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LESSONS THAT SMALL ECONOMIES SHOULD LEARN FROM THE CRISIS – THE CASE OF MONTENEGRO

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Starting point:

A lack of optimism best describes the current situation in the Montenegrin economy. The optimism of individuals and companies that was strengthened after the country regained its independence in May 2006, started to evaporate at the end of 2008 when the global financial crisis finally hit the country (later than other parts of the world). Why did the optimism disappear so quickly?

This paper answers this question by briefly analyzing events that preceded the high-optimism phase, discussing the factors that contributed to its sharp fall, as well as drawing the lessons that should be learned from the crisis.

I) ECONOMIC BOOM:

Two key factors that led to the economic boom in Montenegro in the period of 2002-2008 were:
1) The introduction of a new economic system after 2000;
2) The effect of independence in 2008.

At the end of the 1990s, Montenegro drastically changed its economic system. Although it was still a part of the Union with Serbia (FRY - Federal Republic of Yugoslavia), Montenegro began to build an independent economic system (“FRY-two systems within one state“).

The idea of free markets was the fundamental aim of the new economic system in Montenegro. Free market ideas had been developing in Montenegro since the mid-1980s and became even stronger during the transition period. A group of young economists influenced by the basic principles of the Austrian and Chicago Economic Schools, both at the University of Montenegro and abroad, largely contributed to the development of such ideas.

Ideas of economic liberalism were the foundation of the new economic system since 1997. Visas for foreigners were abolished; the average tariff custom rate was reduced from 25 percent to less than 2 percent. Around 80 percent of the economy was privatized rather quickly; new businesses, small and medium enterprises were encouraged; and tax rates were decreased to the lowest level

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in the region. However, the introduction of the Deutsche Mark as legal tender in 1999 was undoubtedly the most important step of the reform (it was replaced by the euro in 2002). It contributed to growing interest by foreign investors, both through privatization and through new, greenfield foreign direct investments. The protection of property rights and contracts became a keystone of the new economic system.

Openness appeared to be the only viable strategy of development, especially for a small state, such as Montenegro (with a surface area of just 13.000km, and 620,000 inhabitants). In addition, because of this emphasized liberalism, Montenegro and Serbia (members of a State Union from 2003) developed rather different understandings of economics which drew them apart and created a favorable political environment for state independence of Montenegro. Independence was indeed re-established by a referendum held on 21st May 2006 with the support of 55.5 percent of the voters.

The creation of the new independent state, which was strongly oriented towards free markets and entrepreneurship, encouraged many investors from Europe, USA, Japan and elsewhere to invest in Montenegro.

During this time, Montenegro registered a strong economic performance, as shown by the following data:

- Among the fastest GDP growth in the region -GDP increased from €1,295 million in 2001 to €3,085 million in 2008 ;
- One of the leaders in the region by FDI inflow – in the period of 2002-2008 FDI inflow amounted to €2,252 million, and the average yearlyFDI inflow was above 20 percent of GDP;
- The euro is used as official currency and inflation rate has averaged around 3-4 percent per annum;
- The unemployment rate fell from 33 percent in 2002, to 10.8 percent in 2008;
- A budget surplus was achieved during the period from 2006-2008;
- Foreign debt was reduced from 42.6 percent of GDP in 2005, to 27.8 percent of GDP in 2008.

II) <u>STAGNATION:</u>

The first strokes of the financial crisis hit Montenegro at the end of 2008. Thereafter, the current economic situation is, without a doubt, dominantly influenced by the crisis. However, as far back as 2007, the first post-referendum government abandoned the reform path set out in the Government strategy document *Agenda of Economic Reforms and Development (2007-2011)*, which continued the direction of economic policy starting from 2002 (*Agenda of Economic Reforms 2002-2007*). The government was warned that its lack of ”courage“ could endanger ongoing reforms in Montenegro. Several privatization projects were suspended, which gave a bad signal to investors and, as a consequence, the capital market in Montenegro experienced a

severe decline. Furthermore, most pension and labor market reforms were abandoned or postponed.

