
**FEDERAL REPUBLIC OF
YUGOSLAVIA**

**BREAKING WITH THE PAST:
THE PATH TO STABILITY AND GROWTH**

*Volume I: The Economic, Social and
Institutional Reform Agenda*

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FISCAL YEAR
January 1 - December 31

CURRENCY EQUIVALENTS
Currency Unit = Yugoslav dinar
1 YUD = US\$ 0.0152
US\$1 = 65.8 YUD

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

BRA	Bank Rehabilitation Agency	IFI	International Financial Institution
BSE	Belgrade Stock Exchange	IMF	International Monetary Fund
CAD	Current Account Deficit	IOSCO	International Organization of Securities Commissions
CEE	Central and Eastern Europe	IRU	International Road Transport Union
CEFTA	Central European Free Trade Agreement	IT	Information Technology
CIS	Commonwealth of Independent States	LMB	Labor Market Bureau
CSW	Centers for Social Work	MSEC	Montenegrin Securities and Exchange Commission
DCR	Directorate for Commodity Reserves	NBY	National Bank of Yugoslavia
DEM	German Mark	NGO	Non Governmental Organization
DOS	Democratic Opposition of Serbia	PAYG	Pay as you go
EBRD	European Bank for Reconstruction and Development	PF	Pension Fund
EIB	European Investment Bank	PRA	Public Revenue Agency
ERTP	Economic Recovery and Transition Program	SAA	Stabilization and Association Agreement
EU	European Union	SEE	Southeast Europe
FDI	Foreign Direct Investment	SFRY	Socialist Federal Republic of Yugoslavia
FMM	Frequency Management Monitoring	SME	Small and Medium Enterprise
FRY	Federal Republic of Yugoslavia	TIR	Transports Internationaux Routiers
FTA	Free Trade Agreement	TM	Telecom Montenegro
GDP	Gross Domestic Product	TS	Telecom Serbia
GNP	Gross National Product	UB	Unemployment Benefits
IAS	International Accounting Standards	UN	United Nations
ICSID	International Center for the Settlement of Investment Disputes	UNMIK	United Nations Mission in Kosovo
ICT	Information and Communications Technologies	WB	World Bank
IDP	Internally Displaced People	WTO	World Trade Organization
IFC	International Finance Corporation	YUD	Yugoslav dinar
		ZOP	Agency for Accounts and Payments

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PREFACE

As part of their overall donor coordination responsibilities in the Southeast Europe (SEE) region, the World Bank was asked to develop, in partnership with the European Commission (EC), an Economic Recovery and Transition Program (ERTP) for the Federal Republic of Yugoslavia (FRY).¹ The ERTP is to be presented at a Donor Pledging Meeting for FRY to be held in mid-2001. The two-volume report outlines a comprehensive structural reform agenda, a priority public investment program and needed sectoral policy reforms. Its purpose is to support the design, implementation and financing of a program for transition and recovery in FRY. The federal and republican governments will find ideas for developing a stabilization, reform, and investment agenda which is consistent with their strategic vision for the future of Yugoslav society, and which will help them to meet the key medium-term challenges which they face in achieving this vision. The donor community will find specific information and an overall framework for planning their medium-term support programs for FRY.

This first volume of the ERTP summarizes the main priorities in economic and social policy and institutional strengthening. It will be of particular interest to the authorities and broader FRY society. Within the constraints of limited or weak data, it begins by describing the political, economic and social starting point for the renewed reform effort. It then summarizes the initial priorities of the new government in late-2000 and its more recent progress in meeting preparing deeper reforms. After outlining a strategic vision for FRY, it presents the three main medium-term challenges which FRY faces in achieving this vision. The next three chapters of the report then summarize the most critical sectoral policy reform and institutional strengthening priorities for meeting the three key challenges. Finally, the report provides a medium-term economic outlook (with a focus on growth and fiscal and external accounts) and the external financing requirements for supporting FRY in meeting these challenges.

The complementary second volume will be of interest to donors, as well as a more general audience. It explains and summarizes the priority donor assistance program, including how its overall size, the relative magnitudes of broad categories of support, and their evolution over time are linked to the current and future needs of FRY. It also indicates how the specific proposed support programs contribute to meeting the overall strategic objectives of FRY, and discusses prerequisites for successful implementation. Fifteen sector-specific or cross-cutting thematic chapters then give a more detailed elaboration of the current state of knowledge, the priority policy reforms, and the sectoral investment and assistance needs across the economy. Cross-referencing between the various sections has been used to guide the reader to additional details or important cross-sectoral linkages. Due to the rapid pace of recent reforms, some of the described reform measures may already have been implemented at the time of reading.

The ERTP is primarily an economic and social development strategy. Therefore, it does not cover all important areas of government policy and donor interest. This focused treatment of themes is not a judgments about the relative importance of any other issues. Important areas such

¹ The Bank and the EC were tasked in April 1999 with coordinating international assistance and guiding economic development strategy in the countries of SEE, including Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Federal Republic of Yugoslavia (including Kosovo), the former Yugoslav Republic of Macedonia and Romania.

as democratization, demobilization, police reform, the problems of refugees and the internally displaced persons (IDPs) (including issues related to their housing) are only some issues which are of higher priority for FRY and donors than their mention here would suggest. These themes should by no means be ignored, and policy measures and donor support in these areas should supplement the program described here.

FRY faces an extended reform agenda. The report suggests some sequencing of priority measures over time, by distinguishing between near-term priorities (in the period to end-2002), and more medium-term priorities over the next 2-3 years. The focus of the report is on the near-term period, including those reforms which should begin during this period but be completed later. The discussion of outer years will be more indicative, primarily to show how the early measures lay the groundwork for subsequent future steps which are important to reaching FRY's strategic objectives. This focus on the initial period reflects not only the urgency of the economic and social situation, but also the fact that the limited amount of existing analysis will require some ability to adapt the strategy to new information, and will thus make detailed future priorities less clear at this point.

FRY's reform priorities must be discussed in the context of its external economic relations. The full *global* dimension is of most direct relevance for macroeconomic and foreign trade policy. The *European* dimension will increasingly influence all areas of policy making, especially as FRY begins to pursue its long-term strategic goal of EU membership, and as a Stabilization and Association Agreement (SAA) with the EU (see Section II.B.) is formulated and then implemented. The *Southeast European region* (SEE) as a whole, and FRY in particular, lies at the crossroads between different continents and cultures. Trade and cooperation with its neighbors will be crucial for FRY's economic revival. In areas where such regional links are most crucial, or where important regional initiatives have been or will be established (e.g. trade and investment policy, energy and transport infrastructure linked to neighboring countries), the analysis will address this dimension. In most other areas, the report will discuss the reform priorities in a largely domestic context.

Equally important are the relations between levels of government within the country. FRY was formed in 1992 out of the Republics of Serbia and Montenegro as the former Socialist Federal Republic of Yugoslavia (SFRY) was breaking up in civil conflict. The Republic of Serbia is by far the larger of the two constituent republics, with around 95 percent of FRY's 10.6 million population and a similar share of its GDP. FRY's federal structure is highly decentralized and fluid. In some areas, the reality differs from its legal form. The federal Constitution gives the republics the responsibility for most economic and social functions. However, it reserves as the main federal responsibilities defense, foreign policy, monetary and trade policy. In practice, the Republic of Montenegro has taken over the responsibility for its monetary and trade policy (although practical cooperation to overcome the consequences continues), and has largely cut fiscal links with the federal government and the government of the Republic of Serbia.

The report examines FRY (excluding Kosovo) within the current *de jure* and *de facto* federal arrangements. Most areas of economic and social policy are already in the republican domain. This fact, along with the inter-republican divergence in key policies and reforms over the past decade, has in most cases required a separate analysis of the two republics. Given the much

larger size of the Republic of Serbia, the greater complexity of its remaining reform agenda, and the fact that this agenda was commenced only at the end of 2000, the report will generally provide more details on this part of FRY. Were the legal and/or actual arrangements to change, some conclusions might have to be adjusted. Nevertheless, there is broad recognition in both Republics that the design of reforms in areas crucial for the free inter-republican movement of goods, services and factors of production should be fully compatible with the need to create a well-functioning single economic space regardless of the ultimate political arrangements.

The report will not examine the priority reforms and assistance needs in the province of *Kosovo*, which is under temporary United Nations (UN) administration, and where a separate donor assistance program is in place (most recently discussed at a technical meeting of donors in February 2001). In a few cases where links between Kosovo and the rest of FRY are particularly important (e.g. trade policy, some infrastructure investments), Kosovo is referred to in the analysis but not in the donor program. This analysis assumes that creation of an integrated economic space will be desirable regardless of the ultimate political arrangements. However, unless otherwise noted, all estimates of GDP and ratios expressed as a share of GDP are inclusive of Kosovo.

Federal Republic of Yugoslavia
Breaking With the Past: The Path to Stability and Growth

EXECUTIVE SUMMARY

As part of their overall donor coordination responsibilities in the Southeast Europe (SEE) region, the World Bank was asked to develop, in partnership with the European Commission (EC), an Economic Recovery and Transition Program (ERTP) for the Federal Republic of Yugoslavia (FRY). The two-volume report outlines a comprehensive structural reform agenda, a priority public investment program, and needed sectoral policy reforms. Its purpose is to support the design, implementation and financing of a program for transition and recovery in FRY. This first volume of the ERTP summarizes the main priorities in economic and social policy and institutional strengthening.

The renewed transition to democracy and a market economy in FRY is taking place under extremely difficult economic and social conditions. These conditions are the combined legacy of three broad developments over the past decade: (a) very poor macroeconomic outcomes in the form of sharp drops in output and trade and high or very high inflation; (b) severe deterioration in the state of the enterprise, financial and infrastructure sectors; and (c) worsened social indicators and increased poverty and inequality.

The political changes which culminated in October 2000 have laid the foundations for making a clear break with the past decade of economic decline. They have done so by creating the basis for economic and social reforms, as well as for enhanced donor support, which can together put FRY on a path to stability and growth.

At the time of the political changes at the Federal level and in the Republic of Serbia, the government of the Republic of Montenegro had already made significant progress in its own reform program. Further advances have since been made, including in price liberalization and improvement of the legal and institutional framework for the financial sector and for foreign investment.

Upon taking office, the new Federal and Serbian authorities moved quickly, concentrating their efforts in three areas; (a) immediate stabilization of the economy; (b) meeting the urgent needs of the most vulnerable during the 2000-2001 winter; and (c) re-integration with the international community. Soon thereafter, the Federal and Serbian governments began to prepare and implement more fundamental reforms. The Montenegrin government continued on its path of reforms, with a focus on fiscal consolidation and strengthening the legal framework. The Federal authorities implemented a deep reform of foreign trade policy, began to reform customs administration, and developed a plan for bank restructuring. In Serbia, major progress was made in domestic liberalization, privatization and tax reform.

However, these were still only early successes on a long and difficult program of reforms and institutional strengthening. Moving onto a path for achieving the strategic goals of full reintegration into the international community in the near and medium-term, achievement of a self-sustaining economy (rapid growth without aid dependence) in the medium-term, and

accession to the European Union in the long-term, will require the federal and republican governments to adopt comprehensive transition reforms and undertake some priority investments and physical upgrading to meet three highly interdependent medium-term challenges:

- Restoring macroeconomic stability and external balance;
- Stimulating growth and creating the basis for a sustainable supply response; and
- Improving the social well-being of the most vulnerable and building human capacity.

The next three sections summarize the reform priorities for meeting these challenges, with a distinction between those which should be commenced immediately and those which need to be pursued in the medium-term. These summaries will focus on reforms which will need to be pursued in both Serbia and Montenegro, although their speed, intensity and sequencing will need to take into account the different starting points in the two republics reflecting Montenegro's earlier start to economic reforms. This will be followed by a discussion of macroeconomic prospects in the event of successful reform and stabilization, and of the risks which FRY will face along the way.

Restoring macroeconomic stability and external balance

The legacy of past fiscal and quasi-fiscal imbalances, and the resulting accumulation of domestic and external debts, has left FRY facing significant macroeconomic risks.² With the adoption of an ambitious stabilization and structural reform program, the pressure to begin re-servicing public debt, and the need to stop the accumulation of new arrears, these imbalances are already coming into the open. In parallel, the renewed servicing of external debt while pursuing economic reconstruction will put significant pressures on FRY's already strained external accounts. Managing and reducing these imbalances will be a severe challenge for the authorities.

Meeting this challenge will require sound and sustained macroeconomic management, key sectoral reforms, and appropriate foreign assistance. The reforms which are most directly linked to meeting this challenge are in the areas of fiscal policy and management, external trade and governance. Reforms to trade and tax policy and their administration have already made important progress. They will support fiscal balance by stimulating growth (hence enlarging the tax base), and by directly improving revenue collection (through simplification, the closing of loopholes, limiting discretion and strengthening the capacity for administration).

In the near-term, the objective of restoring macroeconomic stability and external balance will also be supported by the reforms in other sectors. Particularly important will be the control of structural sources of fiscal and quasi-fiscal deficits. Losses growing out of the low levels of public utility tariffs have been the single largest source of quasi-fiscal deficits in FRY, especially

² Quasi-fiscal deficits reflect operations of a fiscal nature which are undertaken at the direction of the government, but not conducted through the budget. Such activities, usually conducted by banks or enterprises, have an eventual fiscal impact comparable to that of more traditionally defined taxes and subsidies.

in Serbia. Controlling these hidden subsidies requires reforms (some first steps have already been taken) to: (a) raise the prices of *inter alia* energy, public transport, telecommunication services, and pharmaceuticals; (b) cut costs through improved governance in these areas; and (c) continue the policy of no central bank directed credit. Reforms to price and subsidy policies for agriculture will make similar contributions to fiscal sustainability.

In the medium-term, more fundamental reforms will have to be introduced. Improvements in the monitoring and management of public expenditures can work to limit unplanned expenditures and better align commitments with available resources. Better standards of financial management and enhanced transparency in the use of budgetary resources will be crucial for unlocking the donor assistance needed for the near-term balancing of fiscal accounts. Reforms and institutional strengthening to improve the monitoring and management of FRY's large external and domestic public liabilities (both direct debt and implicit and contingent liabilities), along with the reaching of agreements on appropriate concessional debt rescheduling, will also be crucial for fiscal sustainability.

Medium-term reforms to harden enterprise budget constraints will support fiscal stability by cutting the flow of new losses. These reforms should include a generally reduced toleration of unpaid bills, the privatization of enterprises to real strategic owners, and the strengthening of creditor rights through an improved bankruptcy system. Restructuring or liquidating insolvent enterprises in ways which limit the degree to which their liabilities are taken over by the state will also work to ease fiscal pressures. An improved legal, regulatory and supervisory framework for banks will contain the creation of new bad assets. While even the most fiscally-responsible bank resolution strategy will bring some immediate fiscal costs (any attempt at extensive recapitalization of large problem banks would create severe fiscal imbalances), an effective strategy will promote medium-term fiscal stability by curtailing the accumulation of new losses in the banking sector.

Governance reforms which strengthen institutions and reduce corruption are key to ensuring the success of the above measures in the medium-term. These will have direct benefits (reducing the erosion of the revenue base through corruption), as well as indirect effects (through building public confidence in the government, and thus creating support for difficult but necessary measures). Effective and accountable institutions will also enhance the scope for cost savings and for enlarged near-term donor support.

Reforms to better align benefits with available resources in the social sectors will also be critical for improving fiscal sustainability. In addition, labor market reforms will over time work to ease pressure on the social funds.

Stimulating growth and creating the basis for a sustainable supply response

Promoting employment creation and meeting public expectations that progress is being made requires FRY to restart economic activity forcefully and on a sound basis. The reforms, institutional strengthening and investments which will most directly support sustainable growth are in the framework for private and financial sector development, in key infrastructure sectors

(especially energy, transport, telecommunications and water), and in the agricultural sector. Furthermore, sustainable medium-term growth will require increasing attention to the state of the environment and the effective use of FRY's natural resources. These efforts can be grouped into three broad areas:

- (a) quickly implementable reforms and institutional strengthening which bring "early wins" in terms of an immediate supply response, employment creation, and a shift from the gray to the official economy;
- (b) physical reconstruction which removes key barriers and bottlenecks to growth; and
- (c) laying the foundations for reforms such as privatization and the creation of effective regulatory frameworks which will improve the basis for medium-term growth, but where preparatory steps (including the creation of requisite institutions and civil service capacity) are crucial for success.

"Early wins". The most immediate impact on growth and the social credibility of the reform process will come from reforms to remove distortions and bottlenecks which most limit the expansion of output and trade, or which most drive these activities into the informal sector. These reforms to improve incentives to produce and export include: (a) the removal of barriers to entry and development of new enterprises and banks, particularly of SMEs and good private banks, including foreign banks; (b) the reduction of barriers to competition; and (c) the removal of price, subsidy and other distortions (e.g. in agriculture, energy and transport). Other reforms and investments with early benefits include: (a) improving the legal and institutional framework for foreign direct investment; (b) policy shifts to harden budget constraints and strengthen creditor rights; (c) energy price increases to enhance the reliability of energy supply and increase the efficiency of resource use; (d) the cleanup of river beds and measures to revive international trade and road transport; (e) intensifying competition in the telecommunications sector; and (f) building up the foundations for development of the tourism sector in Montenegro.

Physical reconstruction. The poor economic performance of the past decade was partly the result of extensive decapitalization. This reflected chronic under-investment and lack of maintenance (which in turn reflected both pricing policies which starved enterprises of resources and the chronic crowding out of public investments), as well as some destruction of productive assets during the Kosovo conflict. In the near-term, investments to repair aging and damaged infrastructure (in particular in energy, transport, water and agriculture) can help to eliminate critical bottlenecks to growth. Cleanup of environmental hotspots is also needed. Given the severe lack of maintenance over the past decade, and the less obvious need for wholly new investments, the near-term agenda will largely be focused on repair and maintenance. In the medium-term, and as the economy begins to grow, a gradual move away from maintenance towards new infrastructure investments should be evaluated.

Laying the foundations for deeper reforms. Again, early preparatory steps will be crucial for the eventual success of the medium-term reforms. Four areas stand out. First, privatization must be set on a path which ensures the achievement of a new ownership structure conducive to growth. This requires modification of the legal framework, supported by creation and strengthening of

the related institutions. Second, there is a need to begin developing the legal and regulatory framework for energy and municipal utilities, transport and telecommunications, to ensure that these sectors develop in ways which maximize their growth impact. Third, financial sector reforms will create the basis for restored financial intermediation, the direction of credit resources to the most viable enterprises, and the establishment of an effective payments system. Finally, policy and institutional reforms in the energy, infrastructure and agricultural sectors are important not only for creating a sound framework for investments, but also for determining efficiency of a sub-sector's operation, and thus its contribution to growth.

Improving the social well-being of the most vulnerable and building human capacity

While difficult institutional and economic policy reforms are needed, a further drop in living standards, combined with an increase in unemployment would be unacceptable unless combined with a proper poverty alleviation program and social safety net. The reforms which most directly work to improve the well-being of the most vulnerable and build human capacity are in the spheres of social protection, health and education. These reforms will aim to bring immediate near term improvements in social outcomes, and to set the stage for more fundamental longer term changes and institutional strengthening. In the near-term, finances need to be stabilized to bring the arrears under control. In the medium-term, more fundamental reforms to the system will be essential. The quality and efficiency of service delivery needs to be improved, including through maintenance and rehabilitation in health and education. Reforms will also need to improve the access of the poorest residents of FRY to basic social, health and educational services.

While levels of expenditure on pensions and health in relation to GDP will need to be reduced in the medium-term, the allocations to education (which are very low by regional standards in Serbia) will need to be sustained or even increased. In the medium-term, measures to protect the most vulnerable need to focus on improving the structure, coherence and targeting of social welfare programs. At present, expenditures are low (especially in Serbia) and often in arrears. In many key respects, the social protection systems are not designed to cope with a rise in the number of the unemployed or those seeking social assistance. The latter is an issue particularly on account of the expected granting of citizenship to refugees.

In addition, medium-term reforms to restore balance to pension systems can eliminate the chronic delays in payment, reducing vulnerability to poverty by increasing the predictability of benefits. Labor market reforms can work to reduce unemployment, while reforms in health and education can bring improved access to basic services in these areas, particularly for excluded groups. Building a more productive and flexible labor force that better meets the needs of a modern market economy requires reforms and investments to improve the quality and cost-effectiveness of education and health services. Measures to improve the efficiency and financial sustainability of social services are also important for enhancing equity through the provision of adequate and regularly paid benefits and access to affordable basic education and healthcare for the most needy.

These medium-term policy measures should also be supported by reforms in other sectors. Improved budget management can limit the crowding out of pro-poor expenditures by unplanned quasi-fiscal subsidies and by shifting support from enterprises to the individuals most in need. By reducing corruption, better governance can enhance the access of the less well-off to basic public services. Improvements in the business environment which support the rapid growth of small and medium-sized enterprises (SMEs) can bring more pro-poor growth. Well-designed energy price increases and compensating social protection measures can reduce the vulnerability of the poor to energy shortages while freeing up fiscal resources for more direct means of support. The establishment of a universal access mechanism for telecommunications services will help ensure access to basic services for the poor.

Medium-Term Economic Outlook and External Financing Requirements

Successful implementation of the described program of reform, institutional strengthening and investment will create the foundations for sustained growth of incomes and trade in FRY. Achieving this will also require two other important factors: (a) generous, promptly delivered, and well-targeted donor support for the reform program, including the restructuring and reduction of FRY's massive external debt, financial support, and technical assistance; and (b) a relatively favorable external environment.

The restoration of economic growth would come with a similar evolution of the twin fiscal and current account deficits. Both deficits would first rise to higher levels for most of the first half of the decade, before gradually falling to levels more representative of mature transition economies. This is because the more rapid initial growth of needs relative to available resources would first result in a higher fiscal or external financing requirement. Over time, the beneficial impacts of initial reforms would increase available resources while controlling needs, thereby bringing a phased decline in the financing gap. Near-term attempts to fully close these gaps without external resources would be inconsistent with economic and social sustainability, as they would lead either to renewed inflation, inadequate maintenance and investment, or sharp cuts in needed social expenditures. For this reason, significant donor financing and other assistance will be fundamental for restarting the economy.

A comprehensive debt restructuring, including a substantial reduction in total debt stock and debt service payments, would make a major contribution to restoring FRY's creditworthiness, and thereby to reopen its access to international resources at commercial or near-commercial terms. Under an illustrative scenario for debt restructuring,³ FRY's gross external financing needs will total about US\$20.6 billion during the period 2001-2005. The largest share (about 47 percent) is accounted for by arrears clearance on external debt, around 29 percent by the current account deficit net of interest and official transfers but including other net factor payments, around 18 percent by debt service on rescheduled and new debt, and about 6 percent by the accumulation of international reserves to a precautionary level (2.5 months of imports in 2004).

³ This illustrative scenario is not meant to prejudice the outcome of any future agreement between FRY and its external creditors in the Paris and London Clubs.

These needs for the period 2001-2005 are projected to be met from several sources. Multilateral, bilateral and commercial creditors are assumed to finance about 46 percent through agreements that restructure and reduce outstanding debt stocks, and capitalize, restructure and/or reduce arrears. With good progress on reforms, foreign direct investment is expected to grow from a low base to cover about 14 percent of these needs. With the assumed improvement in FRY's creditworthiness, other private sector finance will grow from current low levels to meet about 16 percent of these needs. In addition, around 2 percent of needs are expected to be met by disbursements for urgent needs which were already announced at the 12 December 2000 Donor Coordination meeting.

FRY's remaining financing requirements would still be substantial, about US\$4.6 billion (22 percent of total needs) over the period 2001-2005. These resources will need to come from official bilateral and multilateral sources. They will be crucial for FRY to meet the two equally important challenges of undertaking critical reconstruction and public investments to support growth, and of promoting macroeconomic sustainability in the difficult initial period. For this reason, both the level and composition of external assistance to FRY will be important, as explained in Volume 2 of this report.

Of the estimated US\$4.6 billion disbursements basis financing gap for the five year period 2001-05, US\$1.03 billion is projected to be required in **2001**.⁴ This gap is expected to be further reduced by an amount of some US\$282 million provided by the International Monetary Fund under its proposed Stand-by Arrangement and from structural adjustment lending from the World Bank. Of the remaining gap of some US\$750 million, more than one-half would need to be fast disbursing balance of payments/ budgetary support, because given the slow pace of disbursement of project financing, only limited volumes of such financing can be expected to be disbursed in 2001. If this balance of payments/budgetary support were not forthcoming, the Government would be forced to further compress expenditures, with obvious consequences for critical social expenditures, or to delay the pace of restructuring, with future consequences for growth.

⁴ An alternative presentation which excluded the assumed US\$210 million of disbursements from support announced earlier in 2001 (discussed below), would show this financing gap as US\$821 million.

I. BACKGROUND

A. THE ECONOMIC AND SOCIAL STARTING POINT

1.1 *The renewed transition to democracy and a market economy in the Federal Republic of Yugoslavia (FRY) is taking place under extremely difficult economic and social conditions.* These conditions are the combined legacy of three broad developments over the last decade: (a) extremely poor macroeconomic outcomes in the form of sharp drops in output and trade and high or very high inflation; (b) severe deterioration in the state of the enterprise, financial and infrastructure sectors; and (c) worsened social indicators and increased poverty and inequality.

1.2 Economic decline reflects both external and domestic factors. These negative trends were partly the result of several adverse external factors; the impact on established trade links of severe regional conflict (the breakup of the Socialist Federal Republic of Yugoslavia (SFRY) and subsequent conflicts with FRY's neighbors); international isolation, including economic sanctions; the Kosovo conflict of 1999, which also led to a destruction of productive assets; and the severe drought of 2000, which cut agricultural and hydroelectric power output.

1.3 Even before these events, the SFRY had a history of severe macroeconomic imbalances and high inflation. It had already accumulated a large external debt and its growth rate had begun to decline. In FRY, the last decade brought long delays in economic transition and in the hardening of budget constraints, with sporadic progress giving way to periods of reversal. Authoritarian rule, high military spending and general mismanagement worked to reduce efficiency and erode fiscal balance. In 1993, FRY experienced one of the most acute hyperinflations in world history. Growth potential was further cut by significant deferred maintenance and under investment in the face of tight financing constraints. Finally, weaknesses in governance and institutions eroded implementation capacity. Together with limits to respect for the rule of law, this also created fertile ground for corruption.

1.4 *The political changes which culminated in October 2000 have laid the foundations for a path to stability and growth in FRY.* These changes (described in Box 1.1) have created the basis for a clear break with the a decade of economic decline through accelerated economic and social reforms. They have also been the basis for interest of the international community responding to FRY's needs.

