that is more-or-less understood when the *Made in Japan* label is seen on a product, or if a product has been made according to Japanese technology. Quality control groups discover errors during the production process, which means that they are discovered on time. This gave birth to the motto *poka yoke* (zero rejects).

8. Theory Z

William Ouchi is famous among scholars who have studied the Japanese companies' way of doing business, especially for his Theory Z. In fact, Ouchi is one of the first theorists who attempted to discover the secrets of success of both Japanese and American management. Once he identified them, he then tried to discover the shortcomings of Japanese and American-style management, and to propose a new style of management, or Theory Z, as he named it. Table 1 gives an overview of Theory Z.[27]

The seven characteristics that Ouchi observed were: length of employment in the company, way of making decisions, employee level of responsibility, speed of advancement, control mechanisms, professional career specialization and care for employees within the company.

On the basis of the table it may be concluded that, in putting together his Theory Z, Ouchi adopted a number of characteristics from Japanese management, with slight modifications.

27 Shown according to: M. Jovanović, ibid., p. 119

Table 1. *Theory Z*

Characteristics of American managerial practice	Characteristics of Japanese managerial practice	Z-type organization
1. short-term retention of employees in one company	1. life-long employment	1. long-term employment
2. individualism in decision-making	2. collective decision-making	2. collective decision-making
3. individual responsibility	3. collective responsibility	3. individual responsibility
4. rapid career advancement	4. gradual career advancement	4. gradual career advancement
5. cirect control mechanisms	5. indirect control	5. indirect control
6. specialized professional career	6. non-specialized professional career	6. moderatly specialized professional career
7. selective care for employees	7. care for all company employees in the context of their personalities	7. care for all company employees, including their families

9. Techniques of business organization

The Japanese have also produced a series of techniques that enable managers to better organize the work of employees within their companies and to achieve results that single them out among managers worldwide. The following company management techniques are usually highlighted:

1. just in time,
2. total quality control,
3. quality circles,
4. the *kaizen* concept.

The *just in time system* is the Japanese version of quality management, proposed by American W. Edwards Deming. He conceived a quality control system for the American military that was supposed to improve arms production, i.e., make a system of production that would turn out a large quantity of products with the lowest number of faults possible.

The Japanese embraced Deming's teachings with great enthusiasm. As a result he launched a series of lectures on the topic of quality control in Japan in 1950.[28] As he refused to accept money for his lectures to Japanese managers and workers, the Japanese repaid him by establishing the Deming Prize in 1950, which continues to be awarded to the present day to Japanese companies whose improvements and maintenance of quality control results in a constant innovation of product quality.

The Japanese used Deming's postulates to introduce the *just in time* concept as well as total quality control. The goal of the *just in time* system is to maximally reduce the storage costs of materials and raw materials in the production proc-

[28] www.en.wikipedia.org/wiki/W._Edwards_Deming, 21/4/2008

ess, and to ensure that materials and raw material's are placed on the production line at a precisely set time. By carefully planning the necessary raw material and material supplies, Japanese producers of various types of products have succeeded not only in reducing business costs but in increasing productivity. It is not often mentioned in literature that the Japanese have taken over Deming's concept; instead the concept is mostly ascribed to them. Here, too, the Japanese have acted in a "Japanese" manner: they borrowed a good solution and then perfected it. Thus, during the 1970s, Americans themselves were coming to Japan to see how they apply both the *just in time* system and *total quality control.*

Total quality control (TQC) has also been applied within the quality management concept. The point of this concept was to gain products and services whose quality would be above that of the competition, in order to increase company profits. Also, the application of TQC reduces the number of errors in production, i.e., loss of materials and wastage are minimized, which once again reduces production costs. Thus, for example, Toyota has in its production plants an information board called *andon*, which helps it control product quality during the production process itself. "The *andon* information board depicts the course of the production process with the aid of lights with numbers and letters, which turn on and off. It provides an informative and clear picture of the situation, making it possible to immediately locate the spots where there are difficulties in the production process."[29] This board thus makes it possible to quickly discover errors in specific sectors, and it is possible to halt the production process at any time in case of error.

Quality circles usually consist of small groups of people who are performing similar or connected work, and who regularly meet in connection with the work they are performing. The goal of the circles is to identify, analyze and solve problems connected with production and product quality.[30] The employees who participate in the circles must be qualified for the work in question. They are usually sent to special courses in which they are trained in this technique, so that they can execute the process of analyzing and solving problems in the appropriate way. Each circle has its leader, followed by a coordinator and then the person who will choose the solution to a particular problem.

Testimony to the success of the application of this method in Japan is given in the following examples provided in the book *Intercultural Management*: "The high quality of the innovations made by Japanese quality circles is indicated by the fact that, for example, the big Japanese company Nippon Steel earned 28% of its profits in 1989 thanks to proposals made by innovation groups in that year. At that time, the company had almost 80,000 employees, of whom 50,000 were engaged in direct production. All of them were included in innovation groups, which, during the course of the year, submitted about 500,000 proposals.

29 A. Jurčić, *Evro-azijski menadžment u uslovima globalizacije; interkulturni aspekti*, master's thesis, Megatrend univerzitet, Beograd, 2008, p. 79

30 S. El Kahal, ibid, p. 159

A second example is the Kimitsu Company, also one of Japan's largest steel producers, in which 7,400 workers are included in 1,300 innovation groups." [31]

The *kaizen* concept is a technique of permanent improvement in the way of doing business. It is people-oriented, and assumes a constant reviewing of the possible ways of improving the work of people inside the company. In order to better understand *kaizen*, it is necessary to separate it from the concept of innovation. **Innovations** have to do with a **dramatic improvement** in operations that has come about as a result of investing in new technology and/or equipment, while **kaizen** is oriented toward **small changes** in operations that have come about as a result of constant employee efforts to improve the work process.[32] Kaizen applies to all employees within a company – workers, managers and directors. It is most often applied in the areas of quality, cost control and supply. When changes are implemented by way of constant improvement in business operations, this also improves the company product itself, and increases consumer respect for the company and its products. It has been a long-known fact, learned by all business school students in the area of marketing, that it is financially much cheaper for a company to retain a consumer than to attract a new one.

Hence, the kaizen concept absolutely fits into the said finding, which explains why the Japanese insist on it so much. Kaizen is also applied as a concept in everyday life. This technique shows that the Japanese have an unbreakable connection between the culture of living and the culture of management, which has, on the whole, advanced the economy of Japan.

10. Conclusion

1) Japan has achieved an "economic miracle" primarily by relying on the only abundant factor of production – the human factor: qualified and devoted labor, highly qualified and socially responsible entrepreneurship, and highly efficient management.
2) It is a widely held view among scholars that Japanese management is greatly responsible for Japan's rise from the Asian ocean of poverty to the level of the world's wealthiest countries.
3) Japanese management, which is constantly improving itself, has crystallized as a synthesis of domestic cultural heritage and the management experiences of the most successful Western countries.
4) The main ingredients of Japanese management, which set it apart from other types of management, are of domestic origin: a cult of order, work, harmony and a readiness to sacrifice for the community.

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31 M. Jovanović, ibid, pp. 116-117

32 S. El Kahal, ibid, p. 162

5) Changes in Japanese society and in the external environment are also imposing changes in the Japanese way of doing business. However, the essence of Japanese management has stood the test of time.

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THE ROLE OF THE BALANCED SCORECARD CONCEPT IN THE PROCESS OF FORMULATING AND IMPLEMENTING COMPANY POLICY

Abstract: *Propulsive strategy and its successful implementation represent a key link in the system of business management. The measuring of the effectiveness and efficiency of the chosen strategy, projects, process and people is becoming an increasingly important factor determining the success of an organization. The Balanced Scorecard system is a framework that enables a strategy to become operational, the organizational structure to be adjusted to the strategy, and for strategy to become an everyday job and a continuous process for all employees in the organization. The implementation of the Balanced Scorecard concept allows for a successful realization of the formulated strategy, ensures the realization of the defined mission and goals and secures a company's long-term growth and development.*

Key words: *strategy, Balanced Scorecard, critical success factors, competitive advantage, performance measures*
JEL classification: L1, L21

1. Introduction

Company operations under contemporary business conditions demand an effective strategy and its effective implementation, which ensures the realization of the desired level of performance. The achievement of the desired state is not at all easy, being influenced by a great number of factors: the globalization of the world market has increased international competition on all levels; the competitive battle is becoming ever sharper; the increasing influence on business operations by various interest groups (consumers, creditors, owners, employees, society, etc.); greater social responsibility on the part of economic actors; intensifying processes of company mergers and acquisitions; the creation of various business alliances; the growing significance of doing business by way of information-Internet technologies; the fact that knowledge, i.e., information, has become the most valuable resource.[1]

In the constellation of the great number of factors that shape business operations and which are making them increasingly uncertain, or which shape the environment in which missions and goals are being accomplished, *strategy* appears as that management decision which ensures company survival on the business scene. Management under conditions of changes and discontinuity, in a dynamic and complex environment, requires a strategy by which a company can secure its existence, i.e., its business vitality, through an effective and efficient management of the company's activities in the business environment. A quality and successfully implemented strategy is the *sine qua non* of a company's survival in a turbulent environment.

Strategy is in the first place a striving to establish an adequate relationship between a company and its environment. Strategy encompasses elements that determine a company's place in its environment, its ability to change the given environment, to adapt it to its own capabilities, to take advantage of the opportunities or minimize the threats coming from its environment, etc. It balances the often conflicting interests of both external and internal stakeholders, thus including them into the realization of company operations. Since the mission of a company is to create a market, i.e., to profitably satisfy consumer needs and desires better than the competition and, on that basis, realize its goals, strategy determines a company's business portfolio and its relationship with the competition, both existing and potential. That means that strategy determines the products that a company will offer, the buyers or markets that it will target, the intensity of cooperation with the competition or of their mutual rivalry, etc. Also, strategy determines the methods and tempo of the realization of the chosen strategic options, as well as the desired level and type of flexibility, ultimately ensuring that the company allocates its resources in an efficient way.

Technical-technological progress and especially the accelerated development of information-communication technologies have helped form a totally new environment in which a company strives to successfully carry out its business mission. Namely, in industrial society companies created value by transforming physically tangible inputs (land, buildings, equipment, raw materials) into market-acceptable outputs, i.e., finished products. Contemporary companies doing business in the era of information technology have at their disposal tangible assets whose book value equals about 10-15% of the company's market value.[2]

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1 The following factors are also important for the creation of strategy: strategy is connected with an unknown future; there are many roads that a company might pursue; companies work in a dynamic, competitive environment, etc.

2 A.M. Webber, "New Math For a New Economy", *Fast Company*, January-February, 2000, according to: Kaplan, R., Norton, D., *The Strategy-Focused Organization: How Balanced*

Hence, for industrial-era companies, for which investment into client relations were not critical for success, a classical system of financial reporting based on historical data was sufficient. Today's changed circumstances require a system that grants equal importance to other factors of business success and allows, on the basis of measured corporate value parameters, the providing of information about the possible consequences of the chosen strategic option, as well as about the success of the realization of previously set strategic goals. Thus, the basic assumption is that the main problem of strategic management is not so much the formulation of strategy but its implementation. In striving to highlight the link between long-term goals, strategic options and actions, i.e., the realization of the chosen strategy, strategic management authors Robert Kaplan and David Norton have developed the *Balanced Scorecard* system,[3] which represents a framework that allows a strategy to be operationalized, the structure to be adapted to the strategy, and strategy to become everyday work and a continual process.

In this work we will attempt to explain the place and the role of the Balanced Scorecard concept in strategic management, and especially its significance for improving an organization's strategic focus, which should offer management a clearer picture of the company toward the goal of making effective business decisions. Also, through the fact that the Balanced Scorecard system represents a methodology for the transformation of a company's strategic goals into realistic performance indicators, as well as the fact that it should make possible an appropriate linkage of long-term strategic goals and short-term actions, we shall try to emphasize its importance not only for strategic management but for a company's market success in general. In addition, we shall deal with the importance of the Balanced Scorecard system for the market restructuring of domestic companies, in order to enable them to successfully achieve their business mission under present-day business conditions.

This work shall not engage in a comparative analysis of the Balanced Scorecard system or present its advantages and shortcomings in relation to other concepts, techniques and methodologies of strategic management, as the BSC is in fact grounded in them. However, differently from these, on the basis of measured corporate value parameters, it also gives information on the possible consequences of the chosen strategic option, and, thus, represents an improvement over them.

Scorecard Companies Thrive in the New Business Environment, Harvard Business School Press, Boston, MA, 2001, p. 2

3 In further text, the *Balananced Scorecard* concept will also be referred to by the acronym *BSC*.

2. The relationship between the processes of strategy formulation and implementation

Through the process of **strategy formulation**, strategic alternatives are created and the choice of optimal strategic option is made, i.e., the strategy through whose realization a company will be able to achieve its defined goals and secure its vitality. In order to arrive at an optimal strategy, it is necessary to analyze a company's internal possibilities, recognize future opportunities and dangers, incorporate the ingenuity and vision of leaders, the experience and skills of management, develop learning within the company, define possible strategic options, establish adequate criteria for their evaluation, evaluate strategic alternatives and ultimately choose the optimal alternative. However, without efficient implementation, such a formulated strategy cannot bring success to an organization. A formulated strategy is reflected solely through its realization. Only then will it become evident just how quality the formulated strategy actually was. However, no matter how good the chosen strategy is, it will not have value if it is not efficiently implemented.[4] Therefore, it is highly dangerous for a company to limit itself only to strategy formulation, without connecting it to its implementation.[5]

Implementation – the application of strategy, is a process by which a strategy is turned into a set of actions (programs, budgets, procedures, etc.) through which goals are achieved and value is created, i.e., by way of strategy implementation a company transforms conceptualized solutions into practical achievements.[6] If strategy formulation has a *key role* (representing the essence of strategic management), then it can be said for implementation that it represents the *critical phase* of the strategic management process. For this reason, it is often said that "strategy implementation is only a mirror of the other side of the problem, whose successful solution includes the skill of managing changes, in accordance with the conceptual solutions contained in the strategy,"[7] i.e., that "strategy implementation and strategy formulation represent two sides of the same coin"[8] and that, as such should not be a static process.

