DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR SERBIA AND MONTENEGRO

As approved by the Board of Directors at its meeting on 2 November 2004

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The State Union of Serbia and Montenegro continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. The new loose Union of the two republics was established on 4 February 2003. Under the terms of agreement setting up the Union, both republics committed themselves to staying together for three years, after which either would be able to call a referendum on independence. In accordance with United Nations Security Council Resolution 1244, Kosovo remains a part of Serbia and Montenegro but is currently run by the UN Interim Administration Mission in Kosovo (UNMIK), pending resolution of its final status.

The past year and a half has been overshadowed by the assassination of the Serbian Prime Minister, Zoran Djindjic, in March 2003. Following this event, the Serbian government launched a major crackdown on organised crime, and committed to continuing the reforms launched by Mr. Djindjic. However, the coalition government subsequently lost its majority in parliament and called early elections for December 2003. Serbia's current Government is a coalition of democratic parties with former President of the Federal Republic of Yugoslavia, Vojislav Kostunica, as Prime Minister. During the past year, Montenegro has enjoyed greater political stability and the government is pursuing its reform programme. There has been little progress in market-oriented reforms in Kosovo, and its final status depends on the province's attainment of certain benchmarks – including free and fair elections, free media, the enforcement of rights for minorities, and a sound and impartial legal system. Kosovo's status is to be reviewed in 2005.

The economies of both Serbia and Montenegro have been growing modestly over the past two years. In the Union as a whole, real GDP growth in 2003 was estimated to be around 3 per cent. Signs of improved performance in industry and agriculture are apparent in the first half of 2004 and the pace of growth has increased during 2004. Over the past few years, the authorities in Serbia have had considerable success in fighting inflation and restoring confidence in the local currency. Annual inflation at end-2003 was in single digits, the currency is relatively stable, and foreign reserves have risen steadily. Inflation in Montenegro is also moderate, with price stability aided by the adoption several years ago of the DM (subsequently the euro) as the sole legal tender in the republic. Fiscal performance has improved in both republics and the three-year IMF programme, signed in May 2002, is on track. In Kosovo, economic growth has fallen rapidly after the large infusion of donor assistance in 1999-2001, and GDP per capita in the province is among the lowest in Europe.

Serbia and Montenegro made rapid progress in reform in the first years of transition, but the past year has seen a slowdown. In Serbia, privatisation progressed well in 2001-03 and proceeds from sales exceeded expectations. Several large transactions in the tobacco and oil sectors were completed in 2003, helping to bring foreign direct investment (FDI) of more than €1 billion. Major reforms also occurred in the banking sector, and several state-owned banks are now being prepared for sale in 2004. However, the speed of privatisation has been reduced in 2004 and many important items of legislation relating to the business environment have been held up in the parliamentary process. Privatisation is still a pending issue in the energy sector, with the government continuing to focus on the stabilisation and restructuring of the companies in the sector. The passage of the long-awaited Energy Law in summer 2004 was a significant milestone and will facilitate the establishment of the Energy Regulator this year, as well as paving the way for additional reforms and the development of privatisation strategies. Transition in Montenegro is proceeding, with good results in privatisation of enterprises and banks, but the administrative capacity to implement reforms remains weak and the entrepreneurial culture needs further development. In Kosovo, the privatisation process was stalled for lengthy periods, though it has recently re-started. However, investment levels are unlikely to advance significantly until the long-term status of the province is resolved. The energy sector will require significant reform before long-term financing can be made available.

The next two years are a critical period for Serbia and Montenegro. In order to put in place the conditions for long-term growth and prosperity, the country must move on from its early transition achievements and focus on a medium-term agenda of deeper institutional and structural reforms. The key transition challenges are to:

- Implement key reforms to boost private sector development and improve the investment climate. These include urgent reforms in public sector administration and the judiciary system, measures to increase the external competitiveness of locally-owned businesses, and further efforts to attract sustained FDI inflows, including through large-scale privatisation.
- Reduce red tape and combat corruption.
- Improve financial and commercial discipline in state-owned enterprises and public utilities and restructure major public sector companies.
- Strengthen financial intermediation and increase the capital base of the banking sector through consolidation and the restructuring and privatisation of state banks in Serbia.

For Kosovo, the main challenges include the transition of socially-owned enterprises to commercially viable and competitive businesses, and the further development of micro- and small enterprises, which dominate the economy.

The Bank's activities in Serbia and Montenegro increased significantly during the last Strategy period (mid-2002 through mid-2004) with new commitments of €279 million. Initially, energy and other infrastructure projects dominated the portfolio, but the Bank has since gradually shifted focus to the private sector and diversified its portfolio. Individual exposures to private companies are still small because of their limited size and borrowing capacity, but the number of private local clients (excluding banks) has increased significantly, with eight new clients, of which four have foreign sponsors. Through its SME credit lines to local banks, the Bank has enabled financing for over 30,000 small local enterprises throughout the country. The Bank has been successful in attracting co-financing to all its major public sector transactions from the European Investment Bank (EIB), the European Agency for Reconstruction (EAR) and bilateral donors, and has been a pioneer in syndicating loans with international commercial banks.

Attracting future FDI will be a major challenge for the country, and the Bank will continue to work with good private local companies and banks. In the public sector, sovereign borrowing capacity in the country is limited, and therefore the Bank will expand its shares in non-sovereign public sector projects, and will pursue infrastructure projects that have a strong regional impact and facilitate further integration with the enlarged European Union.

The Bank's strategic priorities will focus on the following sectors:

Corporate Sector
Several areas will be given priority: (i) Privatisation and post-privatisation company restructuring, capital investments in new technology, and environmental improvements, primarily with local investors. (ii) Agribusiness, where Serbia has significant advantages and many local companies with good financial performance and substantial market share. (iii) Projects in the property sector, as this sector is in the early stages of development and there is significant demand for good office, retail and housing space. (iv) greenfield investment with foreign strategic investors who have commercial and viable investment plans and a track record in the given industry. Montenegro's tourism sector is an area where the Bank can play an important role by providing both funding and political comfort to foreign investors. EBRD will continue supporting SMEs through existing financial instruments to local banks and selective DIF investments primarily in Montenegro.

Financial Sector
The Bank will focus on the following areas: (i) Privatisation, financial and operational restructuring of state banks. (ii) Cooperation with strong local or foreign banks looking for opportunities to increase market share by assisting in further consolidation. (iii) Continued support to commercial banks and micro-lending institutions, and implementation of the recently agreed EU/EBRD Western Balkans SME facility.

Energy and other Infrastructure
The Bank will continue to play a crucial role, together with the EIB, the EU and the World Bank, in developing the transport, energy and municipal infrastructure in the country. Priority will be given to infrastructure projects that have a strong regional dimension as well as to supporting the required corporate restructuring in electricity, gas and oil. Significant activities are already underway in developing a Regional Electricity Market in south-eastern Europe. The Bank will continue its efforts to assist in the restructuring, modernisation and eventual privatisation of the country's telecommunications sector, expanding the access to networks and improving the quality of service in preparation for market liberalisation in 2005.

The Bank will focus on developing an institutional framework to support the financing of smaller municipalities, as well as advancing commercial financing in this sector. Where appropriate, the Bank will develop private-public partnerships. Municipal and environmental infrastructure projects on the coast of Montenegro, which are closely linked to the development of the tourism sector, will be considered as sovereign operations.

TC and official co-financing
TC and official co-financing are still crucial for project preparation and institution building, in particular for public sector operations. The Bank will continue its good co-operation with the EIB, the World Bank, the EU (in particular the EAR) and bilateral donor institutions in order to optimise the respective advantages of each institution, secure TC funding and co-financing, and co-ordinate policy dialogue, project prioritisation and donor support.

Kosovo
Due to the unresolved status of Kosovo, EBRD activities remain limited. The difficulties the Bank faces include the failure so far of UNMIK to confirm the legal status of EBRD, the public sector's low borrowing capacity, and very fragmented decision-making regarding private sector development. The Bank will therefore focus on working with local

banks and on assistance to the SME sector, both of which in close co-operation with the EAR. Recent developments with the Kosovo Trust Agency (KTA) make the proposed Turnaround Management Group (TMG) intervention all the more timely. In the infrastructure sector, the Bank will continue to assist the authorities with the implementation of a modern regulatory regime in the telecommunications sector that reflects best international practice, and will engage in dialogue to identify areas in the energy sector for potential Technical Cooperation that may lead to investments.

Annual Meeting

Serbia and Montenegro is due to host the Bank's Annual Meeting (AM) in May 2005, in Belgrade. The meeting will have a particular focus on the Western Balkan countries and will emphasise the advantages of strong cooperation among the countries of that region. Seminars to be held during 2005 in other countries of the Western Balkans will stimulate discussion around themes related to cross-border linkages.

A. SERBIA AND MONTENEGRO

1. THE BANK'S PORTFOLIO

1.1 Overview of the Bank's Activities to Date

The Bank signed its first operation in Serbia and Montenegro in April 2001 and, as of 31 August 2004, net cumulative business volume had reached €585 million, of which €22 million is in **Montenegro**, €3 million in **Kosovo** and the remaining €560 million in **Serbia**. The energy and other infrastructure (transport and municipal) sectors dominate the portfolio, representing 27 per cent and 38 per cent respectively, because of large projects designed to give emergency support to the country in the early part of its transition. Other sectors are fairly evenly represented in the Bank's portfolio, with agribusiness accounting for 11 per cent, financial sector and SME support for 13 per cent, and general industry for eight per cent. Sovereign operations represent 55 per cent of total net business volume, with an average project size of €36 million. Since the last strategy review in June 2002, non-sovereign operations have increased significantly, but their average size remains small at €14 million, reflecting the underdeveloped local private sector and low level of greenfield FDI. Equity accounts for only seven per cent of the entire portfolio.

Table 1: Serbia and Montenegro, Net Cumulative Business Volume by Industry, 31 August 2004

Sector	No of Projects*	EBRD finance (€mln.)	Portfolio Share (%)	Total Project Cost (€mln.)
General Industries	**4.2**	**47**	**8%**	**63**
Specialised Industries	**5.4**	**81**	**14%**	**228**
Agribusiness	3.6	63	11%	175
Property, Tourism and Shipping	1.1	7	1%	35
Telecom Informatics &Media	0.7	11	2%	17
Financial Institutions	**8.8**	**76**	**13%**	**141**
Bank Equity	2.0	6	1%	16
Bank Lending	4.5	40	7%	40
Micro financing	1.2	20	3%	53
Equity Funds	1.1	11	2%	33
Infrastructure	**8.0**	**220**	**38%**	**483**
Transport	3.0	144	25%	349
Municipal & Environmental Infrastructure	5.0	76	13%	135
Power & Energy	**2.0**	**160**	**27%**	**288**
TOTAL	**28.4**	**585**	**100%**	**1,203**
of which debt	22.6	546	93%	
of which equity	5.8	39	7%	
of which private	17.4	202	35%	
of which state	11.0	383	65%	
of which direct	26.1	553	95%	1,103
of which regional	2.3	32	5%	100
of which non-sovereign	19.4	262	45%	

of which sovereign	9.0	323	55%	

Notes:
1. Some projects include both loans and equity. Figures are net of full repayment and cancellations. Amounts are in Euro millions, and include regional projects.
2. The Bank allocates a count of one to stand-alone operations in which all facilities are signed and active, and a count of one for framework operations and their associated sub-operations. Partially signed or partially cancelled stand-alone operations are allocated a fractional count, depending of signed active facilities within the operations.

1.2 Implementation of the Previous Country Strategy

The last country strategy, approved in June 2002, outlined the following strategic priorities and transition goals: (i) support for SMEs and development of financial infrastructure; (ii) promoting private sector development through financing existing private local companies as well as local or foreign investors participating in privatisation/post-privatisation and greenfield projects; (iii) financing of key infrastructure in roads and railways, energy and municipal sectors, with preference whenever possible without recourse to the sovereign.

Overall, the Bank was successful in implementing the Country Strategy. Financial sector and SME development were enhanced considerably through eight new operations: equity investments in two local banks; micro and SME credit lines for several banks including the Bank's first ever credit line to an NGO, in Montenegro; and the introduction of the Trade Facilitation Programme to the country. In the private corporate sector, the Bank signed several loans to or equity investments in local companies, mainly in the pharmaceutical and agribusiness sectors. Several private sector projects signed recently have a strong regional dimension, through support to cross-border investments between neighbouring countries. In infrastructure, the Bank focused in the last two years on the implementation of existing public sector projects in energy, transport and municipal infrastructure, and doubled the level of disbursements. One of the infrastructure loans, to the Belgrade municipality, does not have a sovereign guarantee.

Despite the difficult internal environment and the need to focus mainly on local companies in Serbia and Montenegro important progress was achieved in implementing the operational priorities of the strategy and achieving transition impact. Two factors that were key to this achievement were, first, a sustained effort in policy dialogue by the Bank with all levels of government, as well as the Central Bank, and second, the mobilisation of substantial amounts of donor funding. The Bank's record in advancing transition in other countries of the region has given it a credibility with locals and donors when it comes to pushing urgent reforms, whether in infrastructure sectors such as roads, railways and energy, in the financial sector, or in the legal framework for private sector development. The transition progress in these areas is outlined in more detail in the next section.

1.3 Transition Impact of the Bank's Portfolio and Lessons Learned

Transition Impact

The Bank has played a key role in helping to advance the transition in Serbia and Montenegro, both through direct investments and through technical assistance projects. All signed projects to date (with one exception) have been rated by the Bank's Office of Chief Economist as having good or excellent transition impact potential, though in many cases the risk that this potential will not be achieved is assessed as high, mainly because of the difficult political and business climate. No project has yet been evaluated by the Bank's independent Project Evaluation Department, as the portfolio is still at an early stage with the majority of signed projects still disbursing.

The Bank has been very active in advancing transition in the financial sector. For example, the highly successful micro-finance bank, ProCredit bank, was the first new one to be established after the fall of the Milosevic regime. It now has 23 branches throughout the country and has become one of the major lenders to the SME sector with over 31,000 loans (€194 million) to entrepreneurs and small businesses, including a substantial number of loans to primary agricultural producers. Another example of transition impact in the financial sector is one of the early transactions – a subordinated loan to Raiffeisen Bank – which has been upgraded from good to excellent transition impact potential, as the loan has supported growth and consolidation of the banking sector beyond the Bank's original expectations. This transaction, although quite common in more advanced transition countries, has already had a major impact on the consolidation of the sector. In 2004, the Bank has extended its first ever loan to an NGO, Alter Modus, which provides micro-loans in Montenegro. With an average loan size of less than €2,000, Alter Modus offers credits to micro-businesses that never before had access to finance from the formal banking sector.

The Bank has also achieved substantial transition impact in private corporate sector operations, especially in sectors where some reforms have already occurred. For example, in the agribusiness sector – one of the most attractive sectors due to the presence of a large number of branded food and beverage manufacturing companies – the key reforms achieved so far include the increase in the sector's private ownership through privatisation efforts, and in particular the development of medium-sized agribusiness companies, often owned by local entrepreneurs. This has allowed the Bank to support several agribusiness projects, including an equity investment in the leading juice producer, Fresh & Co, and loans to a salty snacks producer, Marbo, and to a coffee manufacturer, Grand, to fund both their growth in the local market and regional expansion. The Bank's financing contributed to corporate governance improvements, for example, through the introduction of international accounting standards and covenants contained in the Bank's legal documentation. The Bank's support to the leading pharmaceutical company, Hemofarm, has brought about the introduction of the most advanced technology in this sector and has enabled the company to certify its products for the EU and USA markets. EBRD financing for Hemofarm, Frikom, Marbo and Lura is promoting regional cross-border investment.

In the public sector, the Bank's Infrastructure projects have given major incentives for reform. The introduction of new laws, better accounting and financial management, improved procurement procedures and more rigorous environmental requirements have been introduced. Associated TC operations are contributing to the restructuring of the railway and road sectors.

Important transition impact has been achieved through other Technical Assistance projects. In particular, successful implementation of the Belgrade Stock exchange upgrade and the introduction of the Secured Transaction Law are complementing the support given by other IFIs, including the World Bank which is at present implementing a Company Registrar project. These two TC projects are also contributing to private sector development and the growth of credit by local financial institutions.

Lessons learned

The Bank has learned a number of valuable lessons in the initial years of activities in Serbia and Montenegro:

Public sector operations take time and hands-on support: Major problems were encountered in some public sector operations, and significant effort was invested by Bank staff to make the projects effective and start to disburse. Some utilities and municipalities were not familiar with the Bank's procurement rules and procedures, and suppliers of work and goods were nervous about the process due to the poor image of the country and risks of possible corruption. However, actual procurements were fully satisfactory and without serious incidents. During 2004, the Bank dedicated more senior staff to the disbursement effort and to additional support, including training, to the clients during the procurement and disbursement period. Some improvements have been achieved. In future public sector projects in the pipeline, particular attention will be given to the provision of training and guidance to new clients during project preparation.