1.5 *Growth and export trends.* The last decade saw a collapse in per capita GDP, most recently a sharp 16 percent decline in 1999 which primarily reflected the impact of the Kosovo conflict.¹ In that year, the GDP of Montenegro, which accounts for less than 10 percent of FRY GDP, fell by less (9%) than in FRY as a whole. In 2000, real GDP in FRY rebounded slightly by around 6 percent, primarily reflecting a comparison to the year of the Kosovo conflict. Despite this recent rebound, recorded per capita GDP in FRY remains below one-half of its 1989 level –

¹ The low reliability of macroeconomic data requires caution in interpreting all such figures. This weakness reflects several factors, including the erosion of capacity under sanctions and limited budgetary resources, the high apparent share of the shadow economy, the previous absence of market clearing prices for goods and foreign exchange, and some methodological weaknesses. Donor support for strengthening statistical capacity in FRY will be extremely important.

one of the largest declines in Central and Southeastern Europe (See Chart 1.1). *Foreign trade* volumes have fallen even more, with exports in 2000 down 61 percent and imports 31 percent from 1989 levels. During this period, FRY moved from being a traditional net exporter of food and energy to being a net importer of these goods. In the late-1990s, the Republic of Montenegro moved to gradually introduce a *de facto* separate trade policy and customs regime.

Box 1.1 – Recent Political Changes and Near-Term Political Challenges

In October 2000, the Democratic Opposition of Serbia (DOS) coalition came into office on a wave of popular support. Soon thereafter, the parliament of the Republic of Serbia was dissolved and a multi-party caretaker government appointed to lead the republic until early elections in December 2000. These elections gave DOS a large majority in the Serbian parliament. The new Serbian government took office in January 2001. The new governments are committed to substantial economic reform.

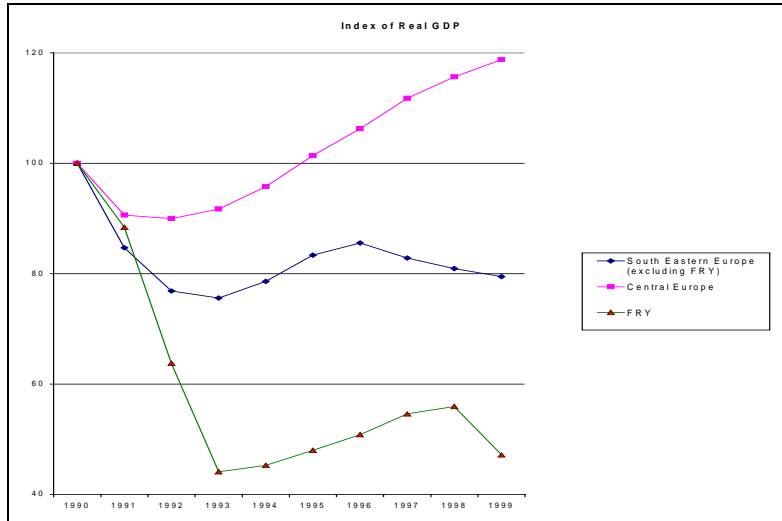
However, serious political challenges remain. First, maintaining the focus of the 18-party coalition be difficult. Second, a key uncertainty remains the status of FRY's relationship with the Republic of Montenegro, where the governing party favors greater independence and a looser confederation. The April 2001 parliamentary elections in Montenegro indicated no clear consensus within the republic on this issue, which remains under discussion between the parties. Third, the Serbian province of Kosovo remains under international administration.² The recent outbreak of violence in the neighboring Presevo valley of southern Serbia has increased tensions. Fourth, and perhaps most critically, after ten lost years, the population now has high expectations of a speedy return to "normal life" and increased incomes.

1.6 Production and trade were severely hampered by a multiple exchange rate regime for the Yugoslav dinar (YUD). Until late-2000, the official exchange rate was kept at a highly overvalued 6 dinars per German mark (DEM) while the market rate gradually depreciated to 30 YUD/DEM in December 2000, implying a black market premium of up to five times. Over time, intermediate 'incentive' rates began to account for a growing but still limited share of transactions. Requirements to surrender 10 percent of export receipts at the official rate, and to pre-deposit 5 percent of planned imports, also acted to constrain foreign trade and output expansion. In parallel, the Republic of Montenegro moved first to enlarge the scope for making payments in DEM, and finally declared that currency the sole legal tender on its territory in November 2000. This move created greater monetary stability in Montenegro, but also introduced complications to payments between the two republics.

1.7 High inflation rose further in 2000. In December 2000, the price level in Serbia reached 115 percent above one year previous. This reflected a large liquidity emission in the run up to the September elections and the removal of price controls in the last days of the outgoing government. As a result, the average monthly inflation rate jumped from 5.5 percent in the third quarter of 2000 to 27 and 17 percent respectively in October and November 2000, before falling to around 3 percent per month in early 2001. The level of monetization is exceptionally low at 3-4% of GDP. As described more fully below, the resulting very limited scope for monetary financing of fiscal deficits has important implications for the design of fiscal policy and the level and structure of external assistance needs. In Montenegro, inflation in 2000 reached 25 percent, despite the use of the DEM. The resulting substantial real appreciation in Montenegro was partly the result of renewed confidence, but partly also of high inflows of foreign assistance and of rapid increases in minimum and public sector wages.

² UN Security Council Resolution 1244 (June 1999) established a transitional UN authority (UNMIK).

Chart 1.1 – Real GDP Trends in Economies in Transition (1990 = 100)



1.8 *Huge quasi-fiscal deficits have been the main source of macroeconomic instability.*³ In recent years, the consolidated government deficit on a cash basis was kept relatively low reaching only 0.9 percent of GDP in 2000. This low deficit hides a number of important effects. First, the Republic of Montenegro accounted for around three-quarters of the deficit, which represented a very large almost 10 percent of its own GDP. However, Montenegro’s deficit was fully financed by foreign grants. The remaining one-quarter of the cash deficit in FRY (0.2 percent of FRY GDP) was at the federal and Serbian levels.

1.9 Second, low cash deficits are very deceptive, as they have been achieved through four unsustainable elements of fiscal policy: (a) a drastic compression of real spending; (b) the non-servicing of a very large public debt (para. 1.12); (c) the accumulation of direct budgetary arrears, especially on pensions, child allowances, and health funds (the flow of net new arrears amounted to over 2 percent of GDP in 2000); and especially (d) the toleration of large quasi-fiscal deficits in major enterprises and banks (particularly in the energy sector – see Section III.C). While income per capita dwindled rapidly, these quasi-fiscal activities were used to support the vulnerable or politically influential social groups and organizations. These government measures were arbitrary and not fully transparent, and undermined market discipline and creditor rights. Quasi-fiscal deficits in the energy and agricultural sectors were often financed through the banking sector. The accumulation of inter-enterprise debts represented a more general source of financing. The monetary financing of such deficits has been the primary source of inflation. Real fiscal revenues have been lower than planned because of tax exemptions, rate cuts and the development of the gray economy.

³ Quasi-fiscal deficits reflect operations of a fiscal nature which are undertaken at the direction of the government, but not conducted through the budget. Such activities, usually conducted by banks or enterprises, have an eventual fiscal impact comparable to that of more traditionally defined taxes and subsidies.

1.10 *Government spending accounts for a high share of GDP.* In 2000, consolidated government outlays reached 39.7 percent of GDP. The net accumulation of budgetary arrears, at the federal level as well as in both republics, means that expenditure commitments were even greater. This high level primarily reflects high spending on pensions, health, defense and internal security. Even excluding military pensions, cash outlays on pensions reached 11.8 percent of GDP in 2000. Health care absorbed a further over 6 percent of GDP. Defense outlays in 2000 (including military pensions and benefits) are estimated at around 6 percent of GDP. With the tax burden already high, fiscal consolidation will require concerted cuts in expenditure commitments, which will in turn require comprehensive sectoral reforms.

1.11 *External imbalances have also been large.* In 2000, FRY's resource balance showed a very large deficit of US\$1.52 billion, or 16.8 percent of GDP. However, given the important role of private remittances in both Serbia and Montenegro, and of official grants to Montenegro, the current account deficit has actually been estimated a much lower US\$400 million, or 4.4 percent of GDP. This ratio was below average levels over the previous years, partly reflecting a reduction in available external financing. In contrast, in 1997, when the privatization of 49 percent of Telecom Serbia had raised significant external financing, the current account deficit had reached 9.6 percent of GDP.

1.12 *Debt stocks have reached unsustainable levels.* The fiscal and external sustainability of the Yugoslav economy is undermined by a crushing burden of external and public debt. A foreign debt of around US\$12.2 billion (136% of 2000 GDP), most of which is in arrears, leaves FRY highly indebted (see Section V.D. for details). As most of this debt was contracted or guaranteed by the state, and as the government may incur additional domestic liabilities through the planned compensation of frozen foreign currency deposits, and possibly through bank and enterprise restructuring, the underlying public debt is even larger (Section II.A.).

1.13 *The enterprise sector is in very poor condition.* The past decade brought under investment, the loss of markets and contacts, and isolation from technological advances. It also retarded the evolution of market-oriented ownership structures that had begun to emerge in the late-1980s. Progress in privatization was limited, especially in the Republic of Serbia, where privatization was also biased in favor of insiders. Aside from one very large investment in the Serbian telecom sector, foreign direct investment (FDI) was negligible. In addition, a complex web of major arrears has built up between the governments, companies, banks and people. As a result, FRY embarks on its renewed transition with a still dominant state and socially-owned enterprise sector that is thoroughly accustomed to soft budget constraints and thus inefficiently organized, substantially loss-making and excessively indebted. The private sector, mainly composed of small and medium-sized enterprises (SMEs), has been much more dynamic and profitable. However, it is small and severely constrained by over regulation and an uneven playing field tilted towards the larger socially-owned companies. Repressive regulation has pushed much economic activity into the informal economy, while the uneven playing field has resulted in a severe lack of investment and working capital (Section III.A.).

1.14 *The financial sector is non-functional and loss-making.* There is no notable activity in credit markets and mobilization of resources for new investment is negligible. Large parts of the system – particularly the largest banks – suffer from liquidity. Public confidence in the sector

has almost entirely been lost, particularly in Serbia. Governance and ownership of the banking system is in itself a serious problem. The underlying framework of creditor and property rights has long been abused and is deeply distrusted. In spite of an adequate regulatory environment, there is a largely weak institutional base, unable to enforce the rules (Section III.B.).

1.15 *Poor economic performance has been the key factor in the rise of poverty.* The brunt of the economic adjustment over the past decade has been through a decrease in earnings, with real wages measured against the constant poverty basket losing 60 percent of their value between 1991 and 2000. Recorded average net wages in Serbia are now about US\$70 per month, and pensions about US\$60 per month. In Montenegro, the respective levels are about twice as high. Many workers have also been affected by delays in their wage payments, especially in Serbia. Over the last winter, the population experienced cuts in electricity and heating delivery. Basic staples were either in shortage, or experienced massive price increases which also cut their availability to the poor. Savings are very low and many segments of the society have run out of reserves. The impact of armed conflicts, with an estimated 630,000 refugees from Bosnia-Herzegovina or Croatia, or internally displaced persons (IDPs) from the province of Kosovo (totaling around 6 percent of FRY's population), has been particularly severe.⁴ The evolution of poverty and inequality in FRY is summarized in Box 1.2 below, and is discussed more extensively in Volume 2 of this report.

Box 1.2 – Poverty and Inequality in FRY

Absolute poverty has increased. While the existing data were not used consistently to analyze the extent and profile of poverty, some preliminary conclusions are possible. Prior to the 1990s living standards were relatively high, and inequality fairly low. Absolute poverty is now about twice as high as it was in 1990. Based on the World Food Programme minimum consumption basket, an estimated 1.3 million FRY residents (12 per cent of the population) live in absolute poverty, with roughly the same incidence in Serbia and Montenegro. In addition, about 20 per cent of the population is near-poor (using the Federal Statistical Office food basket). Unemployment, when measured in a consistent and internationally comparable way is not nearly as high as is reported by official statistics (around 30 percent in 2000), although it is on a rising trend. Unemployment seems to be of a long-duration nature symptomatic of rigid labor markets. The unemployed, the elderly, the disabled, and families with many children and/or single parents appear to have the highest risk of poverty, as do the refugees and IDPs. Regional differences are also important, with higher poverty rates in Southern Serbia and Northern Montenegro.

Coping strategies have mitigated the worst cases of deprivation. Public safety nets play a relatively minor role compared to informal coping mechanisms. It is estimated that 15-20 percent of adults are engaged in some form of gainful activity that does not imply a regular employment contract or registration. As much as 40 percent of households receive income from such activities. The second type of informal activity is subsistence farming. Over half of the households in Serbia are reporting to produce themselves at least part of their food supply (26 percent in Montenegro). These coping strategies prevented the worst cases of deprivation and no major signs of malnutrition are apparent. Nevertheless, some of the very poor have only limited access to both subsistence farming and informal employment. In many of these cases, poverty is an outcome of failing to find a place in the informal economy.

Inequality is moderate by regional standards but rising. For now, inequality remains moderate by regional standards and poverty remains relatively shallow - with incomes of the average poor 23 per cent below the poverty line. However, the clustering of households around the poverty line implies that even small changes in household income will directly affect the poverty status of a considerable number of people. With the liberalization of economic activities, inequality is likely to increase, undermining the trickling down of growth benefits to the poor. As there are many working poor, improvements in the real wage and employment restructuring are prerequisites to rapidly lift them out of poverty.

⁴ These figures are based on the last census of refugees recently completed by UNHCR.

B. INITIAL PRIORITIES OF THE NEW GOVERNMENTS

1.16 *While the Montenegrin government continued its previously commenced reform efforts, the new federal and Serbian authorities moved quickly upon taking office.* They concentrated their efforts in three areas; (a) immediate stabilization of the economy; (b) meeting the urgent needs of the most vulnerable during the 2000-2001 winter; and (c) re-integration with the international community. Good progress was made on all fronts, with significant assistance and cooperation from the international community.

1.17 *Enforcing stability.* FRY's fiscal and quasi-fiscal positions had become unsustainable without strong domestic adjustment and foreign support. In late-2000, the authorities tightened macroeconomic policies to control inflation, first through their own efforts and later with the support of an IMF Emergency Post Conflict Facility approved on December 20, 2000. Under that program, the Serbian parliament adopted a 3-month budget and the federal and Montenegrin parliaments adopted full 2001 budgets. The consolidated cash-based budget was balanced through a combination of expenditure cuts and measures to increase revenues, including hikes in excise tax levels and better enforcement of customs rules. In parallel, the National Bank of Yugoslavia (NBY) shifted to giving almost no credits to the budget or to enterprises. It also began to reform exchange rate policy. In early December 2000, the exchange rate of the dinar was unified at the highly depreciated market rate of 30 YUD/DEM. The dinar was then made convertible for current account transactions by the elimination of administrative impediments to foreign currency purchases and sales. Despite a formal managed float, the tight monetary and fiscal policies have sustained that rate while allowing the NBY to accumulate additional foreign reserves. The combination of recent real depreciation, exchange rate unification and current account convertibility has improved prospects for growth and export expansion.

1.18 *Meeting urgent needs.* Upon taking office in the run-up to winter, the new federal and Serbian authorities faced a desperate situation in the energy, agricultural and health sectors. Severe shortages of heat and electricity reflected the legacy of past mismanagement, excessively low tariffs, under investment and lack of maintenance, and the impact of a severe drought on hydro power generation. Agriculture had suffered from policies which distorted incentives and from a lack of critical inputs. The problems in the health sector, including a shortage of pharmaceuticals, reflected the impact of the collapse of economic activity on available financial resources.

1.19 Based on an urgent needs assessment prepared in collaboration with the UN,⁵ the authorities focused on protecting the most vulnerable by mobilizing sufficient assistance to assure the availability of critical goods, particularly energy (electricity and gas for heating), basic foods and medicines, and to improve the delivery of social assistance. A first Donor Coordination Meeting in December 2000, co-hosted by the World Bank and the European Commission, raised some US\$500 million toward meeting these needs. This substantial and rapidly mobilized assistance was effective in keeping basic services functioning, alleviating some of the more pressing social problems, and keeping economic disruption to manageable levels.⁶ While most of this assistance was "in kind" and was provided outside the budget, some

⁵ "Urgent Needs in the Federal Republic of Yugoslavia," December 2000, UN OCHA.

⁶ FRY was also helped by an exceptionally mild winter, which lessened the pressure on the energy sector.

was earmarked for specific social payments. Some of this assistance also took indirect pressure off the budget by reducing the quasi-fiscal deficits in the energy and health sectors.

1.20 *Re-integration with the international community.* Soon after the political changes of October, FRY became the full member of the UN, IMF, the European Bank for Reconstruction and Development (EBRD), Stability Pact for Southeast Europe and other international bodies. In May 2001, FRY's membership in the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC) was approved. Discussions are underway to renew its country operation status with the European Investment Bank (EIB). It has been decided to solve the issue of succession on the basis of an equal treatment of all former Yugoslav successor states, and to share assets in the Bank for International Settlements according to the IMF formula.

C. RECENT PROGRESS IN PREPARING DEEPER STRUCTURAL REFORMS

1.21 In Montenegro, where reforms and institutional development had generally progressed further over recent years, the authorities continued to move forward on several fronts. In late-2000, the prices of key consumer staples were partially freed, with the full liberalization of milk and bread prices planned for August 2001. The republican parliament passed new laws on the central bank, commercial banks, foreign investment, securities, and telecommunications which are broadly consistent with international standards. A new Company Law, Bankruptcy Law, and Public Procurement Law, all designed to be consistent with international best practices, are under preparation. In December, a Securities and Exchange Commission was established. More recently, the government has committed to freeze the minimum wage, which had increased by a very high 50 percent in 2000, at least for the remainder of 2001. The government is also working to accelerate the privatization program, including through international tenders and voucher privatization of smaller firms). A tax Action Plan to improve revenue mobilization is under implementation with donor assistance. The Council of the Central Bank of Montenegro has recently been appointed. The central bank has itself recently appointed an administrator for the largest commercial bank to focus on resolving the liquidity and capital adequacy problems of that bank.

1.22 Upon taking office, the federal and Serbian governments also moved to prepare and begin implementing comprehensive structural reforms to transform FRY into a more complete market economy. The outgoing Serbian government freed most prices in early October, bringing sharp price increases which eased shortages but affected real wages. More recently, the federal government prepared and implemented a significant reform of the foreign trade regime with a view to suppressing excessive administrative regulations, revising import and export licenses, limiting the use of quotas and simplifying the tariff regime. In addition, it has reformed customs and taken other measures to limit corruption and smuggling.

1.23 The new Serbian government has also begun a bold tax reform, involving a reduction in the number of taxes, a lowering of some tax rates, and a widening of the tax base through the elimination of exemptions (Section II.B). In April, the sales tax was unified from multiple taxes with multiple rates, while most exemptions were eliminated. Excises taxes were similarly streamlined. Expansion of the base for personal income tax (brining in previously non taxed

benefits) is being prepared. All of these measures will work to improve incentives, enhance revenue collection and reduce possibilities for arbitrary application and corruption.

1.24 The Serbian government has also halted privatization under the existing legal framework (Section III.A.). In parallel, it has begun to develop a new framework which will allow 70 percent of enterprise equity to be offered to strategic investors with a view to establishing clearly defined and dominant owners. This work includes preparation of new legal acts on privatization, creation of a new privatization agency, and preparations to sell about 30 “early win” firms to strategic investors with the assistance of international investment banks.

1.25 In the banking sector, reforms are underway to promote entry of new banks and improve prudential regulations and their enforcement. In tandem, efforts have begun to develop a strategy to restructure insolvent banks in Serbia (including a time-bound plan to intervene in the largest insolvent banks this year) and to strengthen the Bank Rehabilitation Agency (BRA) to manage the resolution/liquidation process. A prerequisite for these interventions, a comprehensive audit of most commercial banks, will soon be completed.

1.26 To control important structural sources of quasi-fiscal deficits, the Serbian government raised average electricity prices by 60 percent in April 2001, and has planned further increases of 40 percent in both June and October. District heating tariffs and other public utility tariffs have also been increased. Plans to delink pension benefits from wage levels, and to restore pharmaceuticals prices to more realistic levels will also contribute to cutting quasi-fiscal deficits. Finally, the inclusion of an much enlarged envelope for social assistance in the 2001 Serbian budget will increase the preparedness of the social safety net for the difficult reforms that lie ahead.

1.27 More recently, the federal, Serbian and Montenegrin governments have embarked on a reform agenda for 2001 to be backed by an IMF Stand-By Arrangement (SBA). This program, which includes many of the measures outlined in this report, aims to address macroeconomic imbalances through restrictive budgets and sustained tightening of monetary conditions. It also includes numerous elements of a deeper structural reform agenda, including in public finances and the restructuring of enterprises and banks.

D. KEY MEDIUM-TERM CHALLENGES

1.28 *A strategic vision for FRY.*⁷ Looking further into the future, FRY’s main strategic objective is to make a clear break with the recent past and move forward along with the rest of the region by working towards three goals— full reintegration into the international community in the near and medium-term, achievement of a self-sustaining economy (rapid growth without aid dependence) in the medium-term, and accession to the European Union in the long-term, with the intermediate goal of concluding a Stabilization and Association Agreement with the EU (see Box 1.3 below). The desire for *re-integration into the international and regional communities* is partly economic. The restoration of FRY’s external ties, including trade links

⁷ This section draws on materials presented by the federal, Serbian and Montenegrin government officials to the first Donor Coordination Meeting for FRY, co-hosted by the World Bank and the European Commission, in Brussels on December 12, 2000.

and normal relations with official and other creditors, can become the engine of growth for its small open economy. As one of the largest and most centrally-located countries in Southeast Europe, this reintegration will allow FRY to make a vital contribution to the peace, stability and development of the whole region.

1.29 The desire for *self-sustainability* reflects a wish of Yugoslavs to become a solvent and reliable trading and business partner benefiting from international trade and private investment flows, and thus to allow grants and other assistance to be phased out over time. This goal also reflects FRY's desire to achieve the positive performance of the most successful transition economies in Central and Eastern Europe, and to avoid the pitfalls that some of the neighboring countries have at times experienced. The path to achieving this goal will be long, but the immediate and intermediate steps along this path could allow FRY to catch up with the leading Central and Eastern European economies.

1.30 *EU membership* is seen not only as a natural 'return to Europe', but also as a means for achieving other desirable outcomes. These include the consolidation of democracy and the achievement of a well-governed and vibrant civil society freed from fear and corruption. From the economic and social policy perspective of this report, eventual European integration is seen as a vehicle for a sustained, broad-based increase in living standards. The foundation for this growth is an efficient and open market economy with great scope for private initiative.

1.31 ***Key medium-term challenges.*** To move onto a path for achieving this vision, FRY will have to overcome the legacy of many years of economic mismanagement and international isolation, and reverse the inherited structural weaknesses in the economy by starting the long-delayed move to a more complete market economy. More specifically, it will have to adopt comprehensive transition reforms and undertake some priority investments and physical upgrading to meet three highly interdependent medium-term challenges:

- *Restoring macroeconomic stability and external balance.* As noted above, the legacy of fiscal imbalance, and the risks associated with fiscal pressures, are very large. These risks will increase as FRY begins servicing its external debt and as macroeconomic tightening squeezes enterprises and banks and reveals their hidden quasi-fiscal liabilities. Meeting this challenge will require sound and sustained macroeconomic management, key sectoral reforms (particularly in banking, energy, pensions, health and transport) and appropriate foreign assistance.
- *Stimulating growth and creating the basis for a sustainable supply response.* Promoting employment creation and meeting public expectations that progress is being made requires FRY to restart economic activity forcefully and on a sound basis. This will require ambitious reforms to liberalize trade, spur private sector-led growth and restructure the financial sector. It will also require sectoral reforms and investments in key sectors such as energy, transport, water and agriculture. Growth which creates employment while reintegrating the large gray economy will particularly require deregulation, tax reform, and reforms to pensions and health to control the growth of payroll tax rates.

- *Improving the social well-being of the most vulnerable and building human capacity.* While difficult institutional and economic policy reforms are needed, a further drop in living standards, combined with an increase in unemployment would be unacceptable unless combined with a proper poverty alleviation program and social safety net. Measures are needed to move FRY from the humanitarian interventions of last winter to more carefully designed policies and programs. There is also a need to strengthen healthcare and education systems to build a more productive, healthier and more flexible labor force that better meets the needs of a modern market economy.

Box 1.3 – The EU Stabilization and Association process and the Stability Pact for South Eastern Europe

In May 1999, the EU adapted its existing policy for the Western Balkans region into the EU's Stabilization and Association process (SAP), a framework which governs bilateral relations with the countries of the region, i.e. the Federal Republic of Yugoslavia and its neighbors (Albania, Bosnia and Herzegovina, Croatia and the former Yugoslav Republic of Macedonia). The SAP covers all aspects of relations, ranging from assistance to contractual relations, and is designed to facilitate (subject to each country's compliance with conditions) progressive integration into EU structures, as a way of promoting regional cooperation, security and development. The process leads to the signature and implementation of Stabilization and Association Agreements (SAA) with the EU, which are based on the gradual implementation of a free trade area and the implementation of reforms designed to achieve a phased adoption of EU standards. The first SAA was signed with the former Yugoslav Republic of Macedonia on 9 April 2001, and the next of which was initialed with Croatia in May 2001 and is expected to be signed in the autumn.

In parallel, the EU initiated a Stability Pact for South Eastern Europe, which also includes Bulgaria and Romania, adopted in Cologne on 10 June 1999. FRY became a full participant in the Pact on 26 October 2000. In the founding document, more than 40 partner countries and organizations undertook to strengthen the countries of Southeastern Europe "in their efforts to foster peace, democracy, respect for human rights and economic prosperity in order to achieve stability in the whole region". The Pact establishes a political commitment to a comprehensive coordinated and strategic approach to the region. It is a forum for its members to identify measures and projects that can contribute to the stability and development of the region. The economic integration of the region, within itself and into the European and world economies, is a central objective under the Pact. The main organizational structure of the Pact is the South-East European Regional Table, which brings together representatives of the participant countries. The Regional Table reviews progress in implementing the Pact's projects and initiatives, and ensures coordination among three working tables on democracy, economic reconstruction, and security.

Under the Stability Pact, the European Commission and the World Bank (which already have a donor coordination responsibility), are given a special mandate to coordinate a comprehensive regional approach to development in South Eastern Europe. In response to this mandate, the World Bank strategy paper "The Road to Stability and Prosperity in South Eastern Europe" (March 2000) formulates the medium and long-term economic development goals of the Stability Pact. The common goals of the region are defined as follows: (a) private sector development; (b) poverty reduction and social development; (c) institutional development and governance; (d) increased investment in infrastructure, and (e) improvements in environmental protection.