4 G.G. Dess, G.T. Lumpkin, M. L. Taylor, *Strategic Management: Text and Cases,* McGraw-Hill/Irwin, New York, 2004, p. 15

5 Many theoretical models that depict strategy creation make no link whatsoever between the strategy's creators and its implementation. Blind acceptance of such approaches on the part of top management can bring serious trouble to companies. This is testified by various crises that have appeared within companies whose planning was merely formal, the end product being piles of inflexibly set plans which someone else had "only" to realize.

6 J. Todorović, D. Đuričin, S. Janošević, *Strategijski menadžment*, Institut za tržišna istraživanja, Beograd, 1997, p. 325

7 J. Todorović, *Strategijski i operativni menadžment,* Conzit, Beograd, 2003, p. 260

8 J.D. Hunger, T.L. Wheelen, *Essential of Strategic Management,* Prentice Hall, Upper Saddle River, NJ, 2007, p. 123

A formulated strategy often requires the carrying out of certain changes in the company. Those changes are reflected in changes in management style, in the system of relations with the surroundings, in production assortment and/or the market, in the organizational structure, business culture, etc. It is the activities of implementation that ensure the realization of the chosen strategy. Those activities are:

- the transformation of strategic goals into ongoing plans and programs, the allocation of tasks into functional areas and organizational units and setting a budget for each group of tasks;
- the creation of an organizational structure that will allow an effective and efficient achievement of the strategy (ensuring harmony between strategy and structure);
- the development of skills and competencies on which the strategy is based;
- the choice of personnel for key positions;
- acquainting employees with the strategy and motivating employees to implement the strategy;
- the creation of adequate working conditions and business culture (if the new strategy demands it, a new business climate and/or culture can be created);
- establishing a system of rewards;
- establishing an information system in order to secure efficient support for management; i.e., decision-making;
- adjusting policies and procedures in order to ensure a maximally successful realization of the strategy;
- coordinating activities between the organizational parts, and
- developing a system of control and review in order to monitor strategy implementation and take corrective measures (in terms of changing specific programs or budgets and, if necessary, the strategy itself, etc.

It is necessary to carry out all these activities so that the chosen strategic choices are realized as efficiency as possible. However, in order to implement strategy successfully, the activities that are to be implemented should be contemplated during the strategy formulation phase itself. It is necessary to pose the following questions: who is charged with strategy implementation; what must be done in order to direct the company toward the realization of the set goals and a new direction for action; are the necessary means and resources for the implementation of the strategy available; what kinds of changes will the new strategy bring to the organization; how to efficiently mobilize resources and channel them toward the achievement of the goals? In other words, as can be seen from the questions that have been posed, efficient strategy implementation requires respect for its demands in the strategy formulation phase itself (especially when it comes to the evaluation of strategic alternatives from the standpoint of their feasibility in the given circumstances). Thus, at the moment of strategy formulation, it is necessary to understand the size and kind of changes that its implementation will require. As can be seen in Figure 1, "threats to the success of the strategy exist both in the areas of its formulation and in the areas of its implementation."[9]

Figure 1. *The relationship between strategy formulation and strategy implementation*[10]

		STRATEGY FORMULATION	
		Good	Bad
STRATEGY IMPLEMENTATION	Good	SUCCESS	ROULETTE
	Bad	DIFFICULTIES	FAILURE

An organization will achieve *success* not only through a well-formulated strategy but also through its successful realization. That means that the strategy formulation process needs to encompass a great number of external and internal factors, recognize, i.e., anticipate their future influence on the organization and define a strategy for whose efficient implementation financial, human, informational and other resources can be secured. A company may also find itself in a *roulette* situation, when the strategy is poor while its implementation is good. In such a situation, the organization strives to identify and remove the weaknesses of the chosen strategy during the realization of the strategy itself. *Difficulties* appear when a well formulated strategy is poorly implemented. It is then necessary for all the company employees to make an added (and sometimes substantial) effort in order to eliminate the elements responsible for the poor implementation. However, when difficulties arise, more often management opts to change strategy than to eliminate barriers to its implementation. At the end, *failure* is unavoidable when strategy is poorly formulated and then poorly implemented. In such circumstances, an organization will not be able to efficiently realize its mission and goals, thus bringing its survival on the market scene into question. Therefore, it is necessary for companies to establish the best possible link between strategy formulation and implementation within the organization, so that they may successfully carry out their missions and defined goals and thereby ensure sustainable competitive advantage and business vitality in contemporary business conditions.

9 J. Todorović, ibid., p. 260

10 J. Todorović, ibid., p. 256

3. The role of the Balanced Scorecard concept in contemporary business

Among the authors who have dealt with the relationship between strategy formulation and implementation, by using a new approach, two American authors in the area of strategic management, Robert Kaplan and David Norton, have succeeded in demonstrating the connection between organizations' long-term goals, strategic options and short-term plans and actions, i.e., in connecting strategy formulation with its implementation. This is the concept known as the Balanced Scorecard concept. BSC is a clear concept of measuring an organization's particular business functions, with the goal of finding a balance between financial capabilities and a continued improvement of strategic performances and results. The system allows the creation of a vision and a strategy, and the development of tools for their successful realization.

The Balanced Scorecard recommends viewing an organization from four aspects, developing a system of standards, and collecting data and analyzing them, in order to predict business performance and the organization's future positioning. The Balanced Scorecard system is a framework that ensures that a strategy will be operationalized, and that the organization will be adapted to the strategy. In other words, BSC is a methodology for the transformation of an organization's strategic goals into realistic performance indicators, which should allow an adequate connection between long-term strategic goals and the company's short-term actions. It significantly eases the setting of goals and helps in the allocation and prioritization of resources, as well as enabling managers to maintain or change the chosen strategic options. *Most important of all, BSC enables reporting on the organization's efficiency in carrying out its mission and goals, i.e., its strategy.*

In order for a company to satisfy ever-changing buyer needs, employees should be able to take on totally different responsibilities, adopt new knowledge and learn new skills. In that context, BSC's incorporation of growth and learning prospects represents perhaps its greatest contribution, assuming the continued education of managers and executives and the development of an organizational culture in which personal and corporate advancement are of great importance. This is especially important due to the fact that in a contemporary organization, based on *knowledge as a competitive advantage*, employees are viewed as human capital which, together with structural capital, makes up an integral part of intellectual capital.

The interconnection of management style, organizational culture and organizational structure strongly influences the value of structural capital which, together with human capital, predominantly determines a company's market success, i.e., the legitimacy and vitality of its business. Namely, it has been proven that there is an active link between management style and organizational culture. Also, it is known that type of organizational culture determines flexibility, as a category that represents one of the most important preconditions of a company's growth and development. As far as organizational structure and its link to management style is concerned, it is important to point out that an informal organizational structure exerts a stronger influence on its propulsiveness toward successful strategy implementation, which ensures company growth and development, than does a formal organizational structure. For example, in companies with authoritarian management styles, an informal organizational structure is a brake to company growth and development, i.e., the main source of resistance to changes. On the other hand, in companies with participative and consultative management styles, an informal structure is either not present or it supports the formal structure, improving its propulsiveness towards a successful implementation of the chosen strategy.

The basic precondition for a successful implementation of BSC is for the top management to identify business goals, individual work assignments and success measures in cooperation with lower management and executives. On the basis of that, management and other managing organs will be able to know at all times how much which executive is contributing to the success of the company's overall business performance, as well as his contribution to the achievement of individual and group business goals. Thanks to that, the problem of determining *something that is nowhere explicitly mentioned but which to a great extent determines company value* is significantly remedied and not only does the Balanced Scorecard system represent an efficient methodology for determining the exact *quantity of intellectual capital* but it opens up possibilities for its improvement, i.e., its reproduction and increase.[11]

The key ideas of BSC are: a) financial business indicators are not sufficient for managing a complex organization in a turbulent environment; b) a balanced look at an organization's performance must include at least 4 aspects-perspectives: financial, consumer, internal business processes and learning and development; c) BSC ensures the implementation of a strategy into practice, and mobilizes all available resources for its achievement.

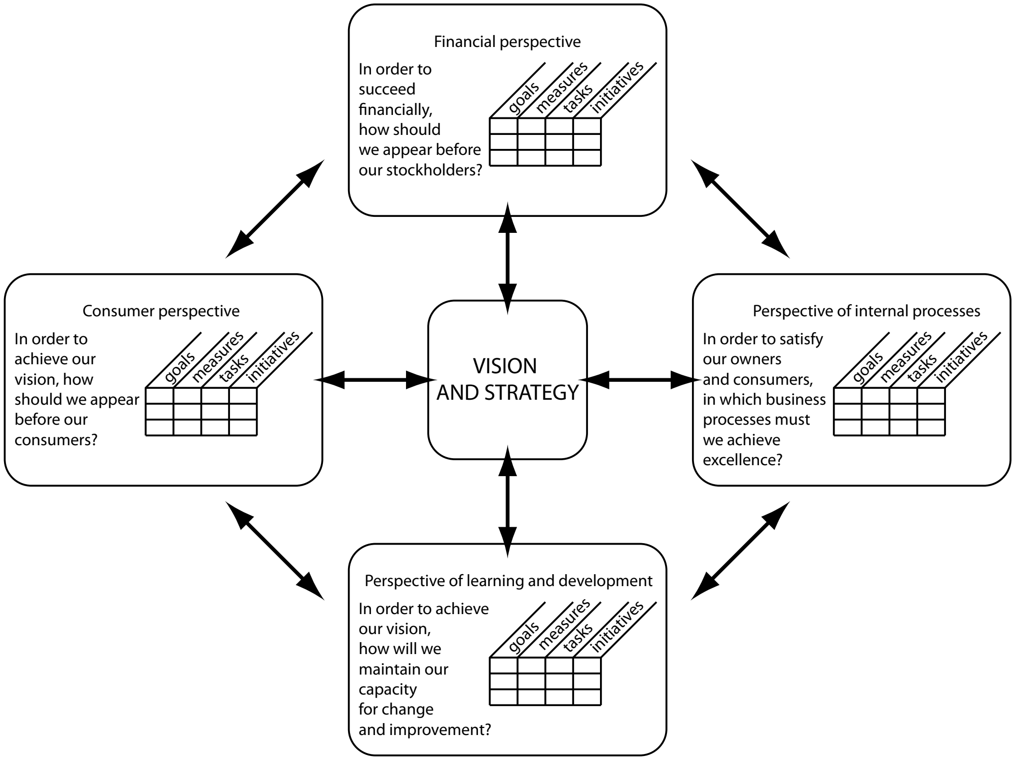
In order to achieve a company's target function – ***creating value for the owner***, in addition to considering the ***financial aspect of its business*** (profitability, earnings growth, cost control, etc.), company management must also devote equal attention to (Figure2):

- **the consumer (marketing) aspect** (the consumers' view of the company) – which represents the company's ability to ensure quality products and services, efficient delivery and buyer satisfaction;
- the company's internal capabilities, i.e., areas through which consumer satisfaction and, by the same token, the gaining of competitive advantage, are best influenced – **the aspect of internal business processes**;

[11] Based on the assumption that what cannot be measured cannot be improved and that intellectual capital is worth as much as the factors that contribute to the realization of a company's individual and group goals, whose constallation determines its usefulness and functioning.

- the ability to innovate and learn, i.e., a company's capability to continually improve its business operations, grow and develop, and maintain and increase its competitive advantage – **the aspect of innovation and learning capability**.[12]

Figure 2. *Aspects of transforming vision and strategy into reality*[13]



Hence, traditional financial measuring is only a part of the BSC methodology, as the Balanced Scorecard system offers a significantly broader space, allowing the possibility of establishing cause-and-effect connections between the objects viewed from these four perspectives. For example, a connection can be made between employee satisfaction, buyer satisfaction and earnings growth. By using BSC, it can be concluded that, for example, increasing employee satisfaction by 4% brings an 8% increase in buyer satisfaction, generating a 4% higher profit. Of course, each organization defines its own success measures and the connections within them.

12 R.S. Kaplan, D.P. Norton, *Strategy Maps*, Harvard Business School Press, Boston, MA, 2004, pp. 30-32

13 R. Kaplan, D. Norton, *The Balanced Scorecard: Translating Strategy into Action,* Harvard Business School Press, Boston, MA, 1996, p. 9

Thus, it turns out that financial results, i.e., the ***achievement of a company's target function***, is a consequence of efforts made within the framework of success in the areas of ***marketing, internal business processes and development***.[14]

At all times, both company management and the other employees should have the following two questions on their minds:

1) To what extent is the organization engaged in the real things (question of effectiveness)?
2) Are work assignments being carried out in the right way (question of efficiency)?

The first question is connected with strategic thinking, while the answer to the second should be provided by using BSC results. In connection with this, business survival depends exclusively on the value that the organization can offer to all stakeholders and its ability to create that value, both from the short-term and the long-term standpoint.

