# CEFTA – Member Countries' Current Accounts Deficits – The Case of Serbia

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*Ten years ago Serbia started transition from centrally-planned to market economy. As a latecomer, Serbia faced many challenges in that process. One of those is current account deficit. Subject of this paper is one of balance-of-payment's most important account – the current account and its deficit in CEFTA-member countries, with the special attention to Serbia. After the introduction, first we examine general issues of balance of payment theory and policy: whether conventional wisdom regarding its equilibrium, as one of finite macroeconomic goals, is valid in a modern international monetary system or not. Traditional balance-of-payment theory had been focused on current account. Modern globalized world economy pushed focus from balance-of-payment's theory and policy to capital account issues, as presently more important account, while current account is only result of capital one's misalignments, and something that compensate it and cover balance of payment discrepancy. That is the reason why traditional question "how to avoid high and rising current account deficit" turned into the question "how to manage high and increasing foreign capital inflow". These questions are even more important for small and open economies in transition, which is exactly the Serbian economy. Secondly, we analyze threats for economic policy decision makers in Serbia, with special regard on current account*

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*deficit, whose importance rise in time of world financial and economic crisis, which redirect funds that use to inflow from developed countries to the others. Finaly, we examine both current account deficit sustainability and its financing. Conclusion is reserved for research's results.*

Key words: *current account deficit, balance of payment, capital account, serbia*

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**Introduction**

Ten years ago Serbia started transition from centrally-planned to market economy, firstly with faster, but later with relatively slower pace, even before the outbreak of world financial and economic crisis. Results were mixed. The best progress was made in financial and banking sector, as well as with foreign trade liberalization, although Serbia has not yet joined World Trade Organization. The worst results were made in corruption minimization, anti-monopoly regulation and "rule of law" - complex of issues which are the biggest obstacle for future progress in transition. As many other transition countries, Serbia has unbalanced current account, which is result of lack of international competitiveness, trade liberalization and capital account surplus. World Economic Forum recently ranked Serbia as 96th competetive economy (of 139). Some of key social and macroeconomic indicators of Serbia are presented in Table 1.

According to the conventional wisdom, balance of payment should be generaly in equilibrium (when claiming balance of payment equilibrium, we consider current account and capital account, since balance of payment, due to double-bookkeeping principle, is always in equilibrium from accountants' point of view). What matters is a mid-term balance of payment equilibrium. To achieve such equilibrium, the necessary condition is that both current account and capital account misalignments are caused by seasoning or cyclical (or similar – temporary reasons). In the long term, current account should be relatively or completely balanced, with neither major surplus nor deficit. Such theoretical situation is far away from reality in most economies. Many of them have unbalanced either current accounts or capital accounts, which brings to the light structural unadjusted macroeconomic situation in particular national economy. Balance of payment equilibrium is only one of overall macroeconomic equilibrium elements, namely external one, while price stability is one of indicators of internal equilibrium. The only trully equilibrium in national economy is when both internal and external balances are achieved simultaneously.

**Table 1**

Serbia – Selected Social and Macroeconomic Indicators

| Indicators | |
|---|---|
| Population, mid-year (millions) | 7.4 |
| Average annual growth of Population (%), 2001-07 | -0.3 |
| Life expectancy at birth (years) | 73 |
| GNI (Atlas method, US$ billions) | 35.0 |
| GNI per capita (Atlas method, US$) | 4,730 |
| GDP (US$ billions) | 41.6 |
| GDP (average annual growth) , 1997-2007 | 5.3 |
| GDP per capita (average annual growth), 1997-2007 | 5.6 |
| Current account balance/GDP | -13.6 |
| Exports of goods and services, (average annual growth), 1997-2007 | 12.3 |

*Source: World Bank (2009), p. 1*

Paper is organized as folowing: Having in mind that having balanced current account (part of the balance of payment, where current transactions are registered), as one of traditionally most important of balance of payment sub balances, is often not met in reality, in the second part of the paper, we question traditional view/conventional wisdom regarding this theoretical issue. In the third part of the paper, we analyze whether sustainable level of current account deficit is possible to define, as well as estimations on present Serbian level of current account deficit sustainability, with special regards on global economic and financial crisis and consequences for balance of payments deficit financing caused by it. At the end of the paper, we are presenting conclusions and recommendations for Serbian sustainable current account and balance of payments deficit levels. Our special focus in the paper is on the issue how world economic and financial crises affected Serbia's current account deficit.

