DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR SERBIA

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ABBREVIATIONS

AREF	Albania Reconstruction Equity Fund
BAS	Business Advisory Services Programme
BEEPS	Business Environment and Enterprise Performance Survey
BPE	Ball Packaging Europe
BPK	Bureau of Payment of Kosovo
BSE	Belgrade Stock Exchange
BSPK	Association of Independent Trade unions of Kosovo
CARDS	Community assistance for reconstruction, development and stabilisation
CBAK	Central Banking Authority of Kosovo
CEB	Central Europe & Baltics
CEB	Council of Europe Development Bank
CEFTA	Central European Free Trade Agreement
CEI	Central European Initiative
CIS	Commonwealth of Independent states
DACU	Development Aid Coordination Unit
DOS	Democratic Opposition of Serbia
DS	Democratic Party
DSS	Democratic Party of Serbia
EAR	European Agency for Reconstruction
EC	European Commission
EIA	Environmental Impact Assessment
EIB	European Investment Bank
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
ICTY	International Criminal Tribunal for Former Yugoslavia
IDA	International Development Association
IFC	International Financial Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IPA	Instrument for Pre-Accession
IPPC	Integrated Pollution and Prevention Control
ISPA	Instrument for Structural Policies for Pre-Accession
KCIS	Kosovo Credit Information Services
KEAP	Kosovo Environmental Action Plan
KEK	Kosovo Energy Corporation
KREF	Kosovo Reconstruction Equity Fund
KTA	Kosovo Trust Agency
LBP	Law on Bankruptcy Proceedings
LIS	Legal Indicator Survey
MEI	Municipal Environmental and Infrastructure
MIER	Ministry of International and Economic Relations of the Republic of Serbia
MIFF	Multi-annual Indicative Financial Framework

MKI	Ministry for Capital Investment
MSMEs	Micro, Small and Medium Enterprises
MTC	Ministry of Transport and Communications
NATO	North Atlantic Treaty Organisation
NEAP	National Environmental Action Plan
NES	National Environmental Strategy
NGO	Non-Governmental Organisation
NIS	Naftna Industrija Srbija
NS	New Serbia
OSCE	Organization for Security and Co-operation in Europe
PCB	ProCredit Bank
PFP	Partnership for Peace Programme
PIA	Pristina International Airport
PISG	Provisional Institutions of Self-government
POEs	Publicly-owned Enterprises
PPA	Power Plant ‘Kosovo A’
PPP	Public- Private Partnership
RATEL	Republic Agency for Telecommunications
RO	Resident Office
SAA	Stabilisation and Association Agreement
SAC’s	Structural Adjustment Credits
SEE	South-Eastern Europe
SMATSA	Serbia and Montenegro Air Traffic Services Agency Ltd.
SME	Small and Medium Enterprise
SOEs	State-owned Enterprises
SPO	Serbian Renewal Movement
SPS	Socialist Party of Serbia
SRS	Serbian Radical Party
TAM	Turnaround Management Programme
TC	Technical co-operation Programmes
TFP	Trade Facilitation Programme
TRA	Telecommunications Regulatory Agency
UCTE	Union for the Coordination of Transmission of Electricity
UN	United Nations
UNMIK	United Nations Interim Administration Mission in Kosovo
USD	United States Dollar
WB	World Bank
WTO	World Trade Organisation

EXECUTIVE SUMMARY

The Republic of Serbia is an independent state that meets the conditions specified in Article 1 of the Agreement Establishing the Bank. It is a parliamentary democracy, with a President elected by universal suffrage. The current President is Boris Tadic, who was elected on 27 June 2004. The government is headed by a Prime Minister, responsible to parliament. Since 3 March 2004, the Prime Minister is Vojislav Kostunica, leader of the Democratic Party of Serbia (DSS). The country's single-chamber Assembly has 250 seats.

In March 2002, with the active involvement of the European Union (EU), Serbia and Montenegro signed a Constitutional Charter creating the State Union of Serbia and Montenegro as the official successor of the Federal Republic of Yugoslavia. The Charter came into force on 4 February, 2003. On 21 May 2006 Montenegro took up the option, envisaged in the Charter, of a referendum reviewing the future of the Union three years after it officially came into being. On a turnout of 86%, 55.5 per cent voted in favour of independence. On 5 June 2006 Serbia's parliament declared that Serbia was the successor of the Union. On 15 June 2006 Serbia officially recognised Montenegro as an independent state. The two governments have agreed on a procedure for the division of assets and financial obligations. On 1 October 2006 the Serbian Assembly unanimously adopted a new Constitution. The new Constitution, which refers in the Preamble to Kosovo being 'an integral part of Serbia', was submitted to a referendum on 28 and 29 October 2006. On a turnout of 54.19 per cent, 52.31 per cent of registered voters voted in favour. Kosovo's ethnic Albanians were not registered and did not take part in the referendum. The parliamentary elections were held on 21 January 2007 and the presidential elections are due to be held in May 2007.

The Serbian economy has been growing strongly over the past couple of years. Real GDP growth in 2005 was around 6.3 per cent and the economy is on track for similar or even higher growth in 2006. Industrial output in the first half of the year rose by more than 6 per cent. Several industries that have benefited in recent years from substantial foreign investment, such as tobacco and base metals, are growing particularly strongly. On the demand side, the continued expansion of credit is fuelling domestic demand, while export growth has also been strong, reaching 30 per cent in 2005 and more than 20 per cent in the first half of 2006. High inflation and current account deficits remain significant macroeconomic problems but annual inflation has fallen from 17.5 per cent at the end of 2005 to around 7 per cent by end-2006, while the nominal exchange rate has appreciated slightly during 2006. The risk profile of the country has improved and several ratings agencies have upgraded the country over the past year. Foreign direct investment (FDI) continues to arrive in record levels, and is projected to be in excess of €3 billion in 2006, mainly as a result of some large privatisations in the telecommunications and banking sectors.

Serbia's transition to market economy started much later than in the other countries in the region, after a lost decade of the 1990s. Serious reforms began after the formation of a broad coalition government in January 2001, under the late Prime Minister Zoran Djindjic. Since then, the pace of reform under successive governments has generally been rapid, but delays have occurred along the way and the scale of the transition challenges ahead is still daunting. Overall, the business environment is much improved relative to a few years ago, but surveys continue to reveal significant barriers to doing business, including corruption. The privatisation programme has advanced significantly in recent years, particularly in the banking sector. The biggest single privatisation since reforms began took place in August 2006 in the telecommunications sector, with the sale of the mobile company, Mobi63, to Telenor of Norway for a sum in excess of €1.5 billion. Further reforms have continued in the roads and railways sectors. However, many medium-size and large companies are loss-making and likely to be unviable in the long-term

The key transition challenges are to:

- **Accelerate the privatisation and restructuring programme** for medium and large companies in order to attract much-needed investment and boost the competitiveness of these industries.
- **Implement important new laws** to promote enterprise performance, including in the areas of competition policy and bankruptcy that have been passed in recent years.
- **Promote competition, commercial orientation and an enhanced role for the private sector** in critical infrastructure sectors such as roads, railways, energy, municipal infrastructure and telecommunications.
- **Manage the development of the financial sector**, by ensuring that credit growth within the banking sector is monitored carefully and that non-bank financial institutions are developed to full potential.

The Bank is the largest institutional investor in Serbia. Between April 2001, when the Bank signed its first operation in Serbia, and 31 December 2006, the Bank achieved a cumulative business volume of €1,108 million. During the last strategy period, the Bank's commitments grew by 97 per cent with new commitments of € 545 million. The portfolio is characterised by strong transition impact potential and the overall quality remains high. The portfolio currently consists of 69 projects, with the highest concentration in infrastructure and the financial sector. Since the last strategy review in 2004, the private sector share of the portfolio increased from 37 per cent to 47 per cent of total business volume. Given the pipeline of future business, this figure is likely to increase over the next strategy period and the Bank will continue to play a major role on the Serbian investment market.

The Bank's strategic priorities for the next two years are as follows:

Corporate Sector: The Bank will continue to provide financing for privatisation and post-privatisation restructuring to both local and foreign corporates. It will focus increasingly on large corporates in their consolidation and future expansion plans, including further regional penetration. The new EBRD-Italy Western Balkans Local Enterprise Facility enables the Bank to support smaller, fast-growing companies through debt, quasi-debt and equity finance, which is still relatively scarce in Serbia. The biggest number of transactions is expected to be generated in agribusiness, but opportunities should arise in other sectors undergoing privatisation and restructuring, particularly in natural resources and general industry. The Bank will continue its assistance and support to local enterprises provided through the TurnAround Management (TAM) and Business Advisory Services (BAS) programmes. The TAM Programme has operated in the country since 2001 and has carried out 86 projects successfully. Of these, 68 were funded by the European Agency for Reconstruction (EAR) and 18 by several bilateral donors. The BAS Programme in Belgrade has started its operations in July 2006 and has undertaken seven projects so far.

Infrastructure: The Bank will continue to play a crucial role, together with the European Investment Bank (EIB), the EU and the World Bank, in developing the transport, energy and municipal infrastructure in the country. The majority of future Bank investments (in terms of volume) are expected in the Transport sector in order to complete the development of a modern highway and railway network on Corridor X. In the municipal sector the Bank expects to continue its successful cooperation with the city of Belgrade and work on completing signed projects. It will also seek to diversify its financing to medium-sized cities and regions, provided that their financial strength is adequate, in order to provide the substantial funds needed to improve local infrastructure in areas such as water and waste water management, landfills and waste management, district heating and urban transport. Finally the Bank will continue to support energy sector development particularly through the commercialisation of the energy utilities and possible future private sector participation and developing operational activities in the sustainable energy and energy efficiency areas.

Financial Sector: Following a wave of privatisation over the past two years, the banking sector is now mostly in private hands and a total of 18 foreign banks have entered the Serbian market. A phase of further consolidation is likely in the coming years. The Bank will seek to assist banks with a strong presence looking for opportunities to develop new products and increase market share by assisting in further consolidation. The Bank will continue to work with local and foreign banks to provide Small and Medium Enterprise (SME) lines, thus fostering the emergence of a healthy SME sector in the Country. Furthermore, the Bank will increasingly look for equity and debt transactions in non-banking financial institutions, primarily in the area of insurance, private pension funds and mutual investment funds.

Kosovo

Regardless of the scope and nature of the international decision on its final status, expected later this year, Kosovo faces huge transition challenges over the coming years. Privatisation has advanced but fresh investment is limited. Reform of large public enterprises is at an early stage. There has been a progress in reforming publicly-owned enterprises (POEs). Eight main POEs, including the airport, the railways, the post and telecommunications, the energy utility (KEK), were incorporated in 2006. However, power sector reform is urgently needed. Following the signing of the Memorandum of Understanding between UNMIK and the EBRD in March 2005, the Bank will continue to focus on working with local banks and micro-lending institutions, including through the implementation of the Western Balkans SME Finance Facility and the newly established MSME Finance Framework for the Western Balkans and Croatia. The Bank will also focus on assisting the SME sector through the newly established EBRD-Italy Western Balkans Local Enterprise Facility, in close co-ordination with the TAM/BAS programme. The Bank will monitor progress in the transport, telecommunications and energy sectors in order to explore potential projects.

A. SERBIA

1. THE BANK'S PORTFOLIO

The Bank is the largest institutional investor in Serbia, having committed over €1 billion across all sectors over the past five years. Within the last strategy period, the Bank's portfolio has developed rapidly, the portfolio remains of high quality and strong transition impact potential is present throughout. The current project pipeline is €350 million and the Bank will continue to play a major role on the Serbian investment market.

1.1. Overview of the Bank's Activities to Date

Between April 2001, when the Bank signed its first operation in Serbia, and 31 December 2006, the Bank achieved a cumulative business volume of €1,108 million. Between mid-2004 and end-2006 the Bank's portfolio grew by 97 per cent with new commitments of €545 million. The portfolio currently consists of 69 projects across all sectors, with the highest concentration in infrastructure and the financial sector. Since the last strategy review in 2004, the private sector share of the portfolio increased from 37 per cent to 47 per cent of total business volume. Most of the portfolio is debt; equity accounts for only 16 per cent of the entire portfolio and is concentrated in the financial sector. In terms of volume, the portfolio is dominated by infrastructure (transport and municipal), financial sector and energy, accounting for 42, 25 and 16 per cent respectively. The agribusiness sector represents 4 per cent of the portfolio and has strong potential for further development as local companies exploit significant competitive advantages in regional and EU markets.

The pace of disbursement of the Bank's portfolio has accelerated recently. In the early years, the Bank had difficulty in disbursing on public sector projects, mainly because tenders for public works typically last a considerable length of time, and local procedures for issuing guarantees contributed to further delays in meeting conditions for loan effectiveness. However, in 2006 disbursements accelerated, reaching €221 million by end-December 2006, while the net portfolio increased by €325 million which represents the highest level since the Bank started operations in Serbia.

Over the strategy period the Belgrade Resident Office (RO) continued to play a leading role in project origination, policy dialogue with Government for public sector projects and pre-privatisation deals, structuring and executing projects, monitoring, and divestitures. Working with the Foreign Investment Council policy dialogue was focused on the removal of administrative and policy obstacles related to various branches of economy. Projects are frequently generated and/or led from RO bankers and they actively work with HQ bankers on all projects in the country. Moreover the Bank's Country Director and bankers have developed a close working relationship with all Government institutions and other key stakeholders, such as public enterprises, clients, other International Financial Institutions (IFIs) and donor organizations. The RO expects to continue to play this role in the upcoming period both in terms of generating new projects, assume a leading role in the monitoring of this large and increasing portfolio and continuing to serve as a link between the Bank and other institutions where local involvement is crucial to ensure the fulfilment of the Bank's transition mandate in the country.

1.2. Implementation of the Previous Country Strategy

The last country strategy, adopted in November 2004 and applying to the then State Union of Serbia and Montenegro, outlined the following priorities and transition goals for the Bank's activities:

- Financial Sector**:** The Bank would 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.
- Corporate Sector: Several areas were selected for priority action: (i) Privatisation and post-privatisation company restructuring, capital investments in new technology, and environmental improvements, primarily with local enterprises. (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 successful industrial track record.
- Energy and other Infrastructure: The Bank would 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.

During the last strategy period, the Bank signed 38 operations (including regional projects) with cumulative commitments reaching €545 million. Thirty-two operations were in the private sector and six projects in the public sector (four transport and two MEI projects). In terms of business volume, more than half of new commitments were in the private sector, mostly through loans and with a strong focus on the financial sector. Equity investments have largely been confined to the banking sector, led by a large pre-privatisation investment in the biggest state-owned bank (Komercijalna Banka), and equity funds through regional projects.

In the financial sector, the Bank provided mortgage and SME lines to both foreign and local banks; notably, the Bank used the Western Balkans SME Finance Facility to finance two local banks with a strong regional focus. Also, the first credit line for the leasing sector was extended in 2006 to Raiffeisen Leasing to foster the development of this rapidly evolving sector.

In the corporate sector, the Bank provided loans to finance the biggest greenfield investment in Serbia since the regime change in 2000 - Ball Packaging Europe's ("BPE") aluminium can production facility. The Bank also signed several post-privatisation projects in the general industry and food processing sectors and provided seasonal commodity-based financing to local and foreign owned agro-processors. The Bank plays a strong role in financing projects that have a cross-border component and in that sense continues to serve as a catalyst for regional trade integration, which is particularly important in SEE after the turmoil of the previous decade.

In the infrastructure sector, the priority was given to projects in railway, road and air navigation sector that have a strong regional dimension as well as the strong corporate restructuring element. The Bank provided a second loan to Serbian Railways to enable the company to meet the increasing flow of freight traffic and to continue implementation of a major programme of rail sector restructuring. Also, the second loan to Serbia's Road Directorate further promoted sector restructuring. The Bank also provided a loan to the Serbia and Montenegro Air Traffic Services Agency Ltd. (SMATSA) helping to consolidate the institutional and financial position of the independent air-traffic services provider.

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

The Bank has been an active participant in the transition progress and continued to innovate to suit the emerging transition needs. Almost all projects signed to date have been judged by the Bank's Office of Chief Economist to have good or excellent transition impact potential, although the risks that this potential is achieved are often assessed as high. However, many projects have been signed relatively recently, and it is therefore too early in these cases to judge whether this potential has been realised. The Bank's impact has been strongest to date in the financial sector where the government has been most receptive to improvements in competition and market expansion. In the public sector, where crucial reforms have advanced much more slowly, the Bank's impact so far has been more moderate.