The Bank is not best suited to provide short-term working capital loan without financial intermediaries: The Bank's Working Capital Facility of €65 million, which was set up in 2001 to provide short term loans for working capital to individual export-oriented companies, was cancelled in 2003 after only one commitment of €4 million had been made. Despite an identified gap in the markets, the market response was quicker than expected, and the financial sector was able to supply credit-worthy companies with short-term financing. Meanwhile, most companies which the Bank screened were rejected either for not meeting basic standards of corporate governance, or for being financially too weak.

Policy dialogue on the investment climate pays off but requires constant effort: The overall business climate is improving, notably with a much-improved corporate tax regime and other selected incentives for Greenfield investments. However, red tape and other bureaucratic obstacles, unclear procedures and lack of standardisation as well as inadequate laws about land and immovable records, are all making for slow and difficult business operations and difficult access to capital.

1.4 Portfolio Ratio and Quality

Based on the current portfolio as of end-August 2004 of €585 million, the private/public portfolio ratio stands at 35/65 per cent. Sovereign lending amounts to 55 per cent, while the other 10 per cent of public sector finance is sub-sovereign (municipal). As discussed in more detail below, sovereign borrowing capacity is limited and the Bank therefore expects fewer state sector projects in the future; in parallel, local private companies are strengthening and the pipeline of private sector and non-sovereign public sector projects is increasing. The ratio is therefore expected to move towards a greater private sector share over the strategy period.

Whilst the overall performance of the Bank's portfolio in Serbia and Montenegro is good so far, the portfolio is at a very early stage of development and will be closely monitored, as many of the borrowers are dealing for the first time with international lenders, and therefore lack experience. The staged nature of some large projects in the energy, transport and municipal infrastructure sector, combined with the high volumes of these projects signed during the last strategy period, has led to a 67 per cent gap (as of end-August 2004) between commitments and disbursements. This gap should gradually close by end-2005, when most of the existing large public sector projects should be fully implemented.

Co-financing is at an early stage in Serbia and Montenegro, with the Bank and other IFIs as almost the only sources of longer term capital. The cumulative co-financing over the past 3 years amounts to €618 million. In the current year (January to August 2004), the Bank has mobilised €87 million of additional co-financing, mostly from other IFIs, existing shareholders or foreign banks with local subsidiaries. As the portfolio is re-oriented further towards private sector operations, and provided the operational environment improves, the level of commercial co-financing is expected to increase significantly over the medium-term.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Political Developments

A loose Union of Serbia and Montenegro came into being on 4 February 2003. However, the past year has seen a considerable degree of turmoil in the larger republic, **Serbia**. Political infighting among reformers in Serbia increased after the assassination of the Serbian Prime Minister, Zoran Djindjic, in March 2003. Following the government's loss of majority in parliament, early parliamentary elections were held on 28 December 2003. The Serbian Radical Party (SRS) emerged as the largest party, with 27 per cent of the votes and 81 seats in a 250-seat parliament. It is led by Vojislav Seselj, a former paramilitary leader now awaiting trial at the International War Crimes Tribunal at The Hague. The Socialist Party of Serbia (SPS) of ex-President Slobodan Milosevic, currently on trial at The Hague, got eight per cent of the vote and has 22 seats. The Democratic Party of Serbia (DSS) of ex-President of the Federal Republic of Yugoslavia, Vojislav Kostunica, has 53 seats and the late PM Djindjic's Democratic Party (DS) has 37 seats while the new G17-Plus party led by former Federal Deputy Prime Minister, Miroljub Labus, won 34 seats. A Government was formed on March 5 with Vojislav Kostunica as Prime Minister and comprising members of DSS, G17-Plus and two smaller parties. The ruling coalition has a minority in parliament and relies on the support of either the SPS or DS for a majority.

Presidential elections in Serbia took place in June 2004. The electoral law no longer required a minimum turnout so these elections finally succeeded after two years of failing to elect a President. The run-off in the second round was between Tomislav Nikolic (SRS) and Boris Tadic (DS) with Mr Tadic winning 1.68 million votes (53.2 per cent) and Mr Nikolic 1.43 million (45.4 per cent). Mr Tadic took office as President of Serbia in July 2004.

In **Montenegro**, the Prime Minister, Milo Djukanovic, remains firmly in power and his government is also pursuing a programme of economic reform. The joint Union is currently awaiting the results of an EU feasibility study to assess the country's readiness to begin negotiations with the EU on a Stabilisation and Association Agreement. The process had been delayed, in part because of slow progress on harmonisation of tariff rates and customs duties between the two republics. On 11 October 2004, the EU foreign ministers lent their support to a "twin-track" approach for Serbia and Montenegro in order to speed up preparations for the feasibility study in the first half of 2005.

2.1.2 Social Conditions

Population. **Serbia** (excluding Kosovo) had a population of 7,498,000 in 2002, according to the final census results reported by the Serbian Statistical Bureau. This was down from 7,839,142 in the 1991 census. The 2002 census included refugees from other republics of the former Yugoslavia – Bosnia and Herzegovina and Croatia, in particular – but not 'internally displaced' ethnic Serbs from Kosovo who were in Serbia when the census was conducted. The census did not cover **Montenegro**, which is estimated to have a population of approximately 650,000, and was boycotted by the ethnic Albanian majority in Kosovo. The population of Serbia and Montenegro (including Kosovo) at the time of the formation of the new Union in February 2003 is estimated at about 10.6 million. Estimates of

Kosovo's population vary. In 2002 UNMIK calculated that the population of the province had declined from the pre-1991 figure of 2 million to around 1.9 million, while the federal statistical office in Belgrade estimated Kosovo's population at about 2.3 million in mid-2001.

The 2002 census indicated that 15.7 per cent of the population of Serbia were below the age of 15 and that 16.6 per cent were 65 or above. The proportion of elderly people in the population of Serbia and Montenegro is estimated to be roughly in line with that in Western Europe, while estimates from UNMIK suggest that Kosovo has the youngest average age in Europe. In terms of ethnic mix, Serbs made up 63 per cent of the total population of what is now Serbia and Montenegro in 1991, and according to the 2002 census, about 83 per cent of the population of Serbia classify themselves as ethnic Serbs. The ethnic Hungarians living in the Vojvodina province in the north accounted for 4 per cent of the population. In 1991, 361,452 (3.5 per cent) people from Serbia and Montenegro were living and working in Europe and North America. It is estimated that between 100,000 and 300,000 (mainly young) people emigrated following the disintegration of the SFRY in 1991.

Education. Elementary education in Serbia and Montenegro is compulsory while full-time education has in the past been free, financed from public funds. National minorities are entitled to education in their mother languages. In the 2001/02 school year institutions of primary, secondary and higher education had 1.4 million pupils and students enrolled. (The figure excludes ethnic Albanian pupils and students in Kosovo.) In 1998 the ratio of pupils to teachers at primary level was 17:1, which placed what was then Yugoslavia above the EU average. The rate of completion of primary education was high: in the school year 1999-2000, 96 per cent of enrolled pupils graduated. There are state universities in Belgrade, Novi Sad, Nis, Kragujevac and Podgorica, and a private university in Belgrade funded by the Karic brothers. In 2000, annual spending on education amounted to 4.6 per cent of social product (SP), and one-third of all public expenditure.

Health. Mortality rates have decreased in recent decades. The average life expectancy in central Serbia in 2000 was 70 for males and 75.1 for females (in Vojvodina, the figures 67.6 for males and 73.3 for females). According to a World Bank estimate, average life expectancy at birth for people born in 1996-2002 was 73, above the average of 69 for Europe and Central Asia. Infant mortality rate in the former Yugoslavia decreased in the post-Second World war period from 117.2 per 1,000 in 1950 to 17 per 1,000 in 2001. The trend of declining infant mortality rates reversed briefly in the early 1990s, rising from 20.9 per 1,000 in 1991 to 21.9 in 1993. The main reason was the deteriorating economic situation in the country. Healthcare infrastructure is best developed in Vojvodina and central Serbia, less developed in Montenegro, and poor in Kosovo. Since 1991 there has been a steep decline in the proportion of resources devoted to healthcare. Public services have deteriorated rapidly. In 1999 there were 24,292 doctors and dentists working in public healthcare establishments (excluding Kosovo, for which data were unavailable). The number of people per doctor/dentist was 345, up from 318 a decade earlier. The total number of hospital beds declined from 62,283 in 1990 to 51,910 in 1999 (excluding Kosovo), resulting in an increase in the number of people per bed from 168 to 204. The average length of stay was 12 days, comparable to other countries in the region.

Currently, the public health system is in crisis. Health institutions lack basic medicines, materials and equipment. Some estimates suggest that 80 per cent of the equipment is obsolete. In Serbia, real spending per head on health fell from $240 in 1989 to $59 in 2000. Although the purchase of essential medicines and medical supplies from abroad – and the provision of humanitarian aid – was exempt from sanctions, lack of foreign exchange made it difficult to import them. Private practices, started in 1990 and generally well-staffed and equipped, have grown rapidly as the quality of service provided by the public sector has deteriorated. There are estimated to be more than 1,000 registered private practices – including 20 doctors' practices, 267 dentists' and 376 pharmacies.

Poverty. After ten years of economic stagnation and decline, poverty was a serious problem in Serbia and Montenegro at the start of transition, and remains so today. Although reliable data on this issue are often scarce, recent surveys in both republics, in the context of the Poverty Reduction Strategy Process, have shed new light on the scale of the problem. According to these surveys, approximately 10 per cent of the population in both republics in 2002 lived below the national poverty lines of €2.40 a day in Serbia and €3.50 in Montenegro. About 2 per cent of the population is unable to afford even the basic food basket. An analysis of the survey data conducted by the World Bank shows that poverty is concentrated among jobless households, those with low levels of education, households with refugees and internally displaced persons (IDPs), and in certain regional areas (the rural south-eastern part of Serbia and northern Montenegro). Both republics have completed Poverty Reduction Strategy Papers (PRSPs), but effective implementation to reduce poverty levels will be a major challenge

2.1.3 Labour Issues

Unemployment is one of the biggest problems facing Serbia and Montenegro. The official unemployment rate is around 30 per cent of the labour force, but labour force surveys suggest that the true rate is much lower, and probably around 11-12 per cent. The difference between the two measures reflects the large informal sector, and the World Bank estimates that informal employment accounts for about 30 per cent of total employment. Unemployment is concentrated among lower-educated people, and the majority of those without a job have been so for over a year. The new Labour Law that came into force in December 2001 is very free-market oriented and came as a response to the major economic and social changes that called for more flexibility in the labour market of Serbia. The most important feature is that, in comparison with the previous labour regulation, the new law is more liberal regarding employment procedures and termination of employment, thus giving more flexibility to employers. It eliminated those features of the old regulation that were viewed as overly protective for workers and highly restrictive for managerial functions.

The law provides for the right of association. In the state sector, about 60 to 70 per cent of workers belong to the unions. In the private sector, only 4-6 per cent are unionised, and in agriculture about 3 per cent. The Alliance of Independent Trade Unions (Savez samostalnih sindikata Srbije), formerly affiliated with the Milosevic regime, claims 1.8 million members (some estimates speak of 800,000). The largest independent trade union is Nezavisnost (Independence), with approximately 600,000 members. It is affiliated to the International Confederation of Free Trade Unions (ICFTU). The third largest trade union is the Association of Free and Independent Trade Unions (ASNS), with approximately 300,000 members, which participated in the Djindjic and Zivkovic governments (its leader was Minister of Labour). Most other trade unions are sector specific and have approximately 130,000 members. The largest is the trade union of the Electric Power Company of Serbia (EPS), with more than 20,000 members.

2.1.4 Legal reform

Legal reform is a top priority in Serbia and Montenegro. The legal framework in both republics is inherited from the pre-war Socialist Federal Republic of Yugoslavia and is a serious impediment to economic development. Some Milosevic-era structures are still relatively intact. According to a 2004 report by the International Crisis Group, it is nearly as difficult to do business in Serbia and Montenegro in 2004 as it was under Milosevic. The EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) in 2002 also highlighted the concerns of enterprises concerning the legal framework, low standards in the judiciary, and red tape and corruption.

In order to remedy this, the government of both republics have embarked on an ambitious reform programme designed to improve the conditions for investment. Over 130 individual policy measures in the ambit of legislative, institutional and administrative reform have been proposed, ranging from a new foreign investment law to training programmes for judges. Recent months have seen substantial progress, including the passage of important new laws on Bankruptcy, VAT, Energy and amendments to the Public Procurement law. In practice, however, implementation is proving much more difficult. The result is often a legal vacuum where old laws have been abrogated while new laws, although technically in effect, have no practical benefit because they have not been fully implemented yet. An example is the new Serbian Law on Registered Charges over Movables Property. Officially it entered into force on 1 January 2004, thereby replacing the old regime. However, it is currently ineffective since in order to be valid under the new law, charges must be registered in a charge registry yet to be created.

The authorities are increasingly aware that they need to focus on the adoption and implementation of a number of key laws. The problems identified above are often compounded by an ineffective and sometimes arbitrary judiciary. Among others there are serious concerns regarding the procedures for appointing and dismissing judges, the distribution of cases, the court budgets, and the financial compensation of judges and public prosecutors. International observers (including among other the Helsinki Committee for Human Rights in Serbia and the International Crisis Group) have concluded that the current circumstances compromise the impartiality and independence of the judiciary.

2.1.5 Environmental Issues

In **Serbia,** the Ministry for Protection of Natural Resources and Environment was restructured according to EU recommendations in 2001 (the new name is the Ministry of Science and Environmental Protection since 3 March 2004). It is responsible for legislative compliance, preparing and enforcing regulations and creating conditions for implementing principles of sustainable development in the country. In addition, the Ministry continues to be responsible for protection of air, water, soil, flora and fauna. The Ministry prepared and sent a draft law on the System of Environmental Protection to the Parliament in January 2004, adopted the Methodological Approach to Preparation and Implementation of the Serbian National Policy Plan (NEPP) and National Environmental Action Plan (NEAP) in February 2004. In addition, the National Waste Management Strategy was adopted and was being implemented.

Serbia inherited from the past decade both poor environmental quality (particularly in a number of hot spot locations such as Bar, Novi Sad, Kragujevac, Pancevo, Obrenovac, Smederevo and Belgrade) and an ineffective environmental policy framework. Much of the air pollution is caused by obsolete industrial technologies and lack of air emission control equipment in heavy industry, power plants and traffic. However, the decline in general economic activity between 1990 and 1999 has effectively reduced industrial pollution and pressures on the environment.

According to the Government, areas which require urgent environmental investment include: (i) development of hazardous storage facilities, (ii) improvement of municipal solid waste disposal facilities, (iii) development of wastewater treatment plants, (iv) addressing major pollution issues in the environmental hot spots and (v) an improvement of water supply in the rural and urban environment. The Bank has been actively supporting the Serbian Government in addressing some of these issues since Serbia and Montenegro joined the Bank in January 2001. The Bank continues its support by working with sponsors and other international organisations to develop bankable projects in this area.

In 1991, the National Assembly of **Montenegro** declared it an “ecological State”, committing the State to protect environment to the highest level. The Ministry of Environmental Protection and Physical Planning prepared, and the Government adopted, a series of environmentally-related laws, regulation and ordinances since 1991. In 2000, Montenegro published its first report on the State of Environment. It outlines the state of the environment in general terms, as specific data are not available due to a poor and unorganised monitoring system. In 2001, the Government adopted the Development Directions for Montenegro, which provided a long-term strategic direction, including environmental, economic, and social aspects.

The Bank’s approach to supporting environmental improvement within Serbia and Montenegro is two-fold. Firstly to ensure, through support of specific environmental project that key environmental concerns are addressed. For example, coastal pollution within Kotor Bay, mainly caused by discharge of untreated municipal wastewater, is currently being addressed through development of a municipal infrastructure project for the City of Herceg Novi. Similarly, the City of Subotica municipal project addresses the pollution of lake Palic on the outskirts of that town. Secondly, all EBRD operations in Serbia and Montenegro are subject to the Bank’s Environmental Policy and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during environmental due diligence.

2.2 PROGRESS IN TRANSITION AND THE ECONOMY’S RESPONSE

2.2.1 Macroeconomic conditions for Bank operations

The economy of Serbia and Montenegro suffered a deep decline in the 1990s and GDP is estimated to have fallen by about 50 per cent in this period. Since the start of transition in late-2000, the country has avoided a “transition recession” but has not yet seen the rapid take-off in growth that many were hoping for. Economic growth in both republics has been modest over the past year. Growth in **Serbia** in 2003 fell to around 3 per cent, down from 4 per cent the previous year. The decline was due partly to a severe drought, which reduced agricultural production by about 10 per cent, and partly to continued recession in the industrial sector. Signs of recovery in the industrial sector are apparent, with industrial output increasing rapidly in the first half of 2004 by 7.5 per cent (in annual terms), according to official statistics. Privatised companies, especially those that attracted foreign investment, are leading the way; for example, US Steel Serbia (formerly Sartid) expects to produce 1.1 million tons of raw steel production this year, which is 40 per cent up from the last year. The agriculture sector also appears to be rebounding, and overall, the economy is on track for real growth that may exceed the government's original target of 4.5-5.5 per cent in 2004.