## 2. Current Account Deficit – Conventional Wisdom And "Sustainable" Level

Current account contains valuable information on both inflow to the national economy, and outflow from the national economy, due to the goods and services trade, as well as current transfers among residents and non-residents. As the current account of balance of payment's is traditionally „more important" part than the capital account, according to conventional wisdom (Machlup, Haberler, Meade), current account should be generaly in mid-term equilibrium. Unbalanced balance of payment's current account traditionally had been concerned as an indicator of unfavourable economic conditions in particular national economy, especially in those economies with balance of payment deficit. Conventional wisdom regarding balance of payment disequilibrium does not exclude short-term imbalances, but consider mid-to-long term disequilibrium as a serious indicator of production-versus-consumption imbalance, as basic macroeconomic elements in particular national economy, which is not possible to maintain for longer period of time, and it would lead sooner or later to either foreign reserves exhaustion or to some mechanism of balance of payment adjusting. According to traditional macroeconomic theory, balance of payment surplus is easier to tolerate, and is possible to tolerate for longer period of time, but it also is not possible to do it for too long. Such theoretical framework is in contradiction with real economic life, where we witness almost permanent imbalance in many countries. Conventional wisdom is characteristic of traditional or "old" view, where balance of payment is treated *per se* (as a phenomenon to be studies as such, by studying the specific determinants of trade and financial flows). In non-traditional, modern or "new" view, where trade and financial flows are the outcome of intertemporally optimal saving-investment decisions by forward-looking agents, balance of payment is treated differently, and not too many texts in international finance even mention it (see f.e. Gandolfo, 2002). We support the idea that balance of payment is too comprehensive and is not too easy to treat it separately in modern circumstances. Despite such position, in this paper we do not observe the exchange rates, and reduce capital flows influence, regardless of its obvious and organic connection as both consequences and causes of current account imbalances. This would be challenge for future researchers and opportunity to use mathematical models in attempts of explaining such comprehensive macroeconomic aggregate like balance of payment is. On the other hand, according to "Lawson Doctrine" (named after economist Nigel Lawson), rational expectation remain regardless current account deficit level, since private sector saving and investment decisions are made, and there is no need for Government intervention, nor hesitation of any serious disturbances. This is pretty much in collision with conventional wisdom of serious disturbance shown through balance of payment imbalance.

One of possible explanation for discrepancy between traditional macroeconomic theory and modern practice is that globalized international monetary and economic system changed dramatically and inevitably in favour of international production factors' mobility increase. Capital movements were present for longer than last few decades, but in last 3-4 decades capital account importance increased massively and rapidly and "shifted pendulum" in favour of capital account on the "see-saw" of balance of payment issues. Traditional balance-of-payment theory had been focused on current account. Modern globalized world economy pushed focus from balance-of-payment's theory and policy to capital account issues, as presently more important account, while current account is only result of capital one's misalignments, and something that compensate it and cover balance of payment discrepancy. That is the reason why traditional question "how to avoid high and rising current account deficit" turned into the question "how to manage high and increasing foreign capital inflow".

It is not a simple task to define how massive current account deficit can be sustained, and for how long. As written above, traditional theory suggests only short term unbalanced current account level is acceptable and desirable. Among many others (U.S.A., Mexico, Chile, Turkey, Estonia, Slovakia, Romania, Bulgaria, etc.), example of Serbia in last decade, witnesses the opposite. However, the case of Serbia is rather a proof of modern globalized economy rule than exception: vast majority of economies, including leading ones, are unbalanced from the external equilibrium point of view. Balance of payment deficit, if cumulated for longer period of time, need to be financed by constant sources of financing: foreign direct investments, portfolio investments, credit transactions or official reserves. Foreign loans have limits, i.e. need to be paid back. This is the reason why sustainability of current account deficit is important, as well as how to finance it, especially when foreign capital inflow is jeopardised due to world financial and economic crisis. Main issue is what sustainability really is, since there is not consensus among academic economist about which exact level of current account deficit is considered unacceptable. The IMF and other international financial institutions established a "limit" of 5%-of-GDP-current-account-deficit, although many countries (Mexico, Chile) proved by their practice that having even bigger deficit is possible, which forced abandoning of quantitative established "limits of sustainability". No universal criteria for current account sustainability assessment are valid for all countries. Many characteristics of particular national economy must be evaluated, such as macroeconomic indicators (inflation rate, GDP growth rate), structure of imported goods (consumption or investment goods), and capital-financial account (foreign direct or portfolio investments; credits – their structure and purpose). Bottom line is that current account deficit is as sustainable as creditors believe it is sustainable in terms of both its volume and durability (Fabris and Kilibarda, 2008, Pp. 10-11). Therefore, to put it in other words, "natural" limits for (im)balance-of-payment is defined by available sources of its financing, regardless the fact it contradicts one of basic economic common sense that production and consumption in one national economy should normally be equal or close to equal. Drastically disordered external balance together with inflation, as a consequence of disordered internal balance and unemployment and as a manifestation of structural disorder in resource utilization, is one of three huge problems that economic profession and policy have been dealing with for a long time. Key price in multitude of foreign economic relations aggregates is apparently exchange rate. Exchange rate is that most important price, using which massive number of import prices denominate and "translate" into domestic currency and in that way it is deciding on mutual competitiveness of two large group of products – foreign and domestic ones – and immediately influencing functioning mechanisms and developing chances of particular economy. There is analogy in register of influences that exchange rate have through the export, deciding on given parameter of non-price determinants of domestic products competitiveness abroad (Madzar, 2006, p.91). Although important, we will not consider in the rest of the paper the exchange rate interdependence with the balance of payment.