1.32 A key prerequisite for meeting these three challenges is *investing in effective institutions*. FRY's institutional capacity has been weakened by lack of investment, "brain drain", years of isolation and weak respect for the rule of law. In many sectors of the economy, the public/private interface has been colonized by informal networks. Creditor and property rights have been abused and remain distrusted. In the limited number of areas where these have already been established, regulatory institutions have often been unable to enforce the rules. If not forcefully addressed, the perception and reality of widespread past corruption would remain a deterrent to potential donors and businessmen. To ensure that reforms will have a chance of being effective, it will be particularly critical to build capacity (including government institutions at national and sub-national level, non-government civil groups, as well as investment in

individual skill building), diagnose and address sources of corruption, build the public's confidence in government (transparency and accountability), and develop rule-based governance. These improved institutions will also have to be increasingly in line with European norms. Encouraging recent first steps in addressing these issues will have to be followed by efforts sustained over many years.

1.33 The successful meeting of these challenges would create a positive synergy, setting FRY on the path of greater stability, income growth, better governance, and integration into Southeastern Europe and Europe as a whole. Under this scenario, described more fully in Section V of this volume, FRY would begin to catch up to, and increasingly resemble, the most successful reformers of Central and Eastern Europe. The combination of a reform-oriented government with a strong popular mandate, the initial progress in reform and stabilization described above, and the renewed support by the international community represent the potential start of a path to meeting these challenges. Turning this potential into reality will require significant efforts from both FRY and donors in the near and medium-term. The significant risks to achieving this positive outcome are discussed more fully at the end of this volume.

1.34 The next three sections of this volume describe the most critical policy reform, institutional strengthening and capacity building priorities for meeting the three key challenges described above. These sections represent a summary of the more detailed sectoral reform agendas described in Volume 2 of this report. These will be followed by a final section which describes macroeconomic prospects assuming that these reform measures are being successfully implemented and that donors and external creditors have provided the required levels and types of financial and technical support.

II. RESTORING MACROECONOMIC STABILITY AND EXTERNAL BALANCE

2.1 As noted, the large macroeconomic risks in FRY primarily reflect unsustainable hidden quasi-fiscal deficits and debt burdens. The combination of: (a) an ambitious stabilization and structural reform program; (b) the need to begin servicing public debt; and (c) the need to stop the accumulation of new arrears and enterprise losses and to deal with their past legacy, is already bringing these imbalances into the open. In parallel, the need to start servicing external debt while also beginning economic reconstruction will put new pressures on FRY's already strained external accounts. Managing and reducing these imbalances will be a severe challenge to the authorities.

2.2 The reforms which are most directly linked to meeting this challenge are in the areas of fiscal policy and management, external trade and governance. Improvements in the monitoring and management of *public expenditures* can work to limit unplanned expenditures and better align commitments with available resources. Better standards of financial management and enhanced transparency in the use of budgetary resources will be crucial for unlocking the donor assistance needed for the near-term balancing of fiscal accounts. Reforms and institutional strengthening to improve the monitoring and management of FRY's very large external and domestic *public liabilities* (both direct debt and implicit and contingent liabilities), along with the reaching of agreements on appropriate concessional debt rescheduling, will also be crucial for fiscal sustainability. *Public revenues* reform should focus on improved tax administration, which will in turn be promoted by tax reforms which ease tax collection through simplification and the introduction of more easily administered taxes.

2.3 Reforms to *trade policy and customs administration* will support fiscal balance by stimulating growth (hence enlarging the tax base), as well as by directly improving revenue collection (through simplification, the closing of loopholes, limiting discretion and strengthening the capacity for administration). Higher export growth will also work to close the external financing gap, reducing the need for official financial support. *Governance* reforms which strengthen institutions and reduce corruption are key to ensuring the success of the above measures. These will have direct benefits (reducing the erosion of the revenue base through corruption), as well as indirect effects (through building public confidence in the government, and thus creating support for difficult but necessary measures). Effective and accountable institutions will also enhance the scope for cost savings and for enlarged near-term donor support.

2.4 The objective of restoring macroeconomic stability and external balance will also be supported by the reforms in other sectors discussed in Sections III and IV below. Particularly important will be the *control of structural sources of fiscal and quasi-fiscal deficits*. Losses growing out of the low levels of public utility tariffs have been the single largest source of quasi-fiscal deficits in FRY. Controlling these hidden subsidies requires reforms (some first steps have already been taken) to: (a) raise the prices of *inter alia* energy, public transport, telecommunication services, and pharmaceuticals; (b) cut costs through improved governance in these areas; and (c) continue the policy of no directed credit from the NBY. Reforms to price and subsidy policies for agriculture will make similar contributions to fiscal sustainability.

2.5 Reforms to *harden enterprise budget constraints* will support fiscal stability by cutting the flow of new losses. These reforms will include a generally reduced toleration of unpaid bills, the privatization of enterprises to real strategic owners, and the strengthening of creditor rights through an improved bankruptcy system. Restructuring or liquidating insolvent enterprises in ways which limit the degree to which their liabilities are taken over by the state will also work to ease fiscal pressures. An improved legal, regulatory and supervisory framework for *banks* will contain the creation of new bad assets. While even the most fiscally-responsible bank resolution strategy will bring some immediate fiscal costs (any attempt at extensive recapitalization of large problem banks would create severe fiscal imbalances), an effective strategy will promote medium-term fiscal stability by curtailing the accumulation of new losses in the banking sector.

2.6 The social sectors have been major contributors to fiscal pressures in FRY. Government spending on *pensions* and *health* has been above regional averages. Both sectors have also run up significant payments arrears (over two years for certain benefits), a further indication of imbalance. While *social assistance* payments have been closer to regional norms, these systems will face increased pressure as restructuring gathers speed, and as increasing numbers of refugees are integrated into FRY's citizenry. Hence, reforms to better align benefits with available resources (possibly supplemented by donor resources in the near-term) will be critical for improving fiscal sustainability. In addition, *labor market* reforms will over time work to ease pressure on the social funds.

A. FISCAL POLICY AND MANAGEMENT

2.7 The priority reforms in fiscal management in FRY are concentrated in four highly inter-related areas; (a) controlling and managing quasi-fiscal deficits and hidden risks; (b) enhancing the transparency and accountability of public spending; (c) strengthening public debt management; and (d) reforming tax policy and strengthening tax administration. The complementary adjustments in expenditure policy, including the level and composition of spending, will be discussed in Section V.B. The formulation of sound economic and social policy will also require the upgrading of FRY's official statistics, which have suffered from the past decade of isolation and lack of funding (see Box 2.1. below).

2.8 ***Controlling and Managing Quasi-Fiscal Deficits and Hidden Risks.*** Over the past decade, the public finance system was undermined by extensive quasi-fiscal activities on both sides of the government's balance sheet (see Sections I.A. and V.B). Along with the gaps in fiscal management described below, the main and pervasive quasi-fiscal problems in FRY are: (a) an economy-wide chain of non-payments, including budgetary arrears; (b) price controls for key goods and services (e.g. in energy and transportation sectors); (c) financial system distortions; and (d) rigid barriers to the shedding of excess labor.

2.9 The policy agenda to limit the creation of quasi-fiscal deficits (QFDs) is largely focused on eliminating their structural sources in factors such as controlled utilities prices which generate enterprise losses, and in the provision of credit to of uneconomic activities. These measures (described elsewhere in the report) need to be complemented by fiscal management reforms which work to control the creation of new such commitments and improve the management of

existing quasi-fiscal liabilities. The *near-term* priority reform agenda focuses on amending the fiscal management process to limit the impact of such spending. This requires ensuring adequate expenditure monitoring and controls, including an auditing of the stock of arrears, enhanced controls of commitments entered into by budgetary organizations, and laying the foundation for an institutional and policy framework for fiscal risk management. Specific measures would include identifying all hidden liabilities and clarifying their legal status, disclosing these liabilities where feasible, formulating an explicit strategy for containing hidden fiscal risks in line with the government's limited debt-carrying capacity, amending the legislation on extra-budgetary funds to prohibit borrowing operations and consolidated their revenue base, closing the Serbian Republican Development Fund, and enhancing the capacity for macro-fiscal analysis as a basis for formulation of more realistic budgets.

Box 2.1 - Building Statistical Capacity in FRY

The statistical system and capacity of FRY has suffered severely over the past ten years. At the same time, the government urgently needs reliable and timely statistics for broad policy formulation. The statistical system needs not only to be strengthened, but in some areas completely rebuilt. Statistical standards used previously differed considerably from those used in the rest of the world. Data collection modes and methods do not adequately capture economic and social developments.

To support the move to a market economy, the statistical system of FRY will need to go through a transition to be able to collect, process, and disseminate information needed by the government. In comparison with other transition economies, FRY lags considerably in the area of international standards and methodologies especially in the area of macroeconomic and trade statistics. More specifically, the statistical system will need to complete the switch from a Material Product System (MPS) to the System of National Accounts (SNA). In the area of micro, household and firm-level data collection, questionnaires for enterprise surveys and household data will have to be revised in conformity with internationally recognized standards.

In addition, a system of sample surveys has to be introduced to replace the system of universal and compulsory reporting. Data collection by means of sampling will require changes in the procedures of processing and aggregation. This in turn may require changes in the organizational structure of the Federal Statistical Office (FSO). More generally, the relationship between the Federal and the Republican statistical offices needs to be clarified, streamlined, and brought in line with the new reformed data collection protocols and dissemination needs. It will be important to ensure the continuity of data collection while reforming existing survey instruments and structures.

2.10 In the *medium-term*, the reform priorities would be: moving to output-oriented budgeting; consolidating legislation and further developing the institutional framework for the integrated management of public liabilities (see below); pursuing intergovernmental fiscal reform to increase transparency, better align revenue and expenditure assignments; and controlling the borrowing operations of local governments and connected entities.

2.11 ***Transparency and Accountability of Public Spending.*** The federal and republican governments need to significantly strengthen budget accountability and control procedures. Fiscal austerity will only be credible and supported by society if the government can to transparently demonstrate that public funds are being spent in the most efficient way and that scarce resources are not being captured by privileged or connected groups. Strong accountability will also be required to mobilize the needed volumes of foreign financial support, which will materialize only if the fiduciary concerns of donors are adequately addressed.

2.12 Strong progress has already been made, especially in Montenegro. In preparation for the IMF SBA, unified federal and republican budgets were prepared, incorporating all sources and uses, including donor aid and most extra-budgetary funds. The entire defense budget has been included in the federal budget and become subject to civilian control. In Serbia, the previous extensive earmarking of tax revenues has been sharply reduced. Cash management and budget reporting are being improved, and stronger commitment controls are being introduced. A medium-term strategy for expenditure management is under preparation. In Montenegro, where the reform of fiscal management had begun earlier, further progress has been made in improving budget execution. A new organic budget law (“Fiscal Management and Accountability Law”) has been prepared to strengthen the role of the Ministry of Finance in public expenditure management and to provide the legal basis for the establishment of a Treasury Department. A new law on public procurement is also being drafted. However, much more will be needed in both Serbia and Montenegro. Comprehensive reforms should be delivered through the restructuring of government accounting, implementing the IMF Fiscal Transparency Code, and restructuring the legal and institutional framework for public spending.

2.13 The *near-term* focus should be on meeting the needs of the initial period of adjustment supported by external financial flows. This will require better fiscal reporting, including monitoring the actual spending of budget institutions. In Serbia, it also includes adopting the IMF Government Financial Statistics (GFS) economic classification.⁸ Special attention will be needed to develop a reporting system for foreign aid flows and for arrears. Second, there is need to establish a supreme audit institution reporting to parliament, to supplement existing audit capacities of the Ministry of Finance and the Agency for Accounts and Payments (ZOP). Finally, there is a need to improve government cash management through consolidation of bank accounts of budget institutions, closure of their foreign exchange accounts, review of the government’s banking arrangements, and adoption of a rolling short-term cash flow plan.

2.14 In the *medium-term*, the focus in Serbia should be on a comprehensive reform of public expenditure system, to bring it closer to the patterns found in mature market-based economies. A strategic medium-term public spending reform would prioritize the following areas: (1) further measures to enhance the capacity of existing and newly established audit institutions; (2) development of MOF financial planning; (3) reform of government accounting and development of treasury ledger accounting; (4) development of a Treasury system; and (5) modification of the institutional and legal framework for public expenditure management. Montenegro has already begun some of these measures, including development of a centralized treasury system within the Ministry of Finance and preparation of an organic budget law. This progress needs to be maintained. In addition, the GFS classification system is being extended to cover extra-budgetary funds, which will allow development of reliable consolidated accounts for 2002.

2.15 **Public Debt Management.** FRY’s extraordinarily large debt burden represents perhaps the largest single risk to fiscal stability (see Section V). Monitoring and managing these liabilities (including strengthening institutional aspects and developing debt restructuring

⁸ This has recently been completed in Montenegro, where the 2001 budget was presented in this format. In addition, the execution of the 2000 budget was published according to a new functional classification.. The government has also begun to disclose data on the accounts of extra-budgetary funds and on the outstanding arrears of the budget and the extra-budgetary funds, both to Parliament (through the budget statement) and to the public.

policies) will be crucial for ensuring macroeconomic sustainability. Existing public debt management arrangements are complex, and are inherited from the decentralized SFRY, where the fiscal power of the federal government was limited. Some elements are sophisticated and maybe adequate to the current needs, e.g. transaction management and monitoring capacity. However, other key elements (e.g. a long-term debt strategy) are largely absent, reflecting patterns inherited from a socialist economy and entrenched by the period of sanctions. The most vulnerable aspect of the existing debt management setup is its fragmentation across the federal and republican levels of government. Debt management capacity also needs to be enhanced to efficiently manage new external assistance flows, in the form of both debt and grants.

2.16 The priority reform agenda for strengthening public debt management has several *near-term* strands. First, there is a need to adjust to a situation where the fiscal power of the federal government alone is inadequate to service foreign debts. The resumption of debt service and borrowing will require the federal and republican governments to jointly develop new provisions to guarantee creditor rights, either through fiscal reform or through appropriately structured guarantees. As creditors of local government or enterprises may require federal or republican guarantees, the design, conditions for granting, and management of such guarantees will assume key importance. The federal and republican governments will also need to strengthen monitoring of local government borrowing and establish required prudential norms. They also need to develop a policy for issuing domestic debt, which could become large in the event that various contingent liabilities are turned into explicit public liabilities. More generally, debt monitoring capacity needs to be strengthened, particularly at the republican level, as does information exchange between the federal and republican MOFs and the National Bank of Yugoslavia.

2.17 In the *medium-term*, there is a need to develop the domestic government debt market and the capacity to re-enter international markets, since aid flows will begin to decline after the first few years. There will also be a need to revise the legislation for public borrowing arrangements to include all types of public liabilities.

2.18 ***Tax Policy and Administration.*** In the area of *tax policy*, the FRY tax system has been supported by high and distortionary taxes, which are neither conducive to long-run growth nor sustainable. FRY's tax system was also characterized by an excessive number of levies, particularly on sales, excisable goods and employment compensation. There have been various forms of discretionary tax exemption.

2.19 The overall objective of the tax reform should be to create a simpler, more transparent tax system, with wider bases, few if any exemptions and relatively low rates. The Serbian government has already made an impressive start in this area, announcing and starting to implement an ambitious tax reform (see para. 1.24.). However, further steps will be needed. The Montenegrin government, which had already begun tax reforms, has prepared a Tax Action Plan focused on the planning and implementation of a comprehensive tax code with a view to broadening the effective tax base and lowering tax rates. Initial implementation will focus on amendments to turnover tax legislation.

2.20 *Near-term priorities.* Impressive recent progress has been made in this area, especially with a particularly far-reaching tax reform in Serbia (see Section I). The focus should now be on

effective implementation of these changes. In addition, several remaining distortions should be removed. The excises on soft drinks, coffee, table salt, and luxuries should be eliminated. Excisable products should be limited to alcohol, tobacco and petroleum products. Rates for gasoline, beer, wine, and domestic cigarettes should be raised in line with regional levels of excise taxation. The existing tax incentives for investors should be repealed. Given the need for enterprises to modernize, the current incentives could be replaced with a tax credit scheme for investment in fixed assets. In the case of income tax, the local facilities and housing charges should be consolidated into the income tax in 2002. Abolition of remaining exemptions can bring benefits in terms of improved incentives, better revenue collection, and reduced corruption, even before extensive institutional development.

2.21 Medium-term priorities. Plans for the implementation of the VAT should be pushed forward in both Serbia and Montenegro. The VAT law should be reviewed in 2001, and a new VAT law enacted, so that the tax administration and taxpayers have one year to prepare for its introduction in 2003. Adjustment of the accounting framework to international standards is an important precondition for effective introduction of the VAT. The excessive burden on labor income also needs to be addressed. However, this will first require decisions to be made with regard to benefits, as the various funds financed by social insurance are currently under funded (Section IV.1.). The relief provision for reduced social insurance contributions for certain companies should be repealed.

2.22 The strengthening of *tax administration* will take several years. This should begin with setting a new tone which works to restore integrity. To this end, the government needs to communicate clearly to the public that it intends to reduce the complexity and administrative burden of the tax system, provide better services and further protection to tax payers, and has zero tolerance for corruption within its ranks. In return, taxpayers and tax officials will be expected to comply fully with their obligations under the law, and if they fail to do so, they will be subject to the full range of penalties provided by the law. The authorities need to reduce the shadow economy and corruption through a favorable environment and targeted anti-corruption measures, including tighter tax administration, improved coordination between various government bodies, and increased transparency of tax administration.

2.23 Near-term priorities. The government should enact a consolidated Law on Tax Administration, which will regulate tax procedures. A Code of Conduct for tax officials and a charter of tax payer rights should also be enacted. In Serbia, there is a need to reorganize and strengthen the Public Revenue Agency (PRA) headquarters and establish within PRA special units to monitor compliance of the largest tax payers. In Montenegro, there is a need to continue implementation of the Tax Action Plan and to enhance cooperation among the various public revenue collecting institutions ahead of the possible gradual merger of their functions.

2.24 Medium-term priorities. The PRA should be reorganized along functional lines (collections, audit, tax payer services etc.), and the financial police should be consolidated within the PRA. The fragmentation of tax administration responsibilities should be reduced, and the PRA's computer system updated. Auditing standards need to be improved to help control tax evasion.

B. EXTERNAL TRADE AND CUSTOMS

2.25 The trade policy of the federal government and the effectiveness of FRY institutions that support the conduct of international trade are critical for the long term sustainable growth of the economy and the reduction of poverty. For a small economy like FRY bordering on many countries, an open trade regime is essential for the development of an efficient private sector and for the integration of the economy in global trade. Trade has traditionally accounted for a significant share of FRY's economy. However, during the past ten years FRY has been running a considerable deficit on the merchandise trade balance. Exports fell by almost 50 per cent between 1998 and 1999, and recovered only marginally in 2000; exports in 2000 were just 39 percent of their 1989 level.

2.26 The last decade was characterized by an import-substitution strategy implemented through quantitative controls which resulted in state patronage and corruption. Acute shortages of foreign currency, both compounded the problem and provided a further justification for a system of licenses and controls of trade and foreign exchange. For much of the last decade, FRY has been isolated from the international economy. In the last few months, the FRY government has taken steps to end this isolation and to seek closer relations with regional trading partners, and the European Union (EU), as well as accession to the World Trade Organization (WTO). The key issues are: (a) reform of trade policies; (b) enhancing capacity to trade; and (c) improving market access.

2.27 ***Reform of trade policies.*** In late 2000, the new federal government introduced a number of fundamental reforms to the foreign exchange and trade system, including the establishment of current account convertibility and the elimination of a range of administrative barriers to trade. These measures have already improved the climate for business and simplified the procedures for carrying out trading activities. In May 2001, a bill was passed by Parliament proposing a major streamlining and simplification of the tariff structure including lower rates and a reduced variance of rates. This is a very important step in overcoming the legacy of the highly protectionist, non-transparent trade regime created by the previous administrations. Many of the serious distortions resulting from the use of licenses and quantitative restrictions for both exports and imports have been overcome, although some quantitative import and export restrictions have been maintained (eg., agriculture, iron, steel).

2.28 Montenegro has enacted its own much more liberal tariff structure although foreign trade policy is a federal responsibility. The FRY and Montenegro governments are engaging in negotiations in order to reach understandings that would facilitate a single economic space and promote trade. Such agreements are essential to efficient economic outcomes.

2.29 ***Near-term priorities.*** The federal government needs to take steps to abolish the few remaining quantitative restrictions and licensing requirements except as required by international agreements, in particular to safeguard national security interests, meet international obligations to protect the environment, contain traffic in illegal substances, maintain appropriate national health and safety standards, and protect the environment. In particular, export controls will continue to apply to about 30 tariff lines of basic agricultural goods to ensure domestic food supplies. It will be important to ensure that these quotas are allocated in a competitive fashion, for instance by auctioning. Alternatively, the government may want to consider applying export

taxes rather than quotas. In addition to those required by international agreements, import licenses will continue to apply to about 40 tariff lines covering steel and iron products. It would be preferable to put in place time-limited safeguard mechanisms, which can shelter the industry during its restructuring period.

2.30 *Medium-Term Priorities.* The federal government should consider further reductions in the tariff rates in the context of WTO accession in about two years. For example, the remaining “nuisance” tariffs of 1 per cent should be eliminated at that time. More generally, a long term structure of low tariffs with relatively little variability and few rates in excess of 10 percent should be the target.

2.31 *Enhancing the Capacity to Trade.* Yugoslavia’s capacity to engage in international trade is severely limited by a variety of constraints, including the limited capacity of customs and border crossings, the lack of access to finance even for creditworthy projects, and the decrepit state of physical infrastructure. Some of these constraints are the result of the long isolation of the economy as well as disruptions caused by the regime of sanctions and the Kosovo conflict. Others reflect the remnants of the previous regime of controls and favoritism. All need to be tackled urgently to complement trade policy reforms and to provide a stimulus to trade, which in turn is essential for the revival of the economy. FRY’s ability to turn this enhanced capacity into actual growth-promoting trade will also require the emergence of a vibrant private sector, discussed in Section III.A. below.

2.32 *Near-term priorities.* The Federal Customs Administration will have to embark on an ambitious program of renewal and modernization. Its leadership has already been changed and seems determined to eliminate corrupt practices. Immediate priorities should be to restore integrity and public confidence in the customs administration, and to build the foundations for a future strengthening of the organization. A comprehensive strategy and national campaign to combat smuggling should be initiated. The customs administration should also undertake a review of the organizational structure at the customs office and port level. Beyond the realms of customs administration, the full restoration of navigation on the Danube is also an urgent priority.

2.33 The operational capabilities of the customs administration should be strengthened, and a modernization of customs clearance procedures should start. In terms of trade facilitation, transit services are highly disrupted by the non participation of FRY in the Transports Internationaux Routiers (TIR) Convention. FRY should be re-integrated into the TIR convention as soon as possible. There is also an urgent need to re-establish foreign credit lines for trade finance, and to establish longer term export credit finance for capital goods exports for which there is productive capacity.

2.34 *Medium-term priorities.* In the customs administration, new computer systems will need to be implemented to address the strained information infrastructure. The lack of competition and inefficiencies in the telecommunication sector, insurance and air transport should be removed through appropriate regulation and then by increased private sector participation. Lack of competition and inefficiencies raise costs and undermine the competitiveness of the export

sector; but they also handicap the operation of the economy as a whole. The Yugoslav authorities need to address these issues as part of their general effort to establish a competitive market.

2.35 Backtracking later on earlier liberalization efforts will be very damaging. For the trade reform to be sustainable and successful, a variety of additional steps are also needed, including an effective macroeconomic policy, development of service sectors, and private sector reforms including the rules and regulations for foreign investment.

2.36 ***Improving Market Access.*** Integration into the European structures and WTO accession require important changes in FRY trade policies and institutions. There are many similarities in the changes needed: An open trade regime will contribute to the long term growth of the FRY economy and will also ease accession to the WTO. Changes in many trade related institutions are needed for the efficient operation of the economy but will also help with the integration of FRY into the EU structures as well as WTO accession. By implementing the policy priorities outlined in the previous two sections, market access will be improved through the facilitation of WTO accession. The conclusion of a Stabilization and Association Agreement (SAA) with the EU will improve and consolidate the enhanced market access already granted unilaterally by the EU, and the conclusion of further free trade agreements with countries in the region will strengthen regional trade. Nonetheless, the pursuit of these integration efforts simultaneously will tax the ability of the FRY authorities to negotiate and implement the many changes needed. The donor community will need to support these integration efforts with appropriate technical assistance and support for capacity building.

2.37 *WTO accession.* The government has created a committee to coordinate the overall accession process. This group is headed by a senior official, with direct access to the highest level of government, and with the participation of appropriate representatives of all the Ministries and other institutions whose responsibilities are related to the WTO commitments. The first two tasks of this group should be (a) to identify the areas (e.g. drafting of revised legislation and regulations, institutional changes) in which the FRY authorities need assistance and to seek such assistance from bilateral donors and multilateral institutions; and (b) to prepare a memorandum outlining the foreign trade regime which will lay the basis for the negotiations with the WTO.

2.38 *Stabilization and Association Agreement with the EU.* The conclusion of an SAA with the EU depends on progress along a wide range of political and economic issues. But on the economic front, the commitments for harmonization of legislation and regulations, as well as for liberalization of markets and increased competition will be compatible with and, in many cases, identical to what the government would have to do to secure WTO accession. As in the case of WTO accession, areas that require alignment and harmonization of FRY legislation and regulations to those of the EU should be identified at an early stage, so that assistance can be sought where necessary. The EU also puts particular emphasis on institution building and strengthening as a basis for effective implementation of the SAA and on trade facilitation measures (e.g. standards, customs, infrastructure).

2.39 *Regional.* Under the terms of a future SAA with the EU, FRY would need to agree that it conclude FTAs with other countries in the region which have also concluded SAAs. Hence, FRY

needs to examine its trade policy regarding regional partners in the near future. This includes both other countries in the Stability Pact and countries in CEFTA. Considerable care needs to be taken to ensure that current and future FTAs meet certain clear standards, for instance in terms of product coverage and ease of implementation.

C. GOVERNANCE

2.40 The change in government has brought about a significant shift in leadership at the senior levels. However despite very encouraging initial progress, achieving an equally dramatic change in the overall structure and fabric of governance of the country will take significant time, effort and resources. A decade of politicization and centralization of authority – combined with economic collapse and “brain drain” – has left in its wake an inherited national governance apparatus with limited capabilities. Much of FRY’s human capacity has migrated to private informal sector occupations or to NGOs. While some of these persons have begun to return to the public sector, this has left the government with a fragile set of institutions. With low public sector salaries (which are unlikely to change significantly in the short term), it will be difficult to fully reverse the drain away from public service. Thus there is an extensive agenda for public sector reform.