Corporate sector: The Bank's projects in this sector have been mostly focused on the restructuring and regional expansion of local food producers, some of which have been successful. A project with Frikom supports the modernisation and expansion of production facilities of ice cream and frozen food as well as corporate governance improvements. ***A lesson learned*** from the Frikom project is that the Bank should carefully review the working capital requirements attached to a project. Working capital, particularly cash availability, is crucial for agro-industry. The Bank could have considered a combination of long-term and short-term lending to insure the borrower's operations comprehensively (PE04-322). The Bank was also active through its two projects with the leading Serbian pharmaceutical company Hemofarm. The Bank's financing has contributed to corporate governance improvements, such as the introduction of international accounting standards and covenants contained in the Bank's legal documentation and led recently to a very successful sale to a major European pharmaceutical company. Moreover, the Bank has had important impact through its investment in BPE Belgrade and Sevojno. The BPE project was highly commended both in Serbia and by the international community; in July 2004 the Stability Pact for Southeast Europe presented BPE with an award for the best greenfield investor in the SEE region. The Sevojno project was the first loan financing for a company privatised under the Government privatisation scheme. Overall, a *moderate* transition impact has been achieved in the *corporate* sector.

Infrastructure: Since 2001, the Bank was involved in several transport, Municipal & Environmental Infrastructure (MEI) and emergency power and energy reconstruction projects in the public sector. Significant transition impact has been achieved in a number of areas. In the railways sector, the main transition objectives of the Bank's 2001 project were, first, a submission of a new Railway Law in line with EU directives, and second, a comprehensive labour restructuring programme. While the Law was submitted in 2002, ratification was delayed until early-2005. However, implementation of the Law is well advanced, labour restructuring has been successfully implemented and institutional reform of the Railway company and the sector is progressing well. In the roads sector, the road recovery project signed in 2002 aimed at the promotion of reforms to institutions, road financing mechanisms and the legal framework. Physical implementation is progressing well and most transition objectives have now been achieved. In the MEI sector, a landmark deal was the first infrastructure loan on a non-sovereign basis to the municipality of Belgrade, which is currently being implemented. Commercialisation of the three involved utilities (water, district heating and urban transport) has advanced significantly. A new project with Belgrade, again on a non-sovereign basis, has attracted significant interest for syndication from the commercial banks. Involvement in the water sector has progressed furthest outside the capital city, as the Bank has provided loans to four municipalities mainly for water and waste-water investments. In general, however, local infrastructure reform has been slow in Serbia reflecting the slow pace of decentralisation which would allow local governments greater autonomy and fiscal resources. In the power sector, the Bank signed two projects, in 2001 and 2003 that focused on the establishment of a sound legal and regulatory framework, the preparation of an Energy Strategy and the establishment of the Energy Regulator. Institutional and sector reforms are well advanced, and much has been achieved through the separation of the transmission company from the integrated utility, the reconnection to the UCTE network, the establishment of an independent regulatory agency and participation in the regional energy market. However, the physical implementation of the project has been delayed and a significant part of the loan for a substation component is at risk of cancellation due to a protracted process of obtaining administrative permits. Although institutional reforms in the EBRD infrastructure projects, which were fully coordinated with other IFIs operation in this area, have been significant, physical implementation and disbursements were slower than originally anticipated. Overall, a *moderate* transition impact has been achieved in the *infrastructure* sector.

Financial sector: The Bank was instrumental in boosting the confidence of depositors and investors in the sector and helped to increase competition. The modernisation and restructuring programme that followed the Bank's equity investment in a local bank (Eksimbanka) resulted in a successful sale to a foreign strategic investor. The Bank also provided the first subordinated loan in the country to Raiffeisen Bank. The trade facilitation programme was introduced in the country and three banks have participated to date. In 2005, the Bank's loan to ProCredit Bank Serbia was the first financial sector transaction to be syndicated in the country. A significant EBRD equity investment in Komercijalna Banka (25% stake), signed in 2006, is supporting the restructuring of one of the largest banks in the country, as well as creating the base for the further development of local capital markets. An equity stake of 25% in a small regional bank Cacanska bank, signed in 2006, will help further develop the regional banking sector and help prepare the bank for privatization. In the non-bank financial sector, the Bank has indirectly contributed to the establishment of the first and main private pension fund in Serbia through its equity investment with Dunav, the leading insurance company, and TBIH Financial Services Group. However, the insurance and pension sectors are still underdeveloped. Several important lessons have been learned from the Bank's activities in the financial sector. ***A lesson learned*** from the Eksimbanka Investment project is that the Bank can help improve the quality of the local intermediary's loan portfolio through small equity participation, and have an immediate impact on local enterprises in the real sector (PEX04-232). Another lesson learned from the ProCredit Bank project is that emphasis must be placed on training local staff, when small business lending operations are managed initially by expatriate staff (PEX05-244). Overall, a *significant* transition impact has been achieved in the *financial* sector.

1.4. Portfolio Ratio and Quality

The portfolio is well developed and diversified. Based on the current commitments of €1,108 million, the private/public portfolio stands at 47/53 per cent, and has improved since the last strategy (37/63). The current ratio reflects the shift in focus from public to private sector operations and the significant increase in the number of private sector transactions and their volume. The average risk rating of the portfolio stands at 6.18 while the private sector risk rating is slightly better and stands at 5.70. The overall quality of the Bank's portfolio is very good. The gap between commitments and disbursements has shrunk from 67 per cent as of end-August 2004 to 55 per cent as of end-December 2006. This trend is expected to continue as disbursements are expected to be accelerated in the public sector, where intensive ongoing procurement and construction activities are under way for most of the large infrastructure projects.

2. OPERATIONAL ENVIRONMENT

2.1. The General Reform Environment

2.1.1. Political Environment

The Republic of Serbia is an independent state which meets the conditions specified in Article 1 of the Agreement Establishing the Bank. It is a parliamentary democracy, with a President elected by universal suffrage. The current President is Boris Tadic, who was elected on 27 June 2004. The government is headed by a Prime Minister, responsible to parliament. Since 3 March 2004, the Prime Minister is Vojislav Kostunica, leader of the Democratic Party of Serbia (DSS). The country's single-chamber Assembly has 250 seats.

Following parliamentary elections on 28 December 2003, a minority coalition led by Mr Kostunica assumed office on 3 March 2004. It consisted of the DSS, G17-Plus and an alliance of the Serbian Renewal Movement (SPO) and New Serbia (NS). The Socialist Party of Serbia (SPS) was not a member of the Kostunica coalition but regularly supported it in parliament. On 30 September 2006 G17-Plus members of the Kostunica government submitted their resignations in protest against the government's failure to achieve full cooperation with the International Criminal Tribunal for Former Yugoslavia (ICTY). For a while, they stayed in their posts pending the adoption of the new Constitution. They left the government after the solemn proclamation of the new Constitution by the Serbian Parliament on 8 November 2006.

In March 2002, with the active involvement of the European Union, Serbia and Montenegro signed a Constitutional Charter creating the State Union of Serbia and Montenegro as the official successor of the Federal Republic of Yugoslavia set up by Slobodan Milosevic in 1992 following the dissolution of the socialist Yugoslavia the previous year. The Charter came into force on 4 February, 2003. On 21 May 2006 Montenegro took up the option, envisaged in the Charter, of a referendum reviewing the future of the Union three years after it officially came into being. On a turnout of

86%, 55.5 per cent voted in favour of independence. On 5 June 2006 Serbia's parliament declared that Serbia was the successor of the Union. On 15 June 2006 Serbia officially recognised Montenegro as an independent state. The two governments have agreed on a procedure for the division of assets and financial obligations.

On 1 October 2006 the Serbian Assembly unanimously passed a new Constitution. The new Constitution, which in the Preamble refers to Kosovo as 'an integral part of Serbia', was submitted to a referendum on 28 and 29 October 2006. On a turnout of 54.19%, 52.31% of registered voters voted in favour. Kosovo's ethnic Albanians were not registered and did not participate in the referendum. The Serbian Parliament solemnly proclaimed the new Constitution on 8 November 2006. The parliamentary elections in Serbia were held on 21 January 2007. The opposition Serbian Radical Party (SRS), whose official leader is Vojislav Seselj, currently on trial at The Hague, emerged as the strongest party, having won 28.6 % of the votes cast and 81 seats in the 250-seat National Assembly. However, it is unlikely to form the new government. This is expected to be a coalition of the parties of the so-called 'Democratic Bloc. The death in March 2006 of former President Slobodan Milosevic passed off without major domestic repercussions. However, the divisive issues of the transfer of General Ratko Mladic to The Hague and the future of the Kosovo province, now under active international consideration, are likely to continue to strain relations among the ruling parties and with the international community.

Serbia's bilateral relations with its neighbours are satisfactory. Those with Croatia are on a constant upward trend. However, progress towards deeper integration with the EU has stalled. The EU called off on 3 May the latest round of talks on a Stabilisation and Association Agreement (SAA) with Serbia, scheduled for 11 May, on the grounds of Serbia's failure fully to cooperate with the International Criminal Tribunal for Former Yugoslavia (ICTY) at The Hague. The EU has stated clearly its readiness to resume talks should the ICTY confirm that Serbia is cooperating fully with it.

2.1.2 Economic Environment

The Serbian economy has been growing strongly over the past couple of years. Real growth in 2005 was around 6.3 per cent, after 9.3 per cent in 2004, and the economy is on track for further robust growth in 2006. Industrial output in the first half of the year rose by more than 6 per cent. Several industries that have benefited in recent years from substantial foreign investment, such as tobacco and base metals, are growing particularly strongly. On the demand side, the continued expansion of credit is fuelling domestic demand, but export growth has also been strong, reaching 30 per cent in 2005 and over 20 per cent in the first half of 2006.

The government has had considerable success over the past year in boosting fiscal revenues, and these have contributed to a general government surplus in 2005 of 0.8 per cent of GDP. Nevertheless, the overall size of government spending remains high at over 40 per cent of GDP in 2005. While subsidies to state- and socially-owned companies are on a downward trend, the government's announced plans for a major capital investment programme under a new "National Investment Plan" could exacerbate inflationary pressures and external imbalances.

The problem of inflation has eased during 2006. The annual rate has fallen from 17.5 per cent at the end of 2005 to around 7 per cent by end-2006. The target of single-digit inflation by end-year, which looked well beyond reach earlier in the year, is now realistic. Some outside factors have helped, notably the easing of oil prices, but the success has been primarily due to a combination of stringent reserve requirements (60 per cent on short-term foreign borrowing), attractive repo rates that are draining liquidity from the banking system and a postponement of increases in selected administered prices. The central bank is moving towards adopting a formal inflation targeting approach, which will probably be in place by the middle of next year. Also, strong capital inflows, combined with a shift in central bank policy towards a more floating exchange rate regime, have led to an appreciation of the dinar and hence lower import prices.

Strong export growth and continued high inflows have contributed to a decline in the current account deficit in 2005. Notwithstanding the strong real appreciation of the dinar, Serbian exporters are increasingly reaching foreign markets, notably in the EU but also recovering markets from other former Yugoslav republics. More recently, Serbia joined the expanded Central European Free Trade Agreement (CEFTA) and its application to the World Trade Organisation (WTO) is proceeding. The risk profile of the country has improved and several ratings agencies have upgraded the country over the past year. Foreign investment continues to arrive in record levels, and is projected to be in excess of €3 billion in 2006, about half of which is accounted for by the sale of Mobi63 to Telenor of Norway.

The huge growth in reserves over the past couple of years poses a dilemma for the government and central bank. In addition to allowing the exchange rate to appreciate, they have responded recently by paying early, or negotiating an early payment schedule, of some IFI debt. The central bank has already made one early payment to the International Monetary Fund (IMF) and will pay the rest next year (a new IMF programme will be discussed after the elections but any such programme is likely to be precautionary only). The government has agreed with the World Bank that the interest and principal payments scheduled for the next three years will be paid off in one go next month. In addition, the government is negotiating with the Paris Club on a possible debt-for-investment swap, and any settlement of the Kosovo situation is likely to involve the removal of about €1 billion of debt from Serbia to Kosovo. Therefore, overall public debt levels are expected to stay moderate, although private debt is rising rapidly. Servicing external public debt, however, will remain a challenge over the next few years, with debt service requirements for 2006 estimated at almost US$ 2 billion, compared with less than US$1 billion in 2004.

The Serbian economy has strong growth potential, but the risks that this potential is not realised are high in the short-term. The main reason is that unresolved issues about the country’s future, especially in relation to ongoing negotiations about the future of Kosovo, threaten to distract attention from urgent economic reforms and, if tensions were to escalate, would deter foreign investment. Large parts of the corporate sector are in urgent need of restructuring and new investment. Another short-term macroeconomic risk is that credit to the private sector will be squeezed by a combination of high public investment and spending and the ongoing battle by the central bank to dampen further inflationary pressures.

2.1.3. Social Conditions

According to the 2002 census, Serbia (excluding Kosovo) had a total permanent **population** of 7,498,001, down from 7,839,000 in the 1991 federal census. The 2002 census did not cover Montenegro and was boycotted by the ethnic Albanian majority in Kosovo. According to the 2002 census, 15.7% of the population of Serbia were below the age of 15; and some 16.6% were aged 65 and above. Almost 83% of Serbia's permanent population classified themselves as ethnic Serbs. Hungarians, making up less than 4% of the total population, were the next largest group. Those defining themselves as 'Yugoslavs' made up 1.1%of the population, Serbian-speaking Moslem made up 0.1%

Elementary **education** is compulsory in Serbia. Up to now full-time education has been free, financed from public revenue. According to 2002/03 data, institutions of primary, secondary and higher education in Serbia (and Montenegro) had 1.3 million pupils enrolled. There are universities in Belgrade, Novi Sad, Nis and Kragujevac. The standard of education has declined since the disintegration of the former Yugoslavia. **Health** statistics show that, despite decreases in mortality rates in recent decades, mortality indicators remain much less favourable than in developed countries. However, Serbia does not appear to have experienced the demographic crisis seen in many transition economies. In 2003 average life expectancy in Serbia was 70.0 for males and 75.2 for females, slightly higher than a decade earlier. The infant mortality rate was an estimated 7.5 per 1,000 in 2004.

2.1.4. Labour Issues

Labour markets in Serbia remain characterised by rigidities and high unemployment. The unemployment rate is currently estimated at around 20 per cent of the labour force, although these calculations are necessarily rough approximations as many individuals work in the informal sector. A new Labour Law passed in 2005 provides considerable protection to workers from dismissal and has been criticised by some international institutions for being insufficiently flexible. The law allows workers, except for the uniformed soldiers and policemen, to form and join trade unions. The government has also adopted a National Employment Strategy for the period 2005-10, and, with the assistance of the EAR, a National Action Plan for 2006-08. Approximately 95% of the workforce is unionized. The trade unions have strong connections to political parties, especially those that supported the Milosevic regime.

The law prohibits trafficking in persons, but there were reports that persons were trafficked to, from and within the republic. Some police officers and other officials were reported to have been involved in human trafficking but there were fewer cases reported than in previous years. The republic remained primarily a transit point for trafficked persons, particularly women and children and to a lesser extent a destination. Victims came through Serbia and often continued to Italy and other West European countries. The police and NGOs reported a large number of cases of internal trafficking, particularly involving victims from Serbia.

2.1.5. Legal Reform

Legal reform in Serbia continues to be a top priority. Although the continuing transition has not yet eliminated all structural barriers, the Serbian government has recognized the need to reform the business environment and open the economy to foreign participation.

In the past two years a number of important legislative acts has been enacted to support the business environment reform, including: law on banks, foreign exchange law, law on securities, companies' law, take-over law, law on investment funds, law on arbitration, law on mortgages and law on the organisation of courts. Certain other, such as the law on foreign investment and law on factoring, have been drafted and await parliamentary vote.

Further, the Serbian government launched its second Action Plan for 2005-2006 identifying barriers and setting up a framework to work with the business community to eliminate these barriers. The Action Plan and the Strategy for Encouraging and Developing Foreign Investment prepared and published by the government in March 2006 recognised the following law related issues as major barriers to foreign investments in Serbia: (i) land ownership and access to land, (ii) improvement and modernisation of court system, (iii) privatisation and deregulation of telecoms sector, (iv) construction laws and building regulations, and (v) non-competitive and uncertain fee and levy structures. The strategy provided for deadlines for adoption of various laws to eliminate the above barriers. Some of the new laws listed in the preceding sentence have been adopted in accordance with the Serbian government's Action Plan.