In small and open economies, such as the national economy of Serbia as a typical representative, importance of foreign capital attraction is very big due to political and economic development in last two decades, which contributed to bringing the whole South-Eastern Europe region thirty years back in past. Two mentioned economies are in such a need of foreign capital that one of the authors described them as "junkies addiction" to it (Kovacevic, 2009). Indeed, monetary policy is to a big extent subordinated to the goal of foreign capital attraction, which is seen as more important goal having in mind its contribution to economic development. Therefore, one of the main tasks of monetary policy is to sterilize effects of foreign investments, which put certain limitation to the monetary policy.

## 3. CEFTA Member-Countries Experiences with Foreign Direct Investments and its Influence on Current Acount Deficit

Liberalization in the region of South-Eastern Europe started with signing of Memorandum on liberalization and trade easing among countries in that region in 2001 in Brussels. Countries that signed Memorandum agree to conduct mutual agreements on free trade by the end of 2002, and to liberalize at least 90% of reciprocal trade, together with simplifying custom procedures and intensifying harmonisation of trade legislature with the EU. Since implementation legged behind signing agreements (more than thirty agreements were signed), it became clear that the very idea to establish free trade association was only on paper. Free trade area idea became real instead, so all South-East Europe countries (except Croatia, that had been it's member since 2002) on 1st of May 2007 joined CEFTA (Central European Free Trade Agreement), that is qualitatively different in comparison to original agreement signed by three Central European Countries (Hungary, Czechoslovakia and Poland). Due to that fact, in literature present agreement is often called CEFTA 2006 (agreement is negotiated in Zagreb in 2006), and network of 32 bilateral agreements was replaced by multilateral agreement. CEFTA 2006 has following features that former bilateral agreements had not:

- possibility to apply so-called diagonal cumulating of origin of goods,
- introducing gradual service trade liberalization,
- improved mechanism for disputes resolving,
- intellectual property rights protection, according to the international standards, and
- commitment to apply rules of World Trade Organization (WTO) regardless whether CEFTA country member is or is not member of the WTO.

**Table 2**

CEFTA member countries

| Country | Year of accession | Year of abandoning |
|---|---|---|
| Croatia | 2002 | - |
| Montenegro | 2006 | - |
| Serbia | 2006 | - |
| Macedonia | 2006 | - |
| Bosnia and Herzegovina | 2006 | - |
| Albania | 2006 | - |
| Moldova | 2006 | - |
| Romania | 1997 | 2006 |
| Bulgaria | 1998 | 2006 |
| Poland | 1992 | 2004 |
| Hugary | 1992 | 2004 |
| Czech Republic (Czechoslovakia) | 1992 | 2004 |
| Slovakia (Czechoslovakia) | 1992 | 2004 |
| Slovenia | 1996 | 2004 |

At this moment, seven countries are CEFTA members: five of six former Yugoslav republics (all except Slovenia), Albania and Moldova (See Table 2). Number of members varied since CEFTA establishing in 1992: foundation members (Poland, Hungary, Czech Republic and Slovakia /then as Czechoslovakia/ in May 2004, in the moment of accession to the EU abandoned CEFTA membership). Except Croatia, that became member in 2002, all present member countries joined CEFTA during the 2006, while multilateral agreement on free trade became valid on 1st of May 2007.