2.41 The challenge of governance in FRY is intensified by the wide variance in needs and in capacity of public institutions in different parts of the country. Moreover, the limited human capacity of the government is stretched by the multiplicity of the challenges it faces: maintaining macroeconomic stability, initiating structural reforms toward transition while restarting economic development in the near term, and rebuilding infrastructure and social assets.

2.42 In the short term, the governance needs at all levels of government revolve around the urgent task of setting up the new government and building immediate capacity to set strategic priorities and organize the normal functions of the state. However, short-term actions should not be taken at the expense of the medium-term objective of the federal, republican, and municipal governments to build efficient, effective and accountable public sectors. Three broad challenges are essential to this goal: (a) public administration reform and capacity building to enhance the effectiveness of the public sector; (b) reduction of discretion in administrative and judicial decision making to improve the efficiency of the public sector; and (c) strengthening of consultation within government and consolidation of the governments’ partnerships with civil society to help build the accountability of the public sector.⁹

2.43 With these challenges also come risks. The political and economic legacy of Yugoslavia has clear implications for the way in which reform is conducted. Specifically, the reform process will need to ensure:

⁹ The accountability of the state is achieved through a multiplicity of mechanisms; participation of and monitoring by state and non state bodies are only two of these mechanisms. Other crucial mechanisms include human resource management systems, financial control systems, and justice systems. Financial control systems are partly discussed in Section II.A.

- *Proper sequencing:* In an environment that has had so much corruption, reforms that reduce discretion and enhance accountability should precede other types of governance reforms;
- *Sufficient preparation for decentralization:* Capacity building at the regional and municipal levels is a crucial prerequisite for decentralization, again recognizing the importance of proper sequencing; and
- *Realistic reform:* Focused, demand driven reforms that have been adequately piloted are best situated to build up experience with reform and develop internal and external constituencies for reform

2.44 ***Public administration reform, capacity building and professionalization.*** FRY's government, like most countries beginning the transition process, has a bureaucracy that is over-staffed, poorly trained, and poorly remunerated. Jobs in the public sector were often created for social, not productive reasons, so that hidden unemployment exists. Ministers have discretion to recruit and promote staff, with each ministry having its own system of advancement. The Government of Serbia has taken a number of important steps to consolidate the structure of governance and lay the groundwork for transition. In March 2001, it announced the creation of a high-level Public Administration Council, which will propose measures to increase the efficiency of government, work with ministries to prepare a medium-term strategy for reforming public administration, and monitor the strategy's implementation.

2.45 ***Reform priorities.*** The Public Administration Council should have sufficient and qualified staff, and should establish clear consultative mechanisms with line ministries. The emphasis of the reform process should be placed on developing systems of accountability, including performance-based human resource management. The success of reviews of the structure, functions, staffing, and management systems of ministries and executive agencies is mixed. To increase chances of success, the Public Administration Council should consider designing a two-stage review: a review of management and control systems in the short term and a review of structure, functions, and staffing in the medium term. The second review could be usefully linked to the development of strategic priorities within a budgetary process and envelope. Salary reform and opportunities for staff training could also be linked to adoption of the recommendations of this second review. The responsibility for monitoring centrally the recruitment, promotion, and remuneration of public servants, and for ensuring that the public service is managed according to law, as well as responsibility for resolving possible conflicts of interest, should be assigned to existing or new public-sector bodies.

2.46 ***Reducing discretion in administrative and judicial processes.*** *Administrative decision-making* in FRY over the last ten years has been riddled with corruption. In large part, this was a consequence of the high level of regulation of the economy and society, and the excessive level of discretion that was embedded in administrative procedures, particularly in the areas of trade, the business environment, utilities and public services. FRY's overworked, unreliable and inefficient *judicial system* is an obstacle for development of a market economy. The courts are overloaded with cases and lacking in basic levels of information technology. Judges are poorly trained and not well remunerated, which may create an incentive for corruption.

2.47 *Reform priorities.* The new government has a strong desire to clean up the old cronyism, systems and procedures. In the *near-term*, the process of reviewing and streamlining regulations and administrative practices in conformity with EU standards will need to be begin, as will the enhancement of audit capacity and other reforms to enhance transparency and accountability (see Section II.A.). Procedures to recruit, select, train, promote, compensate, and hold judges accountable; file and process cases and monitor their disposition; hold auctions; and ensure enforcement of judicial decisions should be reviewed, with the aim of identifying appropriate reforms. In the *medium-term*, the new procurement law that is currently being drafted will need to be implemented. The business community needs to be assured that contracts will be enforced in a timely, competent, inexpensive and efficient manner. Judicial conditions of service will need to be improved, including the quality of court buildings and other physical infrastructure of the judicial system. Donor supported training of judges in all aspects of the laws affecting the development and operation of a market-oriented economy is also important, as is introduction of basic levels of information technology.

2.48 ***Building participation into policy-making and consolidating the state-society partnership.*** The past decade has represented a special period in the history of Yugoslav state-society relations. Non-state institutions such as NGOs and trade unions played a pivotal role in bringing present government to power, and ministers, advisors, and high officials have come into government from civil society institutions. One of the greatest challenges for the leaders of FRY, both inside and outside of government, will be to ensure that this special relationship does not dissolve in the exigencies of the transitional process.

2.49 *Reform priorities.* Improvements in these areas could begin with development of a system of consultation on policy, regulatory, and legal drafting using standard methods, including: open meetings, especially when regulatory decisions are discussed or taken; formation of non-government advisory boards to advise on decision-making of ministries and independent executive agencies; publication of draft policies, regulations, and laws; and adequate periods for notice of and comments on drafts, and methods for addressing these comments.

2.50 Second, external monitoring of public-sector performance by civil society could be useful in strengthening the accountability of public servants. The government might request independent NGOs to contribute to the monitoring of public administration performance, including the judiciary, in areas which are especially vulnerable to inefficiency and corruption, and in measuring the effectiveness of specific reform efforts over time. Third, the government can help to promote a healthy environment by ensuring that the domestic regulatory environment is hospitable to the growth of third-sector institutions, with adequate provisions to ensure accountability. In the *medium-term*, as accountability mechanisms become more developed, the government might consider contracting out some public service delivery to NGOs. Finally, the government can also strive to keep channels open for third-sector institutions to participate in public discourse on important economic and social matters, for example: economic reform, decentralization, and social assistance reform. Some ministries have already established senior advisory committees of experts from NGOs, think tanks and private sector groups to help them to review strategies in their sectors. This important initiative could facilitate the institutionalization and sustainability of state-society links.

III. STIMULATING GROWTH AND CREATING THE BASIS FOR A SUSTAINABLE SUPPLY RESPONSE

3.1 The reforms, institutional strengthening and investments which will most directly support sustainable growth are in the framework for private and financial sector development, in key infrastructure sectors (especially energy, transport, telecommunications and water), and in the agricultural sector. Furthermore, sustainable medium-term growth will require increasing attention to the state of the environment and the effective use of FRY's natural resources. These efforts can be grouped into three broad areas: (a) quickly implementable reforms and institutional strengthening which bring early wins in terms of an immediate supply response, employment creation, and a shift from the gray to the official economy; (b) physical reconstruction which removes key barriers and bottlenecks to growth; and (c) laying the foundations for reforms such as privatization and the creation of effective regulatory frameworks which will improve the basis for medium-term growth, but where preparatory steps (including the creation of requisite institutions and civil service capacity) are crucial for success.

3.2 "*Early wins*". The most immediate impact on growth and the social credibility of the reform process will come from reforms to remove distortions and bottlenecks which most limit the expansion of output and trade, or which most drive these activities into the informal sector. These include the removal of: (a) barriers to entry and subsequent development of new enterprises and banks, particularly of SMEs and good private banks, including foreign banks; (b) barriers to competition; and (c) price, subsidy and other distortions (e.g. in agriculture, energy and transport) to improve incentives to produce and export.

3.3 Donor-supported efforts to quickly and transparently privatize select enterprises to strategic owners can have direct benefits for output, as well as creating added momentum for the future privatization of other firms. Other reforms and investments with early benefits include: (a) improving the legal and institutional framework for foreign direct investment; (b) policy shifts to harden budget constraints and strengthen creditor rights; (c) energy price increases to enhance the reliability of energy supply and increase the efficiency of resource use; (d) the cleanup of river beds and measures to revive international trade and road transport; (e) intensifying competition in the telecommunications sector; and (f) building up the foundations for development of the tourism sector in Montenegro.

3.4 *Physical reconstruction*. The poor economic performance of the past decade was partly the result of extensive decapitalization. This reflected chronic under investment and lack of maintenance (which in turn reflected both pricing policies which starved enterprises of resources and the chronic crowding out of public investments), as well as of some destruction of productive assets during the Kosovo conflict. Investments to repair aging and damaged infrastructure (in particular in energy, transport, water and agriculture) can help to eliminate critical bottlenecks to growth. Cleanup of environmental hotspots is also needed. Given the severe lack of maintenance over the past decade, and the less obvious need for wholly new investments, this agenda will largely be focused on repair and maintenance. Such outlays will only be effective if combined with policy reforms in the respective sub-sector, and with the upgrading of implementation capacity and procurement procedures to ensure sound planning and transparency.

3.5 *Laying the foundations for deeper reforms.* Again, early preparatory steps will be crucial for the eventual success of such reforms. Four areas stand out. First, *privatization* must be set on a path which ensures the achievement of a new ownership structure conducive to growth. This requires modification of the legal framework, supported by creation and strengthening of the related institutions. Second, there is a need to begin developing the *legal and regulatory framework* for energy and municipal utilities, transport and telecommunications, to ensure that these sectors develop in ways which maximize their growth impact. Third, *financial sector reforms* will create the basis for restored financial intermediation, the direction of credit resources to the most viable enterprises, and the establishment of an effective payments system. Finally, *policy and institutional reforms* in the energy, infrastructure and agricultural sectors are important not only for creating a sound framework for investments, but also for determining efficiency of a sub-sector's operation, and thus its contribution to growth.

3.6 The objective of stimulating growth and creating the basis for a sustainable supply response will be supported by reforms in other sectors. These are discussed in Section II and IV. Better *budget management* will work through improving the efficiency of government spending. By supporting the reallocation of expenditures within the budget, it can also create the fiscal space for needed public investments and other developmental expenditures. The cutting of quasi-fiscal deficits in the form of hidden enterprise subsidies will spur restructuring. By improving resource allocation and removing institutional bottlenecks to output and trade expansion, reforms to FRY's highly complex and distorted *trade and tax policy* regimes can bring an immediate supply and export response, as well as creating better medium-term growth prospects (especially when entrenched through the Stability Pact, SAP and WTO processes). Stronger trade competition will also work to harden enterprise budget constraints. Better *governance* in the form of the rule of law, a strengthened judiciary, a streamlined but more effective public service, and reduced corruption, will also enhance the basis for economic growth.

3.7 By creating the basis for a phased reduction in payroll taxes, *pension reform* can enhance the incentives for employment-creating growth and for drawing the informal economy back into the formal sector. Better functioning (less rigid and distorted) *labor markets*, reformed severance benefits, and more effective *social protection* mechanisms can ease the reallocation of labor across firms and sectors and smooth enterprise restructuring. Finally, improvements in the quality of *health* services, and of the quality and responsiveness of the *education* sector to shifting market needs, will create a stronger foundation for growth through human capital development. More efficient health and education sectors will also create the basis for future reductions in the tax burden coming from these sectors.

A. PRIVATE SECTOR DEVELOPMENT

3.8 The current situation of the private sector is described in Section I. To deal with the severely deteriorated situation in the larger firms, and to unleash the potential in the private sector, reform is urgently needed in three areas: (a) launching a multi-track strategy to address the problems of socially- and state-owned enterprises (this will include the privatization of entire companies, the reorganization of some firms prior to privatization, liquidations leading to sales of assets, and "workouts" to extract viable business lines from failing firms -- generally the very

large and those of acute social importance -- to put them back into production again); (b) improving the business environment by removing unnecessary bureaucratic obstacles to the entry and growth of new private firms (generally recognized in all transition countries as the primary engine of growth and job creation), developing a network of supportive institutions, and improving access to capital; and (c) undertaking other reforms which are crucial for both the restructuring of existing firms and the entry and development of new firms, with a near-term focus on the environment for FDI and a medium-term focus on the development of capital markets.¹⁰

3.9 *Socially-Owned Enterprises: Privatization and Restructuring.* The striking difference in profitability (and by implication, productivity) between the private and the non-private sectors is the cornerstone for the proposed three-pronged strategy of enterprise reform.

3.10 *Selling to Strategic Investors What is Marketable.* Under previous governments, the privatization process in the Republic of Serbia had lacked both quality (particularly a focus on sales to insiders) and speed (few firms have been sold). The current Serbian government is addressing these problems through a complete overhaul of the privatization process. The key immediate priority is adoption of a new privatization law to replace the flawed Act on Ownership Transformation. To attract core owners capable of undertaking efficient restructuring and investment, promote good corporate governance and harden budget constraints, this law could *inter alia*; require a majority of capital to be offered for sale to strategic outside investors; have no role for vouchers, debt-to equity swaps, and concessions for special groups such as existing management. Second, to raise public confidence and attract good potential bidders, it could allow a limited range of highly transparent privatization methods. Finally, to speed privatization, it could allow the government (via the Ministry of Privatization rather than line ministries) to initiate the sale of particular enterprises, require the use of streamlined procedures, and include clear deadlines and/or incentives to privatize within a defined time period.

3.11 In parallel, the new law requires new institutional arrangements. These include a clear separation of the roles of the privatization Ministry (policy formulation, drafting of laws and supporting regulations, establishment of a robust privatization program) and of a new Privatization Agency (implementing the privatization program). The agency should be structured as an explicitly temporary institution with a sunset clause, and be given a strong governance structure with well-designed oversight and reporting functions. As a rule, the privatization program should first focus on selling companies in those sectors which can be immediately subject to competition (e.g. producers of tradable goods). Ensuring such competition requires parallel liberalization of the foreign trade regime (see Section II.B. below). In sectors such as energy and other utilities, which will require a well-functioning regulatory framework and institutions, privatization should normally await the establishment of such frameworks, both to increase the sale price through the removal of a key source of uncertainty, and to ensure a proper set of incentives for efficiency and consumer protection.

3.12 The privatization program in the Republic of Montenegro is more advanced than in Serbia, in that an extensive program has already been adopted and institutions have been established. This program envisions tender privatization of large companies, and the use of batch

¹⁰ Reforms to the judicial system, described in Section II.C., will also be of crucial importance.

sales for some medium-scale companies. As both methods are transparent and conducive to attracting good core investors, their use should be expanded, while that of vouchers (enshrined in law as a central method of privatization) could be limited relative to current plans. A partial response to the problems presented by the latter approach would be stronger supervisory institutions, particularly through enhanced independence and capability of the recently established Montenegrin Securities and Exchange Commission (MSEC).

3.13 *Breaking Up Non-Marketable, Failing Firms and Putting Their Assets to Productive Use.* Many socially-owned enterprises may fail to attract strategic external investors. Such firms will play a productive role in the restructured economy only if they are reconfigured into smaller parts. The Serbian and Montenegrin governments should not wait several years before dealing with such firms, as firms sitting for a long time in a “to-be-privatized” category are prime targets for neglect, debt build-up, and asset-stripping. In particular, the new Serbian Privatization Law should include a provision allowing restructuring through out-of-court procedures that run in parallel with formal bankruptcy procedures. This provision will also facilitate privatization of companies that must be restructured before sale because they are too complex in organization, or are encumbered by debt that must be worked out.

3.14 *Imposing Hard Budget Constraints.* Privatization and liberalization of entry for new firms have worked best when complemented by hard budget constraints. Since it will take many years to complete privatization, it is important that scarce government resources in the interim are not absorbed in subsidies to loss-making enterprises and utilities. Unless hard budgets are quickly imposed, even before privatization, there is likely to be a cascade of arrears through the system, severely damaging many productive activities.

3.15 In the *near-term*, pending more fundamental reform of the bankruptcy system, several policy changes could immediately harden budget constraints. These include; the blocking of further credits to enterprises from the Serbian Republican Development Fund ahead of its eventual closure; eliminating state interference in the provision of new bank credit, enforcing collection by the state utilities and the tax administration, beginning with future payments; and stricter and more rapid reporting of delinquent enterprises to the commercial courts by the Agency for Accounts and Payments (ZOP).

3.16 In the *medium-term*, the whole bankruptcy system needs to be reformed, to allow efficient closure of loss-making businesses and the sale of non-core assets. The current federal bankruptcy law is too detailed and provides inadequate safeguards for creditors. Priority measures include making it easier for creditors to foreclose on collateral outside formal bankruptcy proceedings, giving creditors (as opposed to judges) more power to oversee administrators, and introducing incentive compensation to encourage administrators to focus on maximizing creditor recoveries. Bankruptcy can be speeded by streamlining procedures and by reducing the costs for all parties. An intermediate option between debtor-driven composition and administrator-driven liquidation should be considered, as current practice produces either complete shutdown or superficial financial restructuring. Finally, there is also a need for training of bankruptcy trustees, as the capacity of court appointed trustees can become a key obstacle to successful bankruptcy.

3.17 *Private Small and Medium New Enterprises.* FRY needs to take measures to promote the growth of the currently small private sector by promoting new entry, spurring the growth of existing firms and working to legitimize the informal sector.¹¹ The Private sector growth will also be indirectly promoted by other structural reforms, specifically privatization, liquidation of non-viable firms and the sale of their usable assets, and the break-up and eventual restructuring of the large systems. The development of a vibrant SME sector can also contribute importantly to foreign trade expansion and employment creation. The strategy to meet this challenge has three main elements:

3.18 *Improving the business environment.* SMEs are burdened by a myriad of regulations governing their operations. Deregulation can bring early success in stimulating economic growth. This could include: simplification of required reporting by SMEs to the government; reform of labor legislation and regulations (see Section IV.A.); tax reform (especially by simplifying the system, gradually lowering the rate of wage taxation to encourage official rather than informal employment and introducing a standard method for calculating lump sum tax payments for sole proprietorships - see section II.A.); and ending all special privileges given to favored and selected firms by previous governments.

3.19 *Improving government assistance to SMEs.* While private sector development has historically lagged in Montenegro, the Montenegrin government has more actively developed a supporting infrastructure, including a Small Business Agency and the beginnings of a robust support program for SMEs with assistance from the donor community. Government assistance has been limited or inefficiently delivered in Serbia. The challenge for the new Serbian government will be supporting SMEs effectively without introducing new distortions. Many transition governments have moved to highly interventionist SME strategies, including a large bureaucratic machinery supported by donor funding, and requirements for banks to provide subsidized credits. Most of these efforts have failed to work. Subsidies are not sustainable. Most often, the scarce resources offered through subsidies are allocated to the well connected, not those with the best potential. The recent establishment of a Serbian Small Business Agency is welcome. This agency should be initially supported by government, but operate on commercial principles, and be explicitly structured to avoid the above pitfalls. Additional measures could include: appointment of an Ombudsman in the Agency; the holding of periodic open meetings between the government and private sector to discuss changes in laws and regulations prior to their enactment as well as recurring problems faced by the sector; advertising all proposed changes to laws and regulations; and conducting periodic surveys of small firms to ensure that policy measures and other actions have actually addressed business needs.

3.20 *Enhancing access to capital.* Several legal and regulatory changes could provide better incentives for financial institutions to finance the private sector. Particularly important are reform of collateral laws, including a law on floating collateral and the establishment of a collateral registry, and the reform of the bankruptcy system described above. Banking and financial sector laws should be reviewed to ensure that; regulations regarding leasing provide the right incentives with respect to taxation and amortization of leased equipment by the lessor; and

¹¹ Private sector growth will also be indirectly promoted by other structural reforms, specifically privatization, liquidation of non-viable firms and the sale of their usable assets, and the break-up and eventual restructuring of the large systems.

that they allow development of non-bank financial institutions such as credit unions, leasing companies and micro-finance institutions, while restricting their ability to mobilize deposits unless they are adequately supervised.

3.21 *Other Reforms for Private Sector Development.* Several elements of the framework for private sector development are relevant for both the state and socially-owned enterprises and the new private sector. This section deals with three such topics: (a) the framework for foreign direct investment (FDI); (b) capital markets; and (c) competition policy.

3.22 *The framework for FDI.* In light of FRY's prolonged isolation, and the particular role which good new owners can play in spurring recovery, the preparation of a new federal Law on Foreign Investment is an urgent priority.¹² This should clearly guarantee the rights of all investors. Like most Central European countries, FRY should work to repeal the constitutional requirement of "reciprocity" for entry of foreign investments. Until that time, a temporary measure would be a negative list of countries that do not require reciprocity, with investors from other countries required to register (using an automatic, time-bound and consent-by-silence approach) with the government before registering in court. Other useful changes in the new draft Law would include; limiting the current extensive limitations (special approval, no more than 49 percent stake) on foreign ownership to armaments production and a handful of locations where this can be justified on the basis of security; establishing clear access to international arbitration, including a fresh application to join International Center for the Settlement of Investment Disputes (ICSID); and removing distortionary incentives including free access to imported equipment and various tax holidays and exemptions. Tax holidays are a problematic form of investment incentive, and are especially vulnerable to abuse. Other reforms discussed elsewhere in this report (e.g. to taxation and the labor code) will also improve the climate for FDI.

3.23 The responsibility for foreign investment promotion belongs to the individual republics. The Serbian government is establishing an agency for the promotion of FDI to facilitate entry for foreign investors. The agency should serve primarily as an "investment support unit" providing facilitation services. It should market the republic to potential investors, effectively diffuse accurate information on improvements in Serbia, and attract potential investors through a focused promotional effort. The Agency could also become an important element of the policy reform process by providing the government with reliable feedback about potential difficulties or shortcomings in the policy, legal and administrative framework related to FDI.

3.24 *Capital markets.* Changes to capital markets regulations are needed to improve the operations of the Belgrade Stock Exchange (BSE) and to tighten regulatory requirements. Particularly important is extending the BSE's role beyond clearing and settlement to include the depository/registration function. The BSE should rethink its business model as the laws are reviewed, moving from a universal trading place for everything from shares to commodities to derivatives, to an exchange for securities trading. Dematerialization and a central depository function should be adopted. Corporate disclosure and reporting should be strengthened by adoption of International Accounting Standards (IAS) or International Organization of Securities Commissions (IOSCO) principles, and a careful review of the disclosure and other regulations

¹² The legal framework for foreign investment is formally under federal jurisdiction. However, a new Foreign Investment Law for Montenegro was already approved in 2000.

affecting the capital markets against IOSCO principles. In the medium-term, development of a bond market will open an additional channel for financing both the private and public sectors.

3.25 *Competition policy.* In time, a more modern competition law and policy will be necessary. However, the current institutional capacity of the civil service makes it unrealistic to entrust an anti-monopoly authority with powers to supervise anti-competitive conduct. Moreover, given the high concentration in some segments of the economy, anti-competitive conduct is less important than the inherited monopolistic structure, which must be dealt with at least in the most serious cases (the systems).

B. FINANCIAL SECTOR DEVELOPMENT

3.26 The poor state of FRY's bank-dominated financial sector was described in Section I.¹³ The primary aim of priority reforms in this sector is the restoration of public confidence in the banking sector as a basis for renewed financial intermediation and efficient payments. This restoration of confidence must be achieved in a fiscally sustainable way. To maximize the impact on growth, it must be accompanied by reforms and institutional strengthening which raise the quality of intermediation (ensuring that resources are directed to the most effective uses, including by facilitating the entry of reliable new banks). The reform agenda is divided into five inter-related areas: a) strengthening banking legislation and prudential regulation; b) strengthening bank supervision; c) developing and implementing a credible and fiscally-responsible bank resolution strategy; d) resolution of the asset of the intervened banks; and e) reforming the Agency for Accounts and Payments (ZOP) in a way which preserves its positive features and minimizes disruption while moving towards the structure needed for a market economy.

3.27 *Strengthening Bank Legislation and Prudential Regulation.* FRY's financial sector legislation is comprehensive and generally sound. Nevertheless, revisions in certain key laws will be required to enable the sector to be fully supportive of a market driven economy and to bring the legislation into harmony with EU legislation and international best practices.

3.28 In the *near-term*, a comprehensive review of the legal framework should be conducted, ensuring that legislation is upgraded to establish and promote safe and sound banking practices. This includes a review of legislation relating to: (a) the role, responsibilities, and potential liabilities of bank supervisory and statutory boards; (b) the role of bank capital in the system; (c) licensing procedures; (d) the exertion of control in banks; (e) transactions with related parties and affiliates; (f) consolidated supervision; and (g) prudential regulation. This review should identify a medium-term agenda of legal reforms. Bank resolution legislation (i.e., rehabilitation, bankruptcy and liquidation) should also be reviewed to ensure that all necessary tools are in place to facilitate the large resolution program that needed in the banking sector.

¹³ In FRY, banking regulation and supervision is *de jure* a federal function. For this reason, the reform agenda is discussed primarily with reference to federal laws and institutions. In practice, Montenegro has established its own legal and institutional framework and has made greater past progress in their strengthening. Nonetheless, the challenges faced by Montenegro are largely similar to those described here.

3.29 The quality of accounting and auditing poor. Although accounting rules adopted in the early 1990's generally resembled International Accounting Standards (IAS), practice gradually eroded in subsequent years. Hence, accounting and audit laws need to be evaluated and changed to reflect prudent practices and international standards. A schedule for upgrading the accounting law to reflect IAS should be prepared, mapping a migration of existing standards to ones which more clearly reflect the true economic value and condition of the banks.

3.30 ***Strengthening Banking Supervision.*** NBY's current supervisory function is faced with significant challenges. It must play a key role in the banking sector resolution process while simultaneously upgrading its capacity and resources to keep pace with change taking place in the sector. The organization of the supervisory function, its goals and objectives, and its policies and procedures require upgrading in order to effectively support banking reform and to protect the future assets of the system.

3.31 In the *near-term*, an evaluation of the role of supervision in the system should be undertaken together with the identification and drafting of a statement of objectives for governmental endorsement and publication. Management decision making processes, internal procedures, and accountabilities should likewise be evaluated. A code of conduct for supervisors and executive management should be prepared. A plan for internal change should also be drawn up, identifying medium-term objectives.

3.32 Given the evolving role of supervision, a *near to medium-term* plan for building both staff skills and capacity should be developed. Each of the functional areas should be evaluated and changes made to enhance focus, procedures, reporting, communications, responsibilities, and accountabilities. The format and content of regulatory reporting should be evaluated and refined, as should procedures. Internal reporting to NBY management, decision making processes, and information technology also require evaluation and further development. Staffing should be enhanced, in terms of numbers, skills, and remuneration, and training should be started. Consideration should be given to developing a code of conduct applicable to all supervisory staff and senior and executive level NBY management.