2.1.6. Environmental Issues

Serbia inherited from the past decades both poor environmental quality (particularly in a number of hot spot locations such as Bor, 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 adequate air emission control of the heavy industrial, power and energy and transport sectors.

Since February 1991, the Serbian Government has been attempting to establish a modern and comprehensive legal and executive environmental and nature conservation protection functions. The Ministry for Protection of Natural Resources and Environment was restructured according to the EU recommendations in 2002 (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.

In 2003, the Government adopted the National Waste Management Strategy, which is currently being implemented. Waste management is one of the priority also recognized by the present Governments.

The Law on Environmental Protection, as well as SEA, EIA and IPPC Law were adopted in 2004. The first and comprehensive National Environmental Strategy (NES) and National Environmental Action Plan (NEAP) have been prepared with the assistance from EU. NES, Draft Law on Waste Management and Draft Law on Air Protection has been sent to the Parliament for discussion.

According to the NES, general objectives of the environmental policy are: (i) integration of environmental policy with the policies of other sectors; (ii) strengthening of institutional capacities; (iii) improvement of environmental monitoring and enforcement system; (iv) building of comprehensive system of environmental legislation; (v) development of effective system of environmental financing and economic incentives; and (vi) improvement of environmental education..

The NES has established short-term objectives for the period 2006-2010 which are concentrated on improving the legal framework, developing sectoral strategies and investment plans, and improving the monitoring system. The ongoing policy objectives for the period until 2015 focus on extension and modernization of environmental infrastructure, nature conservation and biodiversity related objectives. Implementation of these objectives will concentrate on sanitary landfills, wastewater treatment plants, air pollution abatement technology, traffic improvements etc., and consequently incur high investment costs.

The mid-term objectives suggested by the NES, the Government will need to focus on further pollution reduction (e.g. recycling and reuse of certain waste streams, pollution reduction in navigable waters, sewage sludge management).

The NES has estimated that environmental improvement needed for Serbia to reach the EU environmental standards could cost approximately €4.0-4.5 billion in the next 15 years. Larger share of investments will be needed in the following sectors: energy (29%), waste management (24%), water and wastewater management (21%); and environmental protection in transport sector (12.5%). Total investment in air quality improvement will require 40% of the above mentioned investment. EBRD has been actively supporting the Serbian Government in addressing some of these environmental issues since Serbia and Montenegro joined the Bank in January 2001. The Bank will strive to continue its support by working with sponsors and other international organizations to develop bankable projects in the above mentioned area.

EBRD will continue to ensure that the investment projects in Serbia are implemented according to EBRD Environmental Policy which requires EBRD to ensure that its policies and business activities promote principles of sustainable development. More specifically, EBRD will also continue to ensure that for those investment projects requiring EIA, this process is carried out according to EU, national and EBRD Environmental Policy requirements.

2.2. Progress in Transition and Challenges Ahead

Serbia’s transition to a market economy began much later that on other countries of the region, after the lost decade of the 1990s. Serious reforms began after the formation of a broad coalition government in January 2001, under Prime Minister Djindjic. Since then, the pace of reform under successive governments has generally been rapid, but delays have occurred along the way and the scale of the transition challenges ahead is still daunting.

The privatisation programme has advanced significantly in recent years. Small-scale privatisation is on course for completion in 2007 and more than 200 companies were privatised through auctions in 2005, with a similar pace being maintained so far in 2006. Several large industrial enterprises are being prepared for privatisation, notably the oil and gas company Naftna Industrija Srbija (NIS), where a tender for a minority stake of 25 per cent (with the option to increase the stake to 37.5 per cent) was approved by the government in August 2006. A second stage of privatisation in three years time would allow the buyer to increase its share of the company to 49 per cent.

However, progress on privatisation of other large enterprises has been slower than planned.

The business environment is much improved relative to a few years ago. The implementation of new laws in bankruptcy and company legislation has advanced slowly in 2005 and the first half of 2006. More than 1,000 bankruptcy cases were registered in 2005, but so far, only a small number has been processed. Implementation is being held up by slow progress in training new licensed bankruptcy administrators, and by reluctance of the authorities to speed up this painful process. Business registration procedures have been greatly simplified, but evidence from surveys such as the EBRD/World Bank BEEPS suggests that corruption remains a major problem.

Infrastructure reforms have advanced slowly. The biggest privatisation since reforms began took place in August 2006 in the telecommunications sector, with the sale of Mobi63 (see above). However, there has been little progress in effective market liberalisation in the fixed line sector. Although a new regulator, the Telecommunications Agency, was established in December 2005, the majority state-owned Telekom Srbija retains a stranglehold in the market with little sign of any genuine competition being introduced in the near future.

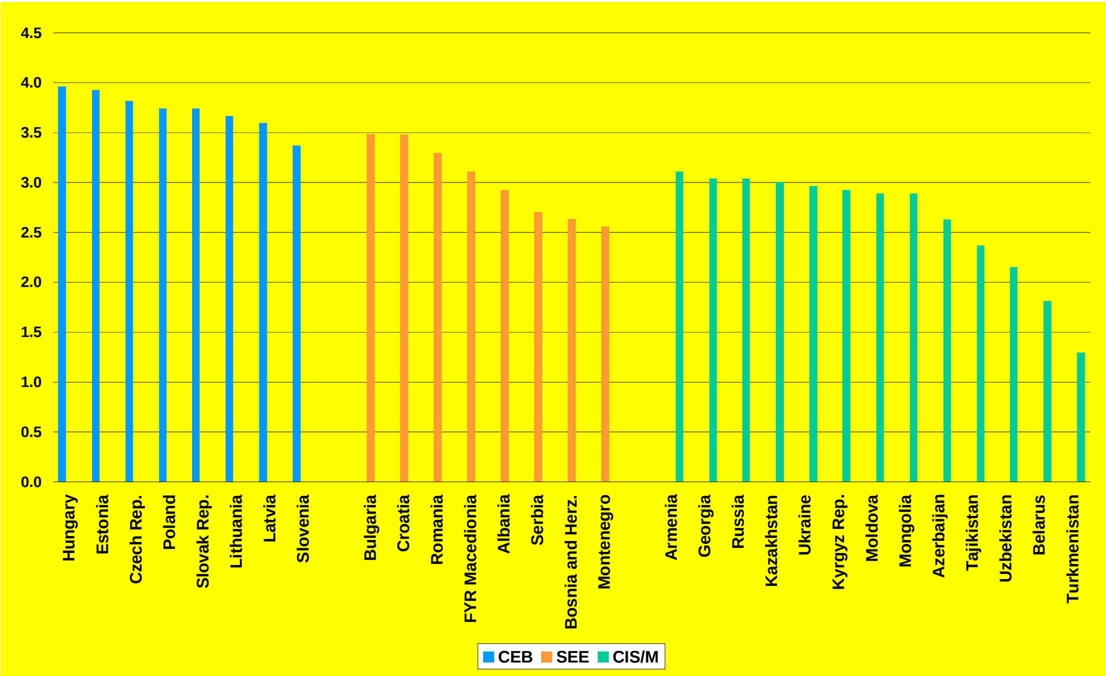
Further reforms have occurred in the roads and railways sectors over the past two years. In roads, out of approximately 25 maintenance companies, some 20 companies were privatised during the course of 2005. In addition, the former Roads Directorate has been transformed to Public Enterprise Serbian Roads as per the new Roads Act passed in late 2005. Consolidated road user charges are above the cost recovery level. In railways, the government finally adopted a new railway law at the beginning of 2006. The Railway Act stipulates for the separation of infrastructure and operations, the implementation of access charges and open access to other operators, and the introduction of a Public Service Obligations. Internal re-organisation, which split infrastructure from operations, has already been implemented. As noted earlier, the Serbian railways have implemented a major programme of staff reduction. Staff numbers have declined to 22,617 from 33,741 in 2001. Moreover, it has implemented the divestiture of non-core activities with 16 non-core subsidiaries.

In the power sector, as outlined above, the groundwork has been laid for further sector reform through the separation of the transmission company from the integrated utility, the reconnection to the UCTE network, the establishment of an independent regulatory agency and participation in the regional energy market. However, there is currently little political will to take these reforms to the next step of full unbundling of the sector, market liberalisation, and privatisation.

A number of significant privatisations have occurred in the banking sector over the past year, including Vojvodjanska Banka, Niska Banka, Panonska Banka and Kulska Banka. As a result, the state’s share of banking capital has shrunk to 21 per cent by mid-2006. In addition, the pre-privatisation agreement signed in March 2006 between the government and the EBRD for Komercijalna Banka will help prepare this bank for privatisation in three years time. In the insurance sector, the NBS has withdrawn the licence of a number of companies that did not satisfy required standards, and it has put up for sale a number of companies, including at least 80 per cent of the second largest company, DDOR Osiguranje, in May 2006.

Serbia still faces major transition challenges over the medium-term. Successive governments have rightly been praised for their commitment to reform in difficult circumstances, but the pace of reform has been somewhat uneven. Given the low starting point of the country, much more needs to be done to bring the level of transition closer to the new EU members. An indication of the scale of the challenges ahead is apparent from the EBRD "transition indicators", published annually in the EBRD *Transition Report*. Chart 1 presents the 2006 average transition score across the region, with countries grouped by three broad regions: central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent states (CIS) plus Mongolia. The chart shows how far Serbia has to go not only to catch up with the EU members of CEB but also with other SEE countries such as Bulgaria and Romania, both of which joined the EU on January 1, 2007.

Chart 1: Average Transition Score



Source: EBRD Transition Report 2006

The main transition challenges facing Serbia include the following:

- **The privatisation programme needs to be completed.** While small-scale privatisation is well advanced, a number of larger state- or socially-owned companies are in need of basic restructuring and need to be either sold or closed down. This programme needs to be accelerated in order to attract much-needed investment and boost the competitiveness of these industries.

- **New laws must be implemented effectively.** Important new laws to promote enterprise performance, including in the areas of competition policy and bankruptcy, have been passed in recent years but the challenge is to ensure effective implementation. Businesses continue to report serious concerns, including corruption.

- **A more commercial approach is needed in the provision of infrastructure services.** Infrastructure reform is advancing but there are many challenges ahead in roads, railways, energy, municipal infrastructure and telecommunications to ensure that competition, commercial orientation and an enhanced role for the private sector are fully introduced.

- **Non-bank financial institutions need to be developed.** The banking sector has seen dramatic progress in recent years, from a position of virtually zero trust in banks at the start of transition. Credit growth is rising rapidly and good-quality foreign banks are now key players on the market. The challenge now is to ensure that credit growth is managed carefully and that non-bank financial institutions are developed to full potential.

2.3. Access to Capital and Investment Requirements

Enterprises in Serbia generally have limited access to outside sources of finance, although the situation is improving rapidly. In the 2005 EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), enterprises in Serbia and Montenegro continued to identify lack of access to finance as a major obstacle to doing business. However, domestic credit is growing rapidly, in line with the fast development of the banking sector (noted above).

Other non-bank sources of finance remain limited in Serbia. Activity on the Belgrade Stock Exchange has increased over the past two years but from a very low base. The insurance sector is still dominated by the state, although plans for privatisation of several large insurance companies have advanced, while pension reform is at an early stage. FDI is buoyant over the past couple of years, and access to foreign capital is likely to be an increasing source of finance for large investments over the medium term, especially given the improved country image and ratings by foreign credit agencies such as Standard and Poor’s and Fitch.

3. STRATEGIC ORIENTATIONS

3.1. Bank’s Priorities for the Strategy Period

The Bank is ready to co-invest with strong foreign corporates willing to expand into the Serbian market. Many western corporates are expected to gradually shift their production facilities further east in search of lower costs of doing business. Serbia will be in a good position to attract such investors due to its proximity to the EU market as well as its skilled labour force. Employee costs are relatively low, the corporate income tax rate is one of the lowest in Europe, and corporate tax holidays and other incentive schemes introduced by the Government may also play a role. The Bank will also actively expand its financing to local corporates, provided that they meet EBRD’s standards of corporate governance and transparency. Some important large corporates have grown rapidly in the past five years, frequently through high leverage and are approaching a point where they can easily emerge as regional leaders after consolidation in their respective fields, with the assistance of a strategic partner like the Bank. The Bank will also seek opportunities to finance strategic investors in other sectors where major privatisations are expected, including natural resources (oil, gas and mining), and insurance.

Over the next two years, the Bank plans to continue working closely with the Government on a range of infrastructure projects that have been identified as top priorities both by the Government and by the EU. They are primarily related to further developing Serbia’s transport network, especially along Pan European Corridor VII

(Danube) and Corridor X (completion of a modern highway from the Hungarian border to FYR Macedonia and Bulgaria). The development of these networks will further foster Serbia's ties with neighbours, its role as one of the key transit countries in Eastern Europe and its potential in attracting new FDIs.

During the next two years the Bank expects that infrastructure reforms, including the introduction of Public-Private Partnerships (PPPs), will advance in Serbia, and that the Bank will be able to play an important role in this process. Being already a leader in the country with the first syndication of an infrastructure project (Belgrade Sava bridge) the Bank will try to repeat this type of financing and will seek other commercial banks to co-finance larger and more complex projects. Not only will this provide capital to clients, but it may also encourage the banking sector to offer new and more complex products to the local market. One such potential PPP in the roads sector is in preparation with the active involvement of the Bank. If all preconditions are met and investors respond to the Government's initiative this would be an excellent way forward in using private money for the infrastructure projects. Due to the country's limited borrowing capacity this would be a way to finance much needed infrastructure development without jeopardising macroeconomic stability.

The Bank is monitoring the current macroeconomic conditions in view of raising local currency funding as soon as feasible. Together with the local counterparts including the central bank and commercial banks, the Bank will be working on preparing the legal and technical environment for this initiative.

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

The Bank will continue to provide financing for privatization and post-privatization restructuring to both local and foreign corporates, and will increasingly focus on financing large corporates as they consolidate and expand throughout the region. The new Italy/EBRD Western Balkans Local Enterprise Facility provides an additional opportunity to target smaller companies with strong growth drivers, primarily in the form of equity financing. Serbia traditionally has a strong agribusiness sector and it is expected that the biggest number of transactions will continue to be generated in this segment. However with privatisation of large state-owned enterprises (SOEs) currently under restructuring, further opportunities are also expected in other sectors particularly in general industry and natural resources. SOEs are expected to become more attractive targets for strategic investors, either as legal entities (after spinning off non-core activities, without major burdens in terms of excess labour force and without previously inherited debt) or as assets through bankruptcy.

Several investments may be financed in the property sector. The Bank will offer selective support to projects that promote better office space, logistics/warehouse, hotels and retail infrastructure, in response to demand, with the provision of mainly long-term senior debt or a combination of debt and equity supported by an agreed exit. The Bank will continue to facilitate the development of quality hotel and office infrastructure in Belgrade and other major cities. The Bank will also endeavour to selectively support residential developments, and projects that promote better logistics and retail infrastructure.

The Bank will continue its assistance and support to local enterprises provided through the TAM and BAS programmes. The TAM Programme has operated in the country since 2001 and has carried out 86 projects successfully. Of these, 68 were funded by EAR and 18 by several bilateral Donors. In line with the focus of TAM moving away from capital cities, 75% of projects have been outside Belgrade. BAS Programme in Belgrade has started its operations in July 2006, thanks to the support of the Netherlands Ministry for Development Cooperation, and has undertaken seven projects so far. There are a further 14 projects in the pipeline. The Programmes are designed to promote private sector development of SMEs, enabling them to adapt to a free market economy and to assist companies to be more competitive on domestic and international markets. Both TAM and BAS will continue to work directly with individual enterprises, providing assistance in restructuring of the business, improving products, technical and environmental upgrades, quality certification, advising on market positioning and helping to develop business management and planning skills. The TAM/BAS will also assist in communicating with potential investors, including the Bank. There are strong parallels between the work of TAM/BAS and the investment priorities of the Bank, and the linking of TAM/BAS expertise with banking teams and resident office will be achieved during both pre-investment and post-investment activities.

3.2.2. 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. The majority of investments in terms of volume is expected in the Transport sector in order to complete the development of a modern highway and railway network on Corridor X. Additional investments are expected in projects to shift transit traffic away from major metropolitan areas. In this regard, the first priority will be to co-finance the completion of the Belgrade Bypass. Similar projects may arise over the medium-term in other cities where traffic density is rising rapidly, such as Novi Sad and Nis. Moreover the Bank will seek to structure bankable deals that will improve navigation Corridor VII (Danube river). The Bank will also seek to support Public-Private Partnerships (PPPs), with the road sector being the most likely candidate for this mode of financing in the medium term.