### 3.1. Foreign direct investments' role in export increase – the case of Serbia as one of CEFTA members

The cycle of massive foreign capital inflow to the developing countries, including CEFTA member countries, is ending due to financial crisis. Many countries, including Serbia, took it for granted – as a result of own successes in attracting FDI (foreign direct investments) and acted as this situation is permanent. Three immediate economic policy options are possible in such circumstances: (1) to reduce public consumption over restrictive budget; (2) to increase interest rate and reduce private consumption mainly over more expensive loans; and (3) to allow controlled depreciation of national currency (Petrovic, 2008, p.5). Export demand decline, together with the high structural dependence of the national product from import, means that for keeping growth rate positive, necessary is either to provide even bigger foreign capital inflow than it was by now, or to stimulate domestic demand, which is typically Keynesian approach applied by all developed economies, especially from the outbreak of the world financial and economic crisis. The very reason why Serbia cannot apply this approach often is because there are no major sources to finance major budgetary deficit. Developed economies can count on domestic or foreign sources borrowing, while for Serbia both sources are non-accessible or very expensive. Domestic financial market is too small, and increase of public sector demand for money would increase interest rate significantly (Milanovic, 2009, p. 3). Foreign capital inflow depends on two groups of factors. The first one is related to the favorable global economic conditions and satisfactory global liquidity. Nevertheless, while mentioned group of factors provide only common framework in a meaning that during the global prosperity time mass of foreign investments growth, the second group of factors include internal factors within the national economy such as: structural reform progress, financial integration etc. Therefore, even in the time of global recession, with a situation which is a result of the world economic and financial crisis, certain (but much lower) quantum of capital available, only economies with better performances are able to attract it. Alongside with positive effects of foreign capital inflows, there are also threats and dangers, like overheating of economic activity and competitiveness' decline (if monetary reserves sterilization policy is consistent – it implies appreciation of national currency that causes loses of competitiveness and increase of reserves, as the side effect of the process).

IMF team researchers (IMF, 2007, p. 106. Also see: Cardarelli, 2007, p. 203) point out on four main lessons related to big capital inflow that could be highly valuable for CEFTA member countries:

- First, countries that experience more volatile macroeconomic fluctuations – including a sharp reversal of inflows – tend to have higher current account deficits and experience stronger increases in both aggregate demand and the real value of the currency during the period of capital inflows.
- Second, episodes during which the decline in GDP growth following the surge in inflows was more moderate tend to be those in which the authorities exercised greater fiscal restraint during the inflow period, which helped contain aggregate demand and limit real appreciation.
- Third, countries resisting nominal exchange rate appreciation through intervention were generally not able to moderate real

appreciation in the face of a persistent surge in capital inflows and faced more serious adverse macroeconomic consequences when the surge eventually stopped.

- Fourth, tightening capital controls has, in general, been associated neither with lower real appreciation nor with reduced vulnerability to a sharp reversal of inflows.

CEFTA member countries are not too successful in FDI attraction in comparison to Central European economies. Structure of FDI attracted by CEFTA member countries is not as favorable as Central European ones due to high degree of brownfield investments in comparison to greenfield ones. Experience of more than one former CEFTA member economies (Poland, Czech Republic, Hungary, Slovenia, Slovakia and Romania) proves positive effect of CEFTA agreement on their economies: eased accession to the EU, increase of foreign trade and FDI. Trade liberalization, together with trade orientation toward the EU, fast restructuring and rebuilding of market institutions encouraged processes that resulted in increase of export. In the year 2006, for example, those countries attracted almost 1/3 of most successful greenfield global investments! South-Eastern European countries – present members of CEFTA – were much slower in trade reform. Today it is widely accepted in those countries that having liberal investment policy only, is not enough to attract sufficient quantity of FDIs. CEFTA membership is precious for gearing up customs and other administrative regulations to be compatible with WTO standards, as well as to create stable, transparent and favorable environment for trade development within the region. The main task for Southern-European economies is to intensify trade and create institutional conditions to attract FDIs, because presently their common characteristic is low level of export concentration, which is a consequence of following facts (D. Milenkovic and I. Milenkovic, 2008, p. 71):

- they have no recognizable export products, nor comparative advantages in traditional meaning,
- they developed in the past wide range of industrial products, without specialization in industry, which resulted in low export concentration coefficient,
- except Moldova (that is not so incorporated into the region), all other CEFTA 2006 member countries have no predominant mutual trade, therefore index of trade complementarities is 30-35. This indicator gives useful information on intra-regional trade possibilities, and in this very case shows that Eastern-European economies have relatively less index values in comparison to the former CEFTA members. In following years their production and export supplies will adjust to the import demand of regional partners. Macedonia and Bosnia and Herzegovina have export supplies less adjusted to the import demand of neighboring economies due to high level of export to the EU. By now, member countries recognized the fact that certain level of complementariness of regional economies was present, especially of former Yugoslav republic economies, which could be useful as important impulse for further specialization of those economies in terms of better mutual linkage and bigger foreign trade level.