The identification of all relevant stakeholders represents the first step. In that context, it is necessary to provide an answer to the following questions: Who are they? What are their needs and desires? How can they contribute to the organization? What is their risk? Figure 3 can prove useful in obtaining the answers to the above questions.

Figure 3. *The place and role of stakeholders in company operations*[15]

Who are the relevant stakeholders?	**What are their needs and desires?**	**How do they contribute to the organization?**	**What is their risk?**
Owners – stockholders	•Financial results •Profit •Dividend	•Capital •Business advice	•Loss of money
Banks	•Timely payments	•Capital •Business advice	•Loss of money
Suppliers	•Earnings •Timely payments	•Low prices •Fast delivery •Durability and design •Quality support	•Loss of money
Employees	•Security •Respect •Interesting work •Salary	•Availability •Knowledge •Loyalty •Inventiveness	•Loss of money •Lack of advancement •Poor work environment
Buyers	•Low prices •Fast delivery •Durability and design •Quality support	•Earnings •Recommendations	•Poor choice of supplier

14 J. Todorović, ibid., p. 145

15 http://www.qpr.com/Solutions/Balanced_Scorecard/BSC_WebCast/QPR5b.html (accessed: 23/11/2007)

In addition to the above, many other stakeholders may exist, such as state institutions, manufacturers, distributors, insurance companies, various partners. They should certainly be recognized and their needs and desires carefully evaluated, along with their contribution to the success of company operations. Each stakeholder has a place and a role in the business process. The underestimation or overestimation of any side might bring not only undesirable but sometimes even catastrophic consequences, which may bring into question the company's survival on the business scene.

Finding the right paths for reconciling the often opposing interests of all the interested stakeholders and defining the mechanisms for maintaining the established balance, means nothing other than choosing the right strategic option. As the external and internal factors whose respective constellations influence company operations are quite turbulent, the application of the appropriate strategic policy often requires various compromises, and individual and periodic solutions that may not always be optimal. Still, by continually measuring performance it is possible to undertake necessary corrective actions in a timely manner, i.e., harmonize achieved performance with planned performance or – if necessary – change strategy. This raises the efficiency of control and review, thus relativizing to a certain extent the need for restructuring the organization.

4. Company strategy and the Balanced Scorecard

Kaplan and Norton defined four key processes for strategy execution within BSC:

1) transforming the vision into goals and strategy,
2) communication and linking,
3) business planning,
4) feedback and learning.

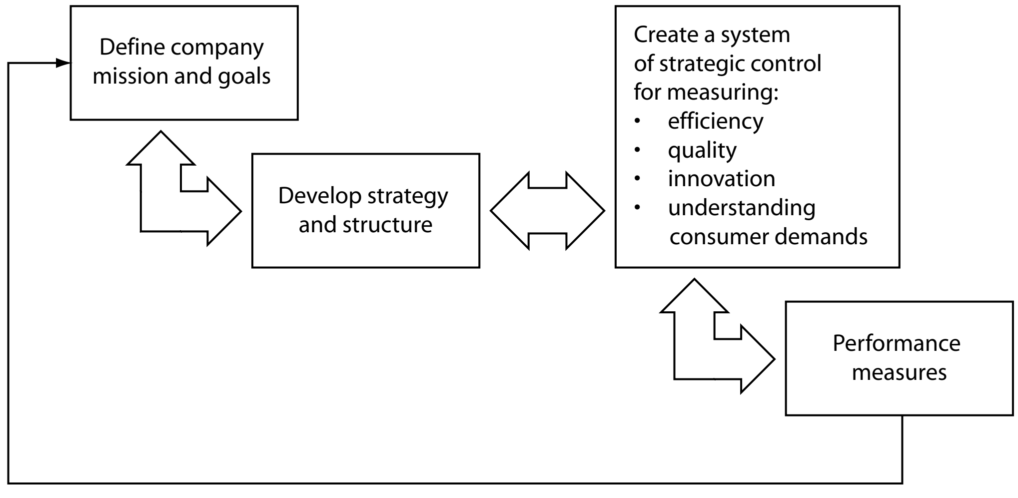
Through these activities, an interlinked system of strategic management within a company is created, which will allow the vision to be transformed into reality in the most efficient way possible. In this way, strategy becomes the basic means of achieving goals, and the company acquires the epithet of a "strategy-guided company." In order to achieve this, it is necessary to:

- transmit strategy into operational programs;
- harmonize the organization with the strategy;
- for strategy creation to becomes an everyday job for each employee;
- make strategy a continual process, and
- initiate changes through executive leadership.[16]

16 R. S. Kaplan, D. P. Norton, ibid., p. Xi

The conceptual framework for BSC, represented in Figure 4, indicates that its starting elements are the organization's missions and goals.

Figure 4. *The Balanced Scorecard conceptual framework*[17]



As a component of strategic management, the mission gives a company its identity (role), its purpose, determines its philosophy (culture, values, views, etc.) and defines the starting components for strategy formulation.[18] Goals represent the level of qualitative and quantitative performance that the company wishes to achieve and toward which its entire operations are oriented. The task of management is to lead the company to the achievement of these performances, i.e., to "guide the company from the starting to the desired state – the goal." The strategic goals that are necessary to achieve are defined on the basis of a review of the strategic situation from four perspectives (the perspectives of the investors, consumers, internal processes and learning and development).

Toward that purpose, it is very important for managers to set goals in cooperation with the employees. The general goals of the above perspectives are shown in Figure 5.

17 C.W.L. Hill, R.G. Jones, *Strategic Management; An Integrated Approach,* Houghton Miflin Company, Boston, MA, 2007, p. 93

18 B. Mašić, *Strategijski menadžment*, Univerzitet "Braća Karić", Beograd, 1996, p. 181

Figure 5. *The basic aspects of BSC and the goals of the organization*[19]

Perspective (aspect)	Goals	
	Profit-based organizations	Non-profit organizations
Financial perspective	Profit	Budget and cost control
Marketing perspective	Satisfying consumer needs	Execution of assumed public obligations
Perspective of internal processes	Ability to create value	Ability to create solutions
Perspective of learning and development	Possessing knowledge	Possessing knowledge

Thus, the goals that have been set must be harmonized. Then, on the basis of the set goals, a structure is developed and a strategy formulated, within which the specific ways, directions and instruments for the realization of the mission and the goals are defined. However, the chosen strategy is subject to changes if the need arises. Kaplan and Norton think that the problem of the success of a company's operations is contained in the transmission of strategy into concrete actions, as there are no adequate *measures* with which to track the success of achieving goals, nor do the employees know what is expected of them. That is why they recommend setting down concrete measures through which to track the success of the strategy's execution.[20] In the end, the performances achieved by the company influence the reexamination of the previously defined mission and the company's defined goals. If a need to redefine the mission and goals arises, then it is necessary to carry that out. This will effect a change in the formulated strategy itself, which was implemented in the preceding period through a series of developed programs, projects, plans and other work assignments.

Performance measures are set for each group of goals (which are defined in accordance with the aspects), and concrete tasks are determined. Employees are clear about what is expected of them, i.e., the concrete tasks that they are supposed to execute. This is connected to employee rewards, which are linked with the degree to which performance measures have been fulfilled. Employees must know at all times what is expected of them and how the successful execution of their tasks reflects on the company's overall success, i.e., on the improved performance of operations as a whole. It is very important to be able to evaluate at all times the individual performance of each employee, because what cannot be measured

[19] http://www.qpr.com/Solutions/Balanced_Scorecard/BSC_WebCast/QPR5b.html (accessed 23/11/2007)

[20] Performance measures can be found in: level of production costs, number of hours needed to produce a product, the number of products that are rejects, number of reclamations and returned products on the part of buyers and consumers, number of new products launched on the market, time necessary to develop a product relative to the competition, research and development costs for a new product, number of repeat purchases, time necessary for product delivery to buyers, etc.

cannot be improved, and that is precisely what BSC makes possible. In such circumstances, for each level of organization it is necessary to define additional performance measures that harmonize individual and corporate goals. By using BSC measures, managers can easily and quickly identify the organizational parts which are not functioning in accordance with the chosen strategy. Finally, each manager and executive at the appropriate organizational level have a readier insight into the demands that are placed on them, as well as into the consequences of their activities, i.e., the success of implementation and the efforts made toward the achievement of company goals. In this way, through precisely set performance measures and employees execution of work assignments, the efficiency of strategy implementation and goal achievement can be monitored, just as systematic strategy improvement can be made through gained experience and the learning process.

Since performance measuring is a process of measuring progress toward a successful execution of predefined goals, it can certainly be said that it is based on the use of information on performance measurements in order to achieve positive effects in the organizational culture, the business system and its processes.

Performance measuring is not an end unto itself but an instrument for more effective management, since the results of performance measuring show only what happened, but not why, or what should be done further. Hence, measurement represents a basis for evaluating progress in the execution of set goals and helps identify strengths and weaknesses, as well as define the steps that should follow in order to improve the process of formulating, i.e., implementing strategy. Finally, one should be prepared for the fact that the first version of a defined system of performance measurement may not be ideal. However, performance management has an evolutionary character, and the experience gained is a significant factor of continued improvement.

In making a connection between mission, goals and strategy and performance measures as control parameters for measuring quality and the efficiency of strategy implementation, the authors of the BSC method have demonstrated that:

1. The creators of strategy, i.e., the company structures that formulate strategy should also be the main implementers of strategy.
2. Efficient strategy implementation requires respect for its demands in the phase of strategy formulation itself (especially in the evaluation of strategic alternatives from the aspect of their feasibility in the given circumstances).
3. A formulated strategy can be successfully implemented only if individual goals are clearly set, along with measures for gauging the success of the implemented actions.
4. Employees must know at all times what is expected of them and how success in the execution of their work assignments reflects on the company's overall strategy implementation and success, i.e., on the improved performance of overall business operations and mission execution.

5. The degree of feasibility of the defined performance measures is a basis for evaluating the success of the implementation of the chosen strategy and helps in the process of identifying strengths and weaknesses, as well as in defining steps that should follow in order to improve strategy implementation, or in order to reformulate the strategy.

Such an approach to the relationship between strategy formulation and implementation shows that, for the successful realization of the company's mission, it is necessary that the key phase (formulation) and the critical phase of the process of strategic management (implementation) have an interactive relationship (simultaneously integrated), that they complement and influence each other, and that the employees who created the strategy are its chief implementers – all with the goal of securing competitive advantage, achieving desired performance and creating value for the owners and other interest groups. Only jointly do strategy formulation and implementation ensure strategic competitiveness and above-average profits. When strategy is formulated, it is also necessary to think about its implementation while, in the course of implementation, effective strategic leaders receive appropriate feedback, which they use to improve the chosen strategy. Only when these two activities are carefully integrated is a company able to achieve the desired result.[21] And the ultimate judgment about the degree to which strategy formulation and implementation are integrated is contained in the relationship of the buyers/consumers toward what the company has to offer.[22]

4.1. Critical factors of success in the implementation of the Balanced Scorecard

The first factor of success in the efficient implementation of BSC is *strategy definition and its acceptance at all levels*. Top management is of crucial importance for measuring performance and improving the process. It should organize frequent formal and informal meetings with employees and managers in order to underline its support for implementation. Subsequently, it is necessary to *abolish organizational barriers*. Organization and performance should be observed through processes, not through sectors or business functions. Also, another important precondition is ensuring the flexibility of BSC in terms of its harmonization with constant business changes. The transformation of strategy into a useful system of performance measures is a continuing, complex and dynamic process and, since the same indicators can be variously interpreted, it is necessary that the established measures can be changed quickly and simply and/or supplemented, in accordance with changing business conditions.

21 M.A. Hitt, R. Ireland Duane, R E. Hoskisson, *Strategic Management: Competitiveness and Globalization,* Thomson South-Western, Ohio, 2005, p. 29

22 A. S. Lojpur, M. Kuljak, *Menadžment*, Ekonomski fakultet, Podgorica, 1995, p. 274

In addition, it is very important to make the input data accessible to all interested parties. Many organizations already possess certain quantitative data that could be useful for establishing performance measures – most often, these are financial, employee and other administrative data. Organizations are already beginning the process of collecting, filtering and preparing data for storage in data warehouses. The transfer of data from various available sources into a system of support for the implementation of BSC should be automatized. This saves time, reduces the possibility of error and avoids the costs of data entry and control. Qualitative data is much less available, as it is usually obtained through various forms of research. In addition, with the development and application of information technologies, i.e., with the use of the Internet, intranet or extranet, it is possible to carry out even very complex research relatively quickly and easily.

The output data must be available to all company employees at all times, because it is often not enough to tell them what to do – but also why they should do it. In that context, it is extremely important to announce the achieved results to all the employees, so that they can see how certain activities reflect on the performance of the entire company. Also, it is necessary to ensure *data security*, as the Balanced Scorecard system often contains confidential data to which access is protected by authorization. Thus, the system can be open to the point where the business secret begins. This can cause conflicts in relation to the use of data on all levels of the organization. However, a well-planned system of selective access can resolve the problem in a satisfactory way.