In the municipal sector the Bank expects to continue its successful cooperation with the city of Belgrade and work on successfully completing signed projects. It will also seek to diversify its financing to medium-sized cities or regional financing, provided their financial strength is adequate, in the area of water and waste water management, landfills and waste management, district heating and urban transport. Policy dialogue will focus on the need for greater fiscal decentralisation in order to ensure adequate financial basis for lending to local governments without a sovereign guarantee.

Finally, the Bank will continue to support energy sector development particularly through the commercialisation of the energy utilities and possible future private sector participation through PPP financial structures. The Bank will endeavour to develop its operational activities in the sustainable energy and energy efficiency areas. The focus will also be on disbursing the remaining amounts under the two loans signed in 2001 and 2003. The Bank will be active in its policy dialogue with stakeholders (regulatory bodies, government institutions, and energy companies) in order to ensure that a sound legal and regulatory framework is being implemented and that the groundwork is laid for full unbundling of the sector, transparent tariff-setting, market liberalisation and eventual privatisation.

3.2.3. Financial Sector

The Bank will seek to assist banks that have a strong presence in the country and are looking for opportunities to increase market share and introduce new products. Even though high reserve requirements make the environment for loan facilities more challenging, the Bank will seek to continue working with local and foreign banks and investment funds such as the European Fund for South East Europe (founded in December 2005 by the German government) by providing SME and mortgage lines, thus fostering the development of a healthy SME sector in the Country. Furthermore, the Bank will increasingly look for equity and debt transactions in non-banking financial institutions. Following the adoption of the new Insurance Law two years ago, the National Bank of Serbia as the new supervisory entity has taken bold steps to clean up the sector and has halved the number of insurance companies. Similarly the state recently launched a tender to sale the second biggest insurer and is in the process of restructuring the biggest local insurance company. All these measures provide reassurance that this sector will follow the path of steps taken in the banking sector; therefore, the Bank will seek to actively participate in the emergence of a healthy insurance sector. Similarly increased financing is expected for other non-banking FIs primarily in the area of leasing and pension funds.

In the financial sector, the Bank will continue to focus on: (i) providing banks with funding and institutional support to assist the banks to develop new products (including TFP and co-financing), growing their business on a sustainable basis, and improve corporate governance; and (ii) channelling more funding to SMEs through commercial banks and micro-lending institutions, including through the implementation of the Western Balkans SME Finance Facility and the MSME Finance Framework for Western Balkans and Croatia.

4. CO-OPERATION WITH OTHER IFIs AND MULTILATERAL DONORS

Cooperation with donors and IFIs has been very good in Serbia over the prior period. The Bank has a close working relationship with all major stakeholders and has co-financed a number of projects with other multilateral and bilateral financial institutions. The teams are in constant dialogue with all key stakeholders and institutional reforms and priorities tied to the Bank's financing are always set in close consultation with all parties. TC and other co-financing have been crucial in ensuring that Serbia achieves substantial strides in areas where the Bank has provided financing like the roads sector and railways. The Bank will continue to work closely with EU/EAR, other IFI's and bilateral donors in this segment over the upcoming period.

4.1. European Union (EU)

The EU is the largest donor in Serbia and has played a leading role in supporting the reconstruction of Serbia through grant funds in the initial phases of transition. The EU's assistance has focussed on good governance and institution building, economic reform, social development and civil society, as well as large contributions to the energy sector, transport and municipal infrastructure.

The EU funding support, as well as other donor activities, is closely coordinated through the Development Aid Coordination Unit (DACU) of the Ministry of International and Economic Relations of the Republic of Serbia (MIER) which was set up by the government as a focal point to increase strategic planning capacities and to improve donor coordination.

The EAR manages the EU's main assistance programmes in Serbia on behalf of the European Commission (EC). Serbia also benefits from EC assistance not managed by the EAR, and this includes macro-financial, humanitarian, democratisation, custom and fiscal planning aid, support for higher education cooperation programmes, the CARDS Regional Programme. In addition, Serbia also receives bilateral contributions made by EU Member States.

The Bank has established very good cooperation with the EAR, and has been actively cooperating in the framework of both TC and co-financing. The EAR is the largest donor of TC Funds towards Bank financed projects, with more than €10.6 million commitments, mostly used for project preparation, implementation and institutional reform prior to investments being made, and supervision works during the project implementation.

The cumulative portfolio of funds managed by the EAR in Serbia now amounts to €1.13 billion. As of June 2006, 86% of these funds have been contracted, and 70% paid. Implementation of the 2006 programme included another €142 million. The EAR started the implementation of their exit strategy. There will be non new budget allocation for 2007 and, by 2008, the Agency activities will come to an end.

Serbia is considered by the EU as a "Potential EU Candidate Country" and, as such, the Country will benefit from the newly established "EU- Instrument for Pre-Accession (IPA)"over the period 2007-2013. The European Commission's CARDS Programme together with the EAR will terminate their activities on December 31st 2006 and will be basically replaced by the "Instrument for Pre-Accession – IPA". The main objective of the Instrument for Pre-Accession Assistance (IPA) is to help Serbia face the challenges of European integration, to implement the reforms needed to fulfil EU requirements and progress in the Stabilisation and Association Process and to lay the foundations for fulfilling the Copenhagen criteria for EU membership. The indicative allocations to Serbia under the Multi-annual Indicative Financial Framework (MIFF) 2007-2009 amount to € 572.4 million. Over the period 2007-2009 the IPA assistance to Serbia will mainly address "Transition assistance" and "Institutional building" with a "Cross Border Cooperation" component. The full implications for operational support of activities falling within EBRD's mandate have yet to be determined.

4.2. European Investment Bank (EIB)

The EIB has started its operations in Serbia in 2001 and is working closely with the Bank on a number of projects. To date the EIB have concluded 19 loan agreements making available financing of €852 million for projects in the financial sector in favour of SMEs and municipal infrastructure, airport modernization, roads rehabilitation and construction, railway rehabilitation, urban infrastructure, energy, health and education, with the transport sector being the largest recipient of funds.

Having contributed €425 million towards Bank financed projects the EIB is by far the largest co-financier in Serbia. This includes two projects in road rehabilitation and construction, railways, air navigation system, power and energy and municipal infrastructure. Most of the co-financed projects have received additional grant funding from the EAR primarily for supervision of works and setting-up project implementation units.

While continuing its support for reconstruction and upgrading of the regional and municipal networks of basic infrastructure (transport, energy and the environment), the EIB plans to increase its assistance to the private sector and lend more in the health and education sectors in the coming years. Also, the EIB intends to explore the possibility of further co-financing opportunities with the EBRD and other IFIs.

4.3. International Monetary Fund (IMF)

The International Monetary Fund (IMF) has to date approved around EUR 2 billion loans to Serbia. Part of the funds have been prepaid during 2006 as the Government has benefited from windfall privatization receipts and has recorded budgetary surpluses over the past two years.

In February 2006, the Executive Board of the IMF completed the sixth and final review of Serbia economic performance under an Extended Arrangement and approved USD 90.1 million disbursements.

On July 21, 2006, following the Montenegro declaration of independence, Serbia's membership was not affected as it became the legal successor of the former State Union.

Additionally, the IMF provides the government and central bank of Serbia with technical assistance and training in its areas of expertise such as fiscal and monetary policy, statistics. The main goal of these projects is to strengthen central bank's human and institutional capacity as well as assist in designing and implementing effective macroeconomic and structural policies.

4.4. World Bank Group / IFC

In May 2001, Serbia and Montenegro succeeded to membership in the World Bank and after the referendum on independence in Montenegro in May 2006, Serbia as the legal successor replaced the Union as a member of the World Bank.

The World Bank has supported Serbia through Government's Economic Reconstruction and Transition Program financed under a three year exceptional IDA allocation of up to USD 540 million.

World Bank's financing over the prior period was primarily in the form of structural adjustment credits (SAC's) linked to policy and institutional 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 is assisting the Serbian authorities implement policy reforms through a three-year (2005-2007) Country Assistance Strategy program of USD 400-550 million, with a three key objectives: (i) more efficient public sector, (ii) more dynamic private sector, and (iii) reducing poverty levels.

Since becoming a member of IFC in 2001, Serbia has received commitments of USD 330 million (as of June 2006), primarily for projects in the financial and manufacturing sectors. Furthermore IFC continues to be one of the leading donors in both in terms of value and volume for various technical assistance projects.

IFC's strategy in Serbia is focused on attracting strategic foreign investors to establish viable financial institutions. IFC will continue to seek investment opportunities in Serbia and in cooperation with other multilaterals will support PPP's as an alternative way to attract private sector investment and fulfil significant infrastructure needs. IFC will also continue to look at opportunities in the oil, transport and power sectors.

4.5. Council of Europe Development Bank

In April 2004, Serbia was approved as the 37th member of the Council of Europe Development Bank (CEB). The CEB, as a multilateral development bank, grants loans to finance projects with a social purpose and it play a key role in the financing of social infrastructure and provide an aid to refugees, migrants and displaced population. So far in Serbia, CEB financed a social housing project for refugees (€20 million) and provided financing of €9.6 million for works to rehabilitated housing damaged by floods in Vojvodina region. The CEB also approved three loan facilities through an Italian bank (total financing €32.5 million) with a purpose to (i) create jobs by expanding the SME sector, (ii) co-finance municipal investments in social infrastructure and (iii) restore and rehabilitate a number of historic and cultural heritage sites.

4.6. Multilateral and Bilateral Donors

Many countries have supported Serbia's transition through financial support and technical assistance. According to data from the Ministry of International Economic Relations, the main bilateral donors up to 2006 are the US, Germany, Italy, Sweden and the Netherlands. Since 2001, the Bank has been actively cooperating with multi and bilateral donors in the framework of both TC projects (for which the aggregate commitments value for the period 2001 – 2006 reached the value of € 32.6 million) and Official co-financing initiatives (€ 670 million is the total amount of contribution to 26 operations). Serbia will remain among the priority countries for the donor community.

Six Donors (EAR, Canada, USA, Italy, France and the Netherlands) account for more than 85% of the total aggregate commitments to Bank-supported projects and the EAR is, by far, the largest donor with more than €10.6 million. There are three sectors which have benefited more from the EBRD TC Fund: Finance (€ 12.9 million), Manufacturing, through TAM/BAS Programme (€ 7.4 million), and Transport (€ 4.8 million). Other sectors having benefited from the TC Support have been Energy, Social services and MEI. To 2006, TC funds in the amount of €5.9 million have been committed to implement assignments in Serbia. EAR (€3.5 million) and Canada (€1.5 million) have been the key donors. Access to credit for small and medium-sized enterprises (SMEs) has been improved through the Western Balkans SME Finance Facility. Additional support has been provided for the TAM and BAS Programmes. In

2003, the Bank set up the Serbia & Montenegro Italian Risk Sharing Facility, whereby the Italian government provided €8.5 million as subordinated co-investment money to make investments in high risk-high return EBRD projects. The Facility money was fully utilised by end-2003 in four large transactions accounting for about €40 million EBRD investment and €80 million total project cost. All transactions are currently repaying.

At the EBRD Annual Meeting held in London in May 2006 the **Multi-donor fund for the Western Balkans** has been officially announced with an initiative to boost private business investment and infrastructure development in the Western Balkan countries, including Serbia. The Fund has become operational in November 2006 with an initial budget allocation of over €13 million provided by fourteen countries.

B. Kosovo

1. THE BANK'S PORTFOLIO

1.1 Overview of Activities to Date

In March 2005, the Bank achieved a Memorandum of Understanding with UNMIK, which granted the Bank the same privileges and immunities as under the Agreement Establishing the Bank. Following the conclusion of the MOU, the Bank increased its business volume by more than six times. As of December 2006, the Bank had a cumulative business volume of €17.9 million (operating assets of €5.8 million), representing 13 private sector projects (equity in ProCredit Bank, Kosovo Reconstruction Equity Fund – co-financed with the Italian Government, a SME Credit Line to Kasabank, a SME Credit Line and a TFP line with Raiffeisen Bank Kosovo, SME and MSE credit lines and a TFP line with New Bank of Kosovo, MSE credit line with the Kosovo Enterprise Programme (KEP), and Euro Fat).

1.2 Implementation of the Previous Strategy

The last country strategy, approved in November 2004, outlined the following strategic priorities for the Bank:

- 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, will be developed.
- In the infrastructure sector, the Bank will support the establishment of an independent telecommunications regulatory agency (TRA) in the implementation of modern standards and identifying solutions for international connectivity of the local telecommunication networks.
- 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.

During the last strategy period, eight operations (two under the Western Balkans SME Finance Facility, one under the new MSME Finance Framework for the Western Balkans and Croatia, three under the new EBRD-Italy Western Balkans Local Enterprise Facility, and two under the regional Trade Facilitation Programme - TFP) were signed.

- The Bank signed a SME Credit Line to Kasabank (EUR 2 million) in May 2005. The team is currently monitoring the situation of the bank in relation to certain operational and corporate governance issues that have arisen and the progress in implementing BPK's Enforcement Order (February 2006) on these matters. The team will consider to make effective the SME credit line as well as to proceed with the TFP line (EUR 1 million) as soon as a satisfactory compliance with the BPK order is achieved.
- The Bank signed a SME Credit Line to Raiffeisen Bank Kosovo (EUR 10 million) under the Western Balkans SME Finance Facility in May 2006 and a TFP line with Raiffeisen Kosovo (EUR 1 million) in July 2006.
- The Bank signed a SME Credit Line to New Bank of Kosovo (EUR 2 million, EUR 1.4 million for EBRD financing and EUR 0.6 million for Italian co-financing) and a MSE Credit Line (EUR 1 million, EUR 0.7 million for EBRD financing and EUR 0.3 million for Italian co-financing) under the EBRD-Italy Western Balkans Local Enterprise Facility in November 2006. The Bank also signed a TFP line with NBK (EUR 0.5 million) in December 2006.
- The Bank signed a credit line to the Kosovo Enterprise Programme (EUR 3 million) under the new MSME Finance Framework for the Western Balkans and Croatia in December 2006.
- The Bank signed a loan to Euro Fat (EUR 1.3 million) under the EBRD-Italy Western Balkans Local Enterprise Facility in December 2006.

The Bank started its assistance and support to local enterprises through the **TAM/BAS programme** in Kosovo in 2005. TAM has carried out 27 projects and BAS 66 projects in Kosovo so far. TAM operations in Kosovo are funded by EAR (EUR 1.5 million granted in 2004. BAS operations are funded by EAR (EUR 0.5 million in 2004) and recently the Netherlands (EUR 0.2 million granted in December 2005).

Telecom Regulatory TC initially started in February 2004 in preparation for the future Bank operations in the sector (such as with Post & Telecommunications of Kosovo, incumbent telecom operator). The TC was restarted in January 2006 and the Bank's consultant is currently assisting PISG Ministry for Transport and Communications and newly established Telecommunications Regulatory Authority (TRA) to develop policy, legal and institutional framework for the sector in Kosovo. The Bank will look to provide further TC in the sector in Kosovo, subject to successful implementation of current TC output.

1.3 Transition Impact and Lessons Learned

The Bank has four MSME credit lines with three local private banks - Kasabank, Raiffeisen Bank Kosovo, and New Bank of Kosova. The Bank also signed a TFP line with the Raiffeisen Bank Kosovo. In the MSE segment, the Bank helped to set up ProCredit Bank Kosovo in 2000. The EBRD owns a 16.67 per cent stake in ProCredit Bank (PCB) worth EUR 1.675 million. PCB's portfolio is growing very rapidly, with the volume of loans to local customers at the end of September 2006 reaching more than EUR 220 million.

Kosovo Reconstruction Equity Fund (KREF) was established in November 1999, a few months after the end of the Kosovo conflict, as a spin-off, cross-border investment of the Albania Reconstruction Equity Fund (AREF), and prior to Serbia becoming a country of operation of EBRD. AREF Fund Manager agreed to extend its operations to Kosovo and a Management Agreement was signed in June 2000. Similarly to AREF, KREF was supported by a special fund created with first loss contributions from the Government of Italy. An extensive search by the Fund Manager produced only six investments worth EUR 1.6 million, indicating the tough investment climate across the province following the collapse of government structures and the loss of all company records, especially for equity-driven deals. Some key **lessons learned** for KREF early years can be derived from a 2004 the Evaluation Department report (PE04-266). These touch upon the need to create sustainable institution building, as well as different mitigating factors while working in post-conflict situations. Today, KREF experience in working in a highly unstable and legally untested territory, in creating a presence on the ground and increasing the Bank’s knowledge of local conditions, and in managing successfully difficult investments (including exposure to the unsophisticated local judiciary system), is proving extremely useful and instrumental for current projects and, in particular, for additional investments approved under the new EBRD-Italy Western Balkans Local Enterprise Facility.