For CEFTA member economies it is important that expected economic growth rate in the EU, as for the rest of the world, is negative, that causes decline of export demand for CEFTA member countries products. This fact, together with high structural dependence of national product from import, means that even more FDIs are needed to provide positive economic growth rate. For Serbia and other CEFTA member economies foreign loans were most common way or foreign capital inflows. This source in terms of present global economic crisis is under question mark. In given circumstances on favorable business clime in Serbia, CEFTA agreement membership is precious, given that it provides more favorable approach to the regional market. Whole region because of CEFTA agreement is more attractive for foreign investors. For entire CEFTA 2006 region, yearly FDI inflow until 2005 has not exceeded 4 billion dollars. Only in 2006 and 2007 FDI inflow became more massive (10.24 and 12,37 billion US dollars, respectively. For comparison, in Poland in 2007 FDI inflow was 17,58 billion US dollars (in Romania and Bulgaria together – 18.2 billion US dollars, not to mention Ireland, where FDI in the same year was 30.59 million USD), that altogether gives clear indication on low FDI level for CEFTA (Mitic, 2008, p. 52).

### 3.2. Balance of payment disequilibrium and foreign direct investments – the case of Serbia as one of CEFTA members

All CEFTA member countries have deficit in balance of payment current and trade account. Surplus that in capital accounts covered current account deficit predominantly came from long-term foreign loans. In case of Serbia in 2008, balance of payments deficit was up to 18% of GDP, or approximately 6 billion euro. Trade deficit in the same year was 8.2 billion euro (import – 15.5, export 7.4). Big balance-of-payment's current account deficit is consequence of gigantic consumption in comparison to savings. Increase of demand is mainly limited by current account deficit. It is the import growth which relaxes this constraint by allowing other demand components – consumption and investments – to rise by faster pace without having balance-of-payment difficulties. Due to the crisis, Serbia is affected by decline in demand of goods with competitive advantages – basic metals and food, which makes 2/5 of Serbian export (Nikolic, 2008a, p. 87). All CEFTA 2006 member countries have relatively big current account deficits in last ten years (see Table 4). Having in mind actual crisis, together with misbalances of trade and current account, for CEFTA member countries FDIs (especially greenfield investments) could be important leverage.

**Table 3**

Balance of payment current accounts of CEFTA members (in % of GDP)

| | 2000 | 2005 | 2007 | 2008 |
|---|---|---|---|---|
| Albania | -5.2 | -5.2 | -9.2 | -9.8 |
| B&H | -17.5 | -26.6 | -13 | -16 |
| Montenegro | | | -26 | -39.6 |
| Croatia | -2.6 | -6.3 | -8.6 | -9 |
| Macedonia | -1.9 | -1.3 | -3 | -9 |
| Serbia* | -2 | -9.2 | -13 | -18 |

*Sources: National central banks, (Nikolić, G. (2008), p. 80)*

*Note: * - data for Serbia&Montenegro until 2005, since Montenegro became an independent state in 2006.*

Serbian trade deficit in first eight months of 2010 was 3.42 billion euro (import was 57.2% covered by export), and it is encouraging that it decreased 6.8% in comparison to first eight months of 2009 (import was 51.2% covered by export). Similar improvements Serbian trade of goods made in 2009 in comparison to 2008, but that was mainly due to effects on world economic and financial crisis. The best comparison of "normal" trends are data up to the year 2008. Deficit of 8.2 billion euro in 2008 in Serbia is 15.2% bigger than in 2007. Total foreign trade of goods was 23 billion euro, which is 15.4% increase in comparison to 2007. Import was 47.7% covered by export (47.6% in 2007). Similar results show both import and export of goods: export in 2008 was 7.4 billion euro, 15.4% more than in 2007, while import was 15.6 billion euro, 15.3% more than in 2007. Unfavorable characteristic of foreign trade in 2008 was huge deficit, but favorable one was that export rose slightly more than import. Main market for Serbian exporting goods are Italy and Bosnia&Herzegovina (both 681.4 million dolars in first eight monthts of 2010), and Germany (642.2 million dolars in first eight months of 2010). Main partners in Serbian import are Russia (1.39 billion dolars in first eight months of 2010), Germany (1.12 billion dolars in first eight months of 2010) and Italy (904.4 million dollars in first eight months of 2010). Altogether, Serbia's main partner in both import and export are the European Union (more than 50%) and CEFTA-member countries (surplus of 866.6 million dollars in first eight months of 2010, mainly due to export of agricultural industry products and processed food).