In **Montenegro**, the real growth rate in 2003 was also sluggish at around 2 per cent. Some improvements are also occurring and growth is likely to increase in 2004 to 3-4 per cent. However, the main uncertainty surrounds the future of the largest company and main export earner, the aluminium conglomerate KAP, for which a tender for the sale of a majority stake was announced in August 2004.

Since late-2000, one of the main successes of the transition has been the stabilisation of prices and restoration of trust in the national currency (in Serbia), the dinar. From triple-digit levels in 2000, annual inflation had fallen in **Serbia** to single-digit levels (below 8 per cent) by end-2003, though some slight increase has occurred during 2004. The dinar has been relatively stable over the past three years although some nominal depreciation occurred last year, more or less in line with the inflation differential between the country and the eurozone. The relatively stable exchange rate in Serbia has been underpinned by strong foreign reserve growth. The range of monetary policy instruments in Serbia is relatively limited, given the weak banking system and the lack of a secondary market for government bills, so at present the main instrument of monetary policy for the central bank is the reserve requirement, which was raised by the National Bank of Serbia (NBS) in July 2004 from 18 to 21 per cent. Inflation has fallen in **Montenegro**, where the euro is the sole legal currency, to an annual rate of around 3-4 per cent. The range of monetary policy instruments in Montenegro is also limited, and the reserve requirement is currently 23 per cent.

Fiscal performance during the transition has also been relatively good (from a low base), with a much-improved revenue performance and hardened budget constraints for public enterprises. However, some slippage occurred in the second half of 2003. The Serbian and Montenegrin governments have agreed with the IMF, under the three-year Extended Arrangement, on a target consolidated general government budget deficit (excluding foreign-financed projects) of 2.5 per cent of GDP in 2004. Achieving the target is feasible but will require strict control of public expenditure, including wage growth in public enterprises. In **Serbia**, the government announced in August 2004 that it would trim spending significantly during the rest of the year, and in October parliament approved a revised budget for 2004, with significant spending cuts. Meanwhile, in **Montenegro**, fiscal performance in 2004 is also in line with IMF targets. The government is writing off old state debts in those companies that are being prepared for privatization, and it is assuming certain other liabilities, such as redundancy payments.

On the external side, trade and current account deficits remain large, with the latter currently running at more than 10 per cent of GDP (before grants), based on recorded data. However, this estimate is likely to be an exaggeration as balance of payments data in Serbia and Montenegro are unreliable, given the significant under-recording of exports and remittances. The deficit has been more than covered by capital inflows, as witnessed by the steady increase in foreign reserves, to the point where they now cover nearly five months of imports. Net FDI more than doubled in 2003 to about US$ 1.4 billion, driven mostly by a few large deals in **Serbia** in the tobacco and oil sectors. Greenfield investment is very limited so far, although the US Company, Ball Packaging, has recently announced a US$ 80 million investment in the country. FDI in 2004 is unlikely to come close to last year's level unless the government can overcome ownership issues in the mobile telephone company, Mobtel, and arrange the sale of a majority share. In **Montenegro**, foreign investors may bid for the state-owned telecommunications company, which is being offered for privatisation.

The external debt of Serbia and Montenegro remains high, even after a substantial debt reduction by official creditors in 2001-2002, and the debt servicing burden will rise sharply in the second half of the decade from the 2003 level of around 13 per cent of exports of goods and services. However, a major breakthrough was achieved in July 2004 as agreement was reached with the London Club on the restructuring and write-off of outstanding debts of around US$ 2.8 billion. Under the terms of the agreement, about 62 per cent of the debt will be written off, with the rest re-paid in long-term bonds with maturity up to 2024, as well as an immediate "goodwill" payment of US$ 40 million to creditors. This agreement has helped to reduce the country's external debt to GDP ratio to below 60 per cent. Nevertheless, the country's capacity to absorb new sovereign debt is limited. A recent analysis of **Serbia**'s external debt sustainability by the National Bank of Serbia suggests that the preservation of medium-term external debt sustainability depends on annual GDP growth of around 5 per cent and export growth (in dollar terms) of 15 per cent. Even then, debt-servicing will be a considerable challenge for years to come, though the risks are manageable at this stage.

Serbia and Montenegro's economic future is tied in closely with political developments and depends on a sustained commitment to reform by the governments of both republics. Long-term growth and prosperity depend on tough decisions being taken in the short-run, especially with regard to large state and socially-owned enterprises. High growth rates are feasible, but will depend on major restructuring of the enterprise sector, along with enhanced and sustained levels of FDI. As noted, robust growth in GDP and exports is essential if the country is to continue to meet its sovereign debt commitments.

2.2.2 Transition success and transition challenges

Serbia and Montenegro started transition much later than most other countries in the region. While **Montenegro** began market-oriented reforms in the late-1990s, **Serbia** had to wait until the fall of the Milosevic regime in October 2000 before beginning a comprehensive reform programme. However, the first two years saw impressive progress in transition as the country made up for lost time. Key achievements included the introduction of comprehensive price and trade liberalisation measures, the launch and implementation of an open and transparent privatisation programme, the overhaul of the banking sector (including the closure of large, insolvent banks) and the beginning of serious legal reforms. In both 2001 and 2002 the speed of reform in Serbia and Montenegro clearly exceeded that of any other transition country and resembled the rapid progress made in the early 1990s by those advanced transition countries that have recently joined the EU.

The preoccupation of the Serbian parliament with constitutional matters and the assassination of Zoran Djindjic meant that the pace of structural reforms during 2003 was much slower than in the previous two years. But despite the difficult political environment, some progress was made last year. Privatisation in both republics advanced: by end-2003 over 1000 medium and small companies in **Serbia** had been privatised through public auctions, while several large privatisations through tenders were carried out according to best international practice, bringing large revenues to the government. A voucher-privatisation programme in **Montenegro** was completed in early-2002. However, a number of large companies in both republics are hardly operational and have serious amounts of old debts, and are therefore of little interest to investors.

Restructuring plans have also been initiated in some of the large utilities, including energy, oil and gas. During 2003, both the **Serbian** and the **Montenegrin** authorities started reform of public utilities. In **Serbia**, the national energy and power utility company EPS is undergoing restructuring, and electricity tariffs have been adjusted towards economic levels. This year the restructuring has continued and a new Energy law enabling the establishment of an Energy Regulator among other issues was passed. A similar restructuring programme in the energy sector is under way in **Montenegro.** The two republics have worked closely with the Bank to establish a new air navigation supervision authority and a publicly-owned operating company, both of which will become operational soon.

In the banking sector, privatisation has advanced well in **Montenegro**, with only one bank still majority-owned by the state, while in **Serbia**, 12 banks were taken into state hands with a view to their restructuring and sale over the next two to three years. The privatisation of three large banks during 2004 is under preparation. The banking sector was also strengthened in 2003 by the abolition of the state payments bureau (ZOP) at the end of 2002. Also, a new General Company Registry (including registration of collateral and leasing) has been established with the support of the World Bank, USAID and EBRD. It is expected that the Registry will become operational at the beginning of 2005.

The new government in **Serbia**, formed in March 2004, has shown some determination, in difficult circumstances, to push ahead with key legislation that had been held up for lengthy periods, while in **Montenegro**, the government is also pursuing a coherent reform programme. However, notwithstanding the progress made over the last three years, there is still a long way to go in transition in Serbia and Montenegro. According to the EBRD transition indicators (published in the annual EBRD *Transition Report*), Serbia and Montenegro is among the least advanced transition countries in south-eastern Europe in terms of progress towards the standards of industrialised market economies. While this is understandable given the late start, it shows that there is no time to lose if the country wishes to catch up soon with its neighbours, not to mention the advanced transition countries that recently joined the European Union.

The key transition challenges facing the country are as follows:

Implementation of key reforms to boost private sector development and the investment climate. In **Serbia**, many laws relating to the business and legal environment await parliamentary approval or implementation, including key laws such as the new Company law, the introduction of VAT (scheduled for January 2005), amendments to the Tax Law, and over 50 other laws. Similarly, the creation of a collateral registry has been delayed, thus preventing implementation of the law over registered charges of mobile assets, which was prepared with Bank technical assistance and which became effective in January 2004. These delays and uncertainties are hindering the urgent restructuring of the enterprise sector and deterring potential foreign investors. In both republics, excessive bureaucracy, red tape and corruption are major impediments to existing and potentially new enterprises, and the weak judiciary is ranked both by investors and by the Government as one of the most serious obstacles to doing business. The legal and regulatory environment throughout the Union is difficult and many areas still require improvement. One area of particular concern is the weak policy-making capabilities of central government, and the consequent need to improve inter-ministerial relations so that the reform agenda can be accelerated and the benefits of donor funding can be maximised.

Restructuring and commercialisation of public utilities and municipalities. While some reforms of public utilities have been initiated, as noted above, progress in many areas has been slow. In order to meet the regional energy market requirements, EPS will have to separate its transmission and distribution activities. Renewing membership with the European transmission grid will also be a key objective. A critical challenge for **Serbia** over the next years is the restructuring and commercialisation of the energy company Naftna Industrija Srbije (NIS). Important new laws for Roads administration and Railways are still awaiting Parliamentary debate, while the essential restructuring of the State Railway Company, ZTP, has only now commenced. Restructuring of the telecommunications sector has been seriously delayed. In **Montenegro**, the Government has initiated the privatisation (supported by the Bank) of the aluminium producer, KAP, the largest state-owned enterprise in the republic and the main source of exports from the republic. As mentioned, work on the restructuring of the Montenegrin electricity company has begun and is supported by the World Bank, USAID and the EAR.

For municipalities in **Serbia**, the key challenges over the next two years will be to continue the upgrade of the environmental infrastructure towards EU standards, in particular in the areas of waste management, water supply and water resource protection, while keeping the cost affordable. In **Montenegro**, urgent measures are needed to ensure uninterrupted water supply and adequate waste-water treatment in the coastal region to underpin the development of the tourism industry. Key transition objectives in both republics will be to further promote commercialisation of utility services, good corporate governance, financial discipline and accountability for results. In **Serbia**, tariffs have been increased significantly from their pre-October 2000 (very low) levels, but still remain below cost recovery. In **Montenegro** tariffs are higher, but low collection ratios are a serious problem. Affordability constraints will remain an issue.

Strengthen financial intermediation and advance consolidation and privatisation in the banking sector. Confidence is being restored to the financial sector but much more needs to be done to strengthen intermediation. One of the highest priorities in **Serbia** is the privatisation of the state-owned banks. In November 2003 Serbian Government selected a privatisation adviser (funded by the World Bank) with the mandate to prepare three banks for privatisation. Due to the political uncertainty in the country and at the time slow progress on the London Club debt, this process was somewhat delayed but has been reiterated as one of priorities for this year. The first bank, Yubanka, should be privatized by the end of this year, and tenders for two other banks are expected soon. In **Montenegro**, the priority is to improve banking skills and longer-term funding, which will lead to an increase in the loan portfolio. Although improvements in both republics have occurred, with the help of foreign banks, access to finance remains limited. Emphasis should also be put on developing the non-banking financial system which is still in its early stages.

2.3 ACCESS TO CAPITAL AND INVESTMENT REQUIREMENTS

Enterprises in Serbia and Montenegro generally have very limited access to outside sources of finance. In the 2002 EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), enterprises in Serbia and Montenegro identified lack of access to finance as the second biggest obstacle (after taxation) to doing business. The BEEPS also showed that internal funds (including retained earnings) accounts for more than 80 per cent of financing needs of enterprises, the highest share in the region. Nevertheless, the situation is gradually improving. The reforms to the banking sector described above are helping to restore confidence. Reserve requirements were progressively reduced during the transition period (although, as noted, they were raised in Serbia by three percentage points in July 2004, in order to dampen inflationary pressures from consumer lending) and credit growth during the past two years was substantial, especially in Serbia. Domestic credit to the private sector grew by more than 20 per cent in real terms during 2003 and is now close to 20 per cent of GDP, although much of this new lending is to households; credit to the private enterprise sector remains limited.

Other non-bank sources of finance remain negligible in Serbia and Montenegro. In **Serbia**, Activity on the Belgrade Stock Exchange increased significantly during 2002, with total turnover doubling from the previous year, but this was from a very low base. **Montenegro** has two stock exchanges but neither has much influence on the investment activity of enterprises. The insurance sector in both republics is still dominated by the state, while pension reforms are at an early stage. The country is not rated by the main international ratings agencies, although this situation may change in the near future now that outstanding arrears to the London Club have been resolved.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

The Bank has been a key partner of the authorities in Serbia and Montenegro since the beginning of transition, and will continue to support the efforts of governments at all levels (Union and republics) to promote the reform agenda and improve the country's investment climate. The Bank's operational priorities will cover the general development of the private sector, further restructuring and consolidation in the financial sector and the rehabilitation of the country's infrastructure and energy sectors, with a strong emphasis on projects (both public and private) that foster regional integration. The Bank will build on its close relationship with the three governments and its constructive dialogue with foreign investors, IFIs and the local business community. The current active project pipeline amounts to more than €400 million, of which 68 per cent is in the non-sovereign (46 per cent private and 22 per cent sub-sovereign) sector.

3.2 Sectoral Challenges and Bank Objectives

Over the coming two years the following activities and sectors will be the main priorities:

3.2.1 Corporate Sector

Local Private Enterprises: The Bank will support local, privately-owned companies by providing loans, or by making equity investments in cases where the companies are of significant size and show good corporate governance. SMEs will continue to be supported through credit lines given to the local banks, while larger corporates, which are growing in numbers, will be supported directly, provided they meet the Bank's transparency, integrity and corporate governance standards. Two sectors that show particular potential for growth and investments are agribusiness and property/tourism:

<u>Agribusiness:</u> In the agribusiness sector, food processing is one of the fastest growing and most successful segments of the private corporate sector. A number of companies are exporting and successfully competing on the regional market. The Bank will continue to seek successful companies in order to finance their further expansion and investments in new technology by providing long-term loans or by making selective equity investments. In addition, the Bank will continue to provide working capital financing to sugar, sunflower, grain and other commodity trades and users.

Outside of the trading and manufacturing sectors, the retail sector has seen positive developments in the recent years with the establishment of new supermarkets and consolidation of existing retail chains. The Bank will continue to provide long-term financing to strategic (local and foreign) investors in the rapidly developing retailing market. This has been identified as one of the sectors that fosters economic growth and promotes efficiencies in primary agriculture.

Direct financing of larger, well-performing local agribusiness companies, using a variety of financing instruments adapted to the sector such as commodity-based financing (e.g., the Warehouse Receipts Programme), will also be continued. In this regard, the Bank and the

Ministry of Agriculture of Serbia have worked on the development of the warehouse receipts legislation, which is expected to create a more sound platform for further provision of working capital to the agribusiness sector, and which will allow the Bank to attract and increase funding from the commercial banks operating in Serbia. (Currently the Bank takes fixed assets as collateral.) In addition, the Bank, through its framework agreement with the FAO, will continue its policy dialogue on the development of the sugar sector.

The Bank will also continue working closely with local banks in order to promote lending to agribusiness SMEs. For example, as of August 2004 ProCredit bank has 17 per cent of its outstanding loan portfolio (€16 million, for 5,700 loans) for small private farms, with an excellent repayment rate, and is the largest lender to the primary agriculture sector. The Bank's Warehouse Receipt Programme (WHR), as well as working capital lines for the commodity purchase, are always contracted in co-operation with a local bank.

Property and Tourism: The development of tourism is one of the **Montenegrin** government's priorities for attracting FDI, and the Bank will provide long-term finance alongside strategic investors. The Bank's future support to larger regional companies involved in this sector should contribute to an increase in the number of foreign visitors. The Bank will also help to provide the necessary infrastructure for tourism through its work on transport and infrastructure projects such as the (already signed) airport rehabilitation project, a new waste-water treatment system, and a new roads project.

In **Serbia**, the Bank will continue to facilitate the development of quality hotel and office infrastructure in major cities, primarily in Belgrade. In addition the Bank will look for opportunities to selectively support residential developments, and other projects that promote better logistics and retail infrastructure, both directly and (for residential development) indirectly through mortgage finance facilities approved for eligible local banks.

Enterprise non-financial support: The TAM and BAS programmes are specifically designed in the Serbia and Montenegro context to assist existing state or socially-owned enterprises by improving their commercial focus and competitiveness. They are supported by the European Agency for Reconstruction (EAR), and they are related to other initiatives funded by the EU, including institution-building in the Ministry of Trade & Industry.

To date, the Programme in **Montenegro** has consisted of 12 TAM projects (completed in mid 2004) and the successful start-up and operation of a BAS Office in Podgorica. An extension of this Programme is currently in the final stages of negotiation and will provide funding for the continuation of the BAS office and a further 10 TAM Projects.