One of the biggest potential problems is the slow implementation of the BSC system. The most time is spent on defining indicators and the collection of relevant data. The speed, currency and accuracy of obtained results (especially in the early phase of use) have a decisive influence on the trust and readiness of management and employees to accept the BSC system. Therefore, fast introduction is a very important precondition for its successful implementation. Continual employee training is necessary, as it ensures that employees are capable of improving processes. Different levels of management, sectors and individuals have different areas of activity and interest. BSC must possess a mechanism through which all these multidimensional elements of the business system are harmonized. Thus, *harmonization with individual needs figures as an important critical success factor.*

It is only when BSC is introduced that its strength becomes obvious. Comparison between achieved and planned results is just the beginning, while results analysis can often produce very useful information. It is necessary to establish a stimulative *rewards system*, in combination with continued performance improvement. In addition to an individual reward system, a team reward system is also necessary, in order to encourage integrated, horizontal teams to work on improving their performances. Finally, in order to ensure efficient implementation of the concept, it is necessary to: explain to everyone the reasons for improving operations through the implementation of the BSC system; set realistic expectations; encompass the entire organization; work on changing the organizational culture; institutionalize the process, carry out strategy checks, etc.[23]

5. Conclusion

The goal of establishing the Balanced Scorecard system is to bring better strategic focus to an organization, i.e., to provide management with a clearer picture of the company so that it can make effective decision. Contemporary business depends on the measurement and analysis of achieved performance, which provide important data on key processes, outputs and results, such as information about buyers, products, operations, the market, the competition, suppliers, costs.

As a direct benefit of introducing the Balanced Scorecard system, Kaplan and Norton highlight the focusing of the entire organization on several key areas that are necessary for the improvement of business operations. What is achieved is the integration of business functions and corporate values such as consumer relations, efficient management, and quality. Finally, each manager and executive at the appropriate organizational level has easier insight into the demands that are being placed on him, as well as into the effects of his actions on the success of goal achievement, i.e., the efficiency of the implementation of the company's formulated strategy.

At the same time, the biggest advantage of the Balanced Scorecard system is also the biggest shortcoming of domestic companies. Namely, the restructuring of companies, which is oriented toward the creation of a propulsive organization structure and an adequate conception and positioning of marketing within the mix of business functions, in accordance with the above-mentioned, should began with changes in the authoritarian management styles that predominate in our business practice. The problem does not lie in the fact that executives are inefficient but in that management often does not possess adequate professional competency to help it communicate with all employees in an adequate way. It is not a rare occurrence that, due to an inadequately conceived work assignment, executives are not able to give their best performance. In addition, the absence of an adequate system of reward, i.e., the existence of a system of reward that stimulates lack of maximum performance, is a chronic ailment of a large number of our companies. Employees must know at all times what is expected of them and how success in carrying out their work assignments reflects on the company's overall success, i.e., on improving the performance of overall business operations, achieving sustainable competitive advantage and securing long-term growth and development.

23 R. Kaplan, D. Norton, "Using the Balanced Scorecard as Strategic Management System", *Harvard Business Review*, January-February, 1996, pp. 78-79

The measuring of the effectiveness and efficiency of the chosen strategy, projects, processes and people is becoming an increasingly important factor that determines the success of business organizations. Moreover, leading companies do not stop with data collection and analysis – they use the obtained data to secure concrete improvements and, thus, through a series of actions, successfully execute formulated strategy, i.e., ensure the achievement of the defined mission and goals and ensure their own vitality.

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THE SIMULATION MODEL AS SUPPORT FOR CORPORATIVE FINANCIAL PLANNING

In preparing for battle I have always found that plans are useless, but planning is indispensable.

Dwight Eisenhower,
President of the USA (1953-1961)

Abstract: *In changed business circumstances, the following question is raised: how can contemporary financial managers improve the quality of their decisions and make them in a relatively short period of time? In that sense, simulation aided by the spreadsheet model has crystallized in contemporary theory and practice as the most efficient and the most frequently used model in corporate financial planning. This work follows the historical development of simulation, on one side, and the development of corporate models, on the other. The work presents the connectedness of simulation models in the form of spreadsheet tables and corporate planning and, following this, various concepts of use, potential problems, as well as advantages over other programs.*

Key words: *simulation, spreadsheet program, corporative financial planning, model*

JEL classification: L25, M41

1. Introduction

The new millennium has not only brought changes in communications and geopolitical activities, but also significant advances in the business sphere. Much is being said and written about the influence of information and new technologies on the economy as a whole. There is no questioning the fact that technology, new ways of communication and information distribution change the very essence of doing business. Permanent improvement of existing company business models is being imposed as an imperative, so that business systems can adjust to changes in the environment. On the other hand, companies seeking to achieve competitive advantage must develop business models more adapted to their environment in order to increase their chances of success. To define a new model and develop it as an innovation that functions in the direction of improving business operations is a great challenge. How do business model innovations influence financial managers during the decision-making process? The basic characteristic of contemporary business is the complexity and speed with which changes occur, so it is clear that financial managers need means and methods that will ease and quicken the decision-making process. The field of corporate planning is of special significance for the operations of business actors, since it links financial and investment decisions, i.e., helps avoid the surprises that may occur in the business process, and facilitates adequate reactions to surprises that cannot be avoided.

Even though in the past corporate planning was tortuous work, which managers had to do “manually”, in the first decade of the 21st century corporate planning and the making of corporate plans without the aid of a computer is unthinkable, difficult and impractical. The use of computers is a part of everyday support to modeling in the decision-making process. Numerous models were available as options in the past, but corporate planning models have shown themselves to be the best, among which the most widely used are those that are implemented as spreadsheet programs. The concept of corporate planning without computer support was abandoned long ago, while the process of accepting this model was not at all easy.

The basics of corporate planning were set down during the 1960s, while the concept of the model was more widely accepted only during the 1980s. In the beginning, the use of these models, as with every novelty, encountered resistance, the most frequently given reasons being: complexity, insufficient organization size and lack of modelers. Current modeling technology simplifies the creation process and, thus, no well-constructed model is complex. Modelers are often not even needed, since contemporary modeling programs allow the user to also be the creator of the model. The problem connected with size is tied to the costs of model construction and, since these costs have been reduced to a minimum – that problem has been excluded as well. Contemporary practice has reached the point where the use of models is necessary and contemporary business cannot be imagined without them.

In order to avoid errors during the creation of spreadsheet programs, certain principles tied to development must be respected.

The development of computer technology and a constantly changing, open and global environment are the basic reasons for the mass use of corporate models. The use of financial models, especially those based on computer use, has been growing rapidly as of late. The primary reason for this is the increasing need for better and faster support to managerial decision-making, as well as for accessible computer hardware and software. A specific feature of spreadsheet models is their universality. Namely, once created, a model can be used many times, simply by changing the data and assumptions for the newly changed conditions.

2. Simulation with the aid of spreadsheet models

Simulation is traditionally viewed as a process of building abstract models that represent some systems or subsystems of the real world, and also includes the performance of certain experiments on them.[1] Contemporaries (Goldsmith, Seila, Sanchez) engaged in the concept of simulations in business decision-making connect it with the use of computers during the modeling of business systems, emphasizing its contribution to managerial decision-making.

The idea for simulation with the help of spreadsheet programs dates back to Mattesich (1961). Still, it is the product of the age of microcomputers. The earliest spreadsheet program that was used – VisiCalc – had limited functionality, but introduced the concept of electronic tables – spreadsheet programs, which save data and calculations in a rectangular series of fields – into business analysis and, thus, into business as a whole. Subsequent spreadsheet programs (Lotus 1-2-3, Microsoft Excel and Quattro Pro) advanced and developed into efficient tools for modeling, analysis and presentation.[2]

Today, spreadsheet programs are available for all the more significant operative systems: Windows, Unix/Linux and MacOS. Microsoft Excel is the predominant spreadsheet program in use today.

The base of any experimental model must be a real system. Simulation modeling is a behavior description, a construction of theories and hypotheses, a prediction of future states or effects that cause changes in a set of data.[3] If real-world data can be presented in the form of a table, then the problem is solved through a spreadsheet program, as a set of values (fields, cells) grouped in rows and columns. Each value in a program can have a predefined value that refers to other values in the table. Conceptually, a spreadsheet program is a presentation of the original accounting paper table. The goal of electronic spreadsheet programs is not only to make a tabular presentation of values but to enable mathematical relations between these values, so that hypotheses can be easily entered into the spreadsheet program, or changed in the spreadsheet program itself.

1 J. Carson, *Introduction to Modeling and Simulation,* Proceedings of the 2005 Winter Simulation Conference, p. 16

2 S. Andrew, *Spreadsheet Simulation*, Proceedings of the 2006 Winter Simulation Conference, p. 11

3 M. Centeno, *An Introduction to Simulation Modeling*, Proceedings of the 1996 Winter Simulation Conference, p. 1

A spreadsheet program represents a big matrix, made up of rows and columns. The intersection of a row and a column defines a field; the field contains a number, table or formula related to other fields in the spreadsheet program. Their ability to connect a field with a formula gives spreadsheet programs great power. If a field in a spreadsheet program is defined with the help of a formula, a change in one or more numbers leads to changes in the entire program. For example, Microsoft Excel is the most popular and the most widely used spreadsheet program.

A spreadsheet model in corporate planning is nothing other than a presentation of a profit and loss statement, a ratio of numbers, money flows and sensitivity analysis in an exclusively electronic form. What makes it different from such reports in a paper format is, among other things, its ability to predict on the basis of selected entered assumptions.

An illustrative example is that of a spreadsheet program that represents a model for calculating an income statement and a balance sheet. It is performed in such a way that the modeler enters data identical to those in paper form, necessary for making a profit and loss statement or a balance sheet. The data needed for an income statement are net income from realization, costs of realization of finished products, etc., i.e. the account of buyers, suppliers, supplies and all other items necessary for making a balance sheet. The next step deals with the definition of formulas with which the sought values are calculated, such as: marginal profit, business profit, earnings per share, total working capital or capital assets, total assets and liabilities. The program contains various variables that figure in the fields. The model user himself enters data into fields that represent input data, while the modeler defines the predefined formulas, and the program automatically makes calculations after the input data are entered. The model can also do predictions. If certain assumptions are entered, such as the interest rates on short-term or long-term loans, size of dividends, etc., the model makes predictions for the period defined by the user.

Spreadsheet programs have great analytical power. The majority of spreadsheet users develops their own models and, thus, save substantial time, even up to a factor of five. The conclusions reached by the APQC consulting company following a survey conducted in 2005 are favorable regarding the use of spreadsheet programs in planning, budgeting and forecasting. Namely, out of 500 companies analyzed worldwide, 56% reported using spreadsheets in budgeting. That figure climbs to 77% in the case of organizations in which only one or a few people perform planning and budgeting activities.[4]

[4] APQC, *Planning, Budgeting, and Forecasting*, June 2005

2.1. Analysis and design of spreadsheet programs

The general principle of simulation with the help of a spreadsheet program encompasses only three quantities, i.e., each field can contain one of three quantities.[5]

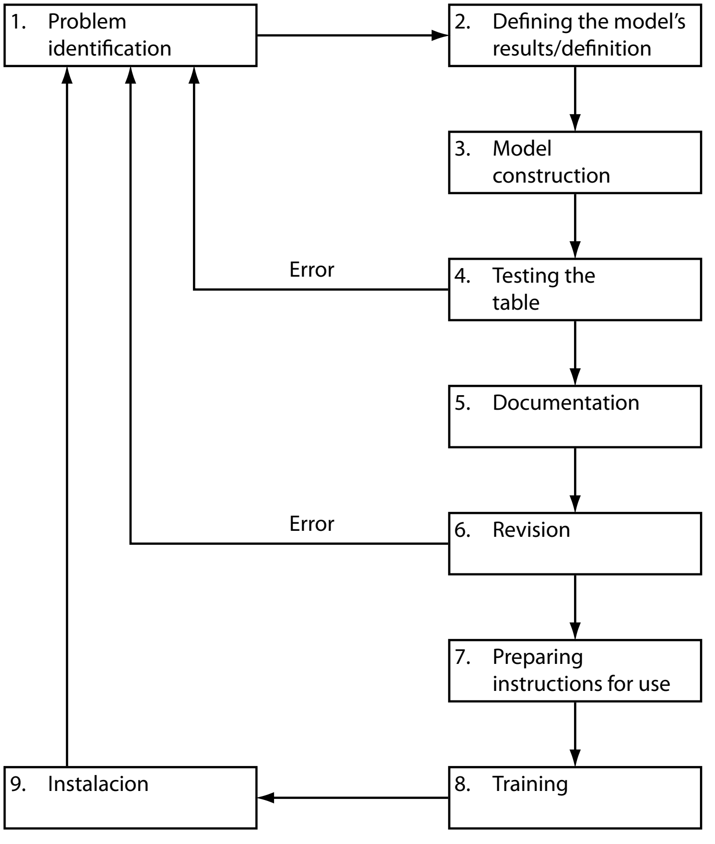
The input quantities represent parameters that the user enters and defines himself, in order to, by manipulating them, arrive at the desired results – outputs; these are random quantities such as demand or paid price, or can be quantities of unknown parameters when sensitivity analyses are performed. In practice, in creating corporate models, two kinds of variables have been identified. *Parameters that can be controlled* are those over which management has a certain degree of control and, most often, defines, sets and changes them itself. Among such inputs are, for example, asset use policy, circulating capital policy, debt policy, amortization policy, merger and acquisition decisions, etc. *External parameters* are parameters from the company's environment. Those are parameters that influence decisions that the organization and its management cannot influence. Since organizations operate in a constantly changing environment and are in constant interaction with it, these parameters must necessarily be plugged into the model. External parameters have to do with demand, supply, costs of labor and material, interest rates on short-term and long-term debt, etc.