The case of Montenegro confirms and reminds us of the importance of two lessons learned from the experiences of other countries. First, reforms are not possible without political will and courage, i.e. self-confidence of a nation is an important economic factor. Second, the case of Montenegro supports the somewhat ironic claim by Zakaria (2009) that success is an essential cause of the global crisis. Being intoxicated by success, we often fail to examine its real sources and neglect any problems that may arise, including structural problems.

Two important structural problems I have in mind are:

1) The distorted relation between tradable and non-tradable goods reduced the export possibilities of the Montenegrin economy. Economic growth failed to bring about a qualitative upgrading of the tradable goods sector, which would have lead to stronger export performance and competitiveness. This was of fundamental importanmce since the adoption of the euro as the official currency, deprived policy makers of the ability to use currency devaluations as a tool for export promotion. Foreign and domestic investments concentrated disproportionately on consumption (including housing and imported luxury goods) and did not channel enough resources into productive investments. This was corroborated by the combination of a liberal economic environment (Montenegro is ranked 68th in terms of economic freedoms on the relevant global rankings) and a relatively underdeveloped legal framework for business activities.
2) The existence of an unfavourable employment structure reflected through the relation between the number of people employed by the state and private sectors. Around 52,000 people work in the state administration (including health and education), which constitutes roughly one third of total employment in Montenegro. The concept of the ”micro-state” (Vukotic 2003) was disputed, and the state administration continued to mimic the needs and structure of the administrations in some larger countries. As a result, the total wage expenses of state administration still account for about 60 percent of the state budget.

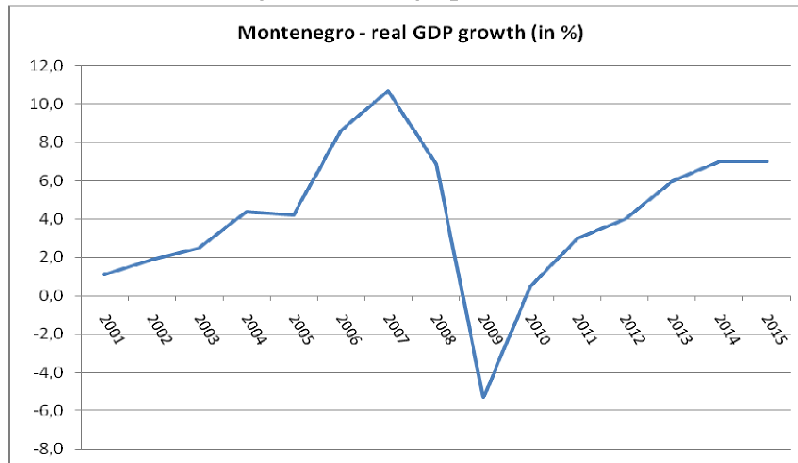
III) THE DECLINE

A small open economy with insufficiently developed institutions, such as in Montenegro, is highly vulnerable to exogenous shocks and can be severely damaged by a global economic crisis. There are several channels through which the global crisis transmitted its effects to Montenegro:

1) Banking flows (financial flows);
2) Trade channels (flow of goods and services).
3) Sharp fall in FDI
4) Falling remittances

The decline of global output and aggregate demand on international markets influenced the GDP level in Montenegro especially through falling prices of some goods (for example aluminium).

The GDP trends are given in the graph below:



Source: Monstat, ISSP; ISSP's projections

This graph well illustrates all phases of development in previous decade – growth, decline, and (expected) recovery. The highly unstable GDP growth rates (regardless of sign) demonstrate that the structure of the Montenegrin economy is very sensitive to external shocks from foreign markets, in the context of a growth model based on unrestricted inflows of FDI into (mainly) real estate investment.

Economic activities were significantly reduced in the first ten months of 2009. Some of the relevant indicators were as follows:

- Bank deposits were reduced by 15 percent on average.
- Domestic savings fell by 12 percent on average.
- Bank loans decreased by almost 10 percent.
- Interest rates reached the level of 10 percent, and even exceeded 15 percent at one point.
- Capital markets became unstable and share prices fell by around 60 per cent.
- Public debt increased by 27.4 percent of GDP[2]

The main features of the real sector during the same period were as follows:

- Unemployment grew from 10.8 percent to 11.66 percent;
- Exports fell by 33.5 percent;
- FDI inflows were sharply reduced.