3.33 ***Credible and Fiscally-Responsible Bank Resolution.*** Bank resolution will be a cornerstone of the financial sector reform program in Serbia and Montenegro. The perceived high level of systemic risk in the sector will not be reduced, and adequate intermediation capacity created, until the problems of insolvent banks are addressed. Given the limited fiscal space and the likely low or negative franchise value of many large banks, a large number of banks will require liquidation in the course of sectoral restructuring. Any attempt at extensive restructuring of banks would be inconsistent with fiscal targets, divert significant resources from other necessary activities, and create major moral hazard problems.¹⁴ In order to avoid using bankruptcy as the mechanism for liquidating banks, the NBY and the Bank Rehabilitation

¹⁴ As described in Section V, the 2001 federal and republican budgets earmark limited funds which could cover little more than the direct administrative costs of bank resolution. As described in Volume 2, the ERTTP program also does not currently include support of a recurrent nature for the financial costs associated with bank restructuring, pending further development of the strategy. Limited financial support could be considered, provided an adequate and fiscally-viable bank resolution strategy is agreed. Any such support could require cut-backs in funding from other areas of the currently-defined ERTTP program.

Agency (BRA) should investigate the possibility of amending and then using the Law on Bank Rehabilitation to conduct *de facto* liquidation of banks while they remain *de jure* in the status of rehabilitation. The FRY authorities should consider pursuing a three phase restructuring strategy for the banking sector, starting immediately and backed by donor-supported technical assistance and capacity building.

3.34 *Phase 1 – BRA Intervention and Implementation of Control.* Following completion of the requisite diagnostic studies, the BRA should intervene all insolvent banks and launch their resolution process. One or more persons should be installed by the NBY or BRA to replace existing management in each of these banks. They would be primarily responsible for preserving the assets of each bank, exercising control and securing records. During this period, the work of the NBY special inspection teams for the large banks would be completed. Based on the results of the inspections and the asset and liability inventories conducted in smaller banks, a cost estimate would be prepared to develop a decision cost matrix for use in determining which of the banks should be selected for an aggressive restructuring program aimed at stabilizing their losses and operations, and which should be put into liquidation.

3.35 *Phase 2 – Launching of Liquidation and Stabilization.* The FRY authorities should make a final selection of banks for stabilization using the cost/decision matrix prepared during Phase 1 inspections and in full consideration of fiscal constraints (any major cash outlays resulting from bank resolution would begin to be incurred at this time). Donor/IFI funded technical assistance to the BRA should be implemented, supporting (a) liquidation oversight and implementation for banks selected for liquidation and (b) the development of stabilization plans and pre-privatization activities for those banks selected for stabilization.

3.36 *Phase 3 – Liquidations and Privatization of Stabilized Banks.* The liquidation process for all banks not selected for stabilization should be completed by around mid-2002, at which point all such banks should be under the jurisdiction of a court-supervised bankruptcy process. For banks for which stabilization was launched, the privatization process (expected to take not more than 12 months) should commence as soon as initial steps of stabilization have started. In the event that the privatization is unsuccessful for any bank, it would be liquidated using the liquidation procedure.

3.37 **Asset Resolution.** Recent preliminary studies by the NBY have identified that about 85 percent of the assets of the system are with banks that have negative equity. The vast majority of these assets are concentrated in the largest banks. As experience elsewhere shows, a successful program of asset resolution will depend largely on a) a fast and reliable legal framework to enforce creditor rights, (b) the ability to implement consolidation and joint resolution of bank and non-bank claims on enterprises, (c) the choice of recovery methods based on enterprise characteristics, especially in relation to privatization plans, and (d) the institutional arrangements that emphasize the outsourcing of implementation.

3.38 In the *near-term*, the enhancement of the legal framework (i.e. laws, procedures, capacity) to provide faster and more reliable enforcement of creditor rights is a fundamental requirement. This should include speeding up and streamlining the foreclosure process and

introducing clear, swift and sure criteria for the commencement of debtor-driven composition, creditor-driven composition, and bankruptcy.

3.39 The asset recovery task facing the government, the NBY, and the BRA is enormous. Instead of developing major capabilities within the public sector for asset resolution, the government should develop and then use well-governed private sector capabilities for asset resolution. The work out institution's choice of methods for recovering on claims against enterprises – e.g., voluntary financial restructuring, composition, more fundamental operational restructuring of the enterprise, or liquidation – will need to be sensitive to the status and condition of various enterprises. The following scheme for coordinating asset recovery with the government's privatization program is proposed:

- *Public enterprises (mostly utilities).* Credits to the public enterprises should be restructured during privatization. Such restructuring could involve absorption of enterprise debt by the state, rescheduling of the loan, or converting the loan into another debt instrument. The work-out institution should identify non-core assets, take control over them, and auction them for cash as soon as possible.
- *Viable socially-owned enterprises.* These enterprises should be able to service debts taken over by the work-out institution. There will be little or no requirement for debt restructuring. Non-core assets could be sold separately to raise cash for general government needs. Operational restructuring of the core business is the responsibility of the strategic investor.
- *“Distressed” socially-owned enterprises.* For enterprises not viable as a going concern, a simple receiver-based approach for winding up these systems seems most appropriate. A new legal option for a fast-track creditor-driven restructuring (ending in liquidation) could be particularly useful in winding up the highly-distressed socially-owned systems. In addition, an equitable claim on asset sale proceeds could be useful in gaining employee acquiescence.

3.40 **Reform of ZOP.** The Agency for Accounts and Payments, commonly referred to by its local acronym ZOP, plays a key role in ensuring government control over virtually all financial flows among economic entities including individuals, and possesses vast amounts of information. This agency of the NBY performs numerous functions that far exceed its supposedly core activity of being the clearing and payments system. In November 1999, Montenegro established its ZOP as a separately functioning institution.

3.41 New policies in FRY call for a major restructuring of ZOP. Given the multiple roles of ZOP, ranging from payments to tax collection functions, these reforms should be jointly led by the central bank and the federal and republican governments. The NBY has already launched efforts to establish a normal bank-based payment system where payments are made directly through banks and settled through NBY reserve accounts (greater progress has already been made in Montenegro). Several functions of ZOP have been transferred to the Ministry of Finance or other agencies. Overall, these changes denote a significant reorganization of traditional institutional roles as between ZOP and NBY over the medium-term. The federal and

republican authorities need to together structure a well designed medium-term plan for consolidating and deepening the separation of the various functions of ZOP.

3.42 *Near-term* priorities to launch this program include (a) the formation of a National Payments Council under the guidance of senior NBY management, including cross-institutional support from the legal and banking community, (b) replacement of the 1998 payments law and an immediate enabling provision for banks to handle internal payments; and (c) rearranging staff assignments between ZOP and NBY. In the *medium-term*, ZOP should (a) redesign the payment systems computer applications to conform to international standards, and (b) reevaluate and modernize existing information technology architecture.

C. ENERGY

3.43 The energy sector consists of electric power, coal production, district heating, and oil and gas production and imports. The sector plays an important role in the economy both directly and indirectly, accounting for about 5 percent of GDP. However, during the 1990s, real energy prices decreased sharply. For example, as of October 31, 2000, the price of electricity stood at 0.9 US\$ cents/kWh or about one-fifth of the estimated economic price level. Had prices remained at their December 2000 levels, FRY energy consumers would have received an annual subsidy during 2001 (in economic terms) of about \$1.2 billion through electricity supply (of which \$0.1 billion is attributable to Montenegro), \$100 million through heat supply, and \$50 million through gas supply.

3.44 The impact of these very low prices on the energy sector has been threefold. *First*, as revenues decreased energy sector enterprises invested less and eventually stopped investments altogether. Maintenance was reduced well below acceptable levels. The energy sector was also subjected to considerable damage during the Kosovo conflict. As a result there is now a large backlog of reconstruction, deferred investments and maintenance that needs to be addressed as soon as possible. *Second*, as prices of electricity and district heating dropped, excessive energy use was encouraged. In particular, consumers started to rely on electricity as a primary or supplemental source of heating, so that household electricity demand increased by about 50 percent over the last decade. *Third*, the lack of adequate revenues for district heating and natural gas distribution companies made it impossible for these companies to pay for their share of the FRY's gas imports, resulting in a debt of around \$300 million owed by the Serbian natural gas utility NIS through trading companies to Russia's Gazprom.

3.45 A number of critical issues need to be tackled virtually simultaneously, both over the short-term as well as the medium term. These are: (a) energy price increases and protecting the poorest from the impacts of these increases; (b) improving payment discipline; (c) repair and rehabilitation of essential capacity; (d) improved energy efficiency; (e) building up institutional capacities in the sector; and (f) policy making, regulation, and sector restructuring.

3.46 ***Energy Price Increases.*** Major tariff increases are needed in the district heating, electric power and natural gas sectors, particularly in the Republic of Serbia. This would encourage efficient use of energy and improve the financial performance of the energy enterprises. The electricity capacity shortage would disappear once damaged power plants come back on line and

prices are increased significantly towards economic levels, inducing a decrease in excess and/or distorted demand.

3.47 For electricity and district heating, prices increases to the economic level should take place over a three-year period. Price increases during the first year (2001) would enable suppliers to cover their operating expenses only. Operating expenses plus debt service would be covered during the second year (2002). That plus a reasonable return on equity would be covered during the third year (2003). Lignite prices in real dollar terms would need to be doubled in the short run to approximately US\$6.4/ton to enable the sector to maintain production. Natural gas prices to households would need more modest adjustments in the order of 20 percent next year. The price adjustments in these various network fuels should be coordinated to avoid distortions in consumption and investment decisions. During this transition period, policy makers should pay special attention to ensuring that wages in the energy sector do not increase faster than in other industrial sectors, and that the proceeds of tariff increases are spent on improved maintenance and high priority investments, as well as on paying off debts to suppliers. In Serbia, the recent decision to freeze the wage bill in EPS and NIS was an important first step.

3.48 In addition, steps must be taken to protect the poor from the impact of price increases. This issue is most important in district heating. Heating is already difficult to afford for the poorest FRY households. Following the proposed tariff increases, it is estimated that at least the poorest two deciles (or about 500,000 households) will find the cost of heating during the 2001-02 winter difficult to afford. Furthermore, around 20 percent of FRY households live in apartments which are not connected to natural gas or heating networks. In addition to the recently introduced block tariff system, direct measures available to the government to address these issues include the introduction of a scheme to partially cover heating costs of the poorest households, and support for investments to convert apartment buildings to non-electricity heating.

3.49 ***Improved Payment Discipline.*** Beyond the need to increase tariffs, urgent attention needs to be paid to two issues: (a) rapidly increasing collection rates in the energy from an average of about 65-70% to near 100%; and (b) eliminating the share of barter payments, assignation and compensation within the collection total, now believed to be about 35-40 percent of collections. As part of a strategy to achieve the required increase in collections, the energy enterprises must be given legal and factual authority to cut off customers that do not settle their utility bills within acceptable time frames and/or do not come up with a workable plan to pay off arrears. To the extent that central and local government entities are part of the collection problem, government budgets should contain adequate resources for these entities to pay their utility bills at current rates. The adequacy of these budget provisions will require close monitoring during the transition period when utility rates can be expected to increase sharply and supplemental budgets or budget reallocations may be required to meet utility bills.

3.50 ***Repair and Rehabilitation of Critical Capacity.*** In the *electric power sector*, the available capacity of thermal power plants in Serbia (which account for two thirds of power generation) is only 76% of installed capacity. This is the result of damage to generating facilities and equipment derating due to the lack of maintenance and/or design deficiencies. The 110-MW

unit in Kolubara A was damaged during the 1999 Kosovo conflict and the 210-MW unit in Kostolac A was damaged after its ceiling collapsed in 2000. If these two units are repaired before the next winter, they would increase available capacity by about 300 MW and reduce by half the need for imported electricity. In other major thermal power plants, derating of generating capacity accounts for the loss of 200 MW in Kostolac B (29% of installed capacity) and 400 MW in Nikola Tesla A and B (14%).

3.51 The high voltage transmission system was also heavily damaged during the Kosovo conflict. About 100 km of transmission lines and 22 transformers with a total installed capacity of 3,700 MVA were damaged or destroyed. Even before the conflict the transmission system was weakened due to prolonged insufficient investment, maintenance and refurbishment of aging facilities. Given that the interconnection of FRY's electric power grid with systems in neighboring countries provides for the regional exchange of electricity, the rehabilitation of power transmission facilities is important both for ensuring stable import of electricity in FRY as well as for the establishment and efficient operation of a future regional electricity market.

3.52 In *the coal sector*, critical investments are needed to avoid a 5-10 percent drop in lignite production in Serbia during 2001/02, with the resulting need to further increase electricity imports. Auxiliary mobile equipment is urgently needed to ensure efficient operation and servicing of the main mining equipment. Mechanical and electrical spare parts, as well as materials for the workshops, are needed for overdue overhauls and for restoring the stocks of parts and materials to a minimum level. To catch up with the backlog of overburden removal and allow the mine fronts to move, land must be acquired. This should be financed through an increase in the internal price of lignite. The situation in the coal mines in Montenegro is just as critical. A lack of equipment overhaul and new equipment could result in a serious drop in coal production which would further increase the need for electricity imports.

3.53 *The oil and gas sector* suffered particularly heavy damage. The refineries have been the focus of some reconstruction, enabling about 70 percent of the capacity to be brought back online. However, the remaining required investments cannot be financed from internally generated funds or commercial credits. As a result, the product mix will not reflect market demand (more light products are needed) in the near- to medium-term. Immediate needs can be met by a combination of importing petroleum products and gas. The refineries' medium-term financing needs can best be addressed by private capital from strategic investors to ensure that investments are well targeted. The natural gas sector has suffered more due to payment problems than conflict damage. Natural gas is expected to increasingly meet the FRY's energy needs because of price and environmental considerations. To enable this, considerable new investments in pipelines and distribution systems are required, which can best be met through private sector participation, possibly on the basis of concessions.

3.54 Proper functioning of the *district heating* systems would significantly reduce electricity demand. Increased heat prices, combined with improved payment discipline, should enable the sector to pay its current natural gas bills. This would result in enhanced and stable gas deliveries, enabling the sector to increase the average heat level supplied to consumers. In turn, this would also help reduce demand for electricity for supplemental heating. Major efficiency gains can be made in the district heating sector through energy efficiency investments on both

the supply side as well as the demand side. For the latter to occur, however, a number of institutional and legal measures need to be taken requiring significant technical assistance and donor support.

3.55 *Energy Efficiency.* There is a pressing need to start preparing and implementing energy efficiency measures to: (a) help the poorest consumers offset the effects of rising energy prices; (b) further reduce demand on the overloaded electric power system; (c) economize on gas and oil consumption; and (d) reduce environmental pollution. The main potential savings would come from effectively addressing the energy efficiency of the household sector, mostly in connection with electricity and its extensive use for heating. Given the lack of information about energy efficiency, the republican governments could establish temporary energy efficiency agencies. These agencies should disseminate information on demand side energy efficiency measures, guide energy audits, implement energy efficiency pilot schemes, and design an energy efficiency strategy that focuses on the highest priorities/returns and the greatest needs. Energy efficiency improvements in industry should be financed by these industries themselves as they have a clear economic interest to do so.

3.56 *Strengthening Institutional Capacities.* The tasks of justifying tariff increases, drafting of energy laws, introducing a regulatory framework, energy sector restructuring, and eventual privatization of parts of the different energy sub sectors will place enormous demands on the Ministry of Mining and Energy in Serbia, the Ministry of Economy in Montenegro, and the energy companies themselves. The government has initiated steps in this regard, by engaging new staff in the Ministry as well as advisors. This effort needs to continue to deepen the skills in the Ministry prior to engaging the considerable technical assistance that will be required. It will be particularly important to follow this with the establishment of regulatory agencies to implement the governments' pricing and, possibly, competition policies. These regulatory bodies will need assistance for institutional strengthening and capacity building. Lastly, the corporate governance of the key entities responsible for energy supply should be improved. Supervisory Boards should be established consisting of business, legal and financial professionals to complement the energy specialists. These Boards should be given clear mandates to guide corporate strategy, financial viability and the protection of shareholder interests.

3.57 *Policy Making, Regulation and Sector Restructuring.* In Serbia, the Ministry of Mining and Energy is entrusted with the development of energy policy. Major energy policy decisions are made by the Cabinet, which also sets electricity, coal, oil and gas prices. The price of district heat is set by local governments. In Montenegro, the Ministry of Economy develops energy policy and regulates energy prices. Neither the Serbian nor the Montenegrin authorities seem to apply transparent energy price setting methodologies and adjustment procedures. International experience suggests that the role of the Cabinet should be restricted to the approval of the broad principles of electricity and gas price regulation. These principles should then be codified in a law. Before the end of 2002, an autonomous agency should be established in each republic to implement the regulation of electricity and (in Serbia) gas prices and to enforce third party access to the electricity and gas transmission systems. The regulatory agency should also provide guidance to the municipalities on setting district heating tariffs.

3.58 The electricity as well as oil and gas sectors in FRY would be best served by expeditious unbundling of the largest vertically integrated monopolies, including NIS and EPS in Serbia. This should be undertaken in line with existing EU directives for the electricity and gas markets. Such a sector restructuring would enhance financial transparency and competition in the sector by allowing third party access to the natural monopoly components. In the near-term, new energy laws should be passed introducing a modern regulatory framework supporting the establishment of an independent regulator(s). Financial discipline and the reliability of financial statements would be much enhanced by improving accounting systems in accordance with Generally Accepted Accounting Principles (GAAP) and reintroducing annual external audits by qualified auditors in accordance with International Accounting Standards (IAS). Longer term, however, good governance and financial transparency should come from privatization of selected parts of these sectors. Preparation of a suitable program of sector restructuring will require considerable technical assistance.

D. TRANSPORT

3.59 There are major deficiencies as well as opportunities in Yugoslavia's transport sector. On the whole, the sector is now much weaker than it was ten years ago. Unsustainable tariff and financial policies and inadequate use of existing funds have resulted in a significant decapitalization of the sector. In general, the quality of infrastructure and equipment is now significantly lower than in neighboring countries. The capability of institutions has also much weakened, as systems and procedures for planning, monitoring, and managing transport activities have been neglected or even misused. Over the past decade, institutions have had to focus on coping with emergencies, leaving little room for developing and implementing long-term plans. This has all resulted in inefficiencies and bottlenecks which are bound to slow down economic recovery if not addressed soon. How much and how fast the sector rebounds will depend essentially on the quality of the market-based incentive framework that the new government will establish for operators and investors in the sector, and the restoration of institutions.

3.60 The transport sector consists of at least five sub-sectors: (1) roads and road transport; (2) railways; (3) maritime transport; (4) river transport; and (5) the broader area of trade and road transport facilitation.¹⁵ Throughout the transport sector, reforms are consistently needed in the following four areas: (a) funding of deferred maintenance (rather than new construction); (b) institutional reform and institution building; (c) regulation; and (d) private sector development and participation. In spite of the short-run fiscal costs of some of these reforms, their implementation will be critical to support the recovery, and will have implications for growth not only in FRY but in the Southeast European region as a whole. Every effort should be made to minimize public costs of the reforms by charging users wherever reasonable and through private sector participation wherever there is sufficient scope for competition or an adequately functioning legal and regulatory framework.

3.61 **Roads and Road Transport.** FRY has a well developed intercity road network, comparable in terms of density and pavement type to that of the most advanced Central and East

¹⁵ More detail is provided in Volume 2, with specific recommendations for both Serbia and Montenegro. There will also be reform and reconstruction needs in the air transport sector. While not discussed here, donors may wish to support such efforts, which could be particularly important for developing the tourism industry in Montenegro.

European countries. In both Serbia and Montenegro, there is presently no obvious road capacity problem and no need for new construction in the medium term. However, the funding of road maintenance has decreased dramatically over the past decade. As a result, the network is in poor condition and in some places deteriorating rapidly. On the positive side, there is a well-developed construction industry in FRY, which was successful on international markets until the early 1990s. There is also a dynamic and entrepreneurial road transport industry with extensive experience and know-how.

3.62 The objectives of the governments in Serbia and Montenegro in the roads and road transportation sector should be:

- To increase considerably the funding available for road maintenance and rehabilitation to address bottlenecks and to stop the long term deterioration of the road network. In the *short to medium-term*, funding should focus on maintenance and rehabilitation rather than on the construction of new roads.
- To set up an efficient system of road user charges in Serbia. The recovery of the cost of road use needs to be much increased through (a) a substantial hike in the taxation of gasoline and diesel fuel, and (b) a simplification of the annual vehicle registration system with the imposition of higher taxation levels for trucks and buses.
- To reinstate the quality of the republican road administrations. In the *near-term*, priority should go to ensuring that decisions are taken on a purely technical and economic basis. Procurement and roadwork supervision need to be done in the best possible way. Also important are the completion of a proper road database and the revamping of the planning and budgeting processes. In the *medium-term*, the organizational and financial independence of the road administrations and their role in monitoring and assisting local governments in the management of local and municipal road networks are also important. However, these should be addressed only when the road administrations have made significant progress in its organization and effectiveness.
- To develop the road maintenance and construction industry. An assessment of contractors' capacity should be carried out rapidly. It would show the volume of road works that can be efficiently carried out by the industry in the coming years, as well as identify measures to promote sorely needed investments in the industry.
- To improve the regulation and competitiveness of the road transport industry in both Serbia and Montenegro. The republican governments are already actively taking measures to streamline road transport laws and regulations. These measures deserve support. In addition, existing constraints to entry into the passenger road transport business need to be removed and sufficient funding allocated for the enforcement of axle load regulations.

3.63 **Railways.** Over the past decade, the lack of funds, poor expenditure policies at the republican level, and economic sanctions have resulted in inadequate maintenance and almost no renewal of assets in the republican railways. The consequences are striking. The condition of

the track has much deteriorated. There is also a serious problem with the fleet of locomotives, freight wagons and passenger coaches. As with the road sub-sector, most of the damage inflicted during the Kosovo conflict has been repaired. The financial situation of the railways is not sustainable. Only about 30 percent of revenues from operations is paid by freight and passenger customers. The railways operate as public enterprises dependent on the republican governments for their essential resources and key decisions, and are not fully accountable for their results. They have a traditional organization by functions, and not one based on business lines as in modern railways.

3.64 Specific near-term and medium-term objectives in the railways sectors of Serbia and Montenegro include:

- To address the most serious operational constraints on the republican railways through a targeted program of investments. Although a deeper assessment is still required, priority investments are likely to include deferred maintenance and rehabilitation of the track and signaling/telecommunications system, repair and rehabilitation of motive power and rolling stock, and rehabilitation of information systems.
- To put the railways on a sound financial footing through financial restructuring efforts. Measures that urgently need to be initiated include; (a) increases in freight tariffs and passenger fares over the next two years, generally to cost recovery levels; (b) replacement of the earmarked sales tax by a general budget subsidy for an interim period of two years, followed by the provision of financial support solely through public service obligation contracts; (c) a plan for the resolution of the railway's foreign and domestic debt; and (d) the transfer to the government of all main railway-owned commercial enterprises, for their privatization and to enable arm's length, commercial relationships between the railway and these enterprises.
- To reorganize the republican railways into autonomous enterprises capable of competing successfully on the internal transport market. The railways urgently need plans of action to lower costs and create incentives for increased efficiency. These would first include measures to reduce staff by as much as 50 percent over a few years through early retirement, severance payments, and retraining. Other actions should include elimination of low volume stations, reduction or termination of low volume passenger services, and reduction in the number of workshops. Lines of business should be given much more importance in the organization of the railway and the management tools necessary to operate on a commercial basis (particularly appropriate costing systems) should be established. Finally, measures that ensure autonomy and accountability of the railway as well as independence from political pressures should be instituted.

3.65 **Maritime Transport.** The only major maritime facility in FRY is the Port of Bar on the Montenegrin coast. It is a well run and well equipped facility. However, it operates at only 20 percent of its capacity. The port is a commercially-managed joint stock company looking forward to a privatization of its activities. While the port offers good performance to its users, its poor financial situation and weak interior connections affect its overall competitiveness.

3.66 The port's future will depend on its ability to attract additional traffic. To facilitate this, the existing road and rail infrastructure is in serious need of periodic maintenance and, in some cases, upgrading (as explained above). In addition, sound policies need to be in place to facilitate the capture of traffic from neighboring countries and to ensure that traffic from Serbia is not hindered by cumbersome customs checkpoints. This for instance entails the immediate removal of the 3 percent tax on Albanian traffic and a continuous focus on trade and transport facilitation within FRY and with the port's main commercial partners.

3.67 To attract external partners, the port will need to reduce the current level of uncertainty, including by addressing the question of its debt arrears. In the *medium-term*, the Republic of Montenegro will also have to review the various options available to privatize port operations progressively, with a careful analysis of the regulatory implications of privatization.

3.68 **River Transport.** FRY is endowed with 1300 km of rivers and canals accepting up to 1,500 tons vessels. The Danube (588 km), which carries most of this traffic, was until the recent Kosovo conflict a major transit corridor connecting the Black Sea to the North Sea through the Main and Rhine rivers. The river's condition and navigability are the most significant concerns today for river transport. In addition to damage during the Kosovo conflict, maintenance of the river bed was significantly reduced over the past ten years.

3.69 Most river operators expect traffic to resume rapidly once the river beds have been cleaned up. The government strategy should consist, in the *near-term*, of restoring safe navigation on the Danube and the Sava River, and allowing the privatization of ports and the river fleet under sound conditions. In the *medium-term*, the strategy should focus on upgrading river navigability and signaling to offset the past reduced maintenance and adapt waterways to new international standards. Restoring the river network would benefit not only FRY but also neighboring countries, such as Romania or Bulgaria, which have been affected by the loss of this competitive mode of transport to Western Europe.

3.70 **Trade and Road Transport Facilitation.** Traders in FRY, as in most of Southeast Europe, face excessive logistical costs for their export, import and transit operations. Long delays and costly procedures increase the logistical costs and force companies to carry excess inventories to ensure timely deliveries. Addressing trade and transport facilitation issues will require an integrated effort entailing: (a) regional reintegration; (b) strengthening of transport operators and freight forwarders, and entry to market; (c) customs administration reforms; and (d) border crossing improvements.

3.71 To actively reintegrate into the international community, FRY should continue to pursue the softening of conditions regarding visa regimes for FRY transport operators and businessmen. It should also continue actively to re-access all international agreements, considering the TIR convention as a priority, with clearance of backlogs and updating of standards. The capacity of FRY to integrate in the EU economic space will depend on the quality of its service providers. The introduction of proper licensing requirements for road transport operators and forwarders, based on competence, reputation and financial standing, will be an essential part of this process. The creation of a Road Vocational Training Center in partnership with the International Road Transport Union (IRU) is also a matter of priority.