2. THE OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Political Developments

Kosovo, still formally a part of Serbia, is administered by the UN Interim Administration Mission in Kosovo (UNMIK). This is under the UN Security Council resolution 1244 of June 1999. The UNMIK-promulgated Constitutional Framework for Provisional Self-Government in Kosovo (the constitutional framework) defines the provisional institutions of self-government (PISG), including a provisional government and a 120-seat Assembly. There are 21 ethnic minority members in the Assembly, including 10 ethnic Serbs and 11 members of other groups, including ethnic Turks, Bosniaks, Gorani, Roma Ashkali and Egyptians. There are two minority ministers in the provisional government, one ethnic Serb and one Bosniak, and three deputy minority ministers. Some ethnic Serbs are boycotting the work of the Assembly. Multiparty elections for seats in the Kosovo Assembly, held in 2004, were judged by international observers to have been generally free and fair. The President since March 2006 is Fatmir Sejdiu. The Prime Minister, also since March 2006, is Agim Çeku.

International action to determine the province's final status, as envisaged under the UN Security Council Resolution 1244, began in 2005. As part of that international endeavour, direct negotiations between Belgrade and Pristina under the auspices of Martti Ahtisaari, the UN Secretary General's Special Envoy for Kosovo, and Albert Rohan, his deputy and former head of the Austrian Foreign Ministry, began in February 2006. At a series of meetings, the two sides adopted strong and incompatible positions: the Serbian side was prepared to concede a wide degree of autonomy for Kosovo, but ruled out independence. The Kosovo Albanian side, while offering the small Serb minority in Kosovo autonomy within a de-centralised system of local government, insisted on full independence for the province. No progress was made in reaching a compromise. On 28 and 29 October 2006, Serbia held a referendum on a new Constitution, which states that Kosovo is an 'integral part of Serbia'. On a turnout of 54.19 per cent, 52.31 per cent of registered voters were in favour of the Constitution. Kosovo's majority-Albanian population was not registered to vote. A recommendation on the province's final status is expected to be made in the first half of 2007 and brought to the UN Security Council.

Following the resolution of the status issue, the European Union is expected to take a leading role in defining, funding and staffing the international presence. The EU will have a leading role mainly to ensure the implementation of the status in particular in the areas of rule of law and economy. Quarterly meetings under the Stabilisation and Association Process Tracking Mechanism are quietly beginning to gain greater government attention.

2.1.2 Economic Environment

In the face of declining donor inflows, overall GDP growth has been low or non-existent over the last few years. Reliable data on economic activity in Kosovo are scarce. However, according to IMF estimates, GDP fell slightly in real terms in 2005. The level of GDP per capita is currently estimated at around EUR 1100, well below the regional average, and poverty and unemployment are widespread. Nevertheless, preliminary indications of economic activity for 2006 suggest an upturn, driven by robust private sector activity, and the current projection is for real GDP to rise by 3 per cent this year. Prices have been falling on average for several years, with the de facto adoption of the euro providing an important anchor. However, there are serious challenges on both the fiscal and external accounts. A donor conference of April 2006 was largely successful in plugging a EUR 80 million hole in the budget for 2006-2007 combined. The government has committed to a tight fiscal policy, but further cuts to spending are likely to be necessary in view of the projected medium-term decline in donor support. The trade deficit is around 40 per cent of GDP, and Kosovo therefore relies heavily on a combination of remittances (about 17 per cent of GDP) and foreign assistance (21 per cent of GDP, excluding capital transfers).

Looking forward to 2006-2008, the outlook is for stable government revenues, austere public expenditure, and moderate GDP growth. The main potential for growth lies in the private sector, which has grown significantly in the last few years, and has proved resilient to the decline in donor inflows. This has been largely driven by SME development. Having been excluded from public jobs for decades, the Albanian community in Serb-held Kosovo had to develop entrepreneurial skills.

2.1.3 Business Environment

The legal framework for doing business in Kosovo has advanced in recent years, and formal administrative obstacles to setting up a business are low by regional standards. However, according to the US State Department Human Rights Bureau for 2005 (report issued in February 2006), there is a widespread public perception of corruption both in the PISG and in UNMIK. There were reports in 2005 of irregularities involving the PISG's handling of its first international tender for a mobile phone licence. UNMIK voided the PISG-selected winner, requesting that the tender be reissued. The main opposition party, the Democratic Party of Kosovo, continued to criticise the government for corruption and presented its allegation to UNMIK for investigation. In 2003 UNMIK promulgated a law on the access to official documents. However, the law exempts UNMIK documents and was rarely used. According to the OSCE, the provisional government did not provide access to documents in 2005.

Increasing business confidence is demonstrated by a strong pick up in imports of capital goods. SMEs are expanding into import substitution and export activities in labour intensive sectors such as wood and food processing. Large wineries are due for privatisation soon, with some foreign interest. The construction sector is still growing, but at slower rates than the post-war building boom. The private sector is learning by doing – a lot of investment over the last few years has been 'copycat investment', as evidenced by the 1400 petrol stations and many motor hotels in Kosovo. Preliminary interest by potential foreign strategic investors has been expressed regarding the lignite and its use in new power generation projects.

2.1.4 Social Conditions and Labour Issues

Population: According to Kosovo Provisional Government statistics issued in October 2006, the province has an estimated population of approximately 1.9 million, of which 88 per cent are ethnic Albanians, 7 per cent ethnic Serbs and 5 per cent others (Roma, Turks, Bosniaks, etc.). (The World Bank estimates the population as 90 per cent ethnic Albanian and 5 per cent Serb.) The age structure of the population is: 61 per cent in the 15-64 year group; 33 per cent in the 0-14 year group; and 6 per cent in the 65-and-over group. The density of population is 175 per sq km.

Health and education*:* Kosovo's reconstruction has progressed due to local efforts and assistance amounting to around EUR 2 billion. Much of Kosovo's infrastructure, destroyed in the 1998-1999 armed conflict, has been restored. Housing has been built providing homes for about 300,000 people, and 1,400 km of roads have been rehabilitated. The rebuilt health clinics and schools have ensured that basic health and education services are maintained. In addition, agricultural production has increased significantly, with wheat, beef and milk production now exceeding pre-conflict levels. However, poverty is still widespread. About 37 per cent of the population live in poverty – up to 15 per cent in extreme poverty (EUR 0.93 a day). In terms of educational poverty, 7 per cent of the population aged 15 and above are illiterate, and half of the adult population has only completed primary education. However, some progress has been made: the illiteracy rate has been reduced to 0.5 per cent among children and youth. However, there is a serious lack of space and classrooms, with some schools operating 3-4 shifts a day. Kosovo's infant mortality rate, at 35 per 1,000 live births, is the highest in south-eastern Europe. Tuberculosis, disability and mental health are major issues. The Kosovo social protection system tries to provide pensions to all individuals of age 65 and above, regardless of their ethnic background. According to the World Bank, socio-economic disparities between Albanians and Serbs are modest and do not appear to be a factor fuelling tensions between the two communities. However, the Serbian government maintains parallel structures for the provision of social services, especially pensions, to the Serbian minority, which are not available to ethnic Albanians. This is seen by outside observers as not helping the province's social integration

Labour: In Kosovo, formal employment is scarce and unemployment is very high. Unemployment in Kosovo was already widespread in the pre-transition period, with an estimated 36 per cent rate in 1990. This climbed throughout the 1990s to an estimated 68 per cent in 1999 before the war. Since the end of the conflict, and despite the recent growth performance and an increase in private sector activity, the situation in the labour market has not improved significantly, with unemployment currently estimated to be at least 40 per cent of the labour force. UNMIK regulations allow workers to form and join trade unions without previous authorisation or excessive requirements, and workers exercise that right in practice. The only significant union, the Association of Independent Trade unions of Kosovo (BSPK), claims over 120,000 members, but only 50,000 of its members, or 10 per cent of the total labour force, are employed. UNMIK regulations provide the right to organise and bargain collectively, and the government does not restrict that right in practice. However, collective bargaining is rare. UNMIK regulations do not recognise the right to strike, but strikes are not prohibited in practice and occur from time to time.

UNMIK regulations criminalise trafficking in persons. However, trafficking of women and children remains a serious problem, with evidence that both international and local PISG officials are involved. UNMIK, the Kosovo Protection Service, the border police, the OSCE, the office of Good Governance ands the Ministries of Health, Education and Public Services, and labour and social welfare bodies are responsible for combating trafficking. The PISG's Action Plan to combat trafficking was published in May 2005, with the purpose of consolidating government efforts to combat trafficking. Kosovo is a source, transit and destination point for trafficked persons. Internal trafficking is a growing problem. The vast majority of women and children trafficked into Kosovo come almost exclusively from Eastern Europe, the Balkans and the former Soviet Union. – primarily for sexual exploitation but also for domestic servitude or forced labour in bars and restaurants and through Kosovo to FYR Macedonia, Albania and Western Europe. In 2005 the UNMIK/KPS joint anti-trafficking unit conducted 2,025 bar checks, 60 raids and 2,386 inspections resulting in the closing of 76 premises suspected of involvement in trafficking.

2.1.5 Environmental Issues

Kosovo has inherited a large number of environmental problems, which accumulated for decades as a consequence of uncontrolled use of natural and mineral resources, industrial production coupled with high level of pollution, as well as lack of appropriate policies, laws and relevant institutions to treat and solve these problems. This has resulted in a clearly visible degraded environment, in some cases even un-repairable, which can have a direct negative impact on the public health.

At the end of the conflict in 1999, the United Nations Mission in Kosovo (UNMIK) started formulating a sustainable development policy. 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.

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. The Administrative Department of Environmental Protection was established by UNMIK in 2000 to deal with environmental transboundary issues. The Law of Environmental Protection was adopted by the Provisional Institutions of Self-Government under the UNMIK in April 2003 followed by preparation and adoption of Kosovo Environmental Action Plan (KEAP) in April 2006. Separately, UNMIK has passed a Regulation No. 2004/49 on the Activities of Water, Wastewater and Waste Services Providers in November 2004. Therefore, the main legal and regulatory framework has been set up. Kosovo's Ministry of Environmental Protection and Spatial Planning is responsible for implementation of KEAP.

Kosovo is currently moving towards European integration processes which demands responsible actions from all relevant institutions, especially in the form of efficient sectoral policies. As seen above, Kosovo has gradually been developing environmental legislative systems and establishing competent authorities, at the central or local level, as well as preparing major policy documents, such as the State of the Environment Report 2003 and the Kosovo Environmental Strategy. These are main achievements of the Ministry of Environment and Spatial Planning. The Kosovo Environmental Action Plan (KEAP), as a part of the Governmental Programme, is the first such a document developed in Kosovo, which aims at gradual improvement of the environmental situation and protection of public health in general. The KEAP, for the next 5 years, will be the main framework of all activities to be undertaken for the purpose of gradual environmental improvement and protection in Kosovo, where all environment-related priority activities of respective local and central institutions should be based on. The Kosovo KEAP specifies concrete tasks for decision makers and indicates clear responsibility for all players. With a clear timeline to finalise primary as well as secondary environmental legislation, the KEAP will enable Kosovo to harmonise its policies with the requirements of environmental *Aquis Communitaire*. This will occur in parallel to the solution of Kosovo's political status and steps towards European integration, where the environment is considered as one of the most important issues.

The KEAP also sets clear guidelines for international funding mechanisms for the donor community in Kosovo, which up to now have assisted environmental developments, and will continue assisting the Ministry of Environmental Protection and Spatial Planning. The realising of these guidelines are priority actions listed in the document for Kosovo in the next five years.

Indeed, the Swedish Government through its development agency, SIDA, financed the development of the KEAP, as well as the Regional Environmental Centre, Field Office Kosovo, is assisting the Government to successfully and timely implement this plan.

Given the low level of large scale industrial activity at present and limited scope for rapid economic development in the short term, EBRD has mainly supported the establishment and growth of the small and medium enterprise sector since the end of conflict. Environmental risk management 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.

2.2 Progress in Transition and Challenges Ahead

Given the post-war situation and the uncertainty over future status, Kosovo’s transition to a market economy has been slow and uneven. The authorities in power since 1999 (both UNMIK and the PISG) have instituted some reforms in a number of areas, notably in the areas of private sector development, the creation of an enabling business environment and banking sector reform. However, in areas of institutional reform such as large-scale privatisation, corporate governance, competition policy and commercialisation of infrastructure, Kosovo has a long way to go. Regardless of the decision on final status, Kosovo faces huge transition challenges over the coming years. These include the following:

2.2.1 Enterprise Sector

Privatisation has advanced but fresh investment is limited. Following the recent removal of the legal logjam to privatisation, Kosovo’s record on small and medium-scale privatisation has been good. By the first half of 2006, 178 enterprises had been tendered for sale by the Kosovo Trust Agency (KTA) with the majority sold, yielding privatisation receipts of more than 10 per cent of GDP. However, agribusiness privatisation has been constrained by land issues, which are now being resolved by the KTA. About 90 percent of privatisations have been to the Kosovo Albanian diaspora.

Looking ahead, the challenge is to complete the privatisation or liquidation of SMEs as soon as possible, and then concentrate on larger enterprises, including public utilities. More generally, further improvements to the business environment will be required in order to attract much-needed investment, both domestic and foreign.

Small Business Finance – access to financing continues to be one of the biggest obstacles for micro and small businesses, particularly in the rural areas. Development of financial services for individual entrepreneurs continues to be a challenge of the overall development of the sector.

2.2.2 Financial Sector

Significant progress has occurred in recent years in Kosovo’s banking sector. There are six banks in the province, all privately-owned, as well as a number of other financial institutions and insurance companies. The largest banks are Pro-Credit Bank and Raiffeisen Bank Kosovo. A bank regulator – the Central Banking Authority of Kosovo (CBAK) - was created under UNMIK and IMF guidance and is performing well. Basle standards are already being implemented and capital adequacy is strong. Leverage is expected to grow only slowly as the private sector expands. The regulator has already received significant foreign assistance and this is expected to continue. All banks are maintaining a minimum total capital to risk-weighted asset ratio of 12 per cent and a Tier I capital to risk- weighted asset ratio of 8 per cent. The liquidity reserve ratio of deposits is 10 per cent.

Notwithstanding the improvements to date, banking sector intermediation is still limited and the development of the non-bank sector is in its infancy. Increased pressure on non-bank microfinance institutions to become commercial and less dependent on grants is leading to various transformation alternatives. The challenge is to advance the development of the sector and to ensure that more funding is available for MSME development.

2.2.3 Infrastructure

Reform of large public enterprises is at an early stage. Kosovo inherited large public companies and utilities that were underinvested and structured according to socialist lines. There has been a progress in reforming publicly-owned enterprises (POEs). 8 main POEs, including the airport, the railways, the Post and Telecommunications, the energy utility (KEK), were incorporated in 2006.

Power sector reform is urgently needed. The state-owned energy utility company 'KEK', is in poor shape and adds an estimated 10 percent to business costs. In August 2006 the Government published a request for the *Expression of Interest* which establishes the process through which the private sector may participate in the development of Kosovo's energy sector ("Energy Sector Development Project"). The Project will involve the: a) Construction of a new power plant 'Kosovo C' with an estimated installed capacity of up to 2100 MW and associated transmission capacity; b) The development of a new coal mine for existing generation units and development of a new mine (the Sibovc mine) for Kosovo C; and c) Rehabilitation of certain units of the existing power plant 'Kosovo A' ("PPA"). This announcement was followed by an International Investors Conference which provided a forum for interested investors to meet with government officials, energy and mining specialists, legal experts and engineers to discuss various aspects of the Project. The conference attracted a lot of private sector interest in the energy market in Kosovo. Investment needs would be high – approximately USD 2 billion for the power plants and another USD 200-300 million for the mines. The Bank would consider working alongside the selected investor in providing part of the financing for the project.