**Table 4**

Balance of payment current accounts of CEFTA members

| Country | | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 1Q |
|---|---|---|---|---|---|---|---|
| B&H | Export | 1288 | 1441 | 1934 | 2640 | 3035 | 801 |
| | Import | 4253 | 4578 | 5715 | 5823 | 7106 | 1878 |
| | Balance | -3066 | -3317 | -3781 | -3183 | -4071 | -1077 |
| Croatia | Export | 5468 | 6435 | 7065 | 8253 | 9000 | 2175 |
| | Import | 12546 | 13343 | 14935 | 17104 | 18826 | 4845 |
| | Balance | -7079 | -6890 | -7870 | -8851 | -9826 | -2670 |
| Macedonia | Export | 1208 | 1347 | 1642 | 1922 | 2449 | 623 |
| | Import | 2039 | 2357 | 2599 | 2997 | 3824 | 1050 |
| | Balance | -830 | -1010 | -957 | -1085 | -1365 | -437 |
| Montenegro | Export | 271 | 452 | 461 | 627 | 628 | .. |
| | Import | 630 | 896 | 974 | 1483 | 2152 | .. |
| | Balance | -359 | -416 | -514 | -855 | -1524 | .. |
| Serbia | Export | 2441 | 2853 | 3617 | 5092 | 6429 | 1675 |
| | Import | 6603 | 8697 | 8470 | 10448 | 13338 | 3621 |
| | Balance | -4262 | -5826 | -4853 | -5356 | -6909 | -1939 |
| Moldova | Export | 698 | 790 | 848 | 983 | 1194 | .. |
| | Import | 1237 | 1419 | 1837 | 2780 | 3346 | .. |
| | Balance | -538 | -629 | -990 | 1727 | -2152 | .. |

*Source: WIIW database, including national statistics, Podkaminer, L., J. Pöschl et al. (2008), p. 85 and The Republic of Moldova Trade Diagnostic Study, p. 1*

Serbian export to CEFTA member countries (Table 4) in last several years shows rising trend, both in absolute and relative figures in comparison to the rest of the world export. In 2006, for example, in CEFTA member countries roughly 2 billion US dollars goods was exported; in 2007 – approximately 2.85 billion US dollars; and in 2008 over than 3.6 billion US dollars, which is very high rate of export growth (over 40% in 4007 and over 25% in 2008). If we know that rate of import growth to CEFTA member economies in the same period was lower (more than 35% in 2007 and about 20% in 2008), it is not difficult to conclude that CEFTA countries are very important for Serbian balance of payment. Especially with the regard that with most of them (including the territory of Kosovo and Metohija, which according to the United Nations Resolution 1244 still is part of the state of Serbia, but which unfortunately is aside of balance-of-payment territory of Serbia) Serbia has surplus of foreign trade (import coverage with export is bigger than 200%). So, while is Serbia importing twice more than exporting, within the CEFTA region, the situation is just opposite! That is why CEFTA membership is important for Serbia as a source of foreign goods trade surplus, especially with Bosnia&Herzegovina and Montenegro.

Very similar situation to the Serbian case regarding foreign trade deficit exists in all other CEFTA member countries, which will be only briefly stated due to the limited possibilities of elaborationin this paper (see for more details: Nikolic, 2008a, p.80-85). Foreign trade deficit in Croatia in first nine months of 2008 was 8.91 billion euro, 17.9% more than in the same period of 2007 (import is covered by export 45.2%). In the same period, Albanian deficit was 1.8 billion euro (14.4% increases), Montenegrin 1.3 billion euro, while in Bosnia&Herzegovina (in first eight months of 2008) it was 3.21 billion euro (21.8% increases), and in Macedonia 1.58 billion euro.

Contrary to the beginning of transition period (1990ies) when negative influence of FDIs were outlined, together with loss of national sovereignty and addiction to foreign capital inflow, today FDIs are seeing as a leverage of export and technological development. It is a long-term interest of every export-oriented economy to attract foreign greenfield investments. Thanks to relatively stable political and judicial environment, Central-European economies were far more attractive for foreign investors than South-Eastern European ones. But good progress in legislative adjustment to the EU standards, which is confirmed with the EU putting Serbia, Macedonia and Montenegro on "White Shengen list" in 2009, made CEFTA countries presently more attractive than they use to be in the past. Not to mention free trade area forming, which could be important factor in attraction foreign investments to the Balkan countries.

FDI inflow to the CEFTA agreement countries could help increasing their export capacity, reducing their balance of payment deficit and improving their overall economic characteristics. It is indicative that all CEFTA agreement member countries are facing high deficit of current account, as a result of large foreign trade deficit. In the first quarter of 2009 global recession was visible, which redirected funds that used to inflow from developed countries to others, to developed countries itself, which made those funds more expensive or even non reachable to countries of our region. FDI inflow to the region will certainly influence economic growth in future, but only if they contribute to the processing industries and tradable goods, which will support export expansion. This scenario could come true if stable political and institutional environment is in place, as well as appropriate economic growth strategy. Main common characteristic of CEFTA agreement countries is uncompetitive export, i.e. uncompetitiveness in the world market, which is a consequence of inherited economic structure during centrally planned economies. Therefore, the need to increase volume of export is among most important goals of economic policy.