3.72 The foreseen traffic will rapidly require upgrading of border crossing facilities on main European corridors. In the *near-term*, detailed design and bidding documents should be prepared for improving such facilities taking into account new procedures and cooperation with other border agencies. The upgrading of five key border crossing points should be carried out in the medium-term (by the end of 2003).

3.73 The Federal Customs Administration has formulated a strategic plan, including legal and procedural changes, and improvements in human resource management, interagency cooperation and information systems. This program needs to be rapidly implemented. Customs reform coupled with proper facilities and information technology will lead to transparent customs procedures, a more reliable business environment, and economic growth as a result of lower prices for imports and more competitive prices/services for exports.

E. WATER AND SANITATION

3.74 The water supply and sanitation sector was well developed ten years ago. The current situation has deteriorated substantially, reflecting ten years of limited investment and lack of maintenance. Nonetheless, the water supply and sanitation services have avoided collapse owing to two factors: (a) the high quality and broad coverage of existing infrastructure and the technical capacity of sector professionals; and (b) their professional pride in maintaining the services. Most areas have high per capita water consumption (figures in the order of 300 liters per capita per day (lpc/d) are not uncommon), well above the rates in comparable and more developed neighboring countries. Physical losses, lack of demand management and inadequate pricing policies and misuse of water supply for non-household activities (e.g. irrigation in peripheral areas) are common. The upside of this situation is that there is significant scope for reducing consumption, addressing shortages and improving service quality with low levels of urgent investments.

3.75 Water and sanitation utilities in FRY were and are, by international standards, overstaffed, fairly inefficient, and lacking in modern management and control systems and governance. While they are sometimes legally independent entities on paper, these enterprises generally have little autonomy and no control over crucial aspects of their business. In particular, investment decisions are usually made at the municipal or national government level, with strong bias towards new infrastructure, disregarding improved maintenance and rehabilitation of existing assets.

3.76 There is no federal agency that regulates water utilities, plans service needs or channels funds or support in a coordinated manner. Several ministries (agriculture, forestry and water management, civil engineering, health, and finance) control utility operations in the areas under their authority, but none have real leadership responsibility for the sector. This, combined with the *de facto* complete decentralization of service provision to municipalities, results in fragmentation, poor planning and lack of advocacy for the sector. The multitude of laws and regulations applicable to the sector further contribute to its fragmentation.

3.77 The tariff system in FRY is based on the cost-plus scheme with cross subsidies for the population by industries. At present, and in spite of the tariff increases in October 2000, revenues of water utilities do not even cover operational costs. Utilities are running out their facilities resulting in heavy deterioration of water and wastewater services.

3.78 In the context of the above, limited financial resources must be allocated to achieve a cost-effective mix of institutional strengthening, rehabilitation, improved efficiency and service expansion. Any expansions of water and wastewater systems should be fully justified with proper economic analysis and take place only after existing systems are operating at maximum efficiency. Federal, republican and municipal governments must rethink past resource allocation policies that did not pay sufficient attention to maintenance and operation and cost-efficient selection of investments. The following actions will help in this respect:

- *Making better use of existing systems.* Before spending scarce resources on capacity expansion, emphasis should be placed on making better use of existing systems by: (a) reducing network leakage through a combined effort of reducing pressure, identifying and fixing leaks, and replacing or rehabilitating pipes and house connections; (b) improving the hydraulic efficiency of pipe networks; (c) improving the efficiency and reducing energy consumption of pumping and treatment facilities; (d) improving maintenance to increase the life of facilities; and e) adequate demand management.
- *Choosing the appropriate level of service.* This should depend on a community's capacity and willingness to pay, as well as on the economic return. In this respect, proper demand management procedures should be in place to avoid waste and improper use of water supplies (e.g. in irrigation), before any expansion of the current capacity is considered. If wastewater treatment investments are planned – whether rehabilitation, expansion or new facilities – these should be cost-effective, with treatment levels decided based on assessments of the economic benefits to be achieved and the assurance of sufficient operation and maintenance capacity.

3.79 Any action plan aimed only at the reconstruction of damaged water supply and sanitation infrastructure, or at the expansion of current coverage, would face great risks of failure if it did not simultaneously lead to the strengthening of the sector's institutional capacity and policy environment. Two aspects of this reform package require special commitment: (a) the development of regulatory oversight capacity; and (b) the improvement of the efficiency and financial sustainability of water utilities.

3.80 *Near-term priorities.* The most important near-term challenges are:

- There are *health risks* because of polluted sources, insufficient water supply and growing environmental problems. This challenge affects mainly the medium size cities and rural areas in Serbia and Montenegro. Simple, limited investments, coupled with adequate policies and water demand management, should form the core of a short term program for 2001-2002 to address these urgent problems.
- *A basic institutional, regulatory and policy framework* needs to be set up to clarify asset ownership, regulate the sector, introduce economic pricing and improve governance.

These actions will lay the basis for the involvement of the private sector in water supply services in larger cities in Serbia and Montenegro (which will be desirable and beneficial in the longer-run once adequate legal and regulatory frameworks have been established) and to advance implementation of the coastal rehabilitation program in Montenegro. Transferring assets ownership fully to the municipal level, while retaining and developing planning and overall regulation responsibilities at the republic level should: (a) clarify amortization and proper commercial functioning; (b) bring service decisions close to final consumers; and (c) properly regulate the services, separating the functions of providing the service and regulating it, thus allowing water utilities to concentrate on their core business. Local governments should hold water companies accountable for their performance, for instance by using performance contracts which clearly define performance and quality targets.

- In Serbia, *responsibilities between the various levels of government should be clarified*. An institution or government entity should be identified and empowered to act as the sector's lead agency, particularly for planning and resource mobilization. The monitoring conducted by the Institute of Public Health (IHP) has to be adequately expanded to the rural areas, not only to protect the rural population from severe health risks, but also to provide information to central and local governments for planning and decision making.
- In rural water supply and sanitation, the role of republican and local governments needs to be defined to facilitate service improvement and monitor progress. Both functions have been mostly neglected in the FRY. Strategies to address rural water and sanitation should be developed and the enabling legal and institutional framework to implement them created.

3.81 *Medium-term priorities*. The most important medium-term challenges are:

- *The financial situation of water and solid waste utilities needs to be improved* through appropriate pricing policies, management strengthening and better operating procedures. To address this challenge, proper incentives and mechanisms for the transfer of resources should be introduced in coordination with the development of the institutional and regulatory capacity. The following initiatives will help to ensure the financial viability of water utilities: (a) reducing consumption through water demand management; (b) adopting adequate commercial management systems; (c) replacing the current tariff formula with one that provides incentives for cost reduction and allows for a reasonable level of profits; and (d) improving efficiency and reduce operating costs. After the legal and regulatory framework has been established, the involvement of the private sector in large cities could become an important instrument to address these challenges and to have a demonstration effect in the sector as a whole.
- *Water quality problems* in important sources and service deficiencies due to deferred maintenance and lack of rehabilitation need to be addressed. Although improved financial capacity of utilities would ease the demands, external support will be needed to address the investments required to improve service quality and reliability, overcoming years of neglect, particularly in medium-size cities.

- *A comprehensive approach to environmental problems needs to be adopted.* This would mean increasing sewerage coverage in those cities that suffer a deficient service and improving wastewater and solid waste disposal systems to avoid environmental deterioration. This challenge is particularly important in the coastal area of Montenegro, where positive initial steps have already been taken on the institutional front.

F. TELECOMMUNICATIONS

3.82 This section covers the telecommunications and broadcasting sectors and the Information and Communications Technologies (ICTs).¹⁶

3.83 *Telecommunications.* The basic structure of the sector in each republic – one fixed line operator providing a full range of services and two mobile operators – is common to transition economies. While teledensity in both sub-sectors is not low, the quality of services is poor. Mobile networks are congested, particularly in Serbia. The 1997 sales contract for 49 percent of Telecom Serbia (TS) has left extensive and long exclusive monopoly rights (to June 2005). In both republics, the holding by the fixed line operator of stakes in both mobile companies hampers governance and competition. Unbalanced tariffs and low productivity (overstaffing, outdated equipment) harm the financial viability of the companies. Low fixed charges and local tariffs require cross-subsidization from international calls, slowing the development of market relations and the Internet, and retarding economic growth. While the regulatory framework in Montenegro is relatively well-developed, there is a regulatory void at the Federal and Serbian levels, where the obsolete and so far rarely applied framework meets neither the key requirements of the WTO, nor the more demanding EU standards.

3.84 At the Federal and Serbian levels, the most immediate priorities are examination of the sale contract for TS (while recognizing the importance of legitimate contracts to the foreign investor community), and filling a regulatory void, beginning with preparation of a new telecommunications law, creation and development of a regulatory body, the drafting of a regulatory “tool kit”, and capacity building for their medium-term implementation. Disposal of both a further stake in TS, and of TS’s stake in at least one mobile operator, should also be on the agenda for the next 18 months. Protecting the poor in the face of higher tariffs requires development of a universal access mechanism for medium-term implementation. In Montenegro, the main immediate priorities are continuing privatization of Telecom Montenegro (TM), and divestiture of TM’s stake in one mobile operator.

3.85 *Broadcasting.* The current transmission by over 1,000 largely unlicensed radio and TV stations is an acute and immediate problem for the Federal and Serbian Governments. This results in interference between broadcasting stations, across borders, and with other activities like air traffic control. The most urgent priority is the enactment and enforcement of a new broadcasting licensing law which provides effective frequency allocation, assignment and frequency management and monitoring (FMM). If this is to be implemented effectively, there is also a near-term need to develop new and immediate capabilities in FFM.

¹⁶ The companion volume also discusses priority reforms in the wider communications sector, including postal services.

3.86 *ICTs.* To escape the “digital divide” and harness the “Web Economy” as an engine of growth, FRY needs to develop its information and communications technologies quickly. FRY is rich in human capital but poor in terms of ICTs and their application. FRY and its business, financial and academic communities score very poorly on the primary requirements for success in this area: (a) basic connectivity (especially in Serbia); (b) the internet; and (c) applications as a means of job creation and an instrument for improvements in education, health, environmental management and thereby poverty alleviation in general.

3.87 The central features of the agenda for managing and accelerating the process of change must be a policy to promote basic connectivity within FRY and between FRY and other countries to facilitate the expansion of the Internet (where it has previously been restricted, including in the academic community), to encourage applications like tele-medicine and distance learning and to promote private sector involvement and SME’s. In the near-term, this requires drafting of minimum e-commerce and modern intellectual property rights and data protection laws, and the first phase of an ICT Strategy Policy along with donor-supported seed money for its medium-term implementation.

G. AGRICULTURE

3.88 Agriculture has always been an important component of the economy of FRY. More resilient than most sectors of the economy, agriculture has contracted less in response to the difficult economic conditions of the last ten years than other sectors. Its importance to the economy has thus increased, and it accounted for 22 percent of both GNP and total exports in 1999. Nevertheless, the sector has deteriorated significantly and productivity is low despite a favorable natural resource base. As a means to preserve stability, the government (particularly in the Republic of Serbia) has kept producer prices and food prices very low, which has created disincentives for production and export. Producers have survived by reducing the use of fertilizer and agricultural chemicals, foregoing repairs and maintenance on equipment, and selling their breeding livestock.

3.89 Three broad sets of constraints must be addressed if the agriculture sector is to recover, begin the process of economic transition and realize its obvious potential: (a) a highly distorted incentive structure inhibits agricultural production and market activity; (b) the private sector lacks both the capital resources to re-build its depleted resource base and the capacity to establish more efficient production and marketing systems; and (c) public institutions are also ill-suited and ill-equipped to support the agricultural sector in a market economy.

3.90 *Improving the Incentive Structure for Production, Marketing and Trade.* In a small country such as FRY, an open, liberal trade policy is the optimal basis for an incentive system for agriculture (in addition to its broader benefits for all sectors of the economy). With only moderate import protection, farmers using existing technology will have adequate incentives to produce and invest. Such reforms should be supported by parallel domestic price liberalization. It will be crucial to include the Directorate for Commodity Reserves in Serbia and the State Commodity Reserve Institution in Montenegro in the ambit of measures to improve the incentive structure. These agencies have wide-ranging powers, often exercised in a non-transparent manner, to intervene in agricultural markets and to influence producer and consumer prices.

3.91 *Near-term priorities.* The Serbian government should liberalize price policy: remove floor prices on most commodities, terminate the parity system, remove margin controls on wholesale and retail prices, and progressively relax and eventually remove price controls on bread and milk. As concerns the commodity reserve institutions, the republican governments should reform their activities: reduce the number of commodities under their mandate for food security, phase out their involvement in short-term price stabilization, reduce and then terminate their involvement in barter transactions, and increase the transparency of their funding and operations. In Montenegro, the proposed liberalization of prices of flour, bread and milk should be implemented.

3.92 *Medium term priorities.* The Serbian and Montenegrin governments should broaden the focus of the reform of the agricultural incentive system to cover issues such as termination of soft-budget support for socially-owned enterprises, reallocation of the agricultural budget to better serve the emerging market economy, and the movement along transition paths to less or no subsidization of commodities.

3.93 ***Promoting Private Sector Activity and Investment in Production, Processing and Marketing.*** An appropriate incentive system is a necessary but not sufficient condition for sector recovery and transition. In the near-term, agricultural and livestock production needs to be supported by an infusion of critical inputs. Farmers and processors must also have access to credit to reconstitute their capital base and introduce modern technology. Structural problems involving privatization of FRY's agro-kombinats (AKs) (which still hold about 20 percent of agricultural land in Serbia and a smaller share in Montenegro) and the development of small and medium-sized processors, suppliers and traders should be tackled to achieve sustained growth and lay the basis for quality improvements and exports. In Serbia, longstanding neglect of the irrigation system reduces production and is a major impediment to improvements in quality. Finally, private producer organizations to serve and educate their members and place their concerns effectively before government are key elements in an agricultural growth strategy.

3.94 *Near-term priorities.* In Serbia, immediate actions are needed to support agricultural production. Last year's drought put severe stress on livestock production, with the dairy sub-sector being most affected by poor nutrition. The average age of tractors and combine harvesters is about 15 years and half are estimated to be non-functional, due to lack of spare-parts, tires and fuel. There is a short-term need to have the combine harvesters and tractors functional to harvest wheat and prepare land for summer crops. Direct provision of farm inputs should be temporary. Where possible, these should be sold or auctioned off as a means to stimulate private sector activity in farm input markets. In both Serbia and Montenegro, there is also a need to improve the access of economically viable rural enterprises to credit, initially supported by donor-financed credit lines for critical inputs (see Sections III.A. and III.B.) Supported by donors, the Serbian government should also initiate planning for irrigation and drainage rehabilitation.

3.95 The republican governments should also continue their efforts to accelerate and rationalize the privatization process in agriculture. Special attention needs to be paid to agro-processing and agricultural supply enterprises owned by AKs, because of the key role of dynamic agri-business firms (as opposed to stagnant and monopoly-positioned ex-agro-

kombinat enterprises) in inducing farmers to develop demand-led, competitive agriculture and in financing inputs. To prevent low-productivity use of AK-held farmland, the governments should not make public land available to AKs or ex-AKs on a soft, long-term lease basis, but rather provide for transition to market lease rates and eventual sale with significant land taxation.

3.96 *Medium-term priorities.* Donors could provide medium-term credit lines on market terms to finance investment in farms, processors, suppliers and rural infrastructure. In parallel, micro credit schemes designed along lines that have worked in many areas of Southeast Europe should be initiated, especially in Serbia. To improve the incentives for banks to extend rural credit, a more streamlined process of foreclosure (which currently takes 3-5 years) should be introduced, together with a more proportionate use of land as collateral (lenders currently require land assets worth twice the value of the loan, when they accept them at all). More importantly, the ability of bank to assess risk and manage loans should be improved through donor-supported training.

3.97 The republican governments need to develop and implement programs to support SME agricultural firms. They will also need to review and amend legislation on the use and ownership of state-owned land. Once the legal issues associated with land ownership are resolved, support for privatization of the farming AKs should be implemented on a similar basis as that for ex-AK agro-processors and agri-businesses. AK-land should be sold in small parcels so that small private farmers can augment their farms with ex-AK land.

3.98 On irrigation, the government needs to institutionally organize its efforts to plan for the long term, and to promote financial sustainability and professionalism in irrigation management. The government should also review the legislative basis for the business activity of private agriculture organizations, cooperatives and other NGOs. Active, viable organizations will be essential in the development of a competitive agriculture.

3.99 *Modernizing and Strengthening Public Agricultural Institutions.* The ministries of agriculture, the separate institutions responsible for education, research and agricultural extension, and the agencies responsible for the quality standards of food and agricultural products are ill-equipped and organizationally ill-suited for operation in a market-oriented economy. These institutions will need a wide-ranging restructuring to redefine their roles, reorganize their structures and acquire new skills and technology and transfer many of their traditional roles to the private sector.

3.100 *Near-term priorities.* The federal and republican governments need to reorganize the respective ministries of agriculture to be consistent with their newly delineated roles and responsibilities, and to start on a process to strengthen their capacity for policy analysis, policy formulation and regulation appropriate to a market economy. A start should also be made in the privatization of activities such as veterinary services. The governments should also establish links between FRY and foreign universities and research institutes, as a basis for modern curricula and research programs. They should also develop a more appropriate institutional framework for research, education and extension institutions, and should train extension staff in farm business management, and the use of modern farm technology, especially as it applies to small farms.

3.101 *Medium-term priorities.* The governments should adapt research and teaching agendas to reflect policy priorities and upgrade research equipment and facilities. They should introduce fees/cost recovery for the extension activities of the Institute for Applied Science and promote the establishment of additional private sector extension services. They should also introduce legislation on protection of plant and animal health that it is consistent with EU standards, modernize the laboratories and facilities that perform this role, and train staff to use upgraded equipment. They should vigorously apply the new legislation and establish an appropriate institutional framework to monitor and enforce the revised standards. As part of the drive to improve export quality, the governments also need to bring quality standards up to and consistent with EU standards.

H. ENVIRONMENT

3.102 For economic growth to be truly sustainable, it must increasingly be of a form which contributes to a clean environment. Environmentally sustainable development will bring benefits in terms of reduced risk to human health, improved well being of the population (including through improved prospects for the tourism industry), and the prevention of irreversible losses on natural resources. Ensuring that other economic reforms are carried under a framework of sustainable development requires direct measures to mitigate environmental damage as well as a proper integration of environmental issues into other sectoral strategies.

3.103 The SFRY was relatively progressive in addressing environmental issues. Until 1988, it invested about 1 percent of GDP in environmental protection. An environmental strategy and a legal framework for environmental management and protection left an overall state of the environment better than in most Eastern European countries. The breakup of the SFRY, conflicts and economic hardships brought a deterioration in environmental outcomes. The sharp increase in energy-intensity per unit of GDP, the use of lower quality fuels, and the emission of harmful gases from power generation and industry brought high levels of urban air pollution. The quality of water resources declined to unsatisfactory levels. The increasing quantity of municipal and industrial wastes, combined with inadequate facilities for their organized disposal, created particular problems in the coastal and larger cities, especially for groundwater quality. In parallel, environmental management systems were disrupted and the capacity for environmental management weakened. The implementation environmental legislation was also hampered by delays in investments in equipment for environmentally-friendly technology, reduced funds for environmental activities, impaired monitoring of the environment, and weakened enforcement and control.

3.104 Addressing these environmental challenges with limited resources will require a focus on key priorities. The environmental reform agenda discussed below, based on the harmonization of the environmental structure and regulatory regime with that of the European Union, has five main elements: (a) creating a well-functioning legal, policy and institutional framework; (b) reducing measured levels of pollution; (c) building on synergies between economic reforms and environmental objectives; (d) strengthening civil society; and (e) promoting regional environmental cooperation.

3.105 *Creation of functioning environmental institutions and the development of a sound and effectively enforced environmental legal and policy framework.* At least three sets of key actions should be taken in the *near-term*. First, the capacity for enforcement of environmental impact assessments and pollution permits needs to be strengthened. This is particularly important for ensuring that new investments incorporate environmental concerns, and for assessing environmental liabilities and the barriers they may create for new investments. Second, donor-supported efforts to create a reliable environmental monitoring and information system will be essential for making sound policy decisions and enforcing standards. Third, there is a need to begin harmonization of environmental laws and regulations with those of the European Union and to begin ratification of key international agreements in the field of environmental protection.

3.106 In the *medium-term*, efforts should focus on: (a) improved vertical and horizontal harmonization of laws and regulations, (b) the removal of gaps in the regulation of certain parts of the environment, (c) encouraging the use of market-based rather than command control instruments, (d) developing environmental management capacity at the municipal level, and (e) promoting public participation in the decision-making process. Efforts will also have to be devoted to mobilize private investments through the establishment of appropriate financial mechanisms which do not create new fiscal risks.

3.107 *Reducing the level of environmental pollution in measurable terms.* This will involve dealing with “hot spots”, reducing atmospheric emissions by improving urban air quality management, protecting the coastline and groundwater sources, and improving hazardous and solid waste management. The most acute environmental impact of the 1999 Kosovo conflict was the creation of “hot spots” in Pančevo, Kragujevac, Novi Sad and Bor. These damaged industrial sites and other “hot spots” pose threats to human health and ecological systems, and require urgent attention. Work has been initiated in three out of the four identified hot spots. Cleanup should continue with financial and technical assistance from donors, and be concentrated on locations where the risk of adverse public health effects, soil pollution and groundwater contamination are the highest. Unless measures are put in place to address urban air quality, economic recovery could raise the level of air pollution beyond that of the end-1980s, in particular in those cities that currently fail to meet air ambient standards. Possible interventions to reduce emissions (some at the margin) include: (a) reducing energy subsidies, (b) switching to lower emission fuels, (c) improving transport system efficiency, and (d) investing in power and heat production sources within clear emission regulations.

3.108 Tapping Montenegro’s great potential for tourism requires reduction of coastal pollution. The severe pollution of the Adriatic Sea, especially in tourist-related areas, reflects untreated sewage and solid waste and oil spills. Throughout FRY, waste streams are threatening valuable groundwater resources. It will thus be important to improve access to good quality groundwater, especially as about 70 percent of FRY’s drinking water comes from groundwater sources. In the *near-term*, Serbia and Montenegro should develop programs for protection of the coastal landscape, sea water and sensitive groundwater sources. In the *medium-term*, there is a need to balance development, landscape and conservation in the coastline through an integrated coastal zone management program. Measures are also needed to address inadequate management of hazardous waste from enterprises and municipal solid waste.

3.109 ***Building on synergies between economic reforms and environmental objectives.*** The incorporation of environmental considerations into the design of economic reforms provides scope for achieving better near-term environmental outcomes. For example, reducing energy subsidies can bring more efficient use of natural resources and less pollution. Similarly, improving management of forest and agricultural lands and irrigation water will increase farm productivity while yielding environmental benefits. Liberalized trade relations may lead to increased investment in cleaner technologies, provided effective environmental regulation and enforcement are in place. In all of these areas, it will be important to identify potential negative effects of such reforms. For example, the removal of fuel subsidies may result in increased air pollution due to substitution by cheaper but dirtier fuels, e.g. fuelwood.

3.110 In the *medium-term*, sectoral reforms in energy could include introducing effective management of air and soil pollution in the energy sector, supporting energy efficiency programs, and piloting clean air programs in critical “hot spots” cities/towns. Reforms in water could include rehabilitating drinking water supply and sanitation systems. Providing safe storage and disposal options for hazardous wastes and restoring or expanding solid waste collection and disposal systems would have similar positive environmental effects.

3.111 ***Strengthening civil society.*** A number of measures are needed in order to help develop a more positive attitude towards environmental laws and regulations while building public trust and credibility for government action. Individuals need to be empowered with information about the cause and effect between public health and environmental degradation. This will motivate individuals and communities to act in support of targeted environmental programs. Strengthening the NGO community, which currently plays an important role in the environmental field, is also necessary (see Section II.C.). Local NGOs could be more active in nature conservation and environmental awareness if they were provided with financial means and communication skills.

3.112 ***Promoting regional environmental cooperation.*** Many of the environmental problems faced by FRY are regional in nature, as natural resources and water bodies are shared with other countries in the Southeast European region. The Stability Pact provides a good basis to FRY to move forward on regional initiatives and programs for improving water resources management, safeguarding transboundary natural resources, protecting transboundary lake ecosystems, and reducing flood risks.

IV. IMPROVING SOCIAL WELLBEING AND BUILDING HUMAN CAPACITY

4.1 The reforms which most directly work to improve the social well-being of the vulnerable and build human capacity are in the spheres of social protection, health and education. The Serbian government has already established these areas as priorities in its 2001 budget, partly anticipating that difficult reforms in other sectors will further strain these areas. These relatively higher resource allocations will now need to be supported by reform efforts, both to bring immediate improvements in social outcomes, and set the stage for more fundamental changes through future reforms and institutional strengthening. Furthermore, while levels of expenditure on pensions and health in relation to GDP will need to be reduced over time, the allocations to education (which are very low by regional standards in Serbia) will need to be sustained or even increased.

4.2 Measures to protect the most vulnerable need to focus on improving the structure, coherence and targeting of social welfare programs. At present, expenditures are low (especially in Serbia), often in arrears, and mostly confined to people with children. In many key respects, the social protection systems are not designed to cope with a rise in the number of the unemployed or those seeking social assistance. The latter is an issue particularly on account of the expected granting of citizenship to refugees. In Serbia, the *ad hoc* humanitarian interventions of the previous winter-while the best that could be implemented in a short time period-now need to be gradually replaced with more carefully designed policies and institutions.

4.3 In addition, reforms to restore balance to pension systems will eliminate the chronic delays in payment, reducing vulnerability to poverty by increasing the predictability of benefits. Labor market reforms can work to reduce unemployment, while reforms in health and education can bring improved access to basic services in these areas, particularly for excluded groups. Building a more productive and flexible labor force that better meets the needs of a modern market economy requires reforms and investments to improve the quality and cost-effectiveness of education and health services. Measures to improve the efficiency and financial sustainability of social services are also important for enhancing equity through the provision of adequate and regularly paid benefits and access to affordable basic education and healthcare for the most needy.

4.4 These aims will also be supported by reforms in other sectors which are discussed in Sections II and III above. Improved *budget management* can limit the crowding out of pro-poor expenditures by unplanned quasi-fiscal subsidies through shifting support from enterprises to the individuals most in need. By reducing corruption, better *governance* can enhance the access of the less well-off to basic public services. Improvements in the *business environment* which support the rapid growth of SMEs can bring more pro-poor growth. Well-designed *energy price* increases and compensating social protection measures can reduce the vulnerability of the poor to energy shortages while freeing up fiscal resources for more direct means of support. The establishment of a universal access mechanism for *telecommunications* services will help ensure access to basic services for the poor.