3. STRATEGIC ORIENTATIONS

The Bank's strategic priorities over the coming two years will be:

- In **the enterprise sector**, the Bank will target its support towards smaller-scale local export-oriented companies showing good corporate governance, by providing loans, guarantees or making equity investments, including through the new EBRD-Italy Western Balkans Local Enterprise Facility. KTA launched 20 privatisation waves for Socially Owned Enterprises (SOEs). The privatised SOEs include Ferronikeli, Balkan Rubber Factory, Llamkos Steel Galvanizing Plant, Peja Brewery, and Grand Hotel. The Bank would support strategic investors, who have purchased these enterprises in Kosovo. In close co-ordination with the newly established EBRD-Italy West Balkans Local Enterprise Facility Team, a TAM/BAS programme will continue to work directly with individual enterprises, providing assistance in restructuring of the business, improving products, technical and environmental upgrades, quality certification, advising on market positioning and helping to develop business planning skills at management level.

- In **the financial sector**, the Bank will continue to focus on (i) providing banks with funding and institutional support to assist the banks develop new products (including TFP and co-financing), grow their business on a sustainable basis, and improve corporate governance; (ii) channelling more funding to MSMEs through commercial banks and microfinance institutions, including through the implementation of the new EBRD-Italy Western Balkans Local Enterprise Facility, the Western Balkans SME Finance Facility, and the MSME Finance Framework for Western Balkans and Croatia; (iii) exploring potential equity investment in local banks, including through the implementation of the new EBRD-Italy Western Balkans Local Enterprise Facility; and (iv) seeking ways to support sustainable commercialisation of profitable non-bank microfinance institutions.

- In **the infrastructure sector**, the Bank will continue to identify the possible ways to support recently corporatised publicly-owned enterprises (POEs) – the Pristina International Airport (PIA) and the telecoms company. The Bank is currently discussing with Kosovo authorities a possible financing to PIA on commercial basis which, if successful, could have important demonstration effects for similar infrastructure financing in the Province. The Bank will also explore its potential projects in support to the railways, district heating and the energy utility (KEK), which where incorporated in 2006.

4. OTHER IFIS & MULTILATERAL/BILATERAL 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.

TC and official co-financing will remain crucial for project preparation and institution building, particularly promoting smaller scale local enterprises and for public sector operations. Teams are in constant dialogue with all key stakeholders and institutional reforms and priorities tied to the Bank's financing are always set in close consultation with all parties.

The Bank will continue its close co-operation with the EU, under the new "EU Instrument for Pre-Accession", the EAR and bi-lateral donor institutions. A decision to create the new Western Balkans Multi-Donor Fund was made at the EBRD Annual General Meeting in London (May 2006). Eleven countries agreed to provide a total EUR 10 million in donor funds towards a new EBRD-driven initiative to boost private business investment and infrastructure development in the Western Balkan countries, including Kosovo. The new multi-donor fund will strengthen EBRD–donor coordination in Kosovo and expand the resources available to support economic growth and regional cooperation.

Kosovo could also benefit from the recently established EBRD-Italy Western Balkans Local Enterprise Facility. The facility consists of a EUR 20 million contribution from the EBRD and an additional EUR 12 million grant-co financing provided by the Italian Government. The proceeds will be used to provide equity, quasi-equity and debt financing to local enterprises in the Western Balkans including Kosovo.

ANNEX 1 SIGNED COMMITMENTS AND PIPELINE IN SERBIA

Signed EBRD commitments in Serbia, 31 December 2006 (in € million)

Operation Name	**Public/private sector**	**Loan/ equity**	**EBRD Financing (Euro mm)**	**Signing date**
ENERGY				
EPS Emergency Power Sector Reconstruction	State	Loan	100	25 Oct 01
EPS Power II	State	Loan	60	21 Oct 03
		Total:	**160**	
INFRASTRUCTURE				
Belgrade District Heating Rehabilitation Programme	State	Loan	20	27 July 01
Belgrade Municipal Infrastructure Reconstruction Programme	State	Loan	40	27 July 01
ZTP Belgrade Reconstruction	State	Loan	57	25 Oct 01
City of Kragujevac Municipal Infrastructure Reconstruction Programme	State	Loan	4	27 June 02
City of Nis Municipal Infrastructure Reconstruction Programme	State	Loan	5.5	27 June 02
City of Novi Sad Municipal Infrastructure Reconstruction Programme	State	Loan	1.9	27 June 02
Republic of Serbia: Road Recovery Project	State	Loan	76	31 July 02
City of Subotica Municipal Infrastructure Reconstruction Programme	State	Loan	9	17 Dec 04
Future Air Traffic Management Modernisation & Upgrading System	State	Loan	30.8	9 Feb 05
Belgrade to Novi Sad Motorway Project	State	Loan	72	20 May 05
Sava River Crossing	State	Loan	49.6	19 June 06
Serbian railways rolling stocks	State	Loan	60	14 July 06
		Total:	**425.8**	
SPECIALISED INDUSTRIES				
ORCO Aparthotels (fund investment)	Private	Equity/ Loan	1.9 0.4	7 Mar 03
Marbo	Private	Loan	9.1	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
GTC House Belgrade	Private	Loan	11.5	12 Sep 03
Grand	Private	Loan	2.8	6 Nov 03
TUI advance Payments	Private	Loan	0.4	19 Dec 03
Frikom	Private	Loan	10.1	21 Jan 04
SBB	Private	Loan/	15	7 June 04

		Equity	1	
SFIR (Fabrika Secera Te-To Senta A.D.)	Private	Loan	6.1	18 Oct 04
SFIR (Star Secer A.D.)	Private	Loan	7.9	18 Oct 04
Europolis II	Private	Loan/ Equity	5.5 2	15 Nov 04
Global Property Fund	Private	Equity	7	29 June 05
SFIR (Fabrika Secera Te-To Senta A.D.&Star Secer AD)	Private	Loan	7	14 Nov 05
GTC Belgrade (19 Avenue)	Private	Loan	8.2	8 Dec 05
Somboled	Private	Loan	10	7 Jun 06
Mladost Sid (Sojaprotein)	Private	Loan	10	20 July 06
BSR Europe Co-Investment Facility	Private	Equity	3.5	14 Aug 06
Europolis III	Private	Loan/ Equity	1.6 1	21 Sep 06
GTC Residential, Belgrade	Private	Loan	8.2	28 Sep 06
Soko Stark	Private	Loan	10	15 Dec 06
		Total :	**168.7**	
GENERAL INDUSTRY				
Tigar Pirot	Private	Loan	1.8	28 Nov 01
Hemofarm A.D.	Private	Loan	18	12 April 02
Hemofarm A.D. Russia	Private	Loan	11	29 April 04
Carmeuse	Private	Equity	0.1	26 Aug 04
Ball Packaging Europe/Belgrade	Private	Loan	20	3 Nov 04
Sevojno Rolling Mill - long term loan	Private	Loan	14	20 May 05
JKR Resource	Private	Loan/ Equity	21.2 9	15 Dec 06
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
WBLEF: EURO FAT	Private	Loan	1.1	15 Dec 06
		Total :	**97.8**	
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
Raiffeisen Bank a.d.	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
Volksbank Serbia Equity	Private	Equity	4.2	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
HVB (Eksimbanka) senior debt facility	Private	Loan	3	17 Dec 03
Societe Generale Yugoslav Bank sub.debt.	Private	Loan	8.5	19 Dec 03

Advent Central &Eastern Europe Successor Fund	Private	Equity	5.3	25 June 04
Raiffeisen Bank Mortgage Loan	Private	Loan	10	4 Aug 04
HVB Bank-Mortgage Loan	Private	Loan	10	1 Sep 04
Raiffeisen International	Private	Equity	5	20 Oct 04
Societe Generale Yugoslav Bank A.D. Belgrade - Mortgage Loan	Private	Loan	2	24 Nov 04
ProCredit Bank Serbia	Private	Loan/ Equity	6 1.7	8 Dec 04
Regional TFP: Cacanska Banka	Private	Loan	0.2	22 Dec 04
Western Balkans SME Finance Facility - Cacanska Banka	Private	Loan	5	22 Dec 04
Volksbank Serbia Credit Line	Private	Loan	10	23 May 05
Argus Capital Partners II	Private	Equity	0.3	7 Dec 05
Southeast Europe Equity Fund II	Private	Equity	7.6	15 Dec 05
Komercijalna Banka a.d. Beograd pre-privatisation	Private	Equity	70	27 Mar 06
HVB Banka Srbija i Crna Gora Second Mortgage Loan	Private	Loan	10	25 May 06
Western Balkans SME Framework-RZB Leasing Belgrade	Private	Loan	5	19 June 06
European Fund for Southeast Europe (EFSE)	Private	Equity	6	19 June 06
Western Balkans SME Facility Credit Line with Metals Banka	Private	Loan	1	7 July 06
Alpha CEE II, L.P. (Equity Fund)	Private	Equity	2.5	11 Aug 06
Western Balkans MSME FW - Opportunity Bank (Serbia) - Equity	Private	Equity	3	14 Sep 06
Cacanska Banka - Equity Investment	Private	Equity	15	25 Sep 06
ProCredit Bank Serbia	Private	Equity	2.5	29 Sep 06
Balkan Accession Fund, C.V.	Private	Equity	2.2	4 Oct 06
Bluehouse equity fund	Private	Equity	1.3	17 Oct 06
AIG New Europe Fund II	Private	Equity	4	15 Nov 06
BACA-HVB Banka Srbija i Crna Gora Mortgage Loan III	Private	Loan	5	15 Dec 06
Kosovo				
ProCredit Bank Kosovo (Formerly MEB)	Private	Equity	1.3	17 Oct 01
Western Balkans SME Finance Facility - Kasabank	Private	Loan	0.5	19 May 05
Western Balkans SME Finance Facility - Raiffeisen Bank Kosovo	Private	Loan	10	21 May 06
WB LEF – New Bank of Kosovo	Private	Loan	2.1	14 Nov 06
Western Balkans MSME FW - Kosovo Enterprise Programme KEP	Private	Loan	1.5	5 Dec 06
		Total:	**255.7**	
		GRAND TOTAL:	**1108**	

EBRD Project Pipeline in Serbia, 31 December 2006 (in € million)

Operation Name	Public/private sector	Loan/ equity	EBRD Financing (Euro mm)
INFRASTRUCTURE			
Belgrade Highway and Bypass Project (Gazela bridge)	State	Loan	80
Pancevo Waste Water	State	Loan	9.5
Solid Waste Regional Landfill (Cacak and Uzice)	State	Loan	5
Belgrade Water and Wastewater Privatisation	Private	Loan	40
One non identified project	State	Loan	38
		Total:	**172.5**
SPECIALISED INDUSTRIES			
Four projects	Private	Equity/ Loan	10 22.2
		Total:	**32.2**
GENERAL INDUSTRIES			
Three projects	Private	Equity/ Loan	10.3 23.7
		Total:	**34**
Financial Institutions			
Seven projects	Private	Loan/ Equity	84.8
Kosovo			
Six projects	Private	Loan/ Equity	24.5 2
		Total:	**111.3**
		Grand total:	**350**

ANNEX 2 ECONOMIC INDICATORS SERBIA

Serbia

	2000	2001	2002	2003	2004	2005 *Estimate*	2006 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.2	5.1	4.5	2.4	9.3	6.3	6.5
Industrial gross output	11.1	0.0	1.7	-2.7	7.5	0.0	na
Agricultural gross output	-13.7	23.2	3.0	-6.0	19.4	-5.2	na
Employment			*(Percentage change)*				
Labour force (end-year)	-2.4	1.8	1.3	2.5	-4.5	na	na
Employment (end-year)	-2.6	0.2	-1.6	-1.3	-6.4	na	na
			(In per cent of labour force)				
Unemployment (end-year)	24.4	25.5	27.6	30.3	31.7	na	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	60.4	91.1	21.2	11.3	9.5	17.2	12.5
Consumer prices (end-year)	113.5	39.0	14.2	7.6	13.4	17.5	6.6
Producer prices (annual average)	44.5	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	91.1	129.6	51.7	25.3	23.7	24.1	na
Government sector			*(In per cent of GDP)*				
General government balance	-1.0	-4.9	-8.3	-3.4	0.0	0.9	2.7
General government expenditure	40.4	43.8	51.8	46.7	45.3	43.1	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	58.5	67.6	73.4	26.7	36.3	42.4	na
Domestic credit (end-year)	58.2	-54.3	48.6	6.4	61.9	41.7	na
			(In per cent of GDP)				
Broad money (M2, end-year)	18.1	15.2	20.3	21.6	24.7	28.2	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	26.3	16.4	9.5	9.0	8.5	8.5	na
Money market rate	97.4	55.3	32.2	27.1	16.3	19.2	na
Deposit rate	5.7	6.4	3.8	2.1	2.0	1.5	na
Lending rate (long-term)	78.7	34.5	19.7	15.5	15.5	16.8	na
			(Dinars per US dollar)				
Exchange rate (official, end-year)	66.5	67.7	59.0	54.6	57.9	72.2	na
Exchange rate (official, annual average)	54.9	66.8	64.2	57.5	58.7	67.2	na
External sector			*(In millions of US dollars)*				
Current account	-327	-528	-2,502	-3,122	-3,302	-2,418	-2,430
Trade balance	-1,788	-2,834	-4,111	-5,565	-6,643	-5,563	-6,000
Merchandise exports	1,923	2,003	2,075	2,477	3,726	4,647	6,000
Merchandise imports	3,711	4,837	6,186	8,042	10,369	10,210	12,000
Foreign direct investment, net	25	165	475	1,360	966	1,481	4,000
Gross reserves, excluding gold (end-year)	516	1,169	2,280	3,550	4,245	5,843	na
External debt stock	10,830	11,125	11,230	13,575	14,099	15,467	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.5	2.7	4.0	4.9	4.4	5.9	na
			(In per cent of exports of goods and services)				
Debt service	2.2	3.9	6.3	12.9	18.8	27.4	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	7.5	7.5	7.5	7.5	7.5	7.5	na
GDP (in billions of dinars)	355	708	919	1,095	1,310	1,630	1,926
GDP per capita (in US dollar)	863	1,413	1,910	2,542	2,977	3,234	na
Share of industry in GDP (in per cent)	26.0	27.2	34.3	na	na	na	na
Share of agriculture in GDP (in per cent)	17.6	17.2	19.3	na	na	na	na
Current account/GDP (in per cent)	-5.1	-5.0	-17.5	-16.4	-14.8	-10.0	-8.4
External debt - reserves (in US$ million)	10,314	9,956	8,950	10,025	9,854	9,624	na
External debt/GDP (in per cent)	167.4	105.0	78.4	71.2	63.1	63.8	na
External debt/exports of goods and services (in per cent)	425.2	405.6	385.4	389.6	272.1	246.9	na

ANNEX 3 POLITICAL ASSESSMENT

Political background

Serbia's held important parliamentary elections on 21 January 2007, whose outcome will determine the course of the country's domestic and foreign policy for the next few years, likely to be critical ones for Serbia. (see below). The last previous occasion of similar importance was in the autumn of 2000 when in the presidential election on 24 September Vojislav Kostunica, the candidate of the Democratic Opposition of Serbia (DOS) coalition defeated President Slobodan Milosevic, who had held power uninterruptedly since 1987. The 18-party DOS coalition soon broke up as a result of deep policy disagreements exacerbated by a bitter personal rivalry between Zoran Djindjic, leader of the Democratic Party (DS), who had become Prime Minister of Serbia in January 2001, and Kostunica, who leads the Democratic Party of Serbia (DSS). In June 2002, Kostunica's DSS left the ruling coalition, with DOS's parliamentary majority increasingly fragile. Djindjic's assassination on 12 March 2003 was a huge blow to the cause of democratic reform and Serbia's European orientations. It was the direct result of Djindjic's two decisions which upset the country's two most powerful constituencies: the first, in 2001, to extradite Slobodan Milosevic to the International Criminal Tribunal for Former Yugoslavia (ICTY), which upset the ultranationalists, and the second, taken only weeks before his assassination, to order a crackdown on organised crime, which upset and alarmed the country's powerful criminal networks.

Continuing bickering within the weakened DOS coalition under Zoran Zivkovic, Djindjic's successor as Prime Minister, led eventually to an early general election on 28 December 2003, at which Kostunica's DSS supplanted the DS as the largest reformist party in parliament. Kostunica formed a new four-party coalition government on 3 March 2004. However, with only 109 seats in a 250-seat parliament, he was able to do so only with the support of the 22 deputies of Slobodan Milosevic's Socialist Party of Serbia (SPS). On 27 June 2004, Boris Tadic, leader of the Democratic Party (DS), defeated in the second round of the presidential election Tomislav Nikolic, candidate of the increasingly popular Serbian Radical Party (SRS). Tadic defeated Nikolic in the run-off by winning 1,7m votes, or 53.2% of the total. That victory was secured only thanks to the voters responding to foreign and domestic appeals to deny the presidency to the ultranationalist SRS, whose leader Vojislav Seselj ran paramilitary units operating in Croatia and Bosnia between 1991 and 1995 and who is currently at The Hague as an indicted war criminal.