After entering the input data of the financial model, the calculations are defined as a set of mathematical and logical relations, which connect input and output quantities. Concretely, in the income statement, the calculations encompass addition and subtraction operations in order to obtain net profits, while in the balance sheet these calculations encompass the summing of individual accounts in order to obtain the value of assets and liabilities. In the model used in corporative financial planning, calculations also include operations performed by the program in order to obtain pro-forma reports.

The data and reports that should be obtained are defined depending on the purpose of the model and management goals, as model outputs. Basically, they show how management measures the performance of the company or one of its parts. For example, management is interested in the level of pay, the profit or sales growth and, in accordance, forms output quantities in the form of reports about forecasted income, profits or sales. The most frequent outputs from the model of corporate financial planning are the expected (planned) income statement and balance sheet, the cash flow report, ratio analysis and sensitivity analysis.

5 S. Andrew, *Spreadsheet Simulation*, Proceedings of the 2006 Winter Simulation Conference, p. 13

Figure 1: *The life cycle of the development of a spreadsheet program*



Source: B. Ronen, M. Palley, H. Lucas, „Spreadsheet Analysis and Design“, Computing Practices, Vol. 31, No. 1, January 1989, str. 88

In practice, all authors define the life cycle of all spreadsheet programs in the same or similar way. Nevertheless, the life cycle must be flexible, in order to depict the various contexts of constructing the already described spreadsheet programs.

The first phase of constructing a spreadsheet program is identifying the problem. The creator defines the nature of the problem that has to be solved. In order for the first phase to be solved successfully, the creator of the model must provide answers to questions tied to the current solution of the problem (if it has been solved at all), the performance of bottlenecks, the solution of the problem by way of a spreadsheet program, source of information. The first phase also includes cost-benefit analysis; defining the length of real time necessary for constructing the spreadsheet program; choosing the type of application for the chosen spreadsheet program (for example, is it a one-time decision-making model or a model that will be used multiple times); identifying the resources that should be used during development. The answers to these questions give a good base for further analysis, i.e., an analysis of creating or purchasing a model. The creator needs to conduct research in order to determine whether there is an existing program that would solve the problem and that can be purchased at an acceptable cost. Otherwise, the only option left to the modeler is to develop his own model. In corporate planning, the identification of a problem is the identification of a need for predicted, pro forma reports as aid in managerial decision-making.

In order for the spreadsheet program that is being created to give results, the input and output variables, their generation, the model structure – menus and macros, if they exist – should be defined in the second phase. A well-defined variable is one in which the modeler achieves the desired goal. Corporate planning is based on the definition of variables and results obtained as standard values through an analysis of the company's base categories. The outputs are highly standardized reports created on the basis of current accounting-related laws.

After defining the variables, the modeler moves on to the phase of model construction, using various commands of the spreadsheet program language. With large models the top-down approach is used, within which model blocks are first made and then subsequently filled with the details. Very often, business corporate models are not demanding but are quite simple, which is why this phase is of decisive importance. The entire model-creating procedure should not be reduced to this phase only, but carried out according to the recommended methodology. The need to create menus and macros defines the moment when the modeler will implement it. The development of modern spreadsheet models such as Excel has greatly simplified this phase, since the commands that are used are almost identical to everyday language.

None of the existing models is good enough unless it passes through a test phase, within which it is necessary to check all the calculations independently of the spreadsheet program. The testing of historic and extreme input data in order to identify errors in formatting and check if it can be determined whether field values can be computed on the basis of assumptions follows that.

After testing, it is necessary to document the model, i.e., define the accompanying text that explains the model, the way it is used, the input and output data, etc. If the model is for internal use, i.e., if the creator himself is using it, there is no need for going into details, as is the case with external user demands. It often happens that the creator of the model forgets which data he needs or – in the worst case – how to use the model.

In case the model does not meet the user's needs, it is desirable to revise the model and its structure.

The optional phases of model creation are the preparation of user instructions and training. If the creator and the user are not the same person, i.e., if the model was ordered, instructions are necessary, as well as perhaps the training of external users before they start using the program. If the user creates the application, user instructions are necessary only if the application is used multiple times.

The basic question with which analysts are frequently faced is: why are spreadsheet programs used in the modeling of financial reports? The reasons are numerous, beginning with the fact that financial reports are highly standardized reports, which always have the same form. The manual production of these reports demands time, while the use of spreadsheet models automatizes this process. The forecasting of financial reports is an even more complicated process, which requires much calculation with great risks attached to manual production. The advantages of spreadsheet models are numerous, especially the following: a great number of functions related to mathematical, statistical and financial calculations, access to data bases, various kinds of graphics, tables and diagrams, characteristics tied to fonts, color and geometrical shapes that improve presentation and automatization by way of the VBA language.[6]

In addition, with the aid of the said characteristics, the simulation process is accelerated, facilitated and becomes more dependable. With their structure, spreadsheet programs allow the creator to organize calculations and results in a natural and intuitive way, in the form of a table. These programs are almost ubiquitous (almost everyone possesses at least one) and data from one spreadsheet program can be easily used in another. In that sense, creators and users can easily transfer the simulation model. Due to the above reasons, spreadsheet programs represent an attractive platform for simulation in financial reporting.[7]

Although numerous authors recommend the use of spreadsheet models in corporate planning, there are certain *problems* tied with their implementation and use. The basic problem with users who develop their own models is insufficient familiarity with systems analysis and the fact that they rarely take into consideration the concepts of reliability, auditing and control. It is an unwritten rule that users pay a high price for independence; thus, in practice, we encounter numerous problems in connection with the construction of spreadsheet problems. The most frequently mentioned errors have to do with logic, inaccurate formula ranges, reference to the wrong field, inaccurately copied formulas, incorrect use of format and column width, accidental copying of formulas and the erroneous use of built-in formulas.[8] With the passage of time and increased user knowledge, the said problems tend to decrease. In the 20th century, managers who could construct any sort of model for support in decision-making were rare. In contemporary business conditions, almost everyone engaged in business has

6 S. Andrew, *Spreadsheet Simulation*, Proceedings of the 2006 Winter Simulation Conference, p. 12.

7 S. Andrew, *Spreadsheet Simulation*, Proceedings of the 2006 Winter Simulation Conference, p. 18.

8 B. Ronen, M. Palley, H. Lucas, *Spreadsheet Analysis and Design*, Computing Practices, Vol. 31, No. 1, January 1989, p. 85

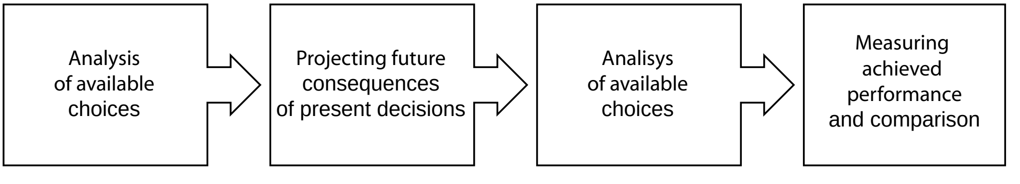
the knowledge and ability to create a model of his own choosing, and this knowledge contributes to comparative advantages in ever-more demanding business conditions. Knowledge as the most important resource in each company is the key to survival in the era of the "new economy," i.e., in the "changing world." [9]

3. Corporate financial planning and forecasting

The continuing process of the realization of development goals compels big corporations to invest and change their structure of assets and spending in order to ensure survival on the market and satisfy the demands of their numerous stockholders. Stockholders, bankers, suppliers, employees and management have certain interests that they are protecting, and track company operations mostly through information from financial reports. In that sense, financial corporate planning based on the planning and forecasting of basic financial reports – income statements, balance sheets and cash flow reports – has become one of the most important facets of business. In order to make the picture complete, these reports are accompanied by sensitivity analysis and ratio analysis. Financial managers make financial and investment decisions, as two indivisible wholes, very quickly and, often, under great pressure. Their decisions are not made independently, due to the high degree of dependence and linkage that exists in the interaction of these decisions. In fact, corporate financial planning is the process of studying the influence of joint decisions, a method for achieving financial goals through a more efficient allocation of resources, whose ultimate result is the financial plan.

Starting from the fact that planning should be tied to a business plan, a set of financial forecasts will have low operational value if company management does not act with the goal of fulfilling these forecasts.

Figure 2: *Corporate financial planning as a process*



The process of corporate planning is depicted in Figure 2. It shows that the process begins with an analysis of where the company was, where it is now and where it is headed, defining not only the most probable direction but also devia-

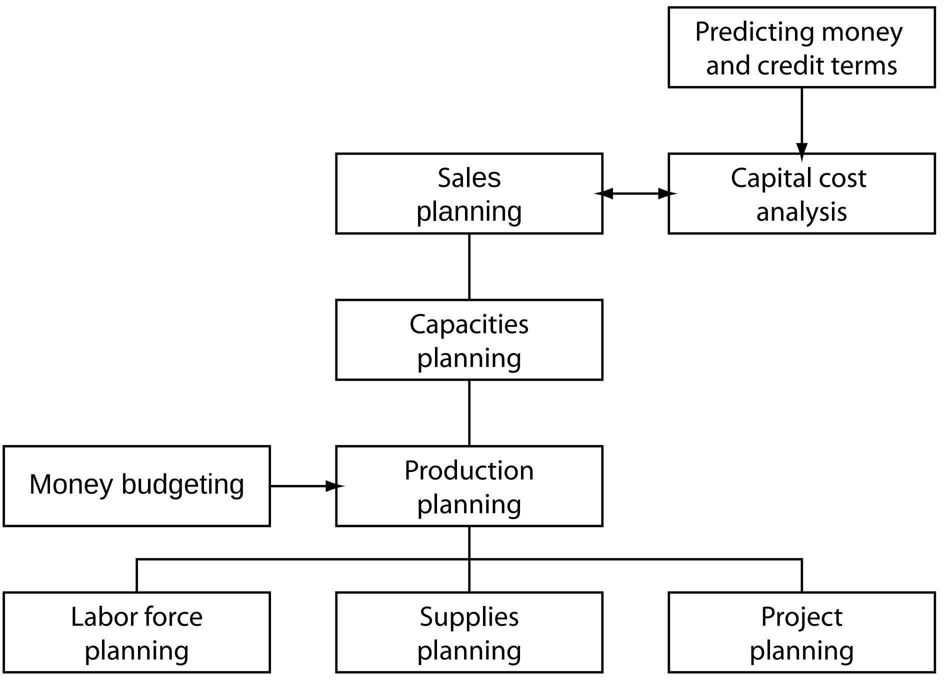
[9] N. Cvetković, S. Kotlica, *Nova ekonomija u svetu koji se menja*, Megatrend univerzitet, Beograd, 2007, p. 46. and p. 39

tions from it. In that context, financial planning compels managers to keep an eye on possible deviations in the company's movement along the projected path.[10]

Corporate planning applies to financial and investment plans, which are transformed on the aggregate level into a synthetic plan – the budget. Forecasting, which represents the starting point and an important element for planning, is also one of the most important management functions and a basis for budgeting activities. Financial management in private and public companies functions under conditions of constant uncertainly and risk. Basically, the forecasting of future sales and related costs provides the necessary information for planning the company's future financial needs. Hence, as can be seen in Figure 3, sales forecasting is connected with various management functions and is the basis for all other plans.

The result of the process of planning within a one-year time horizon is the operative budget, which is used for the decision-making needs of mid-level management and, very rarely, as needed, the highest levels of management. Planning for a period of 3 to 5 years is called long-term or strategic planning and is very frequently identified with corporate financial planning. Corporate planning is usually the task of top management, having the goal of ensuring the most efficient use of resources and achieving the set investment and financial goals.

Figure 3: *Sales forecasting and the functions of management*



[10] R. Brealey, S. Myers, *Principles of Corporate Finance*, Seventh Edition, The McGraw-Hill Companies, 2003, p. 818

Pro forma financial reports are most often used as financial forecasting tools and represent a projection of financial reports at the end of the forecast period. Projections, i.e., forecasts can be based on very extensive, detailed analyses, or can simply be rough, approximate projections. Still, pro forma reports provide information in a quite logical and consistent way.

One of the most important tasks of capital budgeting is to evaluate future cash flows. The quality of the end results is in direct correlation with the precision of the estimate and, in that context, net profit is at the center of all company decisions, as it expresses all the expected benefits expected from the cash flow, even more so than from earnings. A company invests resources with the goal of achieving greater amount in the future. Only cash inflows can be reinvested into the company or into stockholder dividends. Spreadsheet programs are of incalculable value in the creation of cash flow analyses, since they offer the possibility of changing assumptions and very quickly produce output results and give insight into newly achieved flows. As for predicted sales, it is possible to carry out an analysis of multiple different scenarios within a very short amount of time, through a simple change of assumptions.

Sales forecasting is not like other types of forecasting or prognosis. While the goal of other forecasts is only to estimate certain future parameters, sales forecasting is a goal that companies are proactively striving to achieve. In order to construct a quality financial plan, it is first necessary to predict sales. Inaccurate sales projections result in shortages of supplies, short-term financing and delays in the delivery of goods, or even production stoppages until the missing factors are replaced. Contemporaries are proposing various ways of sales forecasting. Thus, for example, Fabozi (2005) proposes regression analysis, market analysis or management opinions as ways of estimating sales levels. On the other hand, Jae and Joel (1998) propose somewhat more complicated methods: time series, exponential settlement, regression analysis and the Box-Jenkins model, which provide more precise and substantially more complex results. When spreadsheet programs first came into use, management expertise was used to forecast sales levels. Regression analysis gains in significance under conditions of a variable environment and the application of ever-more modern techniques. The era of the new economy, characterized by the use of microcomputers and numerous accompanying computer programs, such as Excel, Lotus 1-2-3, VisiCalc, MultiPlan, etc., help simplify regression analysis. All these programs have built-in functions for regressive analysis. In the concrete case of Microsoft Excel it is conducted by entering data at sales levels from previous years. The average growth rate from the past is obtained through the LOGEST function. The role of managers is to, on the basis of past results, predict future sales growth, which also depends on economic movements at home and abroad, the competition, marketing strategy, and access to raw materials. Work on the pro forma report can begin only after sales levels have been predicted.