A. SOCIAL PROTECTION

4.5 Reform requirements in social protection can be subdivided into the areas of pensions, labor market programs, and social welfare.

4.6 **Pensions.** FRY operates a mandatory, pay-as-you-go (PAYG) pension system. With the exception of military pensions, the pension system is under republican jurisdiction. In both Serbia and Montenegro, generous benefits combined with a rapid fall in number of contributors per beneficiary has led to high and unsustainable levels of spending. At the same time, the high share of the elderly among the poor means that the existing resources are not being allocated in a way which reaches the poorest. The trend in dependency ratios, and the experience of other transition economies, suggests this situation is unlikely to improve without substantial reform of the system. Furthermore, given their high share in public spending, pensions are a major source of fiscal pressure. The chronic and substantial accumulation of arrears is not only a source of quasi-fiscal deficits, but also increases social vulnerability among poorer pensioners by increasing the uncertainty of income streams. High payroll tax rates work to discourage employment and growth and push businesses into the gray economy. Putting the pensions system on a secure financial footing is thus essential for macroeconomic stabilization, stronger growth, reintegration of the shadow economy and poverty reduction.

4.7 In this area, a more useful dichotomy than near-term and medium-term reforms is a distinction between reforms which are essential to restoring structural balance to the system (*crucial reforms*), and those which, while important, play more of a supplementary role (*supporting reforms*). As pension systems have a lot of momentum (due to existing retirees), crucial reforms which affect the *long-term* viability of the pension system do not necessarily have an immediate fiscal impact. On the other hand, supporting reforms often bring immediate fiscal returns without ensuring long term sustainability. It is therefore important to conceive of pension reforms in FRY as a package of measures that both bring immediate fiscal relief, and reduce structural imbalances.

4.8 **Crucial Reforms.** The following four measures can be categorized as crucial reforms and are applicable to both Serbia and Montenegro:

- *Raising the statutory retirement age:* Increasing this age from 60 years to 65 years for men and from 55 to 60 years for women would help to contain the long term costs of the system.
- *Equalizing retirement ages for men and women:* There are good reasons for considering this measure, including the greater longevity and typically lower contribution history of women.
- *Changes to the benefit formula:* Current accrual rates are overly generous by international standards and need revision. This is one of a number of changes that could be considered to lower individual *replacement* rates.

- *Changes in valorization rules:* This would also contribute to reducing individual replacement rates to sustainable levels.

4.9 *Supporting Reforms.* The menu of supporting reforms is more extensive, and includes measures that are relevant to both Serbia and Montenegro:

- *Changes in indexation:* Changes to these rules are critical. One way would be to raise the trigger for indexation (currently 5 percent). Another would be to move from wage indexation to price indexation, or half wage/half price indexation, or indexation to whichever is the lower of wage growth and price growth. Wage/price indexation or indexation to the minimum of wage and price growth allows for cost containment in a context where the real wage growth is uncertain. Serbia has indicated its intention to change indexation by mid-year.
- *Making higher minimum pensions less generous:* Some of the higher minimum pensions are well above international standards, and should be eliminated or reduced, possibly in combination with simplification of the structure of minimum pensions. In Serbia the move to using full income as the basis for contributions and benefits provides a good basis for making such changes; Montenegro would need to consider similar measures. Care should be taken in revising the lowest minimum pensions as these are close to the World Food Program poverty line.
- *Raising effective retirement:* The retirement age that matters in practice is not the statutory but the effective retirement age. In FRY, despite the changes in 1997 in the pension legislation, a fair proportion of individuals retire early. One factor which encourages early retirement is accelerated accrual rates in some sectors. These should be reduced. To further discourage individuals from retiring early, their pensions should be reduced by a factor that provides compensation to the pension funds (PFs) for smaller contributions and for the likelihood of having to pay the retiree's pension for a longer period.
- *Reauthorizing disability pensions:* The incidence of disability retirement in FRY remains high, notably in the years preceding statutory retirement age. There is a case for a careful re-evaluation of these pensions, particularly the so-called "Category 2" and "Category 3" pensions.
- *Limiting merit pensions:* Merit pensioners receive higher than average pensions and are responsible for a disproportionate share of spending. Spending on merit pensions could be limited by reducing the number of new retirees who qualify, and making these pensions less generous, e.g. reducing rates of accelerated accruals.
- *Reducing non-pension social benefits:* The PFs also pay a number of other social benefits. These should be rationalized, ideally in a context that looks across the range of social benefits, not only those which are paid out of the PF.

- *Simplifying social insurance taxation:* If the responsibility for paying health contributions was eliminated from PFs, pension and health benefits would become more transparent, opportunities for shifting arrears would be reduced, and revenue predictability would increase.

4.10 Moreover, in Serbia, these changes could be accompanied by: (a) Changes to farmers' pensions (the Farmers' PF is in serious financial problems, and there is a compelling need to review its structure of benefits); and (b) merging the three PFs. In the *medium-term*, a further administrative simplification would be a merger of the three PFs, particularly as the costs of the smaller funds are well above international norms.

4.11 In both Serbia and Montenegro, it will be important to avoid any immediate steps towards setting up a second pension "pillar" (mandatory private insurance) or third "pillar" (voluntary private insurance). With regards to the second pillar, the fiscal space to begin diverting payroll contributions simply does not exist. Even if it did exist, the regulatory capacity to oversee private funds does not. The best way to lay the groundwork for multi-pillar reforms would be to concentrate on bringing obligations of the first government managed pillar in line with payroll contributions, and laying the foundations for open, transparent, and viable banking and financial institutions which would be needed for second and third pillar instruments.

4.12 A further consideration in the first pillar is the degree to which PFs should be involved in the management of private companies. One of the legacies of privatization in the successor states of SFRY is that PFs have become significant shareholders in privatized companies. Managing assets in private companies distracts from the main purpose of the PFs, which is to collect contributions and pay pensions. It is therefore important that a suitable model be devised under which the functioning of the PFs is not compromised, while at the same pensioners are allowed to benefit from assets which they contributed towards.

4.13 ***Unemployment Benefits and Other Labor Market Programs.*** In both Serbia and Montenegro, most of the labor policies of SFRY are still in place although they are not suited to present circumstances. Unemployment compensation is generous, especially in Serbia. However, spending is not high because benefits are confined to those who have a minimum contribution history, and to date there is little open unemployment amongst this group due to limited restructuring. As a substantial increase in the number of claimants is forecast, the system of unemployment insurance needs to be made more affordable and incentive, as enterprise and bank privatization accelerates, compatible. Reforms also need to be accompanied by amendments in severance pay entitlements, so that the combined effect of enterprise-financed payments upon dismissal and unemployment compensation are addressed in a coherent manner. Such reforms can support poverty reduction through avoiding any future accumulation of arrears on benefit payments, and can promote growth by smoothing the process of enterprise restructuring.

4.14 The authorities also face a number of other challenges in reorienting labor market programs to the needs of an emerging market economy. Administrative costs of the system are extremely high, in large part because labor market bureaus (LMBs) spend disproportionate amounts on maintaining staff and offices. These costs need to be lowered. Finally, LMBs spend

a large proportion of their resources on active labor market programs which have not proved cost-effective in other transition economies.

4.15 In the *near-term*, the main priorities are:

- *Reforming unemployment benefits (UB)*: Well-functioning unemployment insurance is extremely important for enterprise restructuring. In Serbia, one of the first reforms would be to lower the income replacement provided by UB. Replacement rates of 30 to 50 percent are more in line with regional standards. A second reform, relevant to both Serbia and Montenegro, would be lowering the maximum benefit period. These reforms would free up resources to cover a greater number of beneficiaries.
- *Focusing spending on cost-effective active-programs*: There is a need to reorient the activities of the LMBs away from wage subsidies, self-employment programs, and job "creation", towards activities such as providing information on vacancies, and job-search assistance. To the extent possible, groups which face particular disadvantages in the labor market should be the target of active programs.
- *Simplifying social insurance taxation*: As with the other social funds, there is a case for pensions and health contributions for those drawing UB to be passed directly to these funds, with an accompanying adjustment in contribution rates.
- *Complementary labor market legislation*: These legal changes would aim to make labor markets more flexible, thereby increasing incentives to hire new workers, and accelerate the return to work for those dismissed.

4.16 Over the *medium-term*, the authorities should focus on addressing the excessive administrative costs within the LMBs. This should be done within the overall context of streamlining social protection delivery infrastructure. Finally, although the payroll tax for unemployment compensation and other labor market services is at the low end of the range by regional standards, especially in Montenegro, it would be hard to justify any increase in payroll contributions in the near term without exploring the scope for cost savings through re-orientation of active-programs and reductions in administrative costs. Over time, reform of pension and healthcare systems should allow a gradual phasing down of payroll tax rates.

4.17 **Social Welfare.** Both Serbia and Montenegro retain the key features of the former Yugoslav social welfare system, though in Serbia in particular, cash transfers became increasingly dysfunctional during the 1990s. The system is characterized by a wide range of cash benefits and social welfare services delivered through a comprehensive national network. Responsibility for social welfare rests with the Republics, and social welfare administration is well-developed with a network of Centers for Social Work (CSWs) throughout FRY.

4.18 The social welfare system will be presented with great challenges in the coming years, given the need to address significant exclusion errors in targeting of social welfare, the likely short term negative social impact of economic restructuring (which will create the need for one-off payments to smooth this process), new demands generated by price liberalization, and the

possible beneficiary inflow due to refugees becoming citizens. The reforms would support long-run fiscal sustainability of the social welfare system by ensuring that increased future demands on the system can be managed with available resources. By enhancing the equity and coverage of social welfare, they will also contribute to poverty reduction. The key issues include: (a) improving the structure of benefits and supporting fiscal sustainability (the structure is overly complex, and the linkage of social welfare eligibility thresholds and benefit levels to wages is undesirable); (b) enhancing equity and dealing with refugees (specific challenges include lessening the exclusion errors in social welfare programs, directing resources to the most well-targeted programs, and managing increased demands on the system in the event that a large share of current refugees apply for citizenship and become eligible for social welfare); (c) streamlining and strengthening social welfare delivery; and (d) upgrading staff skills and promoting partnerships with the third sector.

4.19 *Near-term priorities.* A review of social welfare policy and programs is needed. This is already underway in Montenegro, with EU assistance. The outcome of the review in each republic would be Government approval of a Social Protection Strategy, which would guide legal amendments to be drafted during 2001. These strategies would need to include costing of reform options in consultation with the ministries of finance and local authorities. Immediate steps include delinking social benefit determination from wages in both Serbia and Montenegro, moving from regional to republic-wide eligibility thresholds in Serbia (differentiated rates have worked to limit access to social benefits in the poorest regions), and targeting child allowances in Montenegro. The additional costs of moving to republic-wide eligibility thresholds could be supported by donors. Key issues to be addressed in the overhaul of social welfare policy include the rationalization of social welfare programs, the reform of specific aspects of benefit design, an assessment of new demands on the social welfare system, stronger provisions on the collaboration between the public and non-government social welfare sectors, and new policies to encourage community-based alternatives to institutional care. This policy work would feed into the redrafting of key social welfare legislation.

4.20 *Medium-term priorities.* The basic software and database for CSWs and other social welfare facilities should be developed to report on main program indicators. This will also require hardware and in some cases infrastructural upgrading. At this time, the operational manuals for CSWs for basic client and case management should also be developed. Both ministerial and local staff would need to receive training.

B. HEALTH

4.21 The health system is in crisis. In Serbia, real per capita health spending has fallen from US\$240 in 1989 to US\$59.¹⁷ In 2000, the deficit of the Serbian Health Insurance Fund accounted for 0.75 percent of GDP. By the end of that year, total accumulated arrears were 5.9 billion dinars, or around 2 percent of GDP. The health sector is not only responsible for taking care of the health of the population, it is also an important part of the economy. Including private and military health expenditure, the sector comprises an estimated 13-15 percent of GDP and around six percent of the workforce in FRY.

¹⁷ Including Kosovo, the corresponding figure would be US\$46.

4.22 Despite real declines in health spending and problems with fiscal management, public expenditures in health as a share of GDP remain relatively high, particularly given the current economic situation of the country and declines in real per capita health spending. In 1999 almost 7 percent of GDP went to health care, and in 2000 this declined to approximately 6.6 percent.¹⁸ Estimates of private health spending are unavailable and can only be reliably calculated using a household survey and estimates of public spending based on incomplete data. The difficulty in obtaining the relevant data is in itself an indicator of a system in need of significant reform.

4.23 Since the scope and staffing of the system has not declined markedly with expenditures, revenues are increasingly being raised by charging patients. Out-of-pocket purchases of drugs, surgical materials and food by patients to compensate for shortages and to remunerate providers pose serious problems. While some payments are legally paid to providers working in private practice, others are “under the table” payments given by patients as supplements to public providers to gain access or ensure reasonable quality of care. This practice of informal payments raises equity and access concerns.

4.24 The fiscal crisis is also having an impact on the quality of health care services. Ten years of limited investment and maintenance has left most facilities in serious disrepair. Drugs and medical supplies have been difficult to procure and provide to patients. Patients often delay necessary treatment until they have become sick and more costly to treat. In terms of health outcomes, FRY is barely maintaining what were amongst the best health indicators in Eastern Europe ten years ago. Some minor declines in health status have been reported recently and, although not well documented, are of concern given the conditions in the health sector and the experiences of other countries in the region.

4.25 The fiscal problems in the sector reflect a combination of factors. The most important, and in many ways least understood, is the considerable inefficiency in the system, part of which reflects disincentives to cost savings. FRY’s public spending as a percent of GDP is comparable to levels in Canada and the Czech Republic, although income is considerably lower. Service delivery indicators that reflect the level of inefficiency in a health care system provide a hint of the problems in health care delivery. The average length of stay in health care facilities in FRY at 12 days exceeds the OECD range of 5-9 days. This suggests that hospital stays are some of the most costly elements of health care. An average hospital occupancy rate of 70 percent also reflects underutilization of available infrastructure, and is lower than figures from most neighboring countries.

4.26 Difficulty in mobilizing revenue is the second source of fiscal difficulty. Even after the recent introduction of some co-payments, nearly all of the public sector revenue for health goes to the health insurance funds in the form of contributions paid by employers, the self employed, farmers, the pension fund, and the unemployment fund. Wage contributions are high (19.5% in Serbia, 15% in Montenegro), but compliance is low. Revenue has decreased in recent years due to the low rates of formal employment, falling levels of reported average salaries and non-wage benefits that are not fully taxed. State contributions to the funds for uninsured groups have also

¹⁸ World Bank staff calculations using data from the Serbian HIF, includes arrears incurred during 2000.

been below expected levels. In particular, very little of the federal aid promised to the health insurance funds to cover the cost of treating IDPs and refugees was transferred in 2000.

4.27 This overall shortage of resources is compounded by an inefficient allocation of available funds. This has partly been due to the accounting system, which is not structured to provide accurate costs of services. Planning, budgeting and management of services are based on service inputs and not on quantities of outputs or health outcomes. Procurement practices are therefore inefficient and there is an overall lack of management capacity at all levels in the health care system. An example is the pharmaceutical sector, where inadequate pricing policies have continuously led to shortages of some drugs in pharmacies. Hospital and specialist-based care also contributes to fiscal problems as less costly alternatives are under-utilized as a result.

4.28 Given the current situation, reforms in the design and financing of the health system should focus on three priority areas: (a) achieving fiscal sustainability of the health sector; (b) reforming the delivery system; and (c) developing capacity to formulate, communicate and implement health policy.

4.29 ***Achieving fiscal sustainability of the sector.*** Meeting this challenge requires:

- In the *very near-term*, earmarking budgetary support for pharmaceuticals and urgent repairs will ease the situation in the health insurance funds, but this does not offer longer term solutions.
- Articulating a health policy that defines the priority objectives of the FRY health system, and lays out the preferred organization, financing and delivery modes that will provide the basis for a health system restructuring aligning resource availability and social objectives.
- Developing a health reform agenda to address the inefficiency and equity issues plaguing the system. Reforms should address the incentive structure and lack of accountability in the health delivery system as well as the oversupply problems.
- Controlling expenditures by, among other things, changing pharmaceutical procurement practices and changing incentives in the existing health provider contracts.
- Improving revenue mobilization by raising collections, reassessing levels of contributions, and identifying new revenue sources such as legal co-payments.
- Shifting sickness and transport payments to the ministries of labor which are responsible for benefit management and safety nets.
- Improving data and information on system performance and financial flows to allow monitoring and assessment of the system and its finances

4.30 ***Reforming the delivery system.*** Ten years without capital investment and limited maintenance has left most of the infrastructure in serious disrepair. The excess capacity in the

system means it will be too expensive to upgrade, repair, and/or replace everything. In the *near-term*, the delivery system requires select priority facilities be equipped and repaired in order to ensure a minimum level of quality of services. In the *medium-term*, there is a need to develop and implement a restructuring plan for the entire delivery system. This would include: (a) restructuring the hospital sector; (b) developing primary health care and public health services; and (c) introducing human resources development programs. Donor financed capital investments can be used as incentives to modernize the system while it is being optimized. These programs will have large impacts on both efficiency and quality of health service delivery.

4.31 ***Developing capacity to formulate, communicate and implement health policy.*** In the *near-term*, support to high level task forces in Serbia and Montenegro will facilitate the preparation of a blueprint for reforms that can be used to build consensus as well as the needed steps to restructure the health system that raises efficiency, quality and access. Public expectations should be managed with an active public relations program from the beginning. Other priorities include: (a) providing intensive support to the major institutions that will be involved in health sector reform (the Ministries of Health, the Health Insurance Funds, and the Institutes of Public Health); (b) introducing a manager training programming to strengthen implementation of reforms at the facility level; and (c) developing a communications strategy to accompany the newly defined health policy.

C. EDUCATION

4.32 The SFRY education system was quite well developed, although with important regional differences. In 1989, average coverage of education was 95 percent for the eight-year primary cycle, 80 percent for the (mostly) four-year secondary cycle, and 19 percent for higher education. During the 1990s, education management became much more centralized. The system suffered heavily under the disruptions and economic deprivations of the past decade, including the influx of refugees and IDPs. In Serbia, the overall level of resources devoted to education fell well below regional norms. The proposed priority reform program for education in FRY is designed to address three particularly crucial issues: (a) improving educational efficiency and capacity; (b) reviving the quality of education programs; and (c) improving management and finance of education through decentralization. In each of these areas, the proposed short-term actions will need to be followed up with medium-term actions to deepen the reforms and the investments initiated in the first phase of recovery.

4.33 ***Improving educational efficiency and capacity.*** The adverse environment and negative developments of the last decade eroded the efficiency and capacity of the education sector. Overstaffing has worked to crowd out the payment of adequate salaries, and hence erode the quality of teaching. The inefficient school network (some schools are on double or triple shifts while others operate at well below capacity) and the poor physical state of schools (including due to lack of maintenance and bombing damage during the Kosovo conflict) raise the cost and lower the quality of education. The large influx of refugees/IDPs has also seriously strained education capacity and lowered education coverage, particularly for the primary age group. Greater efficiency in use of facilities and teachers would work to free up resources which could be used to improve the quality and equity of education. The priority reforms and investments for more

efficient development and use of education resources, and for expanded capacity fall into three broad categories:

4.34 *Reducing overstaffing to raise salaries.* In aggregate, FRY's educational sector has too many workers earning average salaries that are too low. Overstaffing is evidenced by class sizes and student/teacher ratios which are low by comparison to many other countries, especially in higher education.¹⁹ Low teachers' salaries erode morale, encourage some teachers to seek supplementary income through other work, and contribute to the occasional practice of charging illicit fees for education or for unearned grades. There is also a problem of arrears in payment of education sector salaries.

4.35 In redressing these problems, it will be important to link the need for higher salaries with the opportunities provided by the current levels of overstaffing. This will require a degree of school consolidation (see below). Further efficiency gains can be achieved through reducing the number of non-teaching staff. The 2001 Serbian budget envisions a 14 percent real increase in average salaries for education employees. Such increases are a good first start, but must increasingly be tied to: (a) initial staff reductions to improve the efficiency of resource use through raising class sizes and student/teacher ratios, (b) a commitment to develop and implement a plan for further staffing rationalization at all levels of education, and (c) a commitment to increase cost recovery in higher education through higher fees. Staff reductions could help to raise the quality of education if carried out on the basis of competence rather than seniority.

4.36 *Rationalizing costs.* Inefficiency also reflects specific programs with high unit costs. One important feature of education in FRY is that all linguistic minority groups have the right to mother-tongue education at all levels. While such a system provides many advantages, it should be recognized that its cost of operation is high. Furthermore, instructional time in primary and secondary education is well below international standards, particularly in the initial grades. Extension of the duration of the school day is a low-cost measure to improve quality and efficiency in schools. Starting single-subject teaching later than grade five is another potential avenue for cost savings.

4.37 The efficiency of higher education is eroded by the long average time to complete an undergraduate degree. Raising student fees and related fees for board, accommodation and transport would strengthen students' incentive to use their time effectively, and would also generate resources to improve teaching conditions in universities. Currently, higher education is free for students who score above a given threshold in the university entrance examination. Students with lower scores pay fees. Since university students are disproportionately from relatively affluent families, raising tuition and related fees in higher education would improve cost recovery from the groups who are most able to bear those costs, and would reduce cross-subsidies to this group.

4.38 *School consolidation and reconstruction.* In both Serbia and Montenegro, there is great scope for improving efficiency of education provision through school consolidation. In parallel,

¹⁹ These average figures must be treated with some caution, and they include both small schools, where low student-teacher ratios may be unavoidable, and large urban schools, where these ratios can be very high.

there is a need to reconstruct and rehabilitate schools, including those damaged or destroyed in the Kosovo conflict. The investments to re-equip and re-build damaged and neglected schools are proposed only in the context of system rationalization and tighter deployment of existing resources. The processes of consolidation and reconstruction should be closely integrated to avoid spending resources on schools which will later be closed.

4.39 *Reviving the quality of education programs.* The education systems in Serbia and Montenegro remain behind other countries in the region. Education is focused on narrow specializations, and pedagogy emphasizes mastery of facts over application and critical thinking. Curricula and teaching methods have stagnated as fresh professional inputs, including new educational materials, have been choked off by sanctions, political interference, and budgetary deprivation. Major changes are needed to make up for a decade of neglect in teaching materials, to update content of education programs, to introduce greater quality assurance through outcome measurement, and to make programs responsive to the needs of the new market economy. Some of the main features of the needed reform are the following:

4.40 *Updating educational materials and equipment.* There is a need to re-equip primary and secondary schools with essential and improved basic educational materials and equipment, so as to raise teaching and learning effectiveness. In addition, the renewal of textbooks can serve as a vehicle for improving relations among communities. In this context, there is a need to analyze existing primary and secondary school textbooks to identify content that is inconsistent with basic values of tolerance. As progress has already been made in Montenegro, the needs are greatest in Serbia.

4.41 *Teacher Training.* The focus should be on active learning, and effective teaching practices for multi-grade classes. As some donor-supported progress has already been made in Montenegro, these needs are particularly great in Serbia.

4.42 *Including excluded groups.* Special efforts need to be made to bring excluded groups into mainstream education. This activity should be targeted to groups with low primary-school attendance and performance – predominately but not exclusively concentrated in Roma communities (see Box 4.1 below). An integrated set of activities for school-aged children and parents includes assistance in establishing legal status, preschool education, after-school tutoring, literacy training and public awareness training for parents, and maternal and child health care. The experience with Roma-targeted programs in other countries shows the need for a holistic approach to raising school participation and school performance. This combines child-centered learning methodologies and the commitment of the Roma community; provision of financial incentives to schools which attract and retain Roma students; catch-up classes for Roma drop-outs and tutoring for Roma students; special training for teachers of Roma children and provision of cultural mediators in schools with Roma students; and offering of optional Romany language and culture classes.

4.43 *Updating vocational education content.* There is a need to align secondary vocational education with the future needs of the economy. Vocational education at the secondary level needs to teach more generic skills for a few areas families of occupational specializations rather than highly specific skills for a large number of narrow occupations. It should for instance put

more emphasis to developing numeracy skills, problem-solving skills, communications skills (including foreign language proficiency) and teamwork skills.

Box 4.1 – Education and the Roma

The Roma in FRY face particularly serious problems in education coverage. In 1981, only 34.8 percent of the Roma population of Serbia were literate, versus an average literacy rate of 78.7 percent for the population of Serbia as a whole. Only one third of Roma children complete primary school. Most do not start school at all, or drop out in the initial two or three years. Those who do attend primary school are often stigmatized by being assigned to schools for the handicapped, because of their lack of command of the Serbian language and other educational handicaps resulting from their environment. This constitutes a serious gap in school coverage at the compulsory level, amounting to about 10 percent of total enrollments.

4.44 *Updating higher education content.* It will take years to overcome the isolation and neglect of higher education of the recent past. The *near-term* efforts should be selective. Developing functional libraries is the most cost-effective means to begin updating the professional content of higher education courses. Donors could support the acquisition of journal subscriptions, IT hardware and software with internet connections, and photocopying machines to university libraries. This can be complemented by programs to send selected faculty on short fellowships and study visits to catch up on professional developments in their respective fields. Such support should be provided to universities which commit to rationalize the deployment and use of teaching staff and to strengthen performance incentives for students and faculty in order to improve the efficiency of resource use. In the *medium-term*, reform efforts should focus on making higher education more flexible at entry, on offering easier transfer opportunities across programs and faculties, and on providing stronger performance incentives to students and faculty.

4.45 *Improving management and finance of education through decentralization.* In the early 1990s FRY moved to centralize education management and finance. Around three-quarters of the financial resources for all levels of education, as well as authority for most decisions was returned to the republican level from the municipal level. This is very high by OECD standards. Municipalities remained responsible for financing the “material costs” of primary and secondary schools, but often lack resources to do so. Households finance 7.3 percent of the costs of education, in the form of textbook purchases and fees for university students below the entry score threshold for free education.

4.46 Both republics now propose some decentralization of management and financing, in order to improve the efficiency of resource use, and the responsiveness of education programs to the needs of the global and local economy. Some progress has already been made in Montenegro. Whatever form decentralization takes, it will need to align responsibilities and resources for management and financing of education at the Republic, regional, and local levels. A recommended model is to adopt uniform per-student grants for each level of education, which could be financed from a variety of alternative revenue sources. This approach would promote broader coverage, would provide incentives for efficient provision, and would smooth regional and local differences in revenue capacity. These reforms will need to be supported by technical assistance to strengthen governance and build management capacity.