Under Tadic, the DS adopted a less hostile attitude towards Kostunica's DSS - and vice versa. At least partly due to policy and cadre concessions by the government, the DS, together with the SPS (and to an extent also the SRS), de facto kept Kostunica in office. What completed this gradual coming together of the entire Serbian political establishment was the Kosovo issue. The decision by Kofi Annan, the UN Secretary-General, in June 2004 to accelerate the process of determining the final status of Kosovo was at least partly due to a growing realization in the international community that unless the Kosovo issue was resolved, by eventually allowing it - in line with the wishes of its majority-Albanian population - to become independent, the whole region could be once again plunged into turmoil and bloodshed. The riots in Kosovo in March 2004, during which Serbian properties including homes and churches were attacked and many Serbs had to flee, served as a warning signal. The imminence of an international decision in early 2007 to grant Kosovo independence or something very close to it led to a Serbian diplomatic offensive abroad aimed at, if not preventing, then at least postponing Kosovo's independence. At home it led to increased cooperation among the parties of the so-called Democratic Bloc aimed at keeping the SRS from gaining power as beneficiaries of the backlash in Serbia against Kosovo's independence. It was this cooperation that produced the new Constitution in October 2006 that mentions Kosovo as 'an integral part of Serbia'. The parliamentary elections on 21 January 2007 showed that this tactic has worked – at least to the extent that the Radicals, while remaining the largest party, have not succeeded in gaining an absolute majority in parliament enabling them to form a government that would almost certainly have set Serbia on a confrontation course with the EU and the United States as well as some of its immediate neighbours. However, it remains to be seen how long the unity of the democratic forces, forged during the campaign preceding the referendum on the new Constitution, will survive against the background of the challenges posed by the Kosovo issue and the EU's demand for a full cooperation with the International Criminal Court for Former Yugoslavia (ICTY) at The Hague as a precondition for the resumption of talks about the conclusion of a Stabilisation and Association Agreement (SAA) with Brussels.

International relations

Ever since the downfall of Slobodan Milosevic in October 2000 the governments in Belgrade have pursued a broadly pro-Western policy aimed at getting what was first the Federal Republic of Yugoslavia (FRY), then the common state of Serbia and Montenegro and now, after Montenegro's independence in June 2006, just Serbia into both NATO and European Union. After the assassination in March 2003 of PM Zoran Djindjic, who had extradited Slobodan Milosevic to the International Criminal Tribunal for Former Yugoslavia (ICTY) in May 2001, the Serbian authorities stepped up their efforts to hand over war-crimes suspects to ICTY. The subsequent arrests persuaded the US in May 2003 to lift its remaining economic sanctions against Serbia and Montenegro and, soon afterwards, to certify Serbia as eligible for US financial assistance to the tune of $110 million. However, Serbia was reminded by the EU, NATO and the United States that close integration with the West meant full cooperation with ICTY. In June 2004 at its summit in Istanbul NATO failed to invite Serbia to join its partnership for Peace Programme (PFP) because its cooperation with ICTY was deemed unsatisfactory, but that invitation was extended (and accepted) in November 2006 over the objections of ICTY's Chief Prosecutor Carla Del Ponte. The European Commission had made it clear that Serbia and Montenegro could not open talks with the EU about a Stabilisation and Association Agreement (SAA) unless it cooperated fully with ICTY. After a batch of Serbian and Bosnian Serb war-crimes suspects voluntarily surrendered to ICTY in early 2005, the European Commission issued a positive feasibility study, effectively a green light for the opening of SAA talks. The talks duly started but the conclusion of the SAA was made dependent on the extradition to ICTY of General Ratko Mladic, commander of wartime Bosnian Serb forces, known to have been until very recently on Belgrade's official payroll. When the government in Belgrade failed to fulfil the informal promise to deliver Mladic by April 2006, the EU called off talks about the SAA on 3 May, In July 2006 Vojislav Kostunica presented the EU with an action plan for Serbia to establish full cooperation with ICTY. In presenting the action, the Serbian government hoped to convince the EU that, since it was doing everything it could to arrest Mladic, the EU might agree to continue the SAA talks even without his arrest. In July 2006 the EU

Council of Minister adopted a revised mandate for Serbia's SAA talks, to reflect the dissolution of the common state of Serbia and Montenegro, but it was emphasized in Brussels that there could be no resumption of the talks without ICTY's agreement. The ICTY's chief prosecutor, Carla Del Ponte, confirmed that its agreement to the talks continuing remained conditional on Mladic's arrest and extradition. Lobbying in Brussels in October 2006 by PM Kostunica and President Tadic failed to lead to a change in the EU's position over ICTY cooperation.

Integrity issues

The investment climate in Serbia has been improving steadily ever since the fall of Slobodan Milosevis's regime in October 2006, but there are serious problems. The power and influence of organised crime were revealed during the official crime inquiry that followed the assassination of Prime Minister Zoran Djindjic on 12 March 2003. The assassination was at least partly a reaction by **organised crime**, with links to the **security services**, to the crackdown on the Serbian underworld which Djindjic was planning and which was known to be imminent The assassination led to the proclamation of the state of emergency lasting 42 days and to arrests of thousands of people as part of a campaign codenamed Operation Sablja (Sabre) to root out organised crime. Subsequent trials – some completed and some of them still going on - of individuals (including active or former members of the security services) revealed the extent of underworld influence in many spheres of public life in Serbia, particularly in the judiciary and the police. There is a widespread public perception of government corruption, confirmed and strengthened by those revelations . According to a recent Gallup survey 60 per cent of Serbs polled believe that government corruption is a major problem. A study published by a leading Serbian NGO in September 2005 reported that unclear legislation and broad discretion in the exercise of government power helped institutionalise corruption as 'the most efficient way of conducting business operations." Many allegations of corruption affecting the privatisation in industry are raised in the media, but, a lack of transparency prevents determining the validity of those allegations. Serbia occupies the 90th place out of 163 countries in the 2006 corruption rankings index compiled by Transparency International. The score of the country is 3 (on a 0 to 10 scale with 10 signifying no corruption). This is a slight improvement from the 2.8 in the previous year (when Montenegro was included). The country shares the 90th place in the corruption index with Gabon and Suriname. It lags significantly behind the countries of Central Europe and neighbouring Bulgaria, but is ahead of Bosnia and Herzegovina, FYROM and Albania.

In the past year the Kostunica government has taken a number of steps to eradicate the corruption in the judiciary, with a number of sackings of senior judges and prosecutors. On 16 September 2005 Supreme Court judge Slavoljub Vuckovic was arrested and charged with accepting a bribe in an organised crime case. On 14 October 2005 the trial was resumed of Milan Sarajlic, former deputy public prosecutor, who was charged with accepting payments from the Zemun organised crime clan in 2004. However, the authorities sometimes appear inconsistent in their approach to the battle against corruption. Investigations into official corruption often appear politically motivated. There are numerous, documented cases of the authorities failing to act on in response to detailed reports of suspected corruption involving a wide range of officials. The annual report for 2005 on Serbia by the US State

Department's Human Rights Bureau of February 2006, states that there is widespread perception of **government corruption**, particularly in the executive and judicial branches. According to the above-mentionedUS report, corruption in the **judiciary** remains a problem. There were reports that government officials attempted to undermine politically sensitive prosecutions, including by applying pressure on prosecutors. According to private-sector perceptions, voiced in the media, corruption in the commercial courts was widespread. Also according to private-sector information,, land transfers were often very difficult, leading many in the private sector to allege administrative corruption. The courts were inefficient and cases could take years to be resolved. Corruption and impunity in the police were problems, and there were only limited institutional means of overseeing and controlling police behaviour. The inspector-general's office, created in 2003, has only a limited authority, and the office has no autonomy to investigate and redress abuses. However, during 2005 three Interior Ministry's inspectors-general recommended disciplinary measures that resulted in 856 cases in financial penalties, reassignments and dismissals. The office filed 29 criminal complaints against 8 ministry employees on charges including forgery, misuse of public funds, corruption, accepting bribes, assault and incompetence. The Centre for Public Security also took disciplinary measures against a number of Interior Ministry employees.

The law prohibits **trafficking in persons,** but there were reports that persons were trafficked to, from and within the republic. Some police officers and other officials were reported to have been involved in human trafficking but there were fewer cases reported than in previous years. The republic remained primarily a transit point for trafficked persons, particularly women and children and to a lesser extent a destination. Victims came through Serbia and often continued to Italy and other West European countries. The police and Non-Governmental Organisations (NGOs) reported a large number of cases of internal trafficking, particularly involving victims from Serbia.

ANNEX 4 LEGAL TRANSITION

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 such laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Serbia, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

Capital Markets

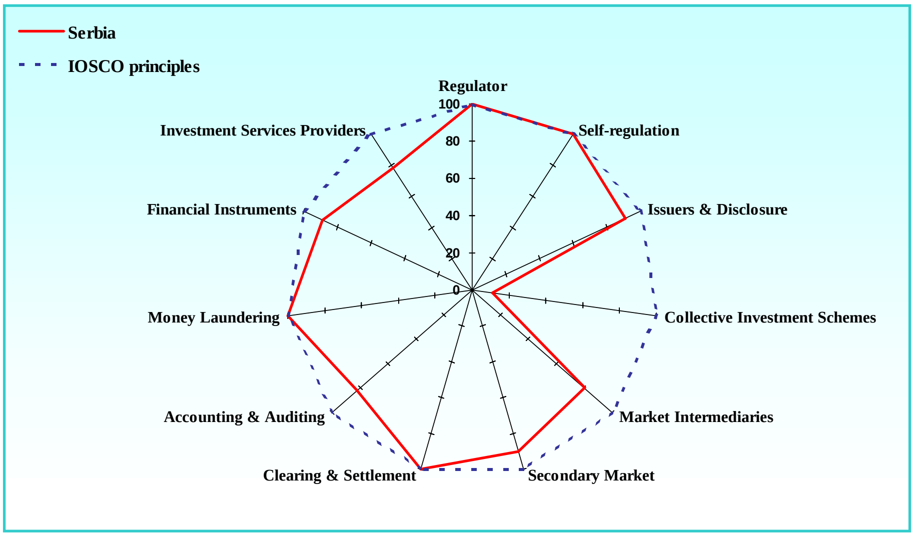
Serbia

The primary legislation governing the securities market of Serbia is comprised of the "Securities and Other Financial Instrument Market Act" (the "Securities Act") of 1 October 2003, last amended in 2006; the "Takeover Act", enacted in May 2006; and the "Law on Investment Funds", enacted on 30 May 2006.

The Belgrade Stock Exchange (BSE) was founded on 21 November 1894 and functioned until the breakout of World War II. In 1953 it was formally closed. It was reopened in 1989 as the Yugoslavian Capital Market and in May 1992, after the break-up of the country, it was renamed back to BSE. In 1996 four departments were set up containing the basic exchange functions: listing, trading, clearing, and marketing. In 2001, large scale privatisation began and the exchange started trading privatised stock. A year later, trade with state bonds started.

According to the EBRD Securities Markets Legislation Assessment conducted in 2005 (see chart below), the country was found to be in "medium compliance" with the Objectives and Principles of Securities Regulation published by the IOSCO. The assessment revealed that the main weaknesses were in the "Collective Investment Scheme" sector, as at the time of the assessment, there was no specific legislation dealing with this issue.

Quality of securities market legislation – Serbia (2005)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2005

Kosovo

The legal framework in Kosovo is s very complex, being a mix of United Nation Interim Administration Mission in Kosovo (UNMIK) regulations and former Yugoslavian law.

The legal framework on capital markets in Kosovo is essentially limited a number of UNMIK regulations applying to the banking sector as there is no stock exchange in the region.

Corporate Governance

Serbia

Corporate governance in Serbia is mainly regulated by the new Law on Business Companies, enacted on 30 November 2004. The law details provisions on incorporation, liquidation, organisation and governance of companies. The previous Law on Enterprises remains in force only with respect to the parts dealing with socially owned companies and with the corporate governance of companies undergoing privatisation.

In 2005, the EBRD conducted a survey for testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed.

The survey revealed that in Serbia there are a number of avenues allowing a minority shareholder to request disclosure of corporate information. On paper, procedures are generally simple, but in reality it is difficult to predict the time needed to obtain an executable court and the obstacles that could be encountered when enforcing executable judgments. Even temporary injunction procedures – which are typically requested in case of urgency – can last for several months. This shortcoming is essentially due to the slow and ineffective court system in Serbia.

When considering the institutional environment, the survey evidenced that the framework for related party transactions is quite effective and the competence of the prosecutor in corporate cases adequate. On the other hand, the quality of company information, the independence of statutory auditors, the competence and experience of courts and market regulators leaves room for improvement. Finally, corruption and partiality of judgements are reported as problems.

Kosovo

As mentioned above, the legal framework in Kosovo is complex, being a mix of UNMIK regulations and old Yugoslavian law. The UNMIK Regulations relevant to corporate governance are essentially Regulation No. 2001/6 “on Business Organisations”; Regulation No. 2001/30 “on the establishment of the Kosovo board on standards for financial reporting and regime for financial reporting of business organisations” and Administrative Direction 2002/22 implementing UNMIK regulation 2001/6 on business organisations.

When considering corporate governance effectiveness, the 2005 EBRD survey revealed a situation in urgent need of reform. Minority shareholders have practically no avenue to request disclosure of company information. The UNMIK Regulations do not provide any legal basis for obtaining redress. While the former Yugoslavian law provides some legal basis for starting a redress action, there is reluctance by local judges to apply the Yugoslavian law, which adds to the uncertainty of the case. Judicial proceedings are complex, long and judgement very difficult to enforce.

When considering the institutional environment, the survey revealed weakness in all areas under consideration. The quality of corporate books and the independence of statutory auditors were only revealed to be acceptable in the case of international auditing firms.

Concessions/Public Private Partnership (PPP)

Serbia

Serbia's 2003 concessions law (the "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. 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. There also exists a clear general policy framework for improving the legal environment and promoting Private Sector Participation in Serbia.

The Concession Law clearly defines its scope of application (concessions, BOT and other modifications of similar arrangements included, clear identification of entities involved and sectors concerned), regulates the selection procedure and provides for a relatively flexible framework for the project agreement.

It is one of the few laws of its kind in the region to contain an implicit reference to the principles of transparency, non-discrimination, proportionality and efficiency ("equal and equitable treatment", "free market competition", "autonomy of will") and a specific obligation for the publication of information related to the competitive procedures in international media (for strategic/international projects). Also, there is a clear reference to "step-in" rights.

Concerning the selection procedure, the Concession Law not only provides clearly for the possibility of pre-selection procedure, but also simplifies the overall procedure (number of steps and bodies involved - proposal for concession award, proposal concession enactment, concession enactment/competent ministry, government, tender commission, negotiation commission and, possibly autonomous province and local self-government unit involved).

The single major shortcoming of the Concession Law is that it does not clearly define its boundaries and lacks coordination with, on one hand the Municipal Activities Law, and the Public Procurement Law provisions and on the other the sector-specific laws.

The EBRD's 2004-2005 Concession Law Assessment which measured the quality of law on the books in its countries of operations, rated the Concession Law as being in "medium compliance" with international standards, taking into account the deficiencies referred to above.

According the EBRD's 2006 Legal Indicator Survey, which measured the effectiveness of laws in practice, the Concession Law was also rated as "medium/satisfactory".

Kosovo
There is a 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." The Law on the Procedure for the Award of Concessions (the "Kosovo Law") is a fairly comprehensive and modern piece of legislation covering definitions, multi-staged selection procedures, project agreement, termination and compensation, security interests and assignment and even unsolicited proposals. However, since the Kosovo Law was only approved in April 2006 its application in practice remains to be assessed.

Insolvency

Serbia
In 2004, the Law on Bankruptcy Proceedings ("LBP") was passed, and 1 February 2005, it became effective, replacing the older Yugoslavian *Act on Compulsory Composition with Creditors, Bankruptcy and Liquidation*. The LBP was reviewed in the context of the 2004 EBRD Insolvency Sector Assessment, despite the fact that the law was only in draft form. The Assessment, which examined the extensiveness of a country's insolvency legislation by comparing them against a set of core elements essential for an insolvency law and measuring the results against internationally recognised standards, found that the LBP had a high level of compliance ranking it amongst the highest in the EBRD countries of operation. The results are set out on the graph below.