The most frequently used, even if quite simple, method of forecasting pro forma reports is the *sales percentage* method. It uses the relationships between sales and all the realized items of the entered income statements and balance sheets to create the pro forma financial reports, which are dependent on sales levels. The procedure is based on two assumptions: first, that the majority of the items in the balance sheet is directly connected with sales and, second, that current asset levels are optimal for current sales levels, i.e., that the company is working at full capacity.[11] Realization demands certain gradual steps from the modeler. The first step is to estimate the items that vary relative to sales, with the aid of historical data. Depending on the quality of the data itself, those elements that can be forecasted with the help of the sales percentage method can be identified fairly dependably, along with those for which some other, more complex methods are needed. The second step is the sales estimates. In the model all items directly depend on the quality of sales projections, which means that this task should be performed as dependably as possible. In this step, sensitivity analysis should also be carried out, in order to see the influences of various sales levels on the other variables in the calculation. The last step is the estimating of individual financial reports on the basis of sales projections.

The sales percentage method is a simple method, due to the low costs of its construction and use. Nevertheless, other authors propose various forecasting methods. Even though this method can provide fairly precise results, it is rarely used. The use of regression requires good knowledge of mathematics and econometrics, since the creation of the model is complex and requires much time. Still, financial managers require somewhat simpler models with a satisfactory level of dependability and tend to favor the sales percentage-forecasting model.

The pro forma reports used in corporate planning are the pro forma income statement and balance sheet, and the planned cash flow report. These are future, forecasted reports, which are, as a rule, expected, but which is not always the case. A pro forma (planned) income statement is a projection of earnings for some future period. Sales percentage is the key for predicting and estimating production costs. Detailed analysis of production, wages and total costs produces the most accurate forecasts. Costs of sales, management and administration are then estimated within this analysis; these are usually budgeted in advance and, thus, their estimates are often accurate. In addition, they are not overly sensitive to sales changes within a relatively short period of time. In order to obtain net profits, other earnings and expenditures, such as interest and tax costs, are also estimated. The pro forma (planned) balance sheet is made on the basis of estimates of individual assets. This synthetic plan shows the expected structure of assets and asset sources at the beginning and the end of the planned period, as well as expected quantitative changes.

[11] R.C. Higgins, *Analysis for Financial Management*, Fourth Edition, Irwin, Chicago, 1995, p. 94.

Once the pro forma income statement, balance sheets and cash flow reports are constructed, management has enough data to produce a master budget, which represents a formal report of management expectations regarding sales, costs and the company's other financial transactions for the coming period. In a word, the budget is the sum of pro forma financial reports and is the basic means of planning and control.[12]

Entering the values from the income statements and balance sheets for the previous three years generates the predicted income statements and balance sheets. In addition to these, the model also generates the predicted income statement and balance sheet as a percentage of sales, giving significant support to financial managers in their decision-making. Also generated on the basis of entered data are reports on cash flows for the entered years, as well as a pro forma report on cash flows for the succeeding years. In order for the financial plan to be complete and ready for the preparation of the master budget, the model also offers a ratio analysis and a pro forma report on ratio analysis as outputs. When comparing the structure of the output data, it is clear that the model not only puts together complete reports but also performs a forecast for them for the next three years, in a form in which all the items are dependent on changes in sales levels. That is actually the most significant item, which gives the model value, power and priority in use relative to all other models used in contemporary business.

Since the only data needed for the generation of all these reports are data from all income statements for the previous three years, balance sheets for the previous four years and, of course, input data related to forecasting, in case of changes in the assumptions these changes are very easily modeled with the aid of spreadsheet programs, by way of a simple change of the input data in the program itself, which means that it is not necessary to construct a new one.

4. Corporate planning models

In the early 1960s, leading corporations such as AT&T, Wells Fargo Bank, Dow Chemical and IBM set the foundations of the corporate planning model. These were clumsy, large simulation models. FORTRAN, as the most modern program language of the time, was the choice of the majority of modelers engaged in the creation of pro forma reports. The models would take several years to construct and the costs of construction often exceeded their utility benefits, which made them useful only to big corporations that could afford the costs and development risks.[13]

12 S. Joel, S. Jae, *Schaum's Outline of Theory and Problems of Financial Management*, Second Edition, The McGraw-Hill Companies, Inc, USA, 1998, p. 18

13 J. Shim, R. McGlade, "The Use of Corporate Planning Models: Past, Present and Future," *The Journal of the Operational Research Society*, Vol. 35, No. 10 (Oct., 1984), p. 885

Advances in computer technology during the 1970s offered greater possibilities for a greater variability and adaptability of corporate models. The appearance of corporate simulation languages gave a chance to those with little programming knowledge to write programs in a language that was compatible with spoken language, primarily the English language. The appearance of Microsoft Excel also contributed to the spread of the corporate planning model.

Having gained experience in the development of basic, deterministic simulations, during the 1960s, companies began trying to consolidate and integrate smaller models into larger corporate models.[14]

Furthermore, some companies began trying to apply more difficult optimization models, which, by using econometric models that connected simulation with the market and the environment, gave them greater predictive abilities. Early successes with the easiest model led to a boom in modeling, but an increased number of failures in more ambitious projects soon dampened the general enthusiasm. Recessions lessen the predictive abilities of corporate models, which exposes their weaknesses. The priority for management must be a model with a well defined purpose. For that reason, the end user must be included in the model's development. Even though negative experiences during the 1970s gave rise to negative attitudes among some managers, a majority of veterans from that period developed a realistic view regarding the model's capabilities and took advantage of technical improvements to construct more servile models.

Today, an increasing number of companies are using, developing or experimenting with some kind of corporate planning model. The corporate planning model has the goal of improving the quality of planning and decision-making, decreasing risk during decision-making and, most importantly, influencing or shaping the future environment to its own advantage.

The above overview indicates that the use of corporate models is almost unlimited. Even though only one example was shown in this paper, it nevertheless has numerous possibilities of use, from projecting financial reports and budget construction, financial forecasting and planning, capital budgeting, to spending analysis, tax planning and savings, analysis of exchange rates, mergers and acquisitions, to planning capacities, financial assets, analysis of risk, cash flows.[15] Depending on use, there are two kinds of corporate planning models. The first are simulation ("what if") models, which are an attempt to mathematically represent company operations or conditions in the economic environment. They simulate the effects of different decisions made by management and are, essentially, tools for a management laboratory. Optimization models, as the sec-

14 Ibid., p. 886

15 For details on the use of spreadsheet programs in corporate models and other spheres, as well as for concrete models, see: C. Holden: "Spreadsheet Modeling in Corporate Finance", according to: *Principles of Corporate Finance* by Brealey and Myers, Prentice Hall, Upper Saddle River, New Jersey, 2002 and S. Nugus: *Financial Planning using Excel, Forecasting Planning and Budgeting Techniques,* CIMA Publishing, 2005

ond type of model, have the goal of maximizing or minimizing criteria or variables, such as net current value, profit or cost. Their purpose is to identify the best decisions in the context of existing limits.

The attitude toward modeling has advanced from the "frightened" attitude of the mid-1970s to today's much more optimistic outlook. Past trends probably explain the generally negative outlook in the research of Higgins and Finn (1976), which examined the views of top management toward modeling in the United Kingdom. Most managers believed that models cannot encompass the complexity of the organization, and that they ignore political views and views on social and consumer behavior. In the few areas where models proved useful, managers didn't have enough time to learn how to apply them. At that time, the image of a manager sitting in front of a computer and dealing with problems of analysis was unrealistic. In essence, the entire concept of the corporate planning model was not abandoned; it was simply delegated to lower levels of management. Thus, the fate of the model was left in the hands of middle management, which used models in operative planning.

At about the same time, Greener-Wooler's review showed the importance of the support of top management for the successful creation of any model. The view of more than 50% of surveyed managers was that models improved forecasting, while 31% of the surveyed managers were undecided. The others did not have sufficient information on models to be able to take any view. Encouraging results followed. Wagner (1979) reported that not only did higher management demand the construction of models but that it also participated in their development. In a survey conducted in the US, none of the executive managers considered models to be useless. Klein (1982) found evidence for substantial savings through the use of modeling, with one deputy financial director reporting a savings of 600,000 US dollars as a result of using a corporate planning model.[16]

Neither was any serious limitations regarding modeling reported in Naylor's review from 1985. Criticism was directed at the inflexibility of certain models, poor documentation and the excessive need for input data.

The refusal of many companies to experiment with corporate planning models mostly stems from fear of the unknown. Confusion regarding what models are and how they are used prevents the exploring of their potential advantages. Thus, the myths that discourage managers from using models, according to the research conducted by Jae and Joel (1998), can be summed up as the following:

First myth: "Models are complicated." On the contrary, *the fact* is that most efficient models have a fairly simple structure, consisting only of essential processes and the problem that is being explored. The mathematics, which is used, is most often basic algebra, while the modeling languages reduce the amount of complex terminology.

16 S. Jae, .S. Joel, *Complete Budgeting Deskbook*, CCH Tax and Accounting, 1998, p. 398

Second myth: "The Company is not big enough." *The fact* is that models do not consist only of wide-scale simulations. Some of the most frequently used models concentrate on only a limited number of problems, and are good for creating simpler and smaller simulations, of the type needed by smaller companies.

Third myth: "The Company does not have any modelers." *Fact*: modern planning languages have such a simplified modeling process that even a beginner quickly gains expertise. In addition, external consultants are also available.

The acceptance of planning models has allowed managers and technicians to identify the areas that require improvement and to formulate success criteria. Optimization models are one of the techniques still used today to improve models.

In all the more recent reviews, business models are irreplaceable, with corporate planning models being at the top. In the business operations of economic entities on the territory of the republic of Serbia, it is not rare to find various kinds of models used and developed by the managers themselves.

5. Concluding remarks

The use of financial models has been growing rapidly of late, especially those based on the use of computers. The reason is quite clear: an increasing need for improved and quicker support in managerial decision-making, as well the accessibility of computer hardware and software.

The three key roles of a financial manager, financial planning and forecasting, the use of capital and giving advice during decision-making process, cannot be conceived without the support of a computer program.

Spreadsheet models, as a pragmatic approach to corporate planning, are a presentation of basic financial reports in electronic form, with added power in the form of forecasting possibilities. Pro forma reports, which are obtained as outputs from the model, are a basic tool of financial planning, because they allow easy data manipulation, i.e., changes in assumptions and data as though they are in the real world. Each change of data does not require the creation of a new program but only a change of the existing data, which gives the program itself great flexibility.

The programs are easy to use and create, do not require extensive programming knowledge or knowledge of a programming language. This characteristic allows managers to carry out implementation, creation and improvement. Additionally, there is no need for additional staff for the purposes of, for example, program maintenance, which is necessary in the case of traditional information systems. Still, it is necessary to respect certain procedure during the creation of spreadsheet models, in order to reduce potential mistakes to a minimum and increase the utility value of the model. Contemporary financial managers require powerful yet simple tools, which have a high level of dependability and produce exact, useful results.

Spreadsheet programs provide very useful support to managers in their decision-making, since they allow the review of multiple different scenarios and the making of the right decision on the basis of analyzing the influence of alternative variable values within each scenario and, in that context, contribute to increased efficiency, less time spent and the quality of decision-making.

Under contemporary business conditions, where competitiveness and profitability can only be achieved at the cost of savings, cost reduction is probably the most important aspect of corporate models. The program allows experimenting with a model as though it is a real system, which means that, among the available alternatives, the one with the lowest costs can be chosen. At the same time, they also serve to prevent an increase in certain costs, in case they should appear during simulation.

The use of simulations in corporate planning, together with the development of computer technology, is opening new horizons. The introduction of econometric models can greatly increase the accuracy of forecasting, and practice has so far produced stunningly accurate results. Of course, this greatly complicates the process of model construction, which is why beginners are advised not to build these models by themselves, without consulting experts.

In essence, despite some minor downfalls, either in the case of small or large companies, the corporate model concept cannot be ignored, as it has become irreplaceable in modern business. It is of vital importance for contemporary managers – as opposed to traditional managers, for whom computers and the accompanying programs were things unknown – to be acquainted with the concepts of simulation and modeling in order to achieve the imperatives set by stakeholders. The reviews and numerous surveys presented in this paper merely affirm the fact that the future of corporate planning is based on the use of spreadsheet programs, which will increase the value and justifiability of the decisions that will be made.

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Book Review
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BUSINESS AS THE ART OF LIVING

*Essay on the book "Business as the Art of Living – **Business** Art de Vivre," by Prof. Mića Jovanović Božinov, PhD, Megatrend University, Belgrade*

The book "Business as the Art of Living" was written by Prof. Mića Jovanović Božinov, PhD, a well-known professor of management and intercultural management both at home and abroad. The book's title itself points to the specificity of the topic with which it deals.