In **Serbia**, a Programme of 25 TAM projects is in the final stages of implementation and will run until early 2006. Discussions are currently being held on a possible extension. In addition to the financing from EAR, TAM has recently received support from Canada and Italy. For projects in Serbia and Montenegro, other bilateral donors have indicated a willingness to fund projects.

3.2.2 Financial Institutions

The activities of the EBRD in the financial sector will concentrate mostly on the following operational priorities:

Pre-privatisation and Consolidation: The Bank will support the **Serbian** authorities with the pre-privatisation of state-owned banks, as there are several systemically important banks still awaiting privatisation. This support will be offered to the Government for the restructuring of these banks, following the recent resolution of London Club debt. The Serbian and Montenegrin banking sectors are still fragmented and there is room for further bank consolidation. In this context, the Bank may support selected merger and acquisition opportunities among local private banks.

Introduction of new products and continuation of existing micro and SME financing: Under the EU/EBRD Western Balkans SME facility together with the European Agency for Reconstruction (EAR), the Bank will support selected local banks in SME financing, where the Bank will provide credit lines while the EAR will support the programme by providing technical assistance for institutional development. This operation will be structured similarly to the one offered to the Accession (new EU member) countries. The Bank will continue to provide SME facilities in Serbia and Montenegro under the existing range of products, supporting existing partner banks and introducing new banks**.** The Bank's Trade Facilitation Programme will be extended to new partner banks. The Bank will continue its mortgage finance programme to the strongest retail banks in Serbia, and will continue to assist micro-enterprises through existing projects in both Serbia and Montenegro.

Non-Banking Financial Institutions: This sector is seriously underdeveloped and institutions are either state-owned (insurance companies) and in need of restructuring, or are very small (leasing companies) and unable to borrow due to low capitalisation and lack of experience. It is possible that, towards the end of the strategy period, the restructuring of the insurance sector will commence or that the Bank will be able to identify better performing leasing companies for possible support.

3.2.3 Public Infrastructure and Utilities

As noted earlier, in light of the limited sovereign debt capacity in the country, but also taking into account the urgent rehabilitation and restructuring needs, the Bank will be highly selective in future projects in this sector, with an emphasis on projects with clear transition impact potential and the participation of the private sector where possible. The Bank will continue to rely on the availability of TC funds for project preparation and to strengthen the project management capacity to ensure successful project implementation. TC will remain essential for institutional strengthening to help achieve the transition objectives.

Regional Projects: The Bank will continue to work together with the EIB, the EU and the World Bank in developing transport, energy and municipal infrastructure in the country. Priority will be given to infrastructure projects that have a strong regional dimension and which support the EU's Stabilisation and Association Process, which places a strong emphasis on regional cooperation. Significant activities are already underway in developing the Energy Community of South-Eastern Europe (ECSEE) for electricity and gas, which establishes minimum physical and regulatory criteria to promote regional trade.

A concept for regional transport infrastructure is being developed under the auspices of the Infrastructure Steering Group for South East Europe (ISG), chaired by the EU, of which the Bank is a member. Improving regional interconnections and integrating into the European transport network are important to strengthen the economic links among the neighbouring countries and with the enlarged European Union.

Transport: ***Serbia and Montenegro****:* A loan to the Serbia and Montenegro Air Traffic Services Agency Limited (SMATSA) for the upgrading of both Belgrade and Podgorica's air navigation management systems is in an advanced stage of preparation and is expected to be signed during the second half of 2004. Implementation of this project will be a key challenge of this strategy period.

Serbia: In the road sector the main focus will be the regional road network, including Pan European Corridor X, and transition elements relating to road financing and further commercialisation of the Roads Directorate. A sovereign loan for the upgrading of the road between Belgrade and Novi Sad (part of Corridor X) to a four lane motorway is in advanced stages of preparation, and the loan agreement is expected to be signed in the second half of 2004. The project is co-financed with the European Investment Bank (EIB). The Bank is also working with the EIB on a project with the Belgrade municipality to construct a bridge over the river Sava.

In the rail sector, the Bank will (during the later part of the strategy period) consider a sovereign loan to the Serbian railway company, ZTP, to support the continued restructuring of the company, a process started under the first railways project signed in 2001, provided that the railway company and government are willing to continue their restructuring process through the implementation of a credible institutional reform programme.

For the transport sector in general, the Bank will seek to support Public-Private Partnerships (PPPs), with the roads sector being the most likely candidate for this mode of financing in the medium term. However, as these structures require larger projects and a more stable political environment than is currently the case, the Bank expects to have a limited pipeline and longer lead time to develop this type of project. The Bank will continue to share its PPP experience with the government.

Montenegro: As in Serbia, the Bank will give emphasis to transport infrastructure projects with a strong regional focus (especially in light of the republic's considerable tourism prospects) and high transition impact potential. In the road sector the main focus will be on a high-priority programme of road rehabilitation, focusing on the country's main north-south corridor. Improvements to road sector financing and reform to the institutional set-up will also form an important part of this project. In the aviation sector, priority will be given to implementation of the signed project for the rehabilitation of the republic's airports. Following upon the success of the Airports of Montenegro transformation, the Government of Montenegro has asked for assistance with restructuring the Port of Bar. This project is supported by the EAR.

Municipal and Environmental Infrastructure: Over the past few years, reforms in municipalities have begun and the legislation relating to local government activities has improved, but the administrative and financial capacities vary greatly between different municipalities. Several IFIs and bilateral donors are active in this sector financing institution building and project preparation, and the Bank is working closely with other donors.

In addition to the continued focus on implementation of signed operations, the Bank will, on a very selective basis, finance sovereign-guaranteed loans to municipalities for projects with mainly environmental objectives such as regional landfills, or projects with a regional dimension. These projects are a priority for the **Montenegro** coastal region where the Bank is prepared to finance very small projects that affect the development of tourism. The Bank will calibrate investment sizes, structures and tenors to ensure long term affordability. Increased private sector involvement in service provision and financing of public services will be encouraged. The Bank will consider follow-up projects with existing municipal clients on a non-sovereign basis, including in sectors such as urban transport, solid waste and district heating.

Within the framework of The Municipal Finance Facility for Transport and Environment for Croatia and Serbia and Montenegro (CARDS 2002), the Bank will consider establishing lending facilities with selected local banks for providing long-term financing for municipal infrastructure projects. In co-operation with the EAR and bilateral donors, the Bank is working with the Government of **Serbia** on creating an institutional framework to support financing of smaller municipalities.

Energy: The Bank's primary objective will be the implementation of the two signed loans, totalling €160 million, to Elektroprivreda Srbije, the electricity company of **Serbia**. Future funding will be aimed at supporting improved environmental management and practices in EPS. This may require some technical assistance in addition to the Bank's funding. The Bank will be looking for an opportunity to finance private investors following the establishment of independent regulator in Serbia. The Bank will also seek to identify projects in **Montenegro** that support transmission linkages in the region, although investment opportunities are limited given the size of the market. The Bank will also seek to support the re-organisation and restructuring of the oil and gas company, NIS, and will seek to identify viable projects to improve efficiency of operations, increase security of supply and enhance access to alternative energy sources.

Energy Efficiency: The main objective will be to successfully implement the Belgrade District Heating project, which has been seriously delayed due to issues related to the reorganization of the company and project preparation. As the country is dependent on import of energy, and as the tariffs are being adjusted to economic levels, this sector remains important for economic and social reasons. All private and public sector projects, while in preparation, will be assessed from the energy efficiency dimension and an energy efficiency component will, if required, be included in the Bank's financing.

Telecommunications: The reform and restructuring of **Serbian** telecommunication sector has been seriously delayed due to the inherited situation in the sector and unresolved ownership issues. While these problems are being resolved, the Bank will assist the Serbian government, through the provision of technical cooperation assistance, to restructure the telecommunications sector in line with the relevant EU directives and practice, in preparation for full market liberalisation in June 2005. Subject to measurable progress in this direction, the Bank will consider non-sovereign financing for the expansion and modernisation of the telecommunications networks of the incumbent, mobile or alternative operators. The Bank will also monitor the situation in **Montenegro**, where the privatisation of the telecommunications company Montenegro Telekom has been re-launched .

4. OTHER IFIS, MULTILATERAL AND BILATERAL DONORS

4.1 Donor and IFI Co-operation

In Serbia and Montenegro the co-operation among the IFIs and multilateral donors has been excellent. The Bank is regularly exchanging views and information about ongoing and planned activities with local representatives of IFIs and donors both in Belgrade and Podgorica. In the period 2000 – 2003, the Bank has raised €289.1 million official co-financing, and €15.9 million for technical co-operation.

The Governments of Serbia and Montenegro have played a proactive role in coordinating donor and IFI activities. In November 2003, a donor co-ordination meeting for the Union of Serbia and Montenegro was held in Brussels to up-date on the implementation of the Economic Recovery and Transition Programme presented at the Donor's Conference in 2001. The Stability Pact for South Eastern Europe (Working Table II), and the Infrastructure Steering Group serve as important coordination forums among the EC, the IFIs and major bilateral donors.

Between the donor conference held in June 2001 in Brussels and end-2003, the international community have committed a total of €3.5 billion of financial support for Serbia and Montenegro.[1] Of this, IFI commitments amount to €1.4 billion and the EU's to €890 million. In 2004, it is expected that IFIs and donors will allocate further €1.2 billion. Approximately €2.2 billion have been contracted, and €1.2 billion disbursed.

The focus of the international assistance was initially on urgent infrastructure reconstruction and humanitarian aid. Later, the focus has shifted towards institutional and legal reform, social development, private sector and infrastructure development. Energy and transport have been main recipients.

In Kosovo €2.2 billion[2] donor funds have been committed since the first donor conference organised in July 1999. The single largest donor has been the EU and EU member states. The US has been the second largest donor. The initial focus of donor grants has been reconstruction of utilities and housing, but is now shifting towards institution building and public governance.

4.2 European Union (EU)

The EU has played a leading role in supporting the reconstruction of Serbia and Montenegro through grant funds. The overriding objective of EU assistance to Serbia and Montenegro, as for the other western Balkan countries, is to facilitate the Stabilisation and Association process and the integration with the EU. The EU's multi-annual indicative programme 2005-06 for financial assistance to Serbia and Montenegro is at an advanced state of preparation. However, the government needs to commit further resources and planning efforts to make greater progress towards EU accession.

The European Agency for Reconstruction (EAR) is responsible for the management of the main EU assistance programmes in the Serbia and Montenegro and the Former Yugoslav Republic of Macedonia. In Serbia and Montenegro, the EAR had by end-2003 committed €777 million in Serbia, €71 million in Montenegro and €907 million in Kosovo. The EAR's 2004 programme amounts to €212 million for Serbia, €18 million for Montenegro and €49 million for Kosovo. In addition, the EU has provided balance-of-payments support in the

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[1] Excluding Kosovo.
[2] Excluding UNMIK and KFOR

context of an IMF programme, and from 1992 to 2003 humanitarian aid through the EU's Humanitarian Aid Office, ECHO.

In **Serbia**, the EU's assistance has focussed on good governance and institution building, economic reconstruction and reform as well as social development and civil society. This includes relatively large contributions to the energy sector, economic development activities, transport and municipal infrastructure**.** In **Montenegro**, the largest contributions have been made towards transport infrastructure, economic development and public administration reform.

A key element of the EAR's strategy is to pave the way for IFI financing by providing grants for project preparation, implementation and institutional reform prior to investments being made. The cooperation between the Bank and the EAR has been particularly good, with the EAR having provided support to several Bank-financed projects across a variety of sectors. The Bank and the EAR have regular consultations to ensure consistency in project selection and policy approach.

4.3 European Investment Bank (EIB)

The EIB resumed its operations in Serbia and Montenegro in December 2001 by providing financing of €66 million for urgent transport rehabilitation project that included reconstruction of roads, modernization of Belgrade airport and rehabilitation of the port of Bar.

Since then, the EIB have concluded 11 loan agreements making available financing of €769 million for projects in airport modernization, roads rehabilitation, railway rehabilitation, urban infrastructure, energy and health, with the transport sector being the largest recipient of funds.

Having contributed €186 million towards Bank financed projects the EIB is by far the largest co-financier in Serbia and Montenegro. This includes projects in roads rehabilitation, railways, airports, air navigation system, power and energy and municipal infrastructure. Most of the co-financed projects have been further enjoying the support of the EAR.

In the coming years the EIB intends to explore the possibility of further co-financing opportunities with the EBRD and other IFIs, in particular, in the fields of municipal infrastructure, health and education, and transport.

4.4 International Monetary Fund (IMF)

In June, 2001, the IMF approved a first SDR 200 million Stand-by Credit for Serbia and Montenegro. In May 2002, the IMF approved an Extended Arrangement for a total equivalent to SDR 650 million to support Serbia and Montenegro's economic programme in 2002-2005. By June 2004, Serbia and Montenegro has drawn SDR 300 million under the Extended Arrangement.

On 7 June 2004, the Executive Board of IMF completed the third review of Serbia and Montenegro's economic performance under the Extended Arrangement, allowing Serbia and Montenegro to draw SDR 100 million from the IMF. The 2004 programme will focus on reducing the current account deficit, enhancing growth prospects, and correcting the existing fiscal and external imbalances.

4.5 World Bank Group / IFC

In May 2001, Serbia and Montenegro succeeded to membership in the World Bank and a three-year envelope of IDA credit of up to US$ 540 million was approved by the World Bank's Board of Executive Directors. Of this envelope, US$ 522 was committed by end of June 2004, with the remaining amount expected to be committed shortly. An additional US$ 30 million was provided in grants.

About 65 per cent of the World Bank's operations have been structural adjustment credits linked to policy reforms. Other sectors financed by the World Bank include pension system, environment, public health, privatisation and bank restructuring, trade facilitation, power and energy.

The World Bank was centrally involved in the preparation of poverty reduction strategy papers for Serbia and Montenegro, which were finalised in early-2004.

Since Serbia and Montenegro became a member of IFC in 2001, it has received commitments of more than $44 million in IFC funds for projects in the food and beverage, finance, and plastics and rubber sectors. The IFC's strategy in Serbia and Montenegro is focused on attracting strategic foreign investors to establish viable financial institutions.

4.6 Council of Europe Development Bank

On 23 April 2004, Serbia and Montenegro was approved as the 37th member of the Council of Europe Development Bank (CEB). As a first operation, CEB is considering financing a social housing project for refugees.

4.7 Bilateral donors

The largest bilateral donors to Serbia and Montenegro are the United States, Germany, Italy and Japan. Other major donors who have supported Bank financed projects are Canada, France, Greece, the Netherlands, Norway, Switzerland, Sweden and the UK.

The United States. The assistance of the United States is tailored to provide support necessary to establish the rule of law and to promote an open and democratic society, as well as to accelerate growth and development of private enterprise. Since 2001, the US allocation has been approximately US$400 million to Serbia and US$200 million to Montenegro, 80 per cent of which has been managed by USAID. The USAID/Serbia and Montenegro program focuses on three main areas, namely (1) Accelerated Development and Economic Growth; (2) More Effective, Responsive, and Accountable Democratic Institutions; (3) Increased, Better Informed Citizens' Participation in Political and Economic Decision Making. Other activities are managed by the US Treasury, the Trade and Development Agency (USTDA), the Department of Agriculture (USDA), the Public Diplomacy Office, the Defense Attaché Office (USDAO) and US Customs.

As of 31 March 2004, the Secretary of State, Colin Powell, could not certify Serbia's compliance with its international obligations with the ICTY tribunal. As a result under US law parts of the assistance programme have been temporarily halted.

Germany. Germany played a major role in developing and financing the Quick Start Projects identified in December 2000. The German assistance to Serbia and Montenegro totals almost €300 million. KfW has handled the majority of German bilateral commitments for Serbia under the Stability Pact, and since 2001 KfW has been involved on its own account.

After initial focus on humanitarian aid and emergency rehabilitation, the German aid has targeted infrastructure development, support to the financial sector and SME development. KfW has provided co-financing to Bank projects in the power and energy, financial institutions and municipal sectors.

Italy. The Italian cooperation is active chiefly in the sectors of SMEs, social services and housing, health, energy, environment, agriculture, and the figth agains crime, after initial emergency aid in supplying heating fuel and food. Italy's commitment for 2000-2003 amounts to €148 million. There have also been initiatives to assist Serbia in the process of privatisation and industrial conversion as well as reforms of the financial sector.

Italy is providing a large part of its assistance to the economic sectors through trust funds with IFIs and international organisations. From the trust fund with the Bank, Italy has earmarked funds for a Risk Sharing facilty for SME development, and for MEI support.

Japan. Having commenced a grass-roots grant aid scheme in 1998, Japan stepped up bilateral assistance after the fall of the Milosevic regime. At the end of FY 2003 (March 2004), total disbursements had reached US$ 76.4 million. Most of this consists of assistance pledged at the Brussels donors' conference of June 2001: (1) the US$ 10 million in emergency relief grant aid following the fall of the Milosevic regime, and (2) US$ 50.2 million of grant aid, and US$ 10 million of humanitarian aid channelled through the UN High Commissioner for Refugees. Another US$ 1.5 million of technical assistance has also been extended for human resources development. The grant aid in (2) above has been utilised in the areas of: public transport (bus service) rehabilitation in Belgrade (US$ 15.2 million); structural adjustment (non-project type) support (US$ 12.5 million, of which US$ 1.17 million to the Republic of Montenegro); donation of medical equipment and facilities to hospitals in Belgrade (US$ 11.4 million), Novi Sad, Nis and Kragujevac; and the modernisation of the Bajina Basta pumped storage hydroelectric power plant (total US$ 11.1 million over two project phases).