The LBP represented a significant improvement over the earlier law. Where the earlier law offered a slow and somewhat cumbersome insolvency process which did little to create a climate for corporate restructuring, the LPB was given high scores for its commencement, hearing and determination process for insolvency cases. The law sets out clear and reasonable deadlines for bankruptcy administrators and the courts, promising a relatively swift and efficient hearing of cases. The LBP was also given high marks for its treatment of creditors, adopting the concept of "adequate protection", fully engaging them in the proceedings and giving them significant power in the decision making process. The LBP further protects the interests of creditors by including a relatively simple means to avoid pre-bankruptcy transactions.

The reorganisation process singled out for its encouragement of reorganisations. Where the previous law provided no mechanism to provide for funds to be advanced to the debtor on a priority basis after the filing for bankruptcy, the LBP clearly deals with the issue of post-filing priority financing.

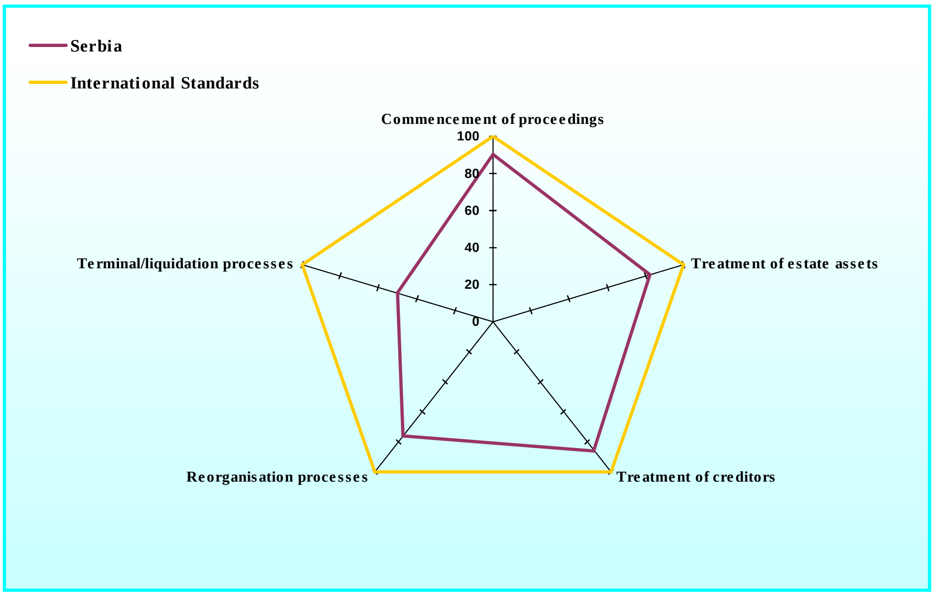
Despite being modern and reasonably compliant with the international standards, the LBP is not without flaws. The law does not provide for a mechanism to administer estates of debtors whose assets are insufficient to meet the costs of administration. The LBP fails to provide a means whereby a third party who is suspected of having information concerning the debtor, assets and affairs generally can be compelled to provide that information to the administrator. The law also fails to provide for set off. Even the reorganisation scheme is not without shortcomings. There is no requirement for independent analysis of a reorganisation plan, no restriction on insider voting on a plan and there is no ability to amend or modify the plan once it has been approved.

Relative to other EBRD countries of operation, the statute is reasonably strong. In practice, however, it appears that there is a significant gap between the extensiveness of the statute and the effectiveness of its implementation. As in most jurisdictions, it will take time to properly implement even the best of laws and Serbia is no different. The 2004 Legal Indicator Survey (LIS), which studied the effectiveness of the insolvency system in practice demonstrated that the Serbian system performed somewhat better than other countries in the survey despite scoring poorly – a reflection of the generally poor effectiveness of insolvency systems within the EBRD countries of operation. There is reason to expect that the effectiveness of the Serbian system will improve in future: the LBP came into force after the 2004 LIS was completed and should create a more efficient system; the creation of the BSA should ensure that administrators are better qualified and supervised; and the capacity building programs being run in Serbia by the EBRD, USAID, GTZ and the World Bank should improve the law, the administration of the law and the training and oversight of the insolvency administrators.

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. 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.

Quality of insolvency legislation –Serbia (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank's Principles and guidelines for Effective Insolvency and Creditor Rights

Systems, the UNCITRAL Working Group on "Legislative Guidelines for Insolvency Law", and others. The fuller the 'web', the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment 2004

Secured Transactions

In 2001, with EBRD technical assistance, Serbia undertook to reform its secured transactions and a Law on Registered Charges over Movable Property was adopted by the Serbian parliament in May 2003. 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.

Officially entered into force on 1 January 2004, the Law did not in effect operate until 15 August 2005 when the Charge Register started to function. The Charge Register is operated by the Business Registration Agency, an independent body which also operates the Company / Business Register and Leasing Register. Early feedback regarding the register was generally positive, in particular it seems that micro and SME financing is using the new system with general satisfaction. However, it is unclear whether the Register has been set up in a way which would enable to take advantage of the advanced features of the Law on Registered Charges over Movables Property, in particular with regard of the description of the collateral.

Kosovo

Secured Transactions in Kosovo are governed by Regulation No. 2001/5 on Pledges promulgated by the Special Representative of the United Nations (UN) Secretary General under the authority of 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. The Law, 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 provides extensive rules on priority, types of collateral, and enforcement of the pledge. There is some concern on the adaptation of the law into local legal tradition – discussion with bank in-house lawyers seemed to suggest that some of the law's features were not well understood.

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, Kosovo Credit Information Services (KCIS), for two years. KCIS founders and management board are drawn from the microfinance and banking community in Kosovo. KCIS 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, some comments were expressed by some that the Regulation presented important flaws and needed some key amendments. Although there were indications in 2004-2005 that the Bureau of Payment of Kosovo (BPK) could take over KCIS or KCIS functions, to create a compulsory credit bureau and that may entail taking over the Pledge Registry, it is unclear whether this has happened at all. Such fragility in the system is most regrettable.

Telecommunications

The sector is currently regulated by the Republic Agency for Telecommunications (RATEL) and governed by the Law on Communications, 2003. RATEL was established as an independent regulatory agency in 2005 and is currently implementing the new regulatory framework for the sector as set out in the 2003 Law. This law reflects internationally accepted standards and is a major step towards harmonisation with relevant European Union sector standards. The Ministry for Capital Investment (the "MKI") – a successor to the Ministry for Transport and Communications – is responsible for longer term sector strategy.

Communications in Serbia represents one of the last untapped marketplaces in Europe. While there appears enormous potential, events of the past decade and a half have left the sector neglected and resulted in one of the most undeveloped markets in Europe. However, the significant positive developments of the last two years indicate an apparent commitment on the part of the Government to tackle and resolve the major sector issues. Recent privatisation of Mobtel/Mobi 63 and the announcement of a third mobile licence should significantly enhance competition. In addition, the establishment of RATEL is a major step in implementation of the sector legal and regulatory framework.

Going forward, the reform an implementation momentum seen over the past 18-24 months must be maintained. RATEL and MKI must be fully supported by the Government in their implementation of crucial reforms. RATEL for its part must move quickly to draw up and implement all secondary legislation necessary for the full functioning of the new regulatory environment. Key issues for RATEL are the facilitation of meaningful competition across the sector through full implementation of a modern, non-discriminatory and transparent interconnection regime and adoption of cost oriented tariffing for regulated services. MKI must urgently finalise and adopt a clear strategy for the sector, issuing publicly available sector policy and strategy documents at the earliest juncture. These documents must clearly direct sector development towards attracting private investment through maximising private participation in the sector (including the appropriately timed privatisation of TS). Both the MKI and RATEL should also seek to settle policy and implementation plans for universal service.

Kosovo

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 Telecommunications Regulatory Authority (TRA) on the basis of the framework Telecommunications Law of 2003 and relevant regulations of UNMIK, acting as the transitional administration. The 2003 law provides for a regulatory body for telecommunications (TRA) which was formally established in 2004.

While practical implementation of the new regulatory regime continues, the sector in Kosovo continues to operate without clear strategic direction. In this respect PISG and MTC (in consultation with UNMIK, where appropriate) should move swiftly to adopt an appropriate policy and strategy for the development of the sector. Such strategy should seek to attract investment into the sector through the maximisation of private participation in the sector, ideally through appropriately timed liberalisation and privatisation of publicly held sector assets. Further, as an appropriate regulatory environment is critical to the attraction of the necessary private investment, PISG and MTC should continue to respect TRA independence and support it in the full implementation of all provisions of the legal and regulatory framework. TRA for its part should move swiftly to fully implement all provisions of the framework currently within its authority.

The EBRD is currently providing the authorities in Kosovo with technical assistance aimed at addressing three interrelated priority areas for telecommunications sector development in Kosovo. The areas being addressed by this assistance are: development of strategic policy; practical assistance to TRA; and, assistance addressing numbering and access code peculiarities currently hindering sector development.

ANNEX 5 EBRD TECHNICAL CO-OPERATION PROGRAMMES

Aggregate TC Funds Commitment and Official co-financing signed projects

Since 2001, the Bank has been actively cooperating with multi and bilateral donors in the framework of both TC projects (for which the aggregate commitments value for the period 2001 – 2006 reached the value of € 32.6 million[1]) and Official co-financing initiatives (€ 670 million is the total amount of contribution to 26 operations).

TC Fund: Six Donors (EAR, Canada, USA, Italy, France and the Netherlands) account for more than 85% of the total aggregate commitments and the ERA is, by far, the largest donor with more than €10.6 million. Three are the sectors having more benefited from the EBRD TC Fund. Finance (€ 12.9 million), Manufacturing, through TAM/BAS Programme (€ 7.4 million) and Transport (€ 4.8 million). Other sectors having benefited from the TC Support have been Energy, Social services and MEI. To 2006, TC fund in the amount of €5.9 million have been committed to implement assignments in Serbia. EAR (€3.5 million) and Canada (€1.5 million) have been the key donors. Access to credit for small and medium-sized enterprises (SMEs) has been improved through the EBRD's Western Balkans SME Finance Facility. Additional support has been provided for the TurnAround Management (TAM) and Business Advisory Services (BAS) Programmes.

Official Co-financing: by far, the EIB (€425) and the Serbian Institutions (€125 million) have been the largest official co-financers and, with a total contribution of € 550 million, are covering more than the 80% of the total. Other relevant co-financers are KfW and DEG, the Polish Investment fund, SECO, JICA, the IFC, and the EAR/EC. By September end, in 2006 no official co-financing in Serbia has been signed. In 2005, there has been a total official co-financing amounting to €239.1 million. The large part of official co-financing (€476.1 million) has been provided in the form of IFI and/or parallel loans. The Grant co-financing amount was €67.7 million. The balance (€126.4 million) was provided as equity and/or participation. The co-financing has been used to implement project in five sectors: Transport (€477.6 million), Energy (€128.1 million), MEI (€26.2 million), Finance and business (€24.2 million) and manufacturing (€14.1 million).

TC Funds and Donors
Aggregate Commitments (2001-2006): € 32.6 million

DONOR	EUR Committed
EAR	10,696,568
Canada	5,540,712
USA	5,095,731
Italy	2,507,708
France	2,096,335
The Netherlands	1,535,200
UK	948,601
Switzerland	785,223

[1] The data are referring to Serbia-Montenegro. Out of the €32.6 million of total commitments, the amount of €5.75 million could be considered as the fun ding made available to implement assignments in Montenegro and/or at regional level.

Denmark	567,157
Germany	548,991
Japan	369,812
Austria	341,899
Sweden	281,785
Ireland	270,462
Greece	250,000
Spain	247,331
BRSF	224,109
Luxemburg	149,658
Norway	126,714
TOTAL	**32,583,996**

Official Co-financing and Donors
Signed projects - Signing years: 2001-2006
€ 670.2 million

DONOR	EUR Committed € million)
European Investment Bank	425.0
Serbian authorities	125.0
KfW/DEG	37.0
Poland investment fund	15.0
SECO	12.9
JICA	12.0
IFC	11.4
EAR/EC	10.0
Italy	10.0
FMO	9.0
SIDA	2.1
China	0.7
USA	0.1
TOTAL	**670.2**

Future scenario: 2006-2007

- Serbia will remain among the priority countries for the donors' community.
- The EAR started the implementation of her exist strategy. There will be non new budget allocation for 2007 and, by 2008, the Agency activities will come to an end.
- Serbia is considered by the EU as a "Potential EU Candidate Country" and, as such, the Country will benefit from the newly established "EU- Instrument for Pre-Accession (IPA)"over the period 2007-2013. The EC has yet to finalise the details of the IPA programme, but has indicated that all previous financial instruments (including the co-funding ISPA instrument) will be merged into one and planning and budgeting will be on a multi-year basis. It is envisioned by the Commission that the recipient country will have the full management of the programmes, through a decentralised system. Over the period 2007-2009 the IPA assistance to Serbia will mainly address "Transition assistance" and "Institutional building" with a "Cross Border Cooperation" component. The

budget allocation should be in the region of €550-€600 over the three years programming period. The full implications for operational support of activities falling within EBRD's mandate have yet to be determined. It's unclear at which level the new instrument could ensure the utmost necessary grant co-financing support provided by the EAR over the previous years.

- Over recent months, EBRD has discussed with donors a proposal to create a new "Multi-donor fund for the Western Balkans" including Serbia. Preliminary discussion took place at the EBRD donor meeting held in November 2005, where several donors asked the Bank to proceed with plans to create a new fund. In January 2006, the Bank presented a background paper, and detailed sector presentations that outlined the priority needs in the region along with the availabilities of assistance from existing bilateral sources. At the EBRD Annual Meeting held in London in May 2006 the Fund has been officially announced and, in November 2006, the Fund will become operational with a likely budget allocation of € 10 million.

Regarding the likely support to the Country from bilateral donors, this is a detailed picture:

Austria
Austria will remains very interested in sectors such as water, waste management. Austria is expected to join the MDF for W. Balkans
Canada
Serbia is considered as a country eligible to receive Canadian support. Canada has been an active donor to Serbia in regional, infrastructure, and financial institutions projects through its Canada EBRD SE Europe Funds. These funds are now almost fully committed and new bilateral funds at the Bank will be focused on Russia, Ukraine, Armenia, and Georgia. Canada has joined the Western Balkan Multi Donor Fund.
Ireland
Ireland will now focus its efforts on the West Balkans Fund. Very limited resources will be available from the bilateral fund.
Italy
Serbia is considered, like other W. Balkans Countries, as a priority Country for Italy. Under the *Italy-EBRD Cooperation Fund for Private Sector Development in the Western Balkans* there is a still uncommitted amount of €1.6 million to implement SME and MEI related activities. The *Italian TC Fund* and the EBRD/CEI TC Fund could be used to implement TC assignments in Serbia. Among the new initiatives developed in 2005, Italian funds in the amount of €12 million have been allocated to implement the *"Italy-EBRD Western Balkans Loan Enterprise Facility"*: it is a risk sharing and equity facility supporting local enterprises in the region, inclusive Serbia.
Japan
Japan has in the past been a very active donor in the Country. Their focus has however shifted towards Central Asia, and additional funding for the Country seems to be unlikely although, in the first months of 2006, the TAM Programme in Serbia benefited from a Japan contribution of €350,000.
The Netherlands
The Netherlands are ready to explore the provision of financial support for the implementation of TC assignment and/or investments in the Country, provided there is a clear commercial Dutch interest. They are expected to join the MDF for W. Balkans.

Norway
Norway show a specific interest on energy and environment projects and is expected to join the MDF for W. Balkans.

Sweden
The Swedish Government (Sida and Ministry for Foreign Affairs) is interested in strengthening co-operation in the Balkan Region. In large scale infrastructure projects, Sida could remain active on a parallel basis.

Switzerland,
The *Swiss CTF Fund* has been replenished in late 2005, and Serbia is considered among the priority countries, also in the frame of possible Investment grant co-financing activities. Swiss funding have contributed to the implementation of a review of the remittances potential in Serbia.

UK
UK fund for SEE is almost fully committed. Any new funding will go to WB Fund.

Other
France and Spain expressed interest in joining the MDF for W. Balkans. *Belgium, Denmark, Greece, Portugal and Taiwan,* all have established TC Funds under which Serbia is eligible and therefore are potential donors to the TC although, so far, their involvement has been sporadic with the exception of Taiwan.