This book is much more than just a textbook. It is also much more than a source of facts and information – it is a "window to the world," revealing what it is that managers actually do. It presents reality and resolves puzzles in a lively and animated way – allowing the reader to begin grasping management on both theoretical and practical levels. The author points out that it is not possible to become an expert by reading about management: it is necessary to engage in it. Changes in today's business environment are big and rapid, and managers spend months trying to comprehend how what they learned in books really functions. As managers, they have to make quick decisions, write plans, organize employees, lead people and hold everything under control from day one. And that's why a careful studying of this book is so important, why the author-manager-professor steers you back to the basics that will instill you with the necessary principles to succeed as managers, ensuring that your success is not just ephemeral but lasting. The professor agrees with the premise on which management pioneer H. Fayol insisted – that managers are not born but become.

And, thus, the book approaches management theory in a quite unusual way. In analyzing management, we take note of all the factors that need to be considered during the realization of business activities. It would seem that there has never been a more challenging time for managers. It is positive for successful managers to influence changes in their environment but, on the other hand, successful managers also adjust to changes. The book examines the key aspects of an environment necessary for planning, organization, leading and control. Special attention is focused on the challenges of the modern environment, which is in a constant state of flux, on the need to rely on the most talented employees, regardless of their cultural identity. Significantly, managers need to be aware of cultural differences in the course of their business activities. In order to prove his position, the author has permeated the book with the idea that managers deal with temporal and human relations which form the background of cultural differences. In fact, the author first began pointing to the necessity of recognizing culture, i.e., linking culture and management, in his book "Intercultural Management," and continued in his book "The Intercultural Challenges of Globalization," when absolutely no one in these parts wrote about this or took notice of the significance of the interaction of these two phenomena. Professor Jovanović weaves the part that deals with scientific management through his own life's story, thus making a link that has become standard in contemporary literature: by sharing his life story he opens the door to the best possible understanding of life and science, i.e., its theoretical part. It can be said, in fact, that this kind of approach, albeit to a lesser degree, is present in all of Prof. Jovanović's books. The book "Business as the Art of Living" portrays the relationship between man and management, the significance of human resources for the development of management, and the significance of understanding and respecting cultural differences. Current knowledge in the field of management, i.e., the development of management both at home and abroad, make up a highly significant portion of this unusual book. Business problems are solved in an interesting way and the reader is directed toward solving similar ones himself.

In order for this book to truly fulfill its role of educating readers, the author draws readers' attention to the fact that the two most frequently identified concepts in the broader context are not one and the same and that they should be separated – i.e., leadership and management. Namely, management is a broader concept, encompassing leadership having to do with human resources.

"Here, it is important to underline that management should not be equated with leadership, as management is primarily oriented toward organization, i.e., the company's inanimate resources (technology, energy, space…), while leadership is almost exclusively tied to the only living resource, to man."

Throughout the book, the author emphasizes the importance of human resources, as a company's wealth is in fact, made up of human resources, and only those companies, i.e., managers that comprehend its significance – are able to secure their own future. In fact, even in everyday life we often hear how the right people in the right place can perform business miracles, but it is just as important to note that managers frequently make the wrong choices when it comes to human resources. Thus, the author emphasizes the importance of permanent education and improvement. Contrary to the almost generalized opinion that it is enough to complete formal education and that it is possible to become a good leader with just a bit of working experience, the book underlines the necessity of permanent education. While the reader is first directed to the significance of management and human resources, he is also made aware of something that the new age brings – the need to take into account a very important, inescapable future factor, the factor of culture. Having expanded his business outside the bounds of his mother country, the author comes in touch with other cultures and at first intuitively takes note of various management approaches, while intellectually elaborating on them in his subsequent numerous papers and books.

What is significant for future managers, based on the professor's personal experience, is the significance of setting a goal, which is the primary step in the first phase of management – planning. It is emphasized that we must always have a goal in front of us – to know what it is that we want to achieve in life. Goals are as important for individuals as they are for business systems. Those who have attended Professor Jovanović's lectures know that he quite frequently begins with an explanation of the concept of management, always underlining that management is a universal activity and that we are all managers, compelled to constantly manage, beginning with our own lives. It is also necessary to define a mission from whom goals emanate, for *how are we to know where to go, if we don't know the purpose of existence*?

"He put aside his little travel bag (that was all he had brought with him), took off his wet raincoat and slipped comfortably into the only armchair in the room. He fell asleep thinking about everything he needed to do before undertaking more serious ventures. He was defining the mission of his arrival to England. His life and business **mission**."

We all have to plan, i.e., set goals, to organize, motivate and exercise control. Some research indicates that our own self-image propels us forward just as much as the goals we set, but also that only a small number of people have defined goals in their lives.

As we read the book we notice the significance of knowing various scientific disciplines, the necessity of constantly working on ourselves, of a desire to keep reaching farther, of a readiness to take risks as well as responsibility – which are all specificities of a great leader – but also of being acquainted with art, for instance. Profit making cannot fulfill a man unless his life has also been fulfilled with **friendship** and **love**.

It is very important to point out that the author has also successfully tackled the new scientific discipline of **risk management**, which has become highly significant in today's world. The importance of innovation and new technologies is also highlighted, as without them it is not possible to make a profit in the contemporary business world.

The part of the book that deals with the author's own life is significant as a portrayal of a personality of a leader, for that is what the author is – able to take both big risks and big responsibilities. The author's specific approach to life, i.e., the art of living, makes him different and more interesting than his surroundings.

Our author's literary and artistic tendencies have come to the fore once again – and they have made this book unique and different as well. The literary approach has allowed a great number of readers to read this book in a different way than all others. In fact, my own approach to reading this book was driven by a desire to learn more about life and about the way in which my professor has achieved his dreams and created a future for a great number of employees as well as his own students.

The book has an affirmative view of the manager's work. With his experience, the professor shows that the work of a manager can be one of the most exciting, challenging and satisfying careers that a man can have.

On the basis of everything written above I can heartily recommend this book by Professor Mića Jovanović Božinov to the broadest reading audience, and especially to the students of Megatrend University – but also to students of other schools of management, and not only them – not just in order to gain new knowledge about the vast possibilities that business offers but also in order to realize their dreams in joyful and right living of the life they have been given, with the hope that reading this book will bring them the same sort of happiness and joy that it has brought me.

And, if you wish to become a manager, or even if you still don't know anything about what a manger is, I recommend this book to you. From its very beginning, it is written so as to stimulate you to reexamine yourself and place yourself in a manager's role – and to make you begin to think like a manager as soon as possible!

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SERBIA ON THE ROAD TO THE EUROPEAN UNION

Essay on the book "Serbia on the Road to the European Union" by Snežana Grk, PhD and Prof. Marijana Vidas-Bubanja, PhD, Institute of Social Sciences, Čigoja štampa, Belgrade, 2007

At a time when one of the key topics on the domestic economic scene has become Serbia's process of stabilization and association to the European Union, along with analyses of the possibilities and challenges that lie on that road, the monograph "Serbia on the Road to the European Union" by Snežana Grk PhD, and Prof. Marijana Vidas-Bubanja PhD, attempts to analyze the overall domestic economic scene and offer some possible answers.

The idea of a united Europe has been present in various historical periods and supported by statesmen, philosophers, artists. When the first ideas about the unification of European nations appeared, the world was in the midst of a cold war between two blocs and the war in Korea, and there was an obvious need to form a third entity that would represent some sort of intermediary between the two superpowers (USA and USSR), which could parry them both economically and politically. As a result of numerous activities of European nations, from the European Coal and Steel Community of 1950, the Rome treaties on the establishment of the European Economic Community and EURATOM (1957), the Single European Act (1986), and a series of treaties, from Maastricht (1992), Amsterdam (1997), Nice (2001) and Lisbon (2007), the European Union was formed as an international organization of a supranational character. The member states are linked by common interests and policies, encompassing the fields of economy, industry, social issues, civil rights, foreign policy. As a regional organization of European states, the European Union is the framework through which its members realize common goals, such as balanced economic and social development, a high employment rate, and the protection of citizens' rights and interests.

The basic goals of the EU are: supporting economic and social development; affirming its own identity on the international scene through a common foreign and security policy (and a gradual creation of a common defense policy, which may lead to a common defense); protecting the rights and interests of the member states through the introduction of EU citizenship; the preservation and further development of the Union as a space of freedom, security and justice, in which the free movement of people is secured, together with a parallel adoption of appropriate measures in the areas of external border control, asylum, immigration and the fight against organized crime, and the preservation of the Community's legacies.

Expansion is the process of accepting new states into full-fledged membership toward the goal of Europe's political expansion, and the achievement of stability and prosperity on the European continent. Since the establishment of the European Coal and Steel Community, European integration has expanded in six waves and now encompasses 27 member states. The Western Balkan states[1] should be the next group of states to join the European Union, in the next decade. It is important to emphasize that all the Western Balkan states have prospects of membership in the EU. This was approved by the European Council in Feira in June 2000, and then confirmed in Thessaloniki in June 2003, as well as at subsequent EU high-level meetings, including the informal foreign ministers' summit in Salzburg in March 2006. In January 2006, the European Commission adopted the Communiqué "The Western Balkans on the Road to the EU: consolidating stability and raising prosperity." [2] This document gives an evaluation of the advancement made since the EU-Western Balkans Summit in Thessaloniki in 2003, and proposes concrete measures and instruments to strengthen EU policy vis-à-vis the Western Balkans.

The EU concludes special kinds of agreements with the Western Balkan countries, called Stabilization and Association Agreements. The name of the stabilization agreement itself is indicative of the EU requirement that these countries should be readied for EU membership through an institutional stabilization process. The Stabilization and Association Process was initiated in May 1999, as an expression of a long-term commitment on the part of the European Union to help the countries of the region, both in terms of political strivings and through financial assistance and help in the development of human capital on the road to full-fledged membership. The Stabilization and Association Process is both a bilateral and a regional process which, on the one hand, establishes relations between the encompassed countries and the EU and, on the other, encourages their mutual regional cooperation. Until now, three countries have signed Stabilization and Association Agreements with the EU: Macedonia (April 9, 2001), Croatia (October 29, 2001) and Albania (June 12, 2006). The first two have

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1 The term Western Balkans refers to five countries: Croatia, Bosnia and Herzegovina, Serbia, Montenegro and Albania.

2 *The Western Balkans on the Road to the EU: consolidating stability and raising prosperity,* Communication from the Commision, Brussels, 27.1.2006. COM (2006), 27 final

become candidates for membership: Croatia received candidate status from the European Council on June 18, 2004, and began accession negotiations on October 3, 2005, while Macedonia received candidate status on December 15, 2005, and is awaiting a European council decision to began negotiations on accession.

As one of republics of the Federal Republic of Yugoslavia, Serbia became a part of the Stabilization and Association Process in November 2000. Since 2001, it has had access to all the measures and instruments of this process, but the decision on beginning negotiations for signing a Stabilization and Association Agreement was not brought until April 2005, after the acceptance of the "two-track" principle for negotiations with the state union of Serbia and Montenegro. Negotiations formally opened on October 10, with the first official round being held on November 7, 2005. In May 2006, negotiations on the Stabilization and Association Agreement were stopped by a decision of the European Commission, then resumed on June 10, 2007, and successfully completed by the initialing of a Stabilization and Association Agreement on November 7, 2007. The Agreement was signed on April 29, 2008, at the meeting of the EU General Affairs and External Relations Council in Luxembourg.

Starting from the above facts, the authors Grk and Vidas-Bubanja have divided the monograph's structure into two complementary wholes. In the first, the total macroeconomic situation in Serbia is analyzed, beginning with an overview of the real sector (inflation, wages, unemployment), external activities and results in trade and investment flows, the effects of privatization and the issues of sustainable development (realized gross national income, the question of budgetary trends, evaluation of the profile of poverty in Serbia). This part of the monograph provides a series of data that could serve as a basis for evaluating Serbia's ability to become a part of the integrated European market in the economic sense.

The second part of the monograph seeks to underscore the significance of knowledge and technology as the key parameters of the development of the contemporary dynamic and global economy, which is also something that the EU defines as priorities in all its development plans and strategies. Particularly analyzed are the performances of the contemporary, knowledge-based information society, which the EU has defined in the Lisbon Strategy as the primary basis of achieving competitiveness in global business conditions by 2010. The authors analyze Serbia's eventual advantages in the application of information-communication technologies and the development of a knowledge-based society under domestic conditions, through the implementation of strategic actions on the national level and by taking advantage of the significant advantages of regional cooperation.

Based on the results of their analysis, Dr. Snežana Grk and Prof. Marijana Vidas-Bubanja conclude that Serbia has to fulfill a series of tasks and criteria as a condition of becoming a member of the big European family. Positive advances have been made on the plane of macroeconomic stabilization, privatization and liberalization, which cannot be said for the restructuring of the public sector, stimulating entrepreneurship and competitiveness, institution building, the passage of laws and their consistent implementation, raising judicial efficiency, reducing corruption, infrastructure modernization. All the above make up a portion of an attractive investment environment, whose significance is especially underlined by the authors. Investments are important for the structural adjustment of Serbia's economy and its infrastructure development, especially in the areas of energy, transportation and telecommunications, as well as for its faster accession to EU membership. It is also necessary to thoroughly order the market as well as the legal environment, which should give an even bigger impetus to domestic savings and foreign investment.

As factors which represent a threat to the state of the Serbian economy, the authors point to the current accounts deficit, the large foreign and domestic debts, the highly risky credit expansion accompanied by "currency clauses," unemployment, poverty, the entrance of speculative capital into the country. Thus, firm and constant steps must be taken on controlling inflation, reducing public spending, conducting a firmer fiscal policy, a stricter monetary and wage policy, a serious structural reform of the real, i.e., economic sector, as well as of the state sector.