B. KOSOVO[3]

1. THE BANK'S PORTFOLIO

1.1 Overview of Activities to Date

As of 31 August 2004, the Bank had a cumulative business volume of €2.9 million (operating assets of €2.5 million), representing two private sector projects (equity in ProCredit Bank, a micro-finance institution and quasi-equity investments in local enterprises through the Kosovo Reconstruction Equity Fund, co-financed with the Italian Government).

During the strategy period the Bank learned from UNMIK that it did not recognise the Bank's status in Kosovo[4]. The Bank engaged in negotiations with UNMIK to achieve a Memorandum of Understanding, as UNMIK signed with the World Bank, that would grant the Bank the same privileges and immunities as under the Agreement Establishing the Bank. However, negotiations failed as UNMIK did not agree to the Bank's tax exempt status for equity investments and for income tax of local staff. The Bank is pursuing the matter further.

1.2 Implementation of the Previous Strategy

The last strategy for the province of Kosovo, approved in June 2002, outlined the following priorities and transition goals for the Bank: (i) continued implementation of the Kosovo Reconstruction Equity Fund ("KREF"); close monitoring of the privatisation of SOEs with a view to identify enterprises for concession or privatisation where the Bank could play a role alongside a strategic investor; (ii) aim at identifying a local bank for investment while continue to support ProCredit Bank; (iii) seek to find motivated counterparts to resume the Bank's technical assistance to the telecommunication sector policy and regulation; as a follow-up the Bank was to consider investment activity in the sector, particularly mobile telephony, that would promote competition and higher quality of service.

ProCredit Bank has successfully expended its business now amidst increasing competition with the growing number of local banks and KREF continued its investments albeit with major difficulties. The Kosovo privatisation process was launched in May 2003 only to be put on hold in August 2003 due to legal problems related to Kosovo's status. The process was re-launched in July 2004 and the Bank has started discussions with some strategic investors interested in the first major privatisation transactions. The Bank has succeeded in identifying interested counterparts, as a result of transfer of most of powers in the telecommunication sector to the PISG, to be able to launch its telecommunications technical assistance project in February 2004.

1.3 Transition Impact and Lessons Learned

The resolution of Kosovo's status is crucial for the Bank's engagement in the infrastructure sector. While significant powers have been transferred to the Provisional Institutions of

[3] As defined by UN Security Resolution 1244.
[4] UNMIK reviews all international agreements signed by the State Union of Serbia and Montenegro and decides on whether it recognises them in their entirety or adapt them to Kosovo's needs or rejects them.

Self Government (PISG), UNMIK exercises oversight, particularly on legal and international issues, and administers public infrastructure. Initial progress has been made with the recent promulgation of the law on international financial agreements as a first step towards enabling IFI borrowing for Kosovo. However, succession to international financial obligations once Kosovo's status is resolved remains unclear and KTA will need to double its efforts to significantly improve management at the public utilities and UNMIK/PISG will have to focus more on economic reforms so that project identification could start for major investments in the infrastructure sector.

In terms of project impact, ProCredit Bank has approved over 41,000 loans since its opening in February 2000 for a total amount of €219 million, making it the leading lender in Kosovo. The ProCredit Bank's business policy has served as an example to the increasing number of local banks. The Kosovo Reconstruction Equity Fund's experience proved that investment conditions (e.g. property rights, customs procedures) are far from satisfactory, even for quasi-equity investments. Due to the difficult investment climate and small number of healthy private business the Fund stopped the investment period in February 2004 with committed funds not fully invested and is now concentrating on the recovery of its investments.

2. OPERATIONAL ENVIRONMENT

2.1 General Reform Environment

2.1.1 Political Developments

Following the UN Security Council Resolution 1244 of 10 June 1999, Kosovo was put under UN administration, entrusted to the United Nations Interim Administration (UNMIK) headed by the Special Representative of the Secretary General (SRSG). The Constitutional Framework for Provisional Self-Government (Reg. 2001/9 of 15 May 2001) divides powers between the SRSG (reserved powers) and Provisional Institutions of Self Government, the PISG (transferred powers). The transferred powers relate, among others, to economic and financial policy, trade, industry and investments, transport and telecommunications. However, the ultimate authority for the implementation of the UN Security Council decision lies with the SRSG, whose significant powers and responsibilities include control over Kosovo budget, customs service, international relations as well as administration of public, state or socially-owned property.

The current SRSG, Mr Soren Jessen-Petersen, took office in August 2004. Under the plan put forward in December 2003 by his predecessor, Mr Harri Holkeri, the UN Security Council is to review Kosovo's future status in mid-2005. The review will examine the province's progress towards the achievement of a set of pre-determined standards (democracy, rule of law, right to return, freedom of movement, respect for property rights, etc.). The province's Albanians want independence, while its Serbs and the government in Belgrade want it to stay under the sovereignty of Serbia and Montenegro.

2.1.2 Economic Environment

Reliable data on economic activity in Kosovo are scarce. However, it appears that economic growth slowed down in 2002-03, after a strong rebound in 1999-2001 which was driven by massive infusion of donor assistance and remittances. Recent reports on industrial activity suggest that GDP may increase only marginally in 2004. GDP per capita levels remain among the lowest in Europe. The main obstacle to growth is the lack of a resolution on Kosovo's final status. The absence of sovereign guarantees has so far prevented international investments in infrastructure and other areas in need of capital. It also has hampered privatisation and exacerbates governance problems in publicly owned enterprises. The uncertain outlook for long-term growth is also due to the lack of an overall economic development strategy, poor regional integration and political pressures on the rapid expansion of current spending.

The overall budget balance, excluding the grant financed Public Investment Programme (PIP), has been remarkably strong up to end-2003. After three consecutive years with budget surpluses, by the end of 2003 the government accumulated cash balances reached about €330 million. Increasing government revenues account for about 45 per cent of GDP, with the majority of income coming from growing VAT and excise tax collections. Government revenues significantly exceeded current expenditures in 2003, putting the current fiscal balance at a surplus of about 10 per cent of GDP. However, the authorities expect to post a fiscal deficit in 2004 of around 4.3 per cent of GDP, to be financed from the accumulated cash balances of previous years.

On the external side, Kosovo's imports, at about €1 billion, are many times higher than exports (mostly food and metal scraps), leading to a very large trade deficit. Inflows of remittances (about 40 per cent of GDP) and income from donor related employment help reduce the current account deficit to about 50 per cent of GDP, excluding grants. This is financed mainly by the still substantial amounts of foreign aid (funded mainly by the EU and other bilateral donors), without recourse to borrowing or other balance of payment support. Decreasing foreign aid is expected to limit Kosovo's imports, shrinking the trade deficit over the next few years.

2.1.3 Labour and Social Conditions

Kosovo is densely populated, with an estimated 1.9 million people occupying a territory of 10,887 km^2 (about 175 people per square km). About 60 per cent of the population live in rural areas and about 42 per cent are below the age of 20. Kosovo has a diverse ethnic distribution. About 88 per cent of people are Albanian, 7 per cent Serbian, about 1.9 per cent Muslim Bosniaks, 1.7 per cent Romas, and about 1 per cent Turkish.

According to the World Bank, in 2002, approximately 36 per cent of the population of Kosovo were living below the poverty line of US$1.65 per adult per day. Although less common, extreme (food) poverty was an important problem, as about 15 per cent of the population lived below the line of 2100 calories per adult per day. This assessment was mirrored by the November 2003 report by Riinvest, which claimed that over 50 per cent of Kosovars were not able to meet other needs than food and clothing, and approximately 12 per cent of the population were not even able to meet their needs for food. The most vulnerable groups include landless, disabled, those with little education, as well as female-headed households and households with large number of children. Poverty also correlates with ethnicity, with non-Albanian and non-Serb population being most affected. Despite the large fraction of poor people, Kosovo does not appear to have substantial income disparities.

High unemployment remains one of the most important problems in Kosovo. In November 2002, there were 256,000 registered unemployed, constituting about 43 per cent of the workforce. Of the 341,000 employed, about 145,000 worked in agriculture (43 per cent) and 85,000 in private enterprises (25 per cent). In 2003, about 70,000 people were employed by central and local government, receiving an average salary of about €180 per month. Although more recent official reports indicate that over 50 per cent of the workforce is not formally employed, the World Bank estimates that, taking into account subsistence farming and informal economy, the number of people looking for employment is between 20 and 30 per cent of the workforce. Unemployment is particularly high among youth, with large numbers of new job seekers entering the workforce each year.

The social security network is under construction, with disability pension scheme to be introduced in 2004. In 2003, the government paid pension benefits to about 100,000 people at an average €36 per month. About 5,500 war invalids received an average €65 per month, while about 50,000 families benefited from social assistance of about €53 per month. The healthcare system remains underdeveloped. UNICEF estimates indicate that as many as 35 out of 1000 children die below the age of five, constituting the highest rate of infant mortality in Europe. There are also significant gender disparities. Although gross primary school enrolment rates are approximately 90 per cent for both boys and girls, at the secondary level just over half of all girls are enrolled in school, compared to almost 75 per cent of boys.

2.1.4 Environmental Issues

At the end of the conflict in 1999, the United Nations Mission in Kosovo (UNMIK) started formulating a sustainable development policy. UNMIK's aims are to establish mechanisms to incorporate environmental concerns in the regular work and projects of all Administrative Departments. The Department of Public Services is primarily responsible for the overall management of Public Services in Kosovo and the implementation of policy guidelines formulated by the Interim Administrative Council in the field of public services.

One of the main sources of pollution in Kosovo is the industrial sector which has give rise to air, water and soil contamination exacerbated by outdated production techniques. The level of degradation and endangerment of the environment has been disproportionately greater than the economic development that has been achieved. The environmental situation jeopardizes further sustainable growth in the territory.

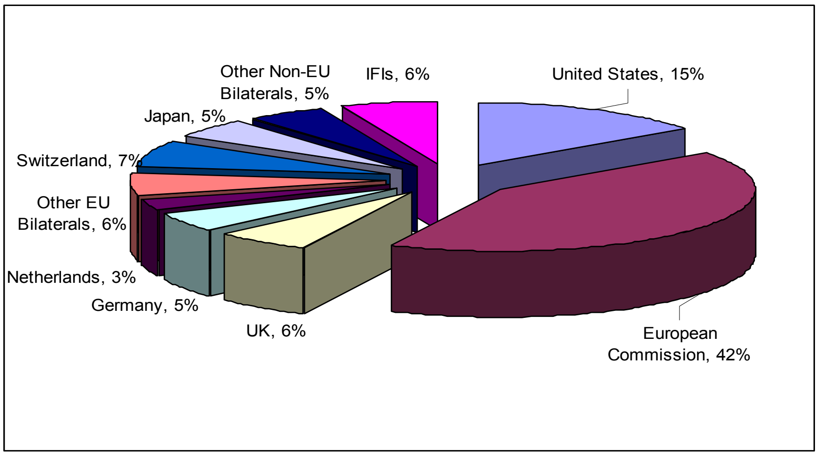
UNMIK has defined three environmental priorities: (i) re-establishment of Institutes to monitor air, water, soil and food pollution; (ii) raising public environmental awareness and (iii) environmental assessment of coal mining and combustion in Kosovo.

Given the low level of large scale of industrial activity at present and limited scope for its significant development in the short term, the Bank has mainly supported the establishment and growth of the small and medium enterprise sector since the end of conflict. Environmental due diligence has been a key component in the institutional strengthening of the local financial sector. Such capacity building, accompanied by monitoring, will probably continue over the next few years.

2.1.5 Donor Assistance

Donor funding plays crucial role in the economy of Kosovo. In total, donors had disbursed over US$ 3.5 billion by end-2003 to support reconstruction and recovery. Direct contributions to the budget and to the public investment programme (excluding UNMIK costs) have amounted to over US$ 2.2 billion. The European Union is, by far, the single largest donor. In 1999 the EU provided €378 million in emergency humanitarian assistance for the victims of the Kosovo crises and further €127 million for reconstruction programmes. This support was continued in 2000 and 2001, when €360 million and €350 million were earmarked. The major reconstruction projects, financed through the European Agency for Reconstruction (EAR), included re-establishment of the energy supplies, rehabilitation and reconstruction of roads, environmental investments, housing and agriculture. The United States has been the second largest donor, followed by Switzerland and the United Kingdom (see Figure 2.1). From IFIs, the largest amounts were committed by the Worlds Bank in grants (about 3% of total commitments) and the Islamic Development Bank (about 2% of total commitments).

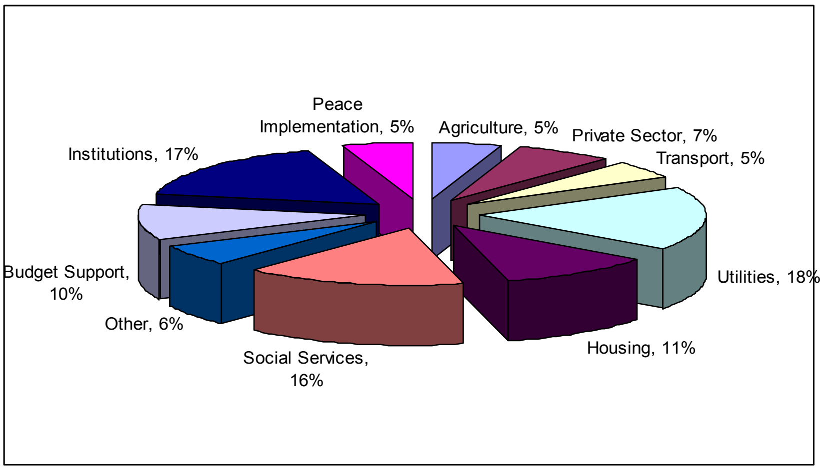
Figure 2.1: Pledges to Kosovo by donors



Source: Transitional Support Strategy for Kosovo, World Bank, 2004

The majority of donor commitments have been allocated to improving public utilities, especially electricity, and to strengthening institutions. Social services (including education, health and water supply), housing reconstruction, agriculture, transport and private sector development have also been other important areas of the donor reconstruction effort (see Figure 2.2).

Figure 2.2: Donor support by sectors 1999-2002



Source: Transitional Support Strategy for Kosovo, World Bank, 2004

2.2 PROGRESS IN TRANSITION AND THE ECONOMY'S RESPONSE

2.2.1 Transition Success and Transition Challenges

2.2.1.1 Enterprise sector

One of the main transition challenges for the enterprise sector is the privatisation of socially-owned enterprises (SOEs). UNMIK and the PISG need to work together to ensure that the re-launched privatisation process works well and that differences in views regarding the Kosovo Trust Agency's (KTA) approach to recognising pre-1999 property rights and KTA's operating procedures do not cause further undue delays. It must, however, be ensured that SOEs are not put in private hands before first introducing appropriate regulation and legal framework for their operations.

Other challenges include: (i) improvement of law enforcement, particularly in respect to private contracts and security pledges, (ii) reduction of unfair competition from informal economy; (iii) improving access to finance for small- and micro- enterprises; and (iv) reconstruction of dilapidated and destroyed infrastructure, mainly in the power sector, essential to run competitive businesses.

2.2.1.2 Financial sector

The transition challenges ahead are as follows: (i) introduce stronger private competition in the market, (ii) bring institutional strengthening to the local banks, in particular the establishment and implementation of appropriate credit and risk management policies, meeting increasing local demand for trade financing and consumer loans, and (iii) strengthen the regulatory and supervisory environment, including introduction of new laws on leasing and other financial instruments.

2.2.1.3 Infrastructure

The main transition challenges in the infrastructure sector are: (i) commercialisation and/or professional management support to the utilities, and (ii) private sector participation. Commercialisation of the utility companies in Kosovo becomes increasingly critical, which is particularly visible for the electricity company, KEK. Since autumn 2003 KTA has increasingly focused on improving management of the public enterprises. Prishtina Airport incorporation has started, to be followed by PTK (the telecom operator). New PTK management has been hired to provide more extensive international expertise in key areas (strategy, investment, finance, legal). KTA has recently with the support of EAR funding, contracted the support of an international utility (ESBI) to KEK both to enable the power company to significantly improve its operations (secure electricity supply, much improved collections) and to keep pace with the development of a regional electricity market in south-eastern Europe. KTA is also moving to the corporatisation of KEK in 2005. An invitation for expressions of interest in a license for a second mobile telephony operator was launched early 2004 and several well-known investors have replied. However, the process was suspended in summer 2004 due to alleged irregularities. In addition, meaningful progress in this area is dependent upon continued UNMIK support and solving issues related to Kosovo's status (e.g. numbering/access code administration and frequency spectrum management, status of Mobtel, a Serbian operator, on Kosovo's territory) as much as upon regulatory environment and the potential investors.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

The Bank will seek to support the efforts of UNMIK and PISG towards progress on Kosovo's reform agenda, in particular through participation in the Economic Strategy and Project Identification Group (consisting of representatives of UNMIK, PISG, IFIs and other donors). However, UNMIK will need to recognise EBRD's status in Kosovo if it wishes the Bank fully to engage.