V. MEDIUM-TERM ECONOMIC OUTLOOK AND EXTERNAL FINANCING REQUIREMENTS

A. THE MACROECONOMIC OUTLOOK

5.1 This section quantifies economic prospects in three key areas: growth, the fiscal accounts and the external accounts. Based on outcomes in the latter two areas, it also derives requirements for external financing through new financial flows and the adjustment of debt stocks. The described scenario assumes successful implementation of the program of reform, institutional strengthening and investment described in the previous chapters. This will be the key determinant not only of productivity growth, but also of FRY's ability to attract the required levels of financing in the form of debt restructuring, official grants and loans, FDI and, eventually, private debt inflows. In the event of delays or incomplete efforts in reform and/or of inadequate levels of financing, a substantially lower growth scenario is likely. The significant risks associated with this scenario are discussed more fully at the end of this section.

5.2 The analysis below shows that the twin fiscal and current account deficits would evolve in a similar qualitative fashion, first rising to higher levels for most of the first half of the decade, before gradually falling to levels more representative of mature transition economies. In both cases, the more rapid initial growth of needs relative to available resources first results in a higher financing requirement. Over time, the beneficial impacts of initial reforms increase available resources while controlling needs, thereby bringing a phased decline in the financing gap.

5.3 More specifically, in the fiscal sphere, the additional expenditures required for resumed debt service payments, new public investments and maintenance, social assistance and the payment of accumulated quasi-fiscal liabilities will initially grow more rapidly than the resources which can be generated by cuts in other expenditures, by revenue measures and through domestic deficit financing (the scope for the latter being particularly low). This will create a *fiscal financing gap*. Over time, the noted additional expenditures will begin to stabilize as a share of GDP, while deep reforms will bring sustainable reductions in expenditures and new quasi-fiscal liabilities, and will enlarge the scope for deficit financing (as the economy is remonetized and capital markets develop). This will gradually reduce the fiscal financing gap. Were insufficient budgetary support to materialize, growth prospects would be reduced, either by a need to impose an even higher tax burden, or by the impact on private investments of crowding out by the public sector or of the higher level of macroeconomic risks.

5.4 Similarly, in the external accounts, the significant needs for reconstruction-related private and public investments, for the resumption of external debt service and for reserves accumulation, will initially grow more rapidly than the levels of exports, foreign direct investment and other sources of private financing. This will create an *external financing gap*. Over time, the noted needs will begin to decline as a share of GDP, while earlier reforms begin to pay dividends in terms of higher exports and private capital inflows. This will gradually work to reduce financing needs from official sources.

Table 5.1: Federal Republic of Yugoslavia – Medium-Term Macroeconomic Prospects

	2000	2001	2002	2003	2004	2010
National Accounts						
GDP (US\$ millions) 1/	9015	11413	13092	14219	15362	24538
Real GDP growth (%)	6.0	5.0	4.0	4.0	4.0	4.0
Investment (% of GDP)	14.3	17.5	19.5	21.0	21.3	22.5
Gross Domestic Savings (% of GDP)	-2.5	-2.1	1.9	5.4	7.1	14.1
Public Sector Balance /2						
Expenditures (%of GDP) 3/	39.7	46.0	48.1	48.1	47.7	44.9
O/w public investment	3.3	3.6	4.0	4.0	4.0	4.0
Revenues (% of GDP)	38.8	39.9	40.5	41.0	41.0	41.0
Deficit (% of GDP)	0.9	6.1	7.6	7.1	6.7	3.9
External Accounts						
Exports of goods and services (% change)	18.6	11.4	13.9	13.9	10.7	10.4
Imports of goods and services (% change)	14.9	24.7	9.2	7.3	7.4	7.4
Current account balance	-400	-782	-1158	-1222	-1199	-1158
as % of GDP	-4.4	-6.9	-8.8	-8.6	-7.8	-4.7
Indebtedness						
TDO/XGS 4/	481.9	304.7	303.1	297.8	293.1	230.2
TDO/GDP 4/	136.2	75.8	74.8	77.1	77.7	71.4
TDS/XGS 4/ 5/	2.2	7.0	20.6	23.1	24.4	23.0
Prices						
Retail Price inflation (e.o.p.)	113.5	35.0	13.5	9.3	7.8	5.0
Real interest rate (e.o.p.) 6/	0.0	28.1	11.3	7.5	4.9	4.0

1/ GDP estimates include Kosovo. The economy of Kosovo is estimated to be about 6 percent of the total FRY economy.

2/ Excludes Kosovo.

3/ Amounts based on cash accounting.

4/ Stock of debt includes short-term obligations.

5/ Exports exclude workers' remittances.

6/ Annualized short-term lending rate. Rate in 2000 is for August.

5.5 Growth and inflation prospects. Under these assumptions and taking into account the uncertainties created by weak data, real GDP *growth* of about 5 percent is expected in 2001. This growth will be driven primarily by the recovery of agriculture and electricity production from the previous year's drought. Industrial output is not expected to make a major contribution to growth at this stage, with the positive effects of sanctions removal, the real exchange rate devaluation of late-2000, and the restoration of some external trade countered by the negative initial impact of the remaining transitional recession (from the hardening of budget constraints and large shifts in relative prices) and the tightening of macroeconomic policy. In Serbia, the latter would also work to bring December-to-December *inflation* from 115 percent in 2000 to around 30-35 percent in 2001. This would be the combined effect of core inflation of around 1-2 percent per month and sharp increases in some administered prices. In Montenegro, fiscal tightening and limits to wage growth are expected to reduce annual inflation to 6 to 7 percent by end-2001.

5.6 From 2002 onwards, growth is expected to average 4 percent per year, a performance which would leave FRY towards the upper end of the Central and Eastern European post-transition experience of the last decade. This would be supported not only by progress on reforms and greater external financing, but also by gradual reintegration of the gray economy and the continuing beneficial effect of sanctions removal. Growth would be driven by improved efficiency of the growing private sector and key infrastructure sectors, especially energy and transport. However, higher sustained growth rates are made unlikely by the remaining transitional recession, and by the still high burden of external and public debt, even after debt restructuring. With such a large debt, the significant gross levels of donor assistance described below will translate into much lower levels of net foreign financing. This dearth of new net resources would limit the scope for extremely rapid increases in public or private investment, and hence of exceptionally rapid recovery. Under this scenario, per capita GDP would rise to about US\$ 1430 in 2005, or about 50 percent of its estimated 1990 level.²⁰ Per capita income is expected to reach about US\$2100-2200, or about 80 percent of the estimated 1990 level, by the end of the decade. Given the strong link between poverty and GDP levels, this would also lead to a sustained decrease in absolute poverty.

B. FISCAL PROSPECTS

5.7 To successfully meet the key challenges outlined above, the federal and republican budgets will have to address three particularly important sets of issues in setting fiscal policy:²¹

- To meet the challenge of restoring macroeconomic stability, budget deficits will need to be limited to levels which can be financed in largely non-inflationary ways. Given the extremely low level of monetization in Serbia, and the use of a foreign currency as legal tender in Montenegro, this constraint severely limits monetary financing. Furthermore, any significant fiscal deficits would work to crowd out needed private sector investments.
- Given the dominant role of quasi-fiscal deficits as a source of macroeconomic instability, meeting that same challenge will require a particular effort to manage the legacy of past quasi-fiscal deficits and to reduce their future creation.
- Meeting the challenges of restoring growth and improving social well-being will require a shift in the level and structure of public expenditures to reflect the new policy priorities and economic and social challenges of a nascent market economy facing fiscal consolidation and economic restructuring.

The government budgets for 2001, which already incorporate many of the reforms proposed in this report, make a start in all three directions.

5.8 ***Limiting budget deficits to available non-inflationary financing.*** Governments in FRY do not have access to private external financing, nor does FRY have a functioning domestic bond market. In this setting, the vast bulk of deficit financing must come official loans and grants and

²⁰ The latter trend depends partly on the degree to which refugees remain in FRY, and are integrated into its population, as extensive integration would lead to rapid growth in recorded population, thus working to pull down the per capita figures.

²¹ Reforms to strengthen the management of public expenditures and liabilities are discussed in Section III.A.

privatization revenues. Assuming good progress on reforms, total financing from both sources is likely to increase, reflecting both greater external support for FRY and acceleration of privatization. This higher level of anticipated financing is seen in the increase in the consolidated *cash-based* budget deficit by 5.2 percentage points to 6.1 percent of GDP in 2001. About 90 percent of this deficit is expected to be financed through external support and anticipated privatization revenues. In the absence of such financing, e.g. due to perceived lack of progress on reforms, expenditures would have to be squeezed further, harming growth prospects.

5.9 *Fiscal financing needs will remain high for several years.* As summarized in para. 5.4, a combination of factors will initially increase the financing gap. These primarily reflect the need for higher near-term expenditures needed to launch FRY on a sustainable growth path. Debt service payments will rise further starting in 2002. Needed public investments and social assistance payments could increase further while remaining quasi-fiscal imbalances will have to be brought explicitly on budget. While other recent and proposed reforms (particularly reforms to social protection and health in both republics and efforts to control salary increases at the federal level and in Montenegro) will bring some cost savings, and while sectoral policy reforms in energy, agriculture and transport will cut the creation of new quasi-fiscal deficits, the largest savings from such reforms will only come over time. As shown in Table 5.1, the net effect is to increase consolidated cash expenditures from 39.7 percent of GDP in 2000 to a peak of 48.1 percent in 2002. As needs stabilize and reforms bring other cost savings, initially gradual and later more rapid control of expenditures is likely, with expenditures falling to below 45 percent of GDP in 2010.

5.10 Since the capacity to further raise consolidated revenues is limited, higher expenditure needs translate into a larger temporary budget deficits. These deficits are expected to rise to the range of 6 to 7.6 percent of GDP during 2001-04, after which they will gradually decline in the second half of the decade, reaching a projected level of below 4 percent of GDP in 2010.

5.11 *Different starting points will require different adjustments in the two republics.* In 2000, Serbia received almost no external budgetary assistance (save for some support for social payments) while Montenegro received official budgetary grants equivalent to a very high almost 10 percent of its GDP. Assuming good progress on reforms, future levels of support for Serbia could be expected to increase, while support to Montenegro could converge towards still substantial but more sustainable levels. This shift is already evident in 2001 budgets, which envision an over 5 percentage point of GDP increase in the cash deficits at the federal and Serbian levels, and a decrease in Montenegro which is even larger as a share of its GDP.

5.12 *The uncertain level, composition and timing of donor support requires innovative budgeting.* At the time of passing the 2001 Serbian budget, little firm external budgetary support was yet on offer. While Serbia is likely to raise additional such support, its uncertain volume, composition and timing complicates budget planning. To better manage the resulting uncertainty, the Serbian budget has been innovatively divided into two parts: (a) a “core” budget which can be financed largely from anticipated domestic resources and some firmly committed foreign resources; and (b) and a supplementary “budget for recovery and reconstruction” (BRR) which is by design scaled to the level of support raised from donors.²² The former is a budget

²² The needs for recurrent cost financing of budgetary expenditures are more fully discussed in Volume 2.

containing only the most essential expenditures which need to be made regardless of the level of donor support, but which alone would provide little basis for growth and development. Adequate and properly conditioned donor support for the BRR would produce a much more growth-oriented and socially sustainable budget.²³

5.13 *Closing the gap.* To sustain macroeconomic stability, the consolidated budget deficit must be reduced to the available level of financing through revenue and expenditure measures. The 2001 budgets close part of this gap through tax reforms and improved tax administration (the consolidated budget envisions total revenues rising by around one percentage point of GDP, primarily due to a revenue-positive tax reform in Serbia – see Section II.A.), but the major impact of such revenue-enhancing measures will be in the future. With consolidated revenues already close to 40 percent of GDP, and with a pending need to increase certain expenditures (including debt service), the bulk of fiscal adjustment must come from efforts to control expenditures.

5.14 *Reducing quasi-fiscal deficits.* As noted above, quasi-fiscal deficits (QFDs) in FRY have taken three main forms – the accumulation of budgetary arrears, the deferral of debt service payments, and the sustained losses of enterprises, particularly the energy utilities and banks. *The cutting of deficits coming from the enterprise sector* must be (and is being) tackled outside the budget through policies which reduce the level of such losses. The NBY has stopped granting directed credits to the agricultural sector. The large recent and proposed future increases in utility tariffs, combined with cost-cutting measures in these utilities (in particular a wage freeze at the Serbian power utility EPS), will significantly cut QFDs. However, the phased nature of tariff increases means that losses will not be entirely eliminated in the first years. To further transform these potential QFDs into more transparent budgetary costs, the government will bring part of the remaining hidden losses on budget through explicit subsidies. For this reason, the Serbian budget envisions an increase in subsidies of over one percentage point of GDP, primarily to reduce the remaining QFDs in the electricity sector.

5.15 *Managing the renewal of debt service payments.* This requires reserving budgetary resources for their repayment, coupled with efforts to restructure these debts (see Section V.E. below). The consolidated deficit for 2001 includes about one percent of GDP for the renewed servicing of FRY's public debt. As debt servicing is fully restored in future years, these expenditures will increase further, with interest costs alone rising to over 4 percent of GDP even under the most favorable assumptions about debt restructuring.

5.16 *Reducing the creation of new budgetary arrears.* This requires better alignment of cash outlays with commitments. In FRY, the largest arrears have accumulated in the extra-budgetary social funds (pensions, health and employment), particularly military pensions at the federal level, and pensions and social assistance payments at the republican level. The 2001 budget tackles these partly through first steps to control commitments (e.g. the delinking of pension from the minimum wage in Serbia and of public sector pay and social benefits from the minimum wage in Montenegro, and a review of entitlements to military pensions at the federal

²³ The BRR represents the largest part of that component of the ERTF which will be financed through the federal and republican budgets. In addition, a slightly smaller part of the ERTF (based on commitments of donor resources which could be considered firm at the time of its passage) was already included in the “core” budget.

level). However, as further progress will take time, the remainder of the adjustment will need to come from a higher but more realistic budgeting of such expenditures. The Serbian budget for 2001 includes a 1.5 percent of GDP increase in budgeted transfers to other levels of government, part of which reflects the provision of resources to social funds more in line with their expenditure commitments.²⁴ The federal budget increases expenditures for social security as a share of GDP for the same reason. The higher planned expenditures coming from such changes will increase transparency while having little impact on aggregate demand, as they primarily reflect the move to a more accurate reporting of commitments.

5.17 *Creating contingency reserves.* The large stock of accumulated explicit or implicit contingent liabilities (see Section II.A.), especially in the banking sector, can translate into actual fiscal liabilities of uncertain volume and timing. In such a setting, prudent budgeting practices include the establishment of a “general reserve” to cover the likely volume of commitments falling due during the year. The 2001 Serbian budget includes a contingency equal to about one percent of GDP. This volume may become inadequate in the event that significant resources are diverted to uses such as the compensation of frozen foreign currency deposits, especially as about one-half of this amount has already been allocated to extra-budgetary funds.

5.18 *Shifting the structure of expenditures to reflect new policy priorities and economic and social challenges.* Past budgets have been characterized by relatively high shares of expenditures on defense, police, pensions and health, and by low shares for public investments and debt service. The shares allocated to social assistance, while average by regional standards, may now be low relative to needs in the upcoming difficult period of restructuring. The 2001 federal and republican budgets work to reprioritize some of these expenditures.

- To redress the exceptionally high past shares for defense and police, the federal budget envisions a one percentage point of GDP decline in defense expenditures,²⁵ while the Serbian budget is based on a real decline in police salaries.
- To reflect a higher priority given to education, the Serbian budget envisions a 14 percent real increase in the average wage in that sector.
- To reflect the upcoming civil service reform, which will cut core public sector employment by around 6 percent in 2001, the Serbian budget envisions an additional 0.2 percent of GDP to cover the required severance payments.
- In anticipation of higher claims on social assistance in the face of economic restructuring, the Serbian budget includes about a one percentage point of GDP increase in transfers to households.

²⁴ Such increases in budgeted transfers also reflect the replacement of various earmarked levies which went to the social funds with more transparent transfers to these funds, with the previously earmarked revenues going directly into the Serbian budget.

²⁵ This is backed by measures to freeze military wages at their January 2001 levels, to reduce the length of military service from 12 to 10 months, to cut material expenditures, and to establish civilian control over execution of defense expenditures.

- To reflect the need of public institutions for additional resources after increases in utilities bills and other operating costs, the Serbian budget includes an increased allocation for “other purchases of goods and services”.

5.19 *Other priorities are included in the BRR.* The Serbian “core” budget reflects only part of the new government priorities. The rest which are less pressing for meeting basic needs, but very important for growth and enhanced social sustainability, would be included in the BRR to be financed by donors. For example, the BRR would include the bulk of the public investment and maintenance agenda. In the ‘core’ budget for 2001, planned expenditures in these areas are well below the actual levels of 2000. In the event that donor support for such needs were not forthcoming, very low public investments would reduce FRY’s growth potential. Similarly, the “core” budget includes only limited allocations to the several newly established social funds (such as the Transition Fund and the so-called One-Off Fund) designed to make one-off payments to vulnerable persons without creating permanent entitlements to such assistance. In the absence of additional donor financing for such efforts, restructuring and retraining could proceed more slowly and the social costs of dislocation would be greater. Finally, the “core” budget includes around 0.1 percent of GDP for bank restructuring, a sum which only covers the direct costs of liquidation and restructuring (salaries, severance payments for redundant bank staff, etc). No resources have been allocated to cover the financial costs associated with restructuring of banks. Pending development of a fiscally and economically sustainable bank resolution strategy, the BRR could be adjusted to include limited conditional external support for bank restructuring (see Section III.B).

C. FOREIGN TRADE AND EXTERNAL BALANCES

5.20 *Export growth.* Although exact estimates vary, exports have clearly fallen even more than GDP over the past decade. Even though the real growth of exports of goods and services is expected to outpace real GDP growth over the next few years, their recovery to historic levels is expected to take longer. Some initial growth (about 11 percent in 2001) could come primarily from the restarting trade in traditional export industries, such as textiles and food processing, and increased trade with neighbors. More rapid growth (peaking at 14 percent in 2003) will come after an increase in domestic supply capacity through private sector development, the upgrading of obsolete machinery and equipment and key repairs to public infrastructure. This development of export capacity will come over time through easier access to capital and inputs, foreign direct investment, and formal integration into the regional economy (through free trade agreements), the EU economy (through a SAA), and the global economy (through WTO accession). In the early years, the most rapid trade expansion is likely to come in the SEE markets. Export growth to the EU will become increasingly important over time, as enterprises are privatized, new firms are established, and reform and investment together support increases in product quality which increase FRY’s ability to penetrate those markets. Successful privatization to strategic investors could have a particularly large impact on exports, as international companies integrate FRY enterprises into their intra-firm trade networks. In real terms, merchandise exports are projected to recover to about 60 percent of their 1990 levels by 2006.

5.21 This export growth will be in the context of about 30 percent real appreciation over the decade from 2000 to 2010. This appreciation from the extremely depreciated levels of late-2000

(when average net wages in Serbia were around US\$50 per month), would initially come primarily from the increased confidence created by improved macroeconomic stability – as observed in other transition economies in the early to mid-1990s. In the outer years, it would come increasingly from rates of productivity growth above those observed in Western Europe.

5.22 *The current account balance.* Import growth is expected to pick up much sooner (reaching over 20 percent in 2001), driven by necessary reform and reconstruction, and by the revival of some processing trade. Along with the resumption of debt service payments, this will work to raise the current account deficit. While the high assumed grant element of donor support will mitigate these effects, the net impact will be an increase in the current account deficit from 4.4 percent of GDP in 2000 to a peak of 8.8 percent in 2002. After donor support has reached its new level, import growth rates would begin to decline. The combined effect of a higher growth rate of exports, the gradual phasing down of donor financing, and the impact of trend real appreciation (see above) on dollar GDP, would gradually bring the current account deficit down to below 5 percent of GDP in 2010, a level more associated with mature transition economies.

5.23 *The savings-investment balance.* Another way to think of the current account of the balance of payments (a measure of the inflow of foreign savings) is as the difference between gross national savings and domestic investment. From 2000 to 2004, the current account deficit is expected to rise by 3.4 percentage points of GDP. This would primarily be driven by a 7 percentage point rise in investments to 21.3 percent of GDP in 2004, reflecting the reconstruction needs in the public and enterprise sectors. Of this increase, 0.7 percentage points would come from public investments (rising to a still modest 4 percent of GDP) and 6.3 percentage points from non-governmental investments (rising to 17.3 percent of GDP).²⁶ The full rise in public investments is projected to be covered by donor resources (provided full financing of the ERTF), as would a part of non-governmental investments (through assistance to enterprises in the energy, transport, agriculture and financial sectors, and through provision of credit lines). Increasing levels of FDI would also support the growth of investment.

5.24 Over this same period, gross national savings would rise from current low levels by 3.6 percentage points to 13.5 percent of GDP.²⁷ This would be the combined effect of a 5.1 percentage point decline in recorded (*cash basis*) government savings and a 8.7 percentage point increase in non-governmental savings. As 2.1 percent of this recorded relative shift reflects the conversion of hidden deficits (budgetary arrears) into explicit government expenditures, the shifts on a *commitment basis* would be smaller. Government savings would fall by 3 percentage points, while non-governmental savings would rise by 6.6 percentage points. The latter increase would be the combined effect of consumption growing less rapidly than income, renewed confidence in domestic banks, increases in enterprise competitiveness, and curtailment of losses in the banking sector.

²⁶ Public investments in 2000 were well above levels of the past decade, primarily reflecting reconstruction efforts following the Kosovo conflict. The increase relative to recent average levels is substantially higher.

²⁷ The current account deficits of the past decade primarily reflected low levels of savings.

D. EXTERNAL FINANCING REQUIREMENTS

5.25 *The burden of external debt.* The large debt inherited by FRY at the breakup of the SFRY, plus some recent borrowings from bilateral sources, has left it with an enormous US\$12.2 billion stock of external debt (including accumulated interest arrears and penalty interest) at end-2000 (Table 5.2). Around 90 percent of this debt in arrears. Timely and significant external financing will be needed to normalize FRY's relations with external creditors, to cover the residual budgetary financing needs, to finance even a limited investment program, and to allow some rebound of imports from currently compressed levels and a buildup of foreign reserves towards prudent levels. Normalization involves debt restructuring through resolution of arrears and the timely servicing of the restructured debt. This normalization began in December 2000, with the clearance of outstanding arrears of US\$130 million owed to the International Monetary Fund and a restructuring of its debt of US\$142 million to Eurofima, the European railways' funding pool. On May 8, 2001, the World Bank's Board of Executive Directors approved FRY's membership in the Bank. One condition of this approval was agreement on a plan to resolve its outstanding arrears to the Bank. These arrears are expected to be resolved in 2001. FRY's temporary exceptional eligibility for loans on concessional IDA terms will make an added contribution to restoring its solvency.

Table 5.2: Estimated External Debt by Creditor
(end-2000, millions of US dollars)

Creditor class	Outstanding Debt	(share of total, %)	In arrears
Multilateral	2574	(21.0)	2170
o/w IBRD	1812	(14.8)	1740
o/w IMF	151	(1.2)	0
o/w Other	611	(5.0)	430
Paris Club	4567	(37.3)	4497
London Club	2809	(22.9)	2035
Other Creditors	2317	(18.9)	1831
TOTAL	12267	(100.0)	10533

5.26 While the debt inherited from SFRY was already large in the early-1990s, FRY's unsustainable debt indicators primarily reflect collapse in output and exports over the past decade. Recorded GDP in current prices declined from about US\$28.5 billion in 1990 to about US\$9 billion in 2000. Merchandise exports, including those to other ex-SFRY republics, dropped even more from about US\$5.8 to US\$1.9 billion during the same period. Debt indicators at end-2000 were extremely unfavorable. FRY's ratio of debt to GDP was 136 percent of GDP and over 480 percent of exports of goods and services.

5.27 Even with strong recovery over the next several years, these indicators are projected to remain prohibitively high.²⁸ FRY is clearly not in a position to service this full debt now or in the future, including to make net payments for several years to come. Therefore, debt restructuring is unavoidable. However, even significant deferral of payments to the outer years will leave high levels of debt servicing costs. Thus, the second element of cash flow relief will be generous *new financing*. Until private inflows are restored, which will take some time, such flows must initially come largely in the form of new official financing.

5.28 However, official financing will and should be scaled back over time. Over time, FRY's ability to service its debts while sustaining recovery will increasingly depend on its access to private financing, which is unlikely with the current stock of debt. Thus, debt restructuring also has to have a second component, namely *debt relief* to lower exposure indicators to serviceable levels. Such a workout would contribute significantly to creating the conditions for a full restoration of creditworthiness and unlocking the new private inflows needed to sustain the recovery and transition in the later years.

5.29 ***An illustrative scenario for external financing.*** An illustrative scenario shows, that a comprehensive debt restructuring, including a substantial reduction in total debt stock and debt service payments, would make a major contribution to restoring FRY's creditworthiness, and thereby to reopen its access to international resources at commercial or near-commercial terms.²⁹ This illustrative scenario takes into account the financial normalization packages offered, or to be offered, by international financial institutions in 2000-2001, and is based on the following assumptions:

- Clearance of arrears to Paris Club creditors during 2001, on terms analogous to those given to Bosnia and Herzegovina in 1998. That is, a flow rescheduling has been assumed with a two-thirds net present value reduction of arrears and current maturities. The remaining debt and maturities are assumed to be rescheduled at a market interest rate with 23 years maturity and 6 years' grace with capitalization of interest during a moratorium period lasting to end-March 2002.³⁰
- A similar net present value debt reduction and repayment schedule by London Club creditors during 2001, excluding around US\$ 500 million bought back by the NBY, and a rescheduling of all other medium- and long-term credits on the same terms.

5.30 Under this scenario, FRY's gross external financing needs will total about US\$20.6 billion during the period 2001-2005 (Table 5.3). The largest component of this amount (US\$9.6 billion, or about 47 percent) is accounted for by arrears clearance on external debt. Around US\$6.0 billion (29 percent) of this financing requirement comes from the current account deficit net of interest and official transfers but including other net factor payments. Debt service on rescheduled and new debt accounts for US\$3.7 billion, or 18 percent. Finally, the accumulation

²⁸ Under the illustrative assumption that debt is restructured without relief (on accelerated Houston terms), while growth rates remain in the 4-5 percent per year range the debt/GDP ratio declines from 136 percent in 2000 to only 113 percent in 2004.

²⁹ This illustrative scenario is not meant to prejudge the outcome of any future agreement between FRY and its external creditors in the Paris and London Clubs.

³⁰ In the near term, this scenario is also roughly equivalent to Houston terms in 2001 and the noted terms in 2002.

of international reserves to a precautionary level (2.5 months of imports in 2004) accounts for about US\$1.3 billion, or about 6 percent of the financing requirements over these five years.

5.31 These needs for the period 2001-2005 are projected to be met from several sources. Multilateral creditors, bilateral creditors and commercial creditors