**Table 5**

Current Account Deficit in CEFTA Countries

| Country | Current Account Deficit as a percentage of GDP | | | |
|---|---|---|---|---|
| | 2000 | 2005 | 2007 | 2008 |
| *Serbia* | *-2** | *-9.2** | *-13* | *-18* |
| Croatia | -2.6 | -6.3 | -8.6 | -9 |
| Bosnia&Herz. | -17.5 | -26.6 | -13 | -16 |
| Albania | -5.2 | -5.2 | -9.2 | -9.8 |
| FYR Macedonia | -1.9 | -1.3 | -3 | -9 |
| Montenegro | - | - | -26 | -39,6 |

*Source: National Central Banks, IMF (Nikolic, 2008, p.80)*

*Note: * - data for 2000 and 2005 include Montenegro (Serbia&Montenegro), since Montenegro became an independent state in 2006.*

It is interesting to underline that so-called "Emerging Europe" (Connoly, 2009) is the only emerging market region to collectively run a current account deficit. Sustained current account deficits lead naturally to higher external debt. But it cannot be argued that the current account deficits were the result of fiscal profligacy (Nuti, 2009, p. 12). For one of other reason Serbia already joined "the Club" of countries with two-digit current account deficit (data for 2008: Bulgaria – 21.2%, Moldova – 15.3%, Romania – 13.3% etc.) (See Table 5).

As transition economies with dynamic economic growth and development, Serbia is facing current account deficit that reflects balance of payment misalignments. It seems that fast economic growth and development born balance-of-payment misalignment, that are limiting factors for future growth, regardless of level of economies' development. In case of Serbia, as economy in transition with severe difficulties in 1990-ies, and consequently relatively low level of GDP in comparison to the level in 1980-ies, current account is even more important, especialy in the light of capital inflow restriction caused by the world financial and economic crisis. Namely, current account surplus in recent past had been compensated by capital account surplus. All governments of Serbia in last decade comprehended foreign capital inflow as a result of their successful policies and took it for granted as well as all credits for it. It seems they did not realise that it was mainly due to favourable global environment and conjuncture. One of the main challenges that both countries are facing at this moment is whether their current balance of payments deficit levels are possible to maintain. To put in other words, in present circumstances caused by global financial and economic crisis, where foreign capital inflow is severely reduced, one of the main challenges for sure is how to manage and finance sustainable level of current account deficit.

There are wide ranges of sources of vulnerability that are common to crises in emerging market economies, and many of those are present at the moment in Serbia. These can include, but are not limited to (Connolly, 2009, p. 5; Roubini and Setser, 2004, p. 32): (i) large macroeconomic imbalances, such as current account deficits, fiscal deficits, or both, that can cause an accumulation of large stocks of public and foreign liabilities; (ii) risky financing of such imbalances (e.g., with short-term debt, foreign-currency debt, debt in place of equity, etc), in ways that render countries vulnerable to liquidity runs that increase the risk of sharp exchange rate depreciation that might lead to a debt crisis through the 'balance sheet' effect; (iii) negative assessments by investors concerning the credibility of a government's commitment to implement policies that might increase a country's long-term creditworthiness; (iv) exchange rate mechanisms that are fixed or semi-fixed that might increase the risk of a large current account imbalance and the risk that borrowers would underestimate currency risk and rely too heavily on foreign-currency debt; (v) inadequate regulation of the banking sector, implicit and/or explicit government guarantees, corruption, and other microeconomic distortions that might lead to moral hazard and excessive levels of investment or borrowing; (vi) political shocks – in the form of elections, scandals, protests, government incapacity, war, etc. – that increase policy uncertainty and unsettle investors; and finally (vii), exogenous shocks that tend to have proportionately larger effects on emerging economies than on developed economies. Such shocks can include commodity price shocks that result in the sharp deterioration of a country's terms of trade, a sudden decline in demand from export markets, sudden increases in the cost or a decline in the availability of finance, and an increase in risk aversion by international investors.

Serbia's bad performance regarding share of goods and services in GDP can be seen in the Table 6, where a very poor percentage of 28.4% is shown, which is far below all other countries, excluding Albania. All countries including Serbia improved their performances significantly. Nevertheless, Serbia's export of goods and services share into GDP is still among the worst in South-Eastern Europe. One of the main causes for such poor indicators is lagging behind the world of a few technology cycles that slowed forming competitive export structure. In Serbia, export is still not the dominant channel of GDP realization, which could be a source of uncompetitive export (Kovacevic, 2009, p. 144). Croatian indicators are similar to Serbian in a sense that both countries are the only ones (exluding Romania) that had not improved their export of goods and services share into the GDP in this decade.