Over the coming two years the following activities and sectors will be the main priorities:

- The Bank will continue its due diligence at **local private banks** with a view to starting a Trade Facilitation Programme that could be expanded to include credit lines, under an EU/EBRD Western Balkans SME facility, and possibly equity investments.

- A **TAM/BAS Programme**, supported by the European Agency for Reconstruction, is being developed. This Programme will relate to other initiatives funded by the EU, including institution building in the Ministry of Trade & Industry, as well as the asset and liability restructuring activities of the KTA. Some 15 enterprises are likely to be assisted with commercial and sectoral activities. Support for smaller enterprises will be related to the BAS Programme and to EU and US funded activity on development of Regional SME Agencies, and competitiveness.

- In **the infrastructure** sector, the Bank will support the local authorities to establish a telecommunications regulatory agency, implement modern standards and identify solutions for international connectivity of the local telecommunications networks, subject to co-operation from the relevant authorities, including UNMIK, and obtaining comfort with respect to the resolution of property rights/international issues with direct relevance.

- The Bank will also seek to identify areas in the **energy** sector where it could provide technical assistance which may eventually lead to investments once a clear strategy for improving collections and establishing a cost recovery regime within KEK has been established.

- The Bank will also continue monitoring any progress with the privatisation of socially owned enterprises (SOEs) and explore potential projects with strategic investors.

4. OTHER IFIS AND MULTILATERAL DONORS

The Bank will pursue the proposed operational objectives in close co-operation with the other IFIs, the European Union and bilateral donors in order to enhance the opportunities for the implementation of its strategy.

Annex 1

Signed EBRD commitments in Serbia and Montenegro, 31 August 2004

Operation Name	Public/private sector	Loan/ equity	EBRD Financing (Euro mm)	Signing date
Public sector				
Energy				
EPS Emergency Power Sector Reconstruction	State	Loan	100	25 Oct 01
EPS Power II	State	Loan	60	21 Oct 03
	Subtotal		**160**	
Municipal infrastructure				
Belgrade District Heating Rehabilitation Programme	State	Loan	20	27 July 01
Belgrade Municipal Infrastructure Reconstruction Programme	State	Loan	40	27 July 01
City of Kragujevac Municipal Infrastructure Reconstruction Programme	State	Loan	5	27 June 02
City of Nis Municipal Infrastructure Reconstruction Programme	State	Loan	6	27 June 02
City of Novi Sad Municipal Infrastructure Reconstruction Programme	State	Loan	5	27 June 02
Transport				
ZTP	State	Loan	57	25 Oct 01
Republic of Serbia: Road Recovery Project	State	Loan	76	31 July 02
Montenegro Airports: Urgent Rehabilitation Plan	State	Loan	11	12 Dec 03
	Subtotal		**220**	
Private sector				
General Industry				
Tigar Pirot	Private	Loan	1.8	28 Nov 01
Hemofarm A.D.	Private	Loan	18	12 April 02
DIF-Progas	Private	Equity	0.4	25 July 02
Pre-Privatisation loan for Kombinat Aluminium Podgorica	State	Loan	3	12 Dec 03
Hemofarm A.D. Russia	Private	Loan	22	29 April 04
Carmeuse	Private	Equity	2.2	26 Aug 04
	Subtotal		**47.4**	
Agribusiness				
Marbo	Private	Loan	7	1 April 03
Fresh&Co	Private	Equity	12.5	27 June 03
SFIR (Fabrika Secera Te-To Senta A.D.)	Private	Loan	9	25 July 03
SFIR (Star Secer A.D.)	Private	Loan	7	25 July 03
Grand	Private	Loan	2.8	6 Nov 03
Serbia/EPH/2003/Warehouse Receipt Programme	Private	Loan	6	19 Dec 03

Frikom	Private	Loan	10.1	21 Jan 04
Lura Group	Private	Loan	8.5	7 May 04
	Subtotal		**62.9**	
Property and Tourism				
ORCO Aparthotels	Private	Equity	1.9	7 Mar 03
GTC House Belgrade	Private	Loan	5.1	12 Sep 03
TUI advance Payments	Private	Loan	0.4	19 Dec 03
	Subtotal		**7.4**	
Telecommunications				
SBB	Private	Loan/ Equity	10.2 1	7 June 04
	Subtotal		**11.2**	
Kosovo				
KREF: Alplast	Private	Equity	0.3	5 Jan 01
KREF: Elsa	Private	Equity	0.3	9 April 01
KREF: Rezonanca	Private	Equity	0.3	30 July 01
KREF: Guri i Kuq	Private	Equity	0.1	12 Nov 01
KREF: Medita NTP	Private	Equity	0.3	6 Feb 02
KREF: Fetoshi	Private	Equity	0.3	1 Mar 02
	Subtotal		**1.6**	
Financial Institutions				
Black Sea Fund	Private	Equity	2	26 Aug 98
US/EBRD SME – ProCredit Bank (Form. MFB Serbia	Private	Loan/ Equity	6.2 3.3	29 Mar 01
Regional TFP: Raiffaisenbank a.d.	Private	Loan	1.2	27 Nov 01
Regional TFP: Eksimbanka a.d.	Private	Loan	2.8	7 Dec 01
Regional TFP: Euromarket Banka	Private	Loan	0.5	7 Jan 02
Raiffeisen Bank Yugoslavia	Private	Loan	12.5	16 Jan 02
Eksimbanka Equity Investment	Private	Equity	1.3	28 Feb 02
Black Sea Fund - Capital Increase	Private	Equity	2.1	31 May 02
Euromarket Banka	Private	Loan	1	19 Dec 02
Euromarket Banka Equity (Capital Increase)	Private	Equity	1.4	19 Dec 02
VB Serbia Equity	Private	Equity	2.5	9 Sep 03
Eksimbanka Capital Increase	Private	Equity	0.7	30 Oct 03
US/EBRD SME – ProCredit Bank (Form. MFB Serbia	Private	Loan	5.9	10 Dec 03
Societe Generale Yugoslav Bank sub.debt.	Private	Loan	8.5	19 Dec 03
Eksimbanka senior debt facility	Private	Loan	3	17 Dec 03
US/EBRD SME – Opportunity Bank	Private	Loan	2.7	19 Dec 03
US/EBRD SME – Alter Modus	Private	Loan	0.9	17 Mar 04
Advent Central &Eastern Europe Successor Fund	Private	Equity	5	25 June 04
Raiffeisen Bank Mortgage Loan	Private	Loan	10	4 Aug 04
	Subtotal		**73.5**	
Kosovo				
ProCredit Bank Kosovo (Formerly MEB)	Private	Equity	1.3	17 Oct 01
	Subtotal		**1.3**	
	TOTAL		**585**	

<u>**Annex 2**</u>

<u>EBRD TC Funds and Official Co-financing</u>

TC Funds and Donors

Aggregate commitments through December 2003

DONOR	€Committed
USA	4,493,891
Italy	3,386,032
Canada	2,200,000
European Agency for Reconstruction (EAR)	1,200,000
United Kingdom	829,800
France	799,896
The Netherlands	638,814
Switzerland	463,187
Austria	341,550
Ireland	260,764
Germany	180,961
Sweden	164,401
Balkan Regional Special Fund (BRSF)	151,568
Luxembourg	149,658
Norway	132,380
Denmark	130,600
Spain	19,981
TOTAL:	**15.9 million**

Official Co-financing and Donors

Signed projects through December 2003

DONOR	€Committed
European Investment Bank	185,900,000
Germany	40,049,728
Poland	15,000,000
Switzerland	12,900,000
Japan	12,000,000
European Union	8,700,000
IFC	7,928,912
The Netherlands	2,919,728
Sweden	2,112,000
Taiwan	700,000
Italy	500,000
USA	400,000
TOTAL:	**289.1 million**

Annex 3

Political Assessment

Serbia and Montenegro is a constitutional democratic republic set up under a Constitutional Charter, negotiated with EU mediation in March 2002 (the Belgrade Agreement). The new common state, which began to function officially on 4 February 2003, is made up of the Republic of Serbia and the Republic of Montenegro. It replaced the Federal Republic of Yugoslavia (FRY), which had come into being in 1992 after the break-up of the Socialist Federal Republic of Yugoslavia (SFRY), a federation of six republics (Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia and Slovenia) and two autonomous provinces (Kosovo and Vojvodina). The State Union of Serbia and Montenegro has a 126-seat single-chamber Federal Assembly, with 91 seats allocated to Serbia and 35 to Montenegro. The Assembly's members were chosen by the parliaments of the two republics to serve for two years. Direct elections for the Assembly are scheduled for February 2005. The President of the new common state, Svetozar Marovic from Montenegro, was elected on 7 March 2003 for a four-year term. He heads a six-member Council of Ministers responsible to the Assembly. The State Union is responsible for foreign policy, the armed forces, human and minority rights, and foreign economic and commercial relations. The main offices of the common state are held by the coalition headed by the Democratic Party of Serbia (DSS) and the Democratic Party of Socialists (DPS) from Montenegro. Under the 2002 Belgrade Agreement, a referendum can be held both in Serbia and in Montenegro within three years to determine whether to continue with the common state or to dissolve it.

If it should be dissolved, the province of Kosovo, currently an international protectorate though formally part of Serbia and Montenegro, reverts to Serbia. In June 1999, after the end of NATO's bombing of FRY and its acceptance of a peace plan and the withdrawal of Yugoslav security forces from Kosovo, the UN authorised, under Security Council Resolution 1244, the setting up of the UN Interim Administration Mission in Kosovo (UNMIK) and the deployment of the NATO-led Kosovo Force (KFOR). Kosovo's political institutions enjoy a limited autonomy. UN Security Council Resolution 1244 upheld formal Yugoslav sovereignty pending a final decision over the province's status. Most of the province's ethnic Albanians, who had been expelled by (or had fled from) the Milosevic regime in 1999, have returned. In contrast, very few of the Serbs, Roma and some other minorities who had left Kosovo before or during the withdrawal of the Yugoslav forces in 1999 have returned. The Serbs now living in Kosovo want to see the province's pre-1999 link to Serbia restored, while the majority Albanian population wants independence. The province's status is due for official UN review in 2005.

Serbia has a 250-seat parliament. Prime Minister Vojislav Kostunica, leader of the DSS, assumed the post of Prime Minister in March 2004, following parliamentary elections in December 2003. His minority coalition also includes the G17-Plus and the Serbian Renewal-New Serbia (SPO-NS) alliance. The DSS holds the main political and security posts, while G17-Plus is in charge of economic policy. Initially, the government depended for its parliamentary majority on the Socialist Party of Serbia (SPS), whose leader is former President Slobodan Milosevic. The Serbian Radical Party (SRS) is the largest party in parliament. Its leader, Vojislav Seselj is currently awaiting trial at The ICTY. The SRS is in opposition, but supports the government from time to time. The Democratic Party (DS) of former Prime Minister Zoran Djindjic, assassinated in March 2003, is also in opposition. In the December 2003 election, it was placed third – after the Seselj Radicals and Kostunica's DSS. The rule that at least 50% plus one voters must turn out for the elections to be valid, responsible for three recent failed presidential elections, has been abolished in the run-up to the presidential elections on 13 June. The post, largely ceremonial but also influential, had been vacant since December 2002. The outcome in the second round on 27 June was a victory for the DS candidate, Boris Tadic. Mr Tadic has promised that the DS will support the government in parliament for the time being provided it sticks to a reform agenda.

Montenegro is a democratic republic, with a legal system based on the 1992 Montenegrin Constitution. It has a single-chamber 75-seat parliament. The government is headed by Prime Minister Milo Djukanovic, who had for a number of years held the office of President. Following parliamentary elections in October 2002, Djukanovic formed in January 2003 a coalition government, comprising the Democratic Party of Socialists (DPS) and the Social Democratic Party (SDP). Filip Vujanovic, former Speaker of the Montenegrin Parliament, was elected President in a direct election in May 2003. Previous direct presidential elections in December 2002 and February 2003 had been declared invalid owing to low voter turnout.

International relations

The fall of the regime of President Slobodan Milosevic in October 2000 marked the beginning of a new chapter in Serbia and Montenegro's relations with the immediate neighbours – not least with Bosnia and Herzegovina, Croatia and Albania. High-level visits have been exchanged with Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania. An agreement finalising the border between Serbia and FYR Macedonia was signed in early 2001. There are now free-trade agreements with all the above-mentioned regional neighbours (that with Croatia came into force on 1 July 2004). Visas between Serbia and Montenegro and Croatia were suspended in 2003 and will remain so at least until the end of 2004. Political and trade relations with Slovenia are also developing satisfactorily, while those with Romania are close. Political and economic relations with Russia have started developing fast under the Kostunica government. International economic and financial sanctions imposed by the West during the Milosevic era were lifted in the wake of Milosevic's downfall and the doors to international financial institutions were opened for Serbia and Montenegro.

In September 2003 the European Commission in Brussels agreed to consider a feasibility study, a key document before starting negotiations about a Stabilisation and Accession Agreement (SAA) with the EU. However, the country has not yet been given the green light for the feasibility study. At the end of the EU Foreign Ministers' meeting on 18 May 2004, reference was made to the slow progress in the implementation of the 2002 Constitutional Charter and the Action Plan for economic harmonisation between Serbia and Montenegro, which the EU demands. Mention was also made of the inadequate cooperation with the International War Crimes Tribunal at The Hague. However, in October 2004, the EU foreign ministers adopted a "twin-track" approach to negotiations with Serbia and Montenegro on the feasibility study.

In June 2003 Serbia and Montenegro applied formally for membership of NATO's Partnership for Peace (PfP) Programme as a first step towards full membership of the

Alliance. NATO's conditions are progress with the modernisation of Serbia and Montenegro's armed forces and full cooperation with the Hague Tribunal. More specifically, the arrest and extradition of General Ratko Mladic, former commander of the Bosnian Serb forces, remains a pre-condition for further steps in that direction. Failure to step up the cooperation with the Hague also threatens some sectors of US financial assistance to Serbia and Montenegro and risks losing US support in institutions such as the IMF. Hague-related demands by the West are meeting considerable public resistance in Serbia, which is to an increasing extent reflected in official government policy. This, in turn, threatens to slow down some aspects of economic and financial cooperation with the West.

Investment climate

The reform of the judiciary and the fight against organised crime were the stated priority of the post-Milosevic governments of Zoran Djindjic and of Zoran Zivkovic (who succeeded Djindjic as Prime Minister after the latter's assassination in March 2003). It is also the stated aim of the government of Vojislav Kostunica who became Prime Minister in March 2004. But it is fair to say that much of the reforming momentum generated by the toppling of the Milosevic regime in October 2000 has been lost by now in Serbia – though not in Montenegro. However, in both republics, there continues to be a widespread lack of public confidence in the judicial system, a legacy of the system's structural weaknesses dating back to the Socialist period but also of its abuse during the Milosevic era. Ironically, the cause of the urgently needed judicial reform may to some extent have been harmed by the measures committed in the name of the defence of the rule of law under the state of emergency proclaimed immediately after the assassination of Prime Minister Djindjic in March 2003.

As part of an operation codenamed Sablja (Sabre), police questioned 10,111 people and detained 2,599. Criminal charges were laid against 3,500 persons suspected of having committed about 5,900 criminal acts. By the end of August 2003, 45 individuals were indicted. The state of emergency did make possible the investigation of individual cases of misconduct or corruption of judges and prosecutors, but also led to wider, more structural measures (including legislative and personnel changes) that were based on irregular procedures. Additional measures following upon the proclamation of the state of emergency allowed for suspension of court presidents and prosecutors, bypassing the normal legal procedures. Replacements were appointed and their tenure subsequently confirmed as permanent. In March 2003, the Serbian parliament retired 35 judges (including one from the Supreme Court) but did so without the legally required involvement of the Supreme Court. Legislative changes were also made under the state of emergency, but remained in force after its lifting on 22 April 2003. The status of prosecutors was changed and the role of the government in their appointment increased. The independence of court presidents was undermined through the setting up of an administrative body – the Council for Court Administration – which was put in charge of their appointment and dismissal. The current Kostunica administration claims that most of what was done under the state of emergency by the then Democratic Party-led government was politically motivated and is now in the process of carrying out a wholesale revision.