[2] Public debt has continued to rise and reached 38.8 percent of GDP by April 2010 (IMF Public Information Notice (PIN) No. 10/67, May 27, 2010).

This sharp decline of economic activity led the government to engage in informal with the IMF in November 2009 to negotiate a possible loan arrangement of around €150-300 million. Although these talks did not lead to any loan agreement, the possibility of a future loan was not excluded altogether.

IV) THE CHALLENGES AHEAD

One of the biggest dangers the Montenegrin economy is facing is a highly indebted public and private sector. Households are highly indebted, and paying their loans is becoming a real burden. On the other side, the banking sector does own a significant amount of liquid funds. However, banks are focused on collecting existing loans, not on extending new ones. High interest rates (above 15 percent) are holding back economic activity. It is still uncertain how long the banks will be able to survive without selling their basic product – loans for new projects – and how much time they will need before starting to extend new loans.

When investment is falling, aggregate demand is more strongly influenced by public spending. However, the decline of economic activity resulting in negative GDP growth significantly reduces the tax base and thus the available funds for public spending. Balancing the state budget becomes a serious problem. What is the right way out: reduction of public spending or tax increases? Will the increase of taxes lead to a decrease of investment in the Montenegrin economy? The IMF proposes a combination of these two measures, suggesting that Montenegro should generate growth from domestic savings and that reliance on foreign capital inflows should be reduced and limited. This is a major challenge that Montenegro faces and its outcome will determine the course of future economic development of the country. Should Montenegro just lean on domestic savings and raise budget loans, or should she follow a development path based on economic freedom and the strong influence of foreign direct investment? Taking new loans can be very dangerous for a small country such as Montenegro, especially if they are used to finance consumer spending. On the other side, a development model based on liberalised markets and economic freedom would ensure that the business environment remains attractive for foreign and domestic investors. It would be hard to expect domestic savings to be invested in an economy that is not fully open for foreign capital.

The liberal economic model based on economic freedom and openness for both domestic and foreign investors is still dominant in Montenegro, but the strength of the opposing model of interventionist development, supported by opposition in the Parliament and a part of the bureaucracy, should not be underestimated. The final outcome will be tested through the realization of several major projects that have already started or are scheduled to start soon (including infrastructure projects, such as the construction of a new highway; promotion of the tourism sector; the development of the energy sector; and support for small and medium enterprise development).

V) LESSONS WE LEARN

The first reaction, conscious or unconscious, to the crisis is an attempt to close our economy with the explanation that all troubles are coming from the outside, from global markets. This raises the dilemma whether to revert to a closed economy based on the nation state or to remain open to the global markets. The crisis has shown, and it is becoming more evident especially in small countries, that the power of state to finance development and efficiently allocate resources is very small. Globalization took away many functions and much power of national states. The traditional role of the state and the belief that politics can solve all economic and development problems is changing. Thus, our focus should be on whether and how Montenegro can use global markets for the development of her economy, and how can she create an environment favourable for foreign and domestic capital, and for foreign and domestic entrepreneurs. In the global economy although the role of the state is important, it has different functions from the traditional nation-state.

The crisis throws up new opportunities but also emphasizes the mistakes that have been made. It shows that economic systems with high public spending and large share of non-productive activity can be sustained only with high GDP growth rates. In the short-run, these high and positive growth rates can be achieved through some exogenous, non-economic factors. But the question is how can we provide high growth rates in the longer-run? Should growth be driven by state interventionism or by the market, or can a new form of better regulated market that combines economic freedom with greater social responsibility be designed?

The experience under socialism has shown that state control of the economy cannot ensure its long-term sustainability. Critics of the free market development model see the structure of the Montenegrin economy as the crucial problem: a small share of tradable and large share of non-tradable goods in production. The lesson we seem to be learning from the crisis is that the economic structure of a country cannot change without a thorough change of view of the role of the state and the role of the market in the economy. In a small state, we cannot strengthen the role of the state and increase public spending, and simultaneously expect the tradable goods to dominate in production structure at the same time.

Besides, we might learn one more lesson from the crisis: human capital and its quality are crucial. People who are used to having a safe job in a state administration while relying on somebody else to solve their problems (usually the state) do not contribute to solving the problems caused by a crisis, but make them even more difficult.

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