**Table 6**

Export of Goods and Services – Comparison 2000 - 2007

| Country | Export of goods as percentage of GDP | |
|---|---|---|
| | 2000 | 2007 |
| Bulgaria | 55.7 | 71 |
| Croatia | 47.1 | 47 |
| FYR Macedonia | 48.6 | 56 |
| Montenegro | 38.4 | 42 |
| Moldova | 49.8 | 43 |
| Romania | 32.9 | 26 |
| *Serbia* | *28.4** | *28* |
| Albania | 17.6 | 27 |
| Bosnia&Herzegovina | 31.1 | 36 |

*Source: Kovacevic, 2009, p.143*

*Note: * - data for 2000 include Montenegro, since Montenegro became an independent state in 2006.*

**Table 7**

Serbian Trade of Goods with CEFTA Countries (Million of dollars)

| | 2006 | | 2007 | | 2008 | |
|---|---|---|---|---|---|---|
| | Export | Import | Export | Import | Export | Import |
| Bosnia-H. | 760.3 | 354.7 | 1,047.4 | 504.1 | 1,347.3 | 629.8 |
| Montenegro | 644.1 | 149.3 | 966.7 | 126.3 | 1,279.7 | 196.5 |
| FYR Maced. | 302.7 | 200.7 | 439.2 | 298.3 | 496.3 | 369.5 |
| *Croatia* | *256.4* | *364.5* | *331.2* | *527.4* | *439.2* | *549.2* |
| Albania | 34.6 | 4.7 | 80.8 | 11.1 | 76.8 | 13.3 |
| Moldova | 4.2 | 7.2 | 4.6 | 11.8 | 6.6 | 25.6 |
| Total CEFTA | 2,002.2 | 1,097.2 | 2,849.2 | 1,491.5 | 3,645.9 | 1,783.9 |
| Total world | 6,627.6 | 13,297.6 | 9,027.7 | 18,317.3 | 11,376.4 | 22,902.2 |
| CEFTA/world | 30.2 % | 7.6 % | 31.6 % | 8.1 % | 32.0 % | 7.8 % |

*Source: Serbian Customs Office (Jovovic and Radovanovic, 2009a, p. III)*

Using the case of Serbia, we will underline importance of CEFTA (Central European Free Trade Agreement) (also known as CEFTA 2006) for Serbia. Export of Serbia to CEFTA member economies in last three years (see Table 7) rise constantly, both in absolute figures, as well as relatively (in comparison to the export to the rest of the world). In 2006 Serbia exported to other CEFTA member countries roughly 2 billion USD world goods. In 2007 – 2.85 billion USD, in 2008 – 3.6 billion USD. Such fantastic rates of export growth (over 40% in 2007, and over 25% in 2008) compared to also big, but lower import growth (over than 35% in 2007 and almost 20% in 2008) indicate importance of this regional trade agreement for Serbia. Having in mind that Croatia is the only major foreign trade partner with whom Serbia has deficit in trade of goods (with Bosnia and Montenegro, Serbia has huge surplus of over 200% coverage of import by export), it is clear indicator of benefit Serbia is enjoying from being in this regional agreement.

## 4. Conclusion

In the paper we discussed current acount deficit in CEFTA member-countries, with the special regard to Serbia. As many other European transition economies, Serbia is facing massive current account deficit (which reflects balance-of-payment misalignments). Nevertheless, due to the unfavorable situation caused by world economic and financial crisis, current account deficit already started reducing, although its level is still very high. Firstly, we questioned in the paper conventional wisdom regarding current-account/balance-of-payment balancing. Secondly, we tried to discuss "sustainable level" of current account deficit in Serbia, although it is not easy to define. Conventional wisdom every mid-to-long-term balance of payment's misbalance consider unacceptable, while lonely voices among modern academic economists are much more flexible. Even though they still accept thesis that structural problems lie behind current account deficit, they also allow possibility of mid-term disbalance, if sources of its financing are accessible. Accessibility of foreign sources is limited in terms of world financial and economic crisis. Bottom line is that current account deficit is as stable as sources of its financing, regardless of conventional wisdom. We tried to prove this in the paper using the case of Serbia. Thirdly, we presented theoretical background of free trade area and history of forming CEFTA 2006 agreement. In the first chapter we considered the role of the foreign direct investments in increasing of export in CEFTA member states, as well as balance of payment disequilibrium and foreign direct investments relationship, with the special reference to Serbia. Our findings can be summarized as follows:

CEFTA agreement plays positive role on Serbian current account, since Serbia has surplus with the most of CEFTA member-countries.

Although Serbian current account deficit decreased in 2009 and 2010 due to world economic and financial crisis, in "normal" times the long term trend is to deteriorate constantly.

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