However, for all its shortcomings, the 2003 state of emergency did reveal the pervasiveness of organised crime and the connection between organised crime and war crimes, both a legacy of the past. Having penetrated the official structures of the former Milosevic regime, they continue to burden the new post-Milosevic authorities, Progress in setting up comprehensive and harmonised legal and institutional mechanisms for fighting corruption and organised crime has been limited, according to the European Commission's staff working paper on Serbia and Montenegro published in early 2004. The Commission paper began by noting that corruption continues to be an area of major concern both in Serbia and in Montenegro. It welcomed the adoption of the Law on Combating Organised Crime in Serbia in July 2002, the Law on the Financing of Political Parties in Serbia in July 2003 and the Anti-Money Laundering Law in Montenegro in September 2003 as progress in legislative terms. According to the Working Paper, the same applies to the adoption of the Law on Public Procurement in Serbia in July 2002. However, those laws need to be fully enforced. Other key anti-corruption measures, such as codes of conduct for public servants and laws on prevention of conflict of interest, still need to be adopted in both republics. This legal vacuum accounts for the failure to react to some serious allegations, involving top government officials and ministers. Comprehensive anti corruption strategies are still lacking, in the EU Working Paper's view, while existing institutions in the anti-corruption filed lack political support and are sometimes obstructed – even by government.

According to the US Department of State report on human rights practices in Serbia and Montenegro published in February 2004, the country serves as a transit country and, to a lesser extent, a country of origin and a destination country, for trafficking in women and girls for the purpose of sexual exploitation. Serbia is primarily a transit country for internationally trafficked women going to Kosovo, Bosnia and Herzegovina, and Western Europe. The primary source countries for trafficking in persons were Moldova, Romania, Ukraine, Russia and Bulgaria. Serbia did not traditionally serve as a major country for trafficked women, but poor economic conditions have increased Serbian women's vulnerability to traffickers, particularly for Roma. Trafficking in children for use in begging and in theft rings is a problem among Roma. There were no reports of government officials condoning, or participating in, trafficking in Serbia, but trafficking in Serbia could not take place without at least some police, border guards and minor officials In 2002 12 police officers who were providing security at venues where trafficked women were present were arrested during raids. Criminal charges were filed against one of the officers, and the others were fined, suspended or sacked. Since the dissolution of the FRY, the position of Anti-Trafficking Coordinator has moved from the federal to the republican level. The coordinator leads a multi- disciplinary anti-trafficking team which includes many Serbian government Ministries, the OSCE and two local NGOs

Serbia and Montenegro (without Kosovo) was ranked in 97th place out of 146 countries in the 2004 Transparency International's Corruption Perceptions Index (released in October 2004), which deals with perceptions of public-sector corruption by business people, analysts and academics. Serbia and Montenegro shares this ranking with FYR Macedonia and several other countries. Only Albania among south-eastern European countries has a lower ranking.

Annex 4

Legal Transition

COMPARATIVE ASSESSMENT OF SERBIA AND MONTENEGRO'S COMMERCIAL LAW

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annexe presents a summary of the results for Serbia and Montenegro, accompanied by critical comments of the Bank's legal experts who have conducted the assessments. Where appropriate, an assessment is provided separately for each of Serbia, Montenegro and Kosovo.

Capital Markets

The primary legislation governing the securities market of **Serbia and Montenegro** is the Securities and Other Financial Instrument Market Act (Službeni list SRJ No. 65/2002, Službeni glasnik RS 57/03) (the "Securities Act"), which came into force on 1 October 2003. This law replaces the previous Securities Law of 1995 ("Službeni list SRJ", No. 26/95 and 59/98) and Law on Stock Exchanges, Stock Exchange Operations and Stock Exchange Intermediaries of 1994 ("Službeni list SRJ", No. 90/94). The Securities Act regulates the terms and conditions for public offering, distribution and trading of securities as well as the rights and obligations and legal status of the legal entities and individuals authorised to deal with securities. In addition, the Securities Act also provides for the regulation and organisation of certain financial intermediaries (including stock exchanges and central registry) as well as regulatory and supervisory bodies on the financial markets.

Originally founded in 1894, the Belgrade Stock Exchange (the "BSE") was closed in the early 1950s and reopened in 1990. The BSE is established as a joint stock company and licensed by the Securities and Exchange Commission. The BSE is responsible for enacting listing, trading, clearing and settlement rules governing its operations, as well as disciplinary rules that govern the conduct of its members.

To regulate the financial sector of **Kosovo**, the United Nations Interim Administration Mission in Kosovo ("the UNMIK") promulgated Regulation (No. 1999/20) "on the Banking and Payments Authority of Kosovo" in November 1999, which was subsequently amended (and essentially replaced) by Regulation No. 2001/24 issued in October 2001. Pursuant to Regulation No. 2001/24, the Banking and Payment Authority of Kosovo (the "BPK") is established as a legal entity having operational and administrative autonomy. The objectives of the BPK are to foster (1) an efficient and safe system for domestic payments and (2) the liquidity, solvency and efficient functioning of a stable market-based financial system, including regulating banks, insurance companies and other financial institutions. To fulfil its objectives, the BPK is given specific powers to, among others, license, supervise and regulate financial institutions operating in Kosovo.

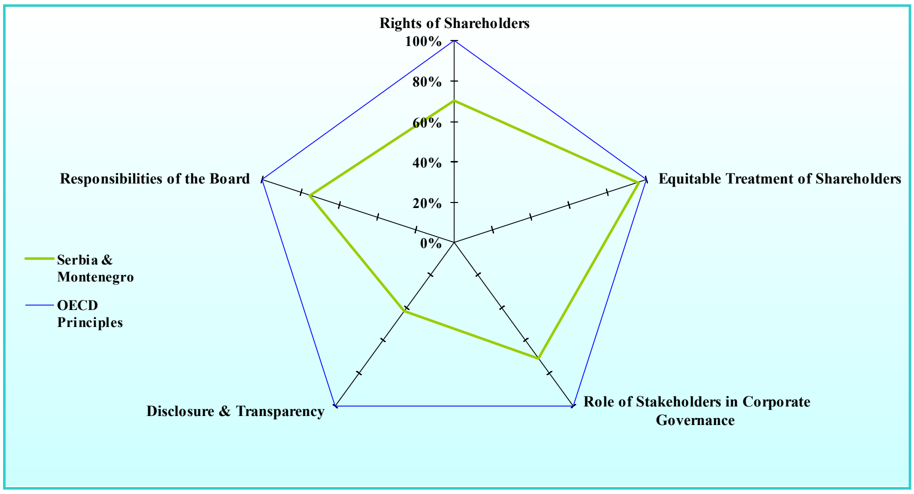
Company Law and Corporate Governance

A Law on Enterprises, currently mainly applicable in **Serbia**, was promulgated in 1996, with subsequent amendments in 1997, 1998, 1999, 2001 and 2002. Under this law, six different types of institutions can be established, namely, general partnership, limited partnership, limited liability company, joint stock company, socially owned enterprise and public enterprise.

In **Montenegro**, an earlier version of the federal Law on Enterprises promulgated in 1996 is still in force. Four forms of association are permissible under the Law on Enterprises: unlimited partnership, limited partnership, limited liability company and joint stock company.

According to the 2003 results of the EBRD's Corporate Governance Sector Assessment Project, **Serbia and Montenegro** is a country whose existing corporate governance related laws (i.e., "law on the books", not how the relevant legislation is being implemented) when compared to the OECD *Principles of Corporate Governance* were rated among "medium compliance" countries. General reform priorities for countries in this category are to improve effective implementation and enforcement of existing legislation, while continuing to reform their existing laws. The above assessment highlighted in particular the need to enhance disclosure and transparency mechanisms in the current legislation (see chart below).

Quality of corporate governance legislation - Serbia and Montenegro (2003)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the 'web', the closer the corporate governance laws of the country approximates these principles.

Source: EBRD Corporate Governance Legal Assessment, 2003

It is worth noting that compared to the 2002 assessment results, Serbia and Montenegro obtained an improved rating in 2003. This was due to the promulgation of a new accounting and auditing law and a new Securities Act previously mentioned. However, while the Securities Act introduced changes which helped enhance the country's legal framework governing certain corporate governance issues, the implementation of this law in practice remains seemingly problematic. One reason is that a number of provisions of this new law are not consistent with the requirements of the existing company law. Accordingly, the Government of the Republic of Serbia was reported to have formed a group of legal experts to draft a new company law, which will hopefully be adopted in 2004.

The main legislation serving as company law in **Kosovo** is Regulation (No. 2001/6) "on Business Organisations" promulgated by the UNMIK in February 2001, which is supplemented by Administration Direction No. 2002/22 issued in October 2002 concerning the establishment of establishing the Kosovo Registry of Business Organisations and Trade Names. According to Regulation 2001/6, a business organisation in Kosovo can be established in the form of a personal business enterprise, a general partnership, a limited partnership, a joint stock company or a limited liability company.

Concessions

Both Serbia and Montenegro have recently adopted new concession laws in an attempt to address drawbacks of previous versions dating back to the 1990s. Such attempts have not however been entirely successful and further reform is recommended. The two republics have separate laws, published in the Official Journal of Serbia No 55/2003 and in the Official Journal of Montenegro No 30/2002 respectively.

The **Serbia** Concession Law sets out a fairly comprehensive framework for the development of concessions in Serbia: it clearly defines sectors, activities and entities which could be developed by way of concessions, as well as the selection process. Nevertheless, the 2004 EBRD Concession Law Assessment project that includes an analysis of Serbia's and Montenegro's legal systems among the EBRD's 27 countries of operations, revealed a few areas that fall short of the good standards against which regimes were benchmarked and that should be improved. In particular, it suffers from the following deficiencies : (i) the law does not clearly define its boundaries and coordination with the sectoral legislation and the Municipal Activity Law provisions; (ii) a lack of coordination with Public Procurement Law; (iii) the possibility of pre-qualification procedure should be specifically provided. The law seems to be designed for big projects such as infrastructure (the award procedure being very much centralised), as opposed to small-sized municipal concessions.

The **Montenegro** Law on Participation of Private Sector in Performing Public Services governs concessions, Build-Operate-Transfer (BOT) arrangements, management and leasing contracts, where concessions seem to be applicable to natural resources only. The law provides for a special regime for each of these arrangements (for management and certain leasing contracts referring to public procurement rules). The law seems to be a combination of different pieces of legislation (in particular, the chapter regulating concessions seems inspired by the Serbia Concession Law) and lacks clarity; certain provisions are repeated, others are conflicting, and a number of public bodies are involved. The results of the above mentioned 2004 EBRD Concession Law Assessment reveal, amongst other deficiencies, that the law does not represent a coherent piece of legislation regulating private sector participation, appears difficult to implement in practice and would therefore benefit from being redrafted, even though many issues are covered.

There is no separate concession law in **Kosovo**. Pursuant to UNMIK Regulation 1999/24, the Kosovo Trust Agency (KTA) is authorised to "grant concessions or leases with respect to enterprises," as long as these concessions are appropriate "to preserve or enhance the value, viability, or governance of the enterprise concerned." It seems that in practice no concessions have been granted so far. The Serbian 2003 Concession Law is not applicable to Kosovo, so that the applicable framework would likely be based on the old Yugoslav legislation. A recently approved package of energy laws introduces a system of licenses in the energy sector.

1.1 Insolvency

According to the Constitutional Charter of the State Union of Serbia and Montenegro, each republic has legislative competence in the field of bankruptcy.

Insolvency (bankruptcy) in **Serbia** is still governed by the *Act on Compulsory Composition with Creditors, Bankruptcy and Liquidation* (the "Serbia Bankruptcy Law") of 1989, as amended in 1993 and 1996. Although a new insolvency law for Serbia has been drafted, it appears to be stalled in the legislative process (at the time of writing this annexe). The Serbia Bankruptcy Law appears quite flexible in that it provides for three different types of processes: compulsory composition (re-organisation initiated by either the debtor or a third-party), bankruptcy (a third-party initiated wind-up) and liquidation (a debtor initiated wind-up). The law on the books seems to favour re-organisation (as a composition can be initiated, if it appears viable, even after a bankruptcy proceeding has commenced) but not at the expense of the creditors as a composition plan requires approval of creditors representing more than 50% of the outstanding debt.

Where the Serbia Bankruptcy Law demonstrates some limitations is at the more advanced level. Foreign insolvency proceedings in respect of a corporation incorporated in Serbia are not recognised. Arrears of wages owed to employees, up to a maximum amount that can be prescribed by the government at any time, enjoy priority over unsecured creditors. In addition, there is no mechanism in the law to provide for funds to be advanced to the debtor on a priority basis after the filing for bankruptcy. Given this limitation, it is difficult to see how a fully leveraged company could, practically speaking, complete a restructuring as it would likely face incredible difficulties in obtaining working capital to fund its restructuring. Some of these problems would be addressed by the draft of the new law referred to above. Specifically, the issue of post-filing priority financing is adequately dealt with in the current draft while recognition of foreign insolvency proceedings remains unaddressed.

Insolvency in **Montenegro** is governed by the Law on Business Organisation Insolvency (the Montenegro Bankruptcy Law) which came into force on 2 July 2002 and replaced and superseded the Yugoslav (now Serbian) insolvency legislation discussed above. As with Serbia, the Montenegro Bankruptcy Law provides for self-induced or creditor induced liquidations and re-organisations, administered by an insolvency administrator. The Montenegro Bankruptcy Law also provides, however, that, upon the approval by the court of a plan for orderly self-liquidation, the debtor may liquidate itself. Assuming that, in practice, plans for orderly self-liquidation are carefully scrutinised by the court, this is an excellent means of keeping the costs of liquidation at a minimum (and therefore increasing potential returns to creditors). There appears to be considerable room for abuse of liquidation proceedings or the threat thereof as the law appears to be silent on what conditions must be present for a debtor to file for liquidation and poses a very low threshold of overdue debt (€2,500) for creditors to file for liquidation. Unlike either Serbia or Kosovo, Montenegro provides for extensive recognition and cooperation in respect of cross-border insolvencies. Upon application to the court, for example, an order may be made recognising a foreign proceeding and entrusting the administration of the debtor's assets located in Montenegro to a foreign insolvency administrator.

There is still very little information as to how this new law functions in practice, the ultimate test to assess the success of the reform.

In **Kosovo**, the Special Representative of the Secretary-General of the UN proclaimed the Law on Liquidation and Reorganisation of Legal Persons in Bankruptcy (the Kosovo Bankruptcy Law) into force, effective 14 July 2003. Pursuant to the authority granted under United Nations Security Council resolution 1244 (1999) and in conformity with United Nations Interim Administration Mission in Kosovo (UNMIK) Regulation No. 2001/9, The Kosovo Bankruptcy Law *does not* apply to government agencies, publicly-owned enterprises, insurance companies and financial institutions and appears to rely heavily on the Montenegro Bankruptcy Law. Under the Kosovo Bankruptcy Law, bankruptcy cases are heard by the specialised District Economic Court located in the jurisdiction in which the debtor's principal place of business is located. The bankruptcy process may be initiated by either the debtor or a creditor and would begin with the submission of a petition to the court. The law sets relatively strict and transparent (i.e. easily identifiable and measurable) conditions under which the debtor or a creditor may submit a bankruptcy petition.

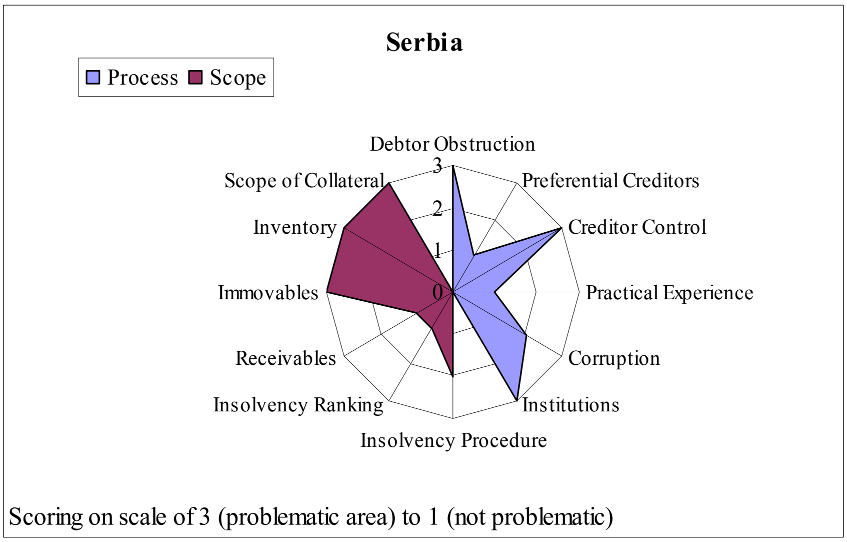
Secured Transactions

Secured transactions was until the creation of the Union a matter of federal competence – however, as early as 1996, Montenegro had gone separately in providing a specific legal regime (Law on the Fiduciary Transfer of Property). In 2001 and 2002, both Montenegro and Kosovo equipped themselves with their respective own specific laws, and Serbia embarked into reform too. However, although a new Law on Registered Charges over Movable Property was adopted by the Serbian parliament in May 2003 and officially entered into force on 1 January 2004, the institutional framework is still missing. In effect, Serbia lags behind. The EBRD has been involved and remains so (see Legal Reform Projects section below) helping the Republic of Serbia equip itself with a functional, market-oriented legal regime.