The authors particularly emphasize the fact that, under conditions in which the contemporary globalized world is making a transition to a new phase of development, in which the key factors of economic growth and presence on the global market are becoming things such as knowledge and cutting-edge technological solutions, investment in knowledge and a greater application of information-communication technologies is perhaps the best and the only way for Serbia to accelerate its economic growth, create new employment and, at the same time, ensure social progress and the democratization of society. In order to make its economy more competitive, Serbia must invest more in the production and application of knowledge through research and development, in the diffusion of knowledge through education and in the application of knowledge through innovation. Serbia's competitive presence on the European and global markets also necessarily requires the application of electronic models of work, communication and business in all economic and non-economic activities that would accompany the overall reengineering of domestic companies and the restructuring of the domestic economy. All the above are, in fact, the conditions set down by the European Union to candidate-countries; thus, in that sense, the realization of a development policy based on knowledge and supported by the application of information-communication technologies is an option that would not only lead Serbia toward the realization of sustainable development, reintegration into the global market, reduced unemployment, and a higher living standard for all its citizens, but also to an easier and faster process of stabilization and association to the European Union.

The authors, Dr. Snežana Grk and Prof. Dr. Marijana Vidas-Bubanja, along with consulting a rich literature and the most current statistical data base of domestic economic trends, have very broadly encompassed and presented a series of relevant questions from a highly current set of problems connected with Serbia's process of stabilization and association to the European Union, as well as with domestic capacities, capabilities and risks that lie on that path. The book can serve as useful reading for all those in public administration who are creatively participating in the realization of this process, as well as for students engaged in the study of the European Union and Serbia's position in that context, and managers and business people who need to position their companies on the competitive and challenging European market.

The specific contribution of the monograph "Serbia on the Road to the European Union" is based on the fact that there is little domestic literature that takes this kind of approach to analyzing the necessity and advantages, as well as the challenges and implications of Serbia's joining the community of European nations.

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THE PROSPECTS OF ECONOMIC, SOCIAL AND ECOLOGICAL SUSTAINABILITY IN THE ERA OF GLOBALIZATION

Essay on the book "Globalization and Sustainable Development," by Prof. Vladimir Grbić, PhD, Megatrend University, Belgrade

In contemporary society, the universalization of the world, i.e., globalization, is a consequence of the expression and action of the general laws of the concentration and centralization of megacapital. In fact the essence of globalization is the integration of capital and its free movement in global proportions. The neoliberal type of radical, global capitalism is interfering with the national development of two-thirds of the world's countries. The question of sustainable development is being raised – achieving economic development that will allow the meeting of one's own basic needs, of both present and future generations. Ecological, social and economic sustainability in transition countries, as well as developing and underdeveloped countries, is hardly achievable, since economic globalization has mainly brought them negative consequences – in the form of great inequality in wealth distribution, rising poverty and unemployment and increasing environmental pollution.

Megatrend University has published the book *Globalization and Sustainable Development*, by Prof. Vladimir Grbić, PhD, which represents one of the most significant attempts on Serbia's academic scene to analyze the topic of positive sustainable development under conditions of globalization, before all in less developed countries.

Professor Grbić's monograph is of a high print quality, with 198 pages, 56 tables and 16 pictures, and 86 sources of cited references. The work is a result of the author's years of scholarly and teaching work in the fields of economic development and international economics.

The book is structured into four main parts. The first part deals with global financial crises that are a feature of the main flows of globalization. The second part analyzes the protectionism of the European Union in agricultural policy, which is a limiting factor in attaining sustainable development in global agriculture. The third part of the book talks about alternative sources of energy, the production of biofuels and especially the exploitation of biodiesel – a leading renewable resource that predominates both in the EU and in Serbia. The fourth part is devoted to the leading living and development problem in the world – the problem of water and its manifestation in transition countries.

The first part of the book consists of six chapters. The first defines and explains the concept of financial crises. Depending on various aspects of observation, there are many definitions. For his part, the author has opted for a synthetic definition of financial crises, with an eye on three aspects: 1) the possibility of a direct analytical definition of the effects of crisis; 2) the need to calculate the scope of necessary measures taken to end a crisis; 3) the various causes of a crisis represent a prelude to the creation of the conditions for their subsequent successful resolution.

The second chapter explains the relationship between financial development and economic development. In the contemporary economy, it is normal for financial development to represent a substantial portion of economic development. The question is whether they are developing at the same speed and supporting each other's development, or whether a gap is being formed. Data inevitably show that it is necessary to pay a certain price in order to attain financial development and stability of gross national product. The third chapter gives a tabular empirical picture of financial crises in the world, while the fourth chapter explains the basic causes that lead to financial crises.

The causes of crises are classified according to two criteria:

1) the instability of macroeconomic indicators – the shortcomings of economic policy as a key determinant of crisis and
2) the imperfection of the financial market as the moving force of crisis.

The fifth chapter considers the consequences of financial crises, which are viewed from three aspects of their activity: first, through their influence on economic growth, i.e., GDP trends, then through their implications regarding various facets of social life (e.g. rise in the crime or divorce rate) and, finally, through their role in creating a different socio-economic framework. The sixth chapter lists the convergence criteria (success criteria mostly related to fiscal stability) which every country should try to fulfill in the implementation of its economic policy in order to prevent the outbreak of financial and banking crises.

The second part of the book is divided into seven chapters and deals with the problem of the EU's agrarian protectionism and its effect on the process of the globalization of the world's economic flows. Although conceived as a reasonable means of support to agriculture, the EU's agrarian policy subsequently acquired a protectionist character, causing, in addition, various effects in countries outside the world's most powerful trade group – the EU. The author examines this phenomenon by first analyzing, in the first chapter, the national roots of agrarian protectionism, which went on to determine the subsequent development of events.

The basic reasons for the establishment of a common EU agricultural policy, which are dealt with in the second chapter, are:

1) a single market,
2) advantages for the Community,
3) parity and productivity,
4) financial solidarity.

The basis goals of the common agricultural policy are:

a) increasing agricultural productivity,'
b) increasing farmer income,
c) market stabilization and
d) guaranteed supplies.

The third chapter is devoted to the mechanism of agrarian prices, its performance and its effects. The functioning of the organized market for agricultural products and the protection mechanism, are secured by the system of the following prices:

1) target (the desired price of agricultural products for a given season),
2) intervention price (the lowest guaranteed price),
3) incoming (the price of products imported from third countries),
4) market price,
5) imported and
6) world price.

The agricultural price system is semi-closed, i.e., it is not debalanced by goods from the global market. The system of protection of domestic agricultural products is made up of non-tariff barriers and export subsidies. Even though it has shown itself to be efficient, the agricultural policy also has its negative effects, which has resulted in several types of pressure for its modification: a) budgetary, b) consumer, c) international and d) pressure to protect the environment.

The topic of the fourth chapter are the reforms implemented after 1992. An imbalance occurred between the management of the supply (having to do with the quota system) and direct (compensation) payments to farmers by way of the set-aside program. Direct payments to farmers are presently the dominant form of intervention within the EU agricultural policy, the main reason being the nature of market conditions. The fifth and the sixth chapter explain the influence of the EU's agricultural protectionism on both underdeveloped and developed countries. It is well known that the EU is the biggest donor of aid to underdeveloped and developing countries. The European Union is the world's leading source of development aid, making up about one third of the total approved aid to developing countries. The goal of the EU common policy is the preservation of a sustainable economic and social development of developing countries, especially the poorest among them, in order to achieve their best possible integration into the global economy. The EU's trade relations with non-European industrially developed countries, which are conceived on the basis of a liberal approach, have been marked by numerous conflicts in practice, mostly because of mutual meddling in business through the application of discriminatory trade policies (production subsidies, various forms of export stimulation). The seventh chapter, for its part, puts the main accent on structural policy and its corrections, i.e., measures taken in order to improve its operability.

The three basic groups of measures of structural agricultural policy are:
a) support for management
b) improving trade channels for agricultural products,
c) reducing regional differences.

Two sets of measures were presented in Agenda 2000 – measures added to the reforms of 1992 and modernization measures, and these sets are the best demonstration of the instrumentalization of structural agricultural policy measures. In elaborating all the questions dealing both with the EU's current and structural agricultural policy, the author has contributed to a better understanding of its scope and limitations on the plane of agricultural protectionism, which significantly worsens the position of other countries in the process of the globalization of economic flows.

The third part of the book is devoted to alternative sources of energy and is divided into four chapters. The search for alternative sources of energy and their gradual application is one of the characteristic of today's world. The first chapter deals with the causes for the ever-increasing interest in the production of alternative energy sources. These are: increased energy prices, 2) the increasing significance of environmental protection and 3) the economic significance of biofuels production. A graphic and tabular depiction of the most important production results achieved in the world and the EU is given. The second chapter defines the basic characteristic of rape and biodiesel production, dealing with natural conditions, planting order and equipment, basic and supplementary land tilling, fertilization, planting and harvesting, transport, drying and storage. The third chapter is devoted to the production of biofuels in our country. The author begins by introducing us to the resource characteristics and input supplies necessary for agricultural production, as well as to the basic problems our country faces in the production of biofuels. Special attention is devoted to the production of oleaceous plants (sunflower, soy, wheat and rape) due to problems with prices and their production costs. Statistical data and the production balance for all the industrial cultures in our country are provided. The subject of the fourth chapter of this section are the negative consequences of biofuels production. The basic manifestation of these consequences is the increased price of food, especially of grains – *agflation*. The causes that have led to these consequences are: climatic factors, increased demand from developing countries, rising oil prices and increased biofuels production. A particular scholarly contribution of this work is its analysis of agricultural inflation, a new phenomenon whose effects are best observed in rising costs of living and increasing poverty and hunger in certain parts of the world.

The fourth part of the book is organized into four chapters and deals with one of the most important questions faced by the entire world populace – the problem of water. It has various forms, of which at least some need to be mentioned: water shortages, water pollution, lack of access to sewage systems and sanitary water, and the economic use of water. A special accent is placed on the problems faced by transition countries – countries that make up a very important component of the main currents of the globalization process. The first chapter gives a comparative analysis of the water sectors in the Southeast European countries, as well as presenting the resource-ecological situation in them, the way they use water and its quality. There is also an examination of the central issues related to changes in water resource-related laws and policies in transition countries and reforms of institutions responsible for the management of those resources. The numerous problems, which also existed earlier, have become magnified in the transition period. Especially conspicuous is the problem of decreasing use of irrigation and run-off systems, as well as the absence of waste-water treatment, even in the largest cities.

The transition process has brought many novelties to the water sector and to rural development. The privatization of agricultural land has contributed to the fragmentation of agricultural land and a reduction in the size of the average land holding. Existing equipment, designed for larger land holdings, no longer met the newly set standards of economic management in agriculture. The irrigation systems, which were constructed in the pre-transitional period, did not wholly fit into the newly establishing system. It was necessary to establish a new system of institutions and actors in the water sector, as well as a new method of stimulation.

The second chapter of the section analyzes the ongoing transition process in Southeast European countries over the last two decades or so, and its influence on the water sector and rural development. The transition from a planned to a market economy requires an institutional construction of a social security network and institutional harmonization with the EU and, in order to achieve this successfully, it is first necessary to achieve macroeconomic stabilization and to liberalize the system of previously "deformed" prices, i.e., it is necessary to adopt a new price policy that is competitive on the global market, and it is also necessary to carry out successful privatization and restructuring of state companies in all sectors. The author then goes on to examine in greater detail the economic dimension of the Southeast European countries, which he considers through the following indicators:

a) trends in the growth of the social product,
b) external economic relations and the development performances of the region's states,
c) data on visible export trends,
d) the current accounts balance,
e) foreign direct investment.

On the basis of available statistical data, it may be concluded that the macroeconomic foundations for further growth have been achieved to a significant degree. The economic growth rate, which was negative during the first years of the transition process, has seen continual growth during the past several years in all the Southeast European countries. Inflation has been significantly reduced, and there is a marked improvement in the reduction of budget deficits in most transition countries. The positive tendency is born out by the fact that the said countries have improved their legislative and institutional systems, which means that the water sector and the implementation of new legal instruments will find significant support from that side.

The third chapter investigates the problems that appear in the course of a country's integration into the international regulation of waters, related to costs that can be divided into: direct (participation costs, i.e., contributions for the work of certain bodies) and indirect (costs that will occur in the coming years due to the higher economic price of water). A separate concern is the issue of Serbia's ratification of the Helsinki Convention on the Protection and Use of Transboundary Watercourses and International Lakes. The convention contains a series of provisions with economic implications. These provisions apply to: 1) prevention, control and reduction of water pollution and cross-border effects; 2) establishing a program for monitoring the state of cross-border waters; 3) research and development work on the development of more efficient techniques for the prevention, suppression and reduction of cross-border influences; 4) exchange and protection of information; 5) bilateral and multilateral cooperation, as well as the financing of a system for warning and alarm, mutual assistance and public information. Even though the ratification of this agreement assumes certain risks, it brings multiple benefits to Serbia and represents an important prerequisite for the entry of the domestic economy into more intense international cooperation. In the final instance, its implementation would result in increased investment activity, the entry of new economic actors into the country and the water sector, increased competition, an improved current accounts position, as well as faster economic growth.

The correct methodological approach used by Prof. Grbic in presenting the subject matter, the numerous relevant sources of cited literature, and the quality and valid analysis of the phenomenon of globalization and of sustainable development are just some of the numerous qualities of this work. The book is primarily intended for students of economics and is of great importance for Serbia's scholarly as well as its expert public.

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