In **Serbia**, the new Law on Registered Charges over Movables Property was adopted in May 2003. It provides for the first time in the country legal means by which lenders, investors and borrowers can secure their operations. The new provisions create a new legal instrument (registered charge) by which movable and intangible assets can be encumbered while the borrower remains in possession of the collateral. The collateral can comprise a wide range of assets, including inventory, receivable accounts, and future assets. Full publicity is provided via a notice filing system, which clearly establishes priority ranking. Provisions ensure that, after a transition period, tax-related claims would also be subject to priority ranking based on registration of the claim. Finally, parties are free to agree on an out-of-court enforcement procedure and collateral realisation either by direct negotiated sale or public auction.

Although the law officially entered into force on 1 January 2004, the filing system is not yet operational. In practice that means that the law, although technically in effect, is not of any practical benefit. Under the law security has to be registered in order to be valid; without a charge registry it will not be possible to create security under the new law. Worse, it may also bring confusion to the users as to what rules of the old regime and of the new regime are effectively in application. The law on financial leasing has entered into force and is being used (registration is not a condition of validity of the contract) but without the adequate means of publicity. There seems little prospect of the position changing in the immediate future. This is of great concern as the Serbian economy is desperately in need of investment. Micro and SME finance are reportedly particularly negatively affected as the lack of publicity system makes the taking of security unnecessarily hazardous. Currently, the only way a security over assets other than real estate can be taken is via some provisions of the Enforcement Law, which require publication at the court of this so-called seizure of assets. This is a lengthy, costly and unreliable procedure. The Serbian government urgently needs to take measures in order to establish and start operating the charge registry. The chart below highlights the obstacles to the practical enforcement of charges in Serbia based on a case study conducted by the EBRD in 2003.

Obstacles to charge enforcement process – Serbia (2003)



Note: The fuller the "web" of the graph, the more serious the problems are in each of the respective categories "Process" factors measure the impact of specific incidences on the enforcement proceedings. "Scope" factors relate to the ability of the system to deal with specific situations or items.

Source: EBRD New Legal Indicator Survey 2003

Note: Data relates to the Republic of Serbia (excluding Kosovo) only.

In 2002, the **Montenegro** parliament adopted the Law on Secured Transactions No. 38/02 which entered into force on 1 January 2003, although it became effective only in the summer 2003 when the filing system became operational. As this law aims to provide an exclusive legal regime for all secured transactions, regardless of their form, it is believed that the law has de facto repealed the 1996 Law on Fiduciary Transfer of Property.

The Law on Secured Transactions, influenced by US Article 9 of the Uniform Commercial Code, provides for a regime by which pledges are created via an agreement, and attach to the charged assets, but become only perfected (that is, opposable to third parties) when registered or when possession of the collateral is transferred by the chargor. The Law on Secured Transactions provides extensive rules on priority, types of collateral, and enforcement of the pledge. There is some concern on the adaptation of the law into Montenegrin legal tradition, indeed the text of the law in local language and the English version differ at times on important elements. The filing office, which is a key element of the regime was set up and started operation in the summer 2003. It is still too early days to evaluate its performance.

Secured Transactions in **Kosovo** is an area of law governed by Regulation No. 2001/5 on Pledges promulgated by the Special Representative of the United Nations (UN) Secretary General under the authority of the UN Interim Administration Mission in Kosovo (UNMIK) pursuant to the authority of UN Security Council resolution 1244 (1999) of 10 June 1999. The Regulation on Pledges entered into force on 7 February 2001. It is strikingly similar to the Montenegrin Law on Secured Transactions; again, an all exclusive approach was adopted, which makes the law applicable to all transactions creating a pledge, regardless of their form. It also provides perfection of the pledge by notice filing. The Registry started operating at the end of 2001. The management of the registry was contracted to an association, Credit Information Services (CIS), for two years. CIS founders and management board are drawn from the microfinance and banking community in Kosovo. CIS expressed some concerns on the institutional set up of the system, in particular on the relationships between the registry, the government and USAID, who supplied the software. Also, concern was expressed by some experts that a few aspects of the Regulation were defective and needed some key amendments.

Telecommunications

The telecommunications sector in **Serbia** remains in a state of significant underdevelopment due to the continued absence of both an adequate regulatory/legislative framework and an inadequate telecommunications network. Years of neglected investment, allied to NATO bomb damage during the 1999 conflict, resulted in Serbia having one of Europe's least developed telecommunications sectors. This underdevelopment manifests itself in a conflictual state ownership in Serbia's principal operators, poor quality of service and absence of any coherent framework for the regulation of the sector.

The foregoing notwithstanding, there have been some positive developments in the sector in the last twelve months with the passage, in 2003, of the new framework Telecommunications Law (the "Telecoms Law") to replace previous relevant Federal Yugoslav law. This law reflects many of internationally accepted standards and signifies a major step towards harmonisation with relevant EU legislation. The sector is currently formally regulated by the Ministry for Capital Investment – the successor ministry to the Ministry for Transport and Communications. Meaningful implementation of the new law has yet to begin, including the functional establishment of the independent regulatory agency envisaged by the new law. The EBRD will assist the government with the effective implementation of the modern regulatory regime included in the Telecoms Law during 2004 (see Legal Reform Projects section below).

On the operational side, the partly state-owned incumbent operator, TS, was partially privatised in 1999, with the Milosevic government selling 49% stake to a consortium comprising Telecom Italia (TI) and OTE (partly state-owned Greek incumbent operator). Partial re-nationalisation occurred toward the end of 2003 with the purchase by the Serbian government of the Telecom Italia shareholding in TS. TS currently possesses a monopoly on all fixed line services and infrastructure including VoIP. The Telecoms Law provides for the continuation of this exclusivity until June 2005, apparently reflecting the original OTE/TI sale agreement. Both TS and the fixed network continue to be neglected in terms of investment.

In mobile telephony, competition in Serbia is currently restricted to two operators, TS and Mobtel. The shareholding of Mobtel is divided 49% PTT Srbija (state-owned parent of TS) and 51% privately held. However, there have been rumours about the transfer of shares in Mobtel by the private owners (the BK Group) to the State ahead of privatisation of the State's shareholding. While the nature and terms of the reported agreement between government and BK Trade in this regard remains unclear, the government did announce (in late March 2004) an agreement with the BK Group involving the transfer of part of the BK Group shareholding in Mobtel to the State ahead of the possible sale of the state's shareholding in Mobtel to a foreign strategic partner. Effective rationalisation of Mobtel shareholding, elimination of cross ownership and full privatisation of Mobtel in the short term will be critically important to sector development and introduction of a competitive marketplace.

Telecommunications in Serbia represents one of the last untapped marketplaces in Europe. While this represents enormous potential, the events of the past decade and a half have left the sector totally neglected and resulted in one of the most undeveloped markets in Europe. The less than transparent transactions that characterised the sector over the last five years have not assisted matters. However, the installation of a new government and apparent serious efforts toward the resolution of the Mobtel issue, combined with the instruments contained in the Telecoms Law now provide a significant opportunity for Serbia to rapidly move towards a competitive and dynamic marketplace for modern services. Nationally, the telecommunications industry is an important industry for Serbia in its own right; however, its true importance lies in its characteristic as a key enabler of growth across the economy. Accordingly, the authorities should act immediately to fully implement the framework contained in the Telecoms Law in a manner that is truly conducive to sector development and private investment

The **Montenegro** government ceased relying upon federal telecommunications law a number of years ago, adopting a new (stand–alone) law of their own in 2001. This law appears to include all principles of a modern regulatory environment and creates an 'autonomous' telecommunications policy for Montenegro, independent of any provisions either formerly at Federal level or currently at Union level. This law provides for an independent regulator and liberalisation of all telecommunication services in Montenegro by December 2003. While privatisation of Telekom Crna Gora, the majority government-owned incumbent operator was planned to accompany liberalisation, full details of the privatisation and concrete plans in its regard have yet to materialise.

While Montenegro appears to be making genuine efforts to move forward with a competitive environment for telecommunications, full implementation of modern regulatory mechanisms will be an essential pre-requisite to make liberalisation meaningful and thereby enhance sector development.

Additionally, going forward, efforts should be made by both republics of the Union to co-ordinate policy development and implementation within the sector.

The telecommunications sector in **Kosovo** is formally regulated by a combination of the Ministry of Transport and Communications (MTC) of the Provisional Institutions of Self-Government (PISG) and the United Nations Mission in Kosovo acting as the transitional administration (UNMIK) on the basis of the framework Telecommunications Law of 2003 and relevant UNMIK regulations. In reality, the regulation of the sector is somewhat chaotic, with the transfer of authority for the sector to MTC (with the exception of certain powers reserved to UNMIK related to international and frequency management issues) are nearing completion. The 2003 law provides for a regulatory body for telecommunications (TRA) which has recently been formally established by PISG. Unfortunately, the true status of the TRA as an independent agency remains unclear and the resources to functionally establish itself appear absent.

1.2 Legal Reform Projects

2.2.1 Telecommunications Regulatory Development Programme

(a) Serbia

The EBRD will shortly begin providing comprehensive regulatory reform assistance to Serbia aimed at assisting with implementing the establishment of a clear, predictable and modern telecommunications regulatory framework likely to attract private investment to enable the overall development of the telecommunications sector. It is intended that this project will address the implementation of the key features contained in the 2003 Telecom Law, including the establishment of an independent regulatory authority for telecoms, establishment of a modern interconnection regime, rebalancing of tariffs and adoption of a sound licensing procedure. This project is being funded by the Government of the United States through its Trade and Development Agency (TDA).

(b) Kosovo

The EBRD has begun providing the authorities in Kosovo with technical assistance aimed at addressing three interrelated priority areas for telecommunications sector development in Kosovo. The areas to be addressed by this project are: development of strategic policy for the sector; practical assistance to the newly formed Telecommunications Regulatory Agency during its initial period of establishment; and, assistance addressing numbering and access code peculiarities currently hindering sector development. This project is being funded by the Government of the United States through its Trade and Development Agency (TDA).

2.2.2 Secured transactions

The project is helping the Republic of Serbia to adopt a modern legal framework for security over movable assets and implement it. The Law on Registered Charges, adopted in May 2003 and entered into force on 1 January 2004, closely adopts the EBRD Core Principles on Secured Transactions and enables security to be taken over a variety of asset classes. However, to date, the necessary charge registry has not been put in place by the Serbian authorities. This project is funded by the UK government and by the Balkan Region Special Fund.

Annex 5

Economic Indicators: Serbia and Montenegro

Serbia and Montenegro

	1998	1999	2000	2001	2002	2003	2004
						Estimate	*Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	1.9	-18.0	5.0	5.5	4.0	3.0	5.0
Industrial gross output	4.4	-24.4	11.1	0.0	1.7	-2.7	na
Agricultural gross output	-3.2	-2.0	-13.7	23.2	3.0	-6.0	na
Employment			*(Percentage change)*				
Labour force (end-year)	-0.6	-7.6	-2.4	1.8	-6.2	0.7	na
Employment (end-year)	-1.8	-6.0	-2.6	0.2	-11.9	-4.4	na
Unemployment (end-year)	26.8	25.5	25.6	26.8	28.9	na	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	29.5	37.1	60.4	91.3	21.4	11.3	8.5
Consumer prices (end-year)	44.5	36.5	113.5	39.3	14.3	7.8	10.0
Producer prices (annual average)	25.5	44.2	44.5	na	na	na	na
Gross average monthly earnings in economy (annual average)[1]	117.7	18.2	83.3	129.6	51.7	25.5	na
Government sector			*(In per cent of GDP)*				
General government balance	na	na	-0.9	-1.3	-4.5	-4.2	-3.4
General government expenditure	na	na	37.6	40.2	47.3	46.8	47.0
Monetary sector[2]			*(Percentage change)*				
Broad money (M2, end-year)	na	67.6	58.5	67.6	73.4	28.6	na
Domestic credit (end-year)	na	130.1	58.2	10.0	-38.2	27.3	na
Broad money (M2, end-year)	16.6	21.0	16.9	14.0	18.6	20.2	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	33.7	26.3	26.3	16.4	9.5	9.0	na
Deposit rate	16.2	13.1	8.3	4.1	2.6	na	na
Lending rate (long-term)	60.3	45.4	77.9	32.5	19.2	na	na
Exchange rate (official, end-year)[3]	10.0	11.7	66.5	67.7	59.0	54.6	56.1
Exchange rate (official, annual average)	9.3	11.1	54.9	66.8	64.2	57.5	56.1
External sector			*(In millions of US dollars)*				
Current account	-660	-764	-327	-528	-1,384	-2,121	-2,577
Trade balance	-1,816	-1,619	-1,788	-2,834	-3,908	-5,040	-5,322
Merchandise exports	3,033	1,676	1,923	2,003	2,412	2,917	3,483
Merchandise imports	4,849	3,295	3,711	4,837	6,320	7,957	8,805
Foreign direct investment, net	113	112	25	165	562	1,395	600
Gross reserves, excluding gold (end-year)	na	289	516	1,169	2,280	3,550	3,600
External debt stock	10,539	10,744	11,403	11,948	11,839	14,303	13,000
Gross reserves, excluding gold (end-year)	na	1.0	1.5	2.7	4.0	4.9	4.5
Debt service[4]	1.9	4.7	2.2	3.9	5.6	11.0	21.3
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)[5]	10.6	8.4	8.3	8.3	8.3	8.3	8.3
GDP (in millions of dinars)	146,300	192,900	381,700	771,800	1,006,900	1,192,800	1,354,000
GDP per capita (in US dollar)	1,475	2,071	834	1,386	1,884	2,492	2,900
Share of industry in GDP (in per cent)	26.1	25.5	na	na	na	na	na
Share of agriculture in GDP (in per cent)	19.0	25.1	na	na	na	na	na
Current account/GDP (in per cent)	-4.2	-4.4	-4.7	-4.6	-8.8	-10.2	-10.7
External debt - reserves (in US$ million)	na	10,455	10,887	10,779	9,559	10,753	9,400
External debt/GDP (in per cent)	67.3	61.8	164.0	103.5	75.5	68.9	53.8
External debt/exports of goods and services (in per cent)	267.0	500.4	447.7	435.6	365.3	360.3	272.7

1 Data from 1999 refer to net wages.
2 Data refer to Serbia only.
3 The exchange rate regime was unified in December 2000. The unofficial rate in October 2000 was 30 Din: 1 DM, compared with an official rate of 6 Din: 1 DM.
4 Serbia and Montenegro was in default of virtually all of its external debt between 1992 and 2001.
5 Population decrease in 1999 is the result of excluding Kosovo population from the total.

Annex 6

Economic Indicators: Kosovo

	2000	2001	2002	2003	2004for
Output and expendiure			*(percentage change)*		
GDP		38.5%	7.0%	1.3%	0.4%
Employment			*(percentage change)*		
Unemployed		14.4%	8.2%	9.6%	na
Prices and Wages			*(percentage change)*		
Consumer prices (end year)		11.7%	3.6%	1.6%	1.0%
Consumer prices (annual average)				0.9%	1.0%
Government sector			*(in per cent of GDP)*		
General government balance (excl grant	-14.4%	1.1%	5.3%	3.8%	-4.9%
General government balance (incl grants	7.2%	8.4%	8.4%	6.0%	-4.9%
General government expenditure	31.5%	23.8%	33.5%	42.1%	46.3%
Monetary sector			*(percentage change)*		
Broad money (M2, end year)		-21.2%	-9.6%	-20.7%	na
Domestic credit (end year)		432.2%	201.1%	161.3%	na
			(in per cent of GDP)		
Broad money (M2, end year)	99.6%	78.5%	71.0%	56.3%	na
Domestic credit (end year)	0.4%	2.2%	6.8%	17.7%	na
Interest rates and exchange rates			*(in per cent per annum, end year)*		
Deposit rate (6m-12m)		2.7%	2.7%	3.0%	na
Lending rate (6m-12m)		15.0%	15.6%	14.3%	na
External sector			*(in millions of EUR)*		
Currennt account		-644.9	-826.2	-777.5	-549
Trade balance		-1361.9	-1480.2	-1420.5	-1061
Merchendise exports		42.6	56.6	71.6	na
Merchendise imports		1404.5	1536.8	1492.1	na
External debt	0	0	0	0	na
Government bank balance	5.7	69.8	258.6	342.7	na
Memorandum items			*(units as indicated)*		
Population (annual average, millions)	1.82	1.85	1.87	1.89	1.90
GDP (in millions EUR)	746	1154	1279	1317	1335
GDP per capita (in EUR)	410	625	684	696	703
Current account / GDP		-56%	-65%	-59%	-41%
External debt / GDP	0	0	0	0	na
Government bank balance/GDP	0.8%	6.0%	20.2%	26.0%	na

Sources: Banking and Payment Authority of Kosovo, Monthly Statistics Bulletin, August 200
Banking and Payment Authority of Kosovo, Annual Report, March 2004
IMF Staff Visit to Kosovo Concluding Statement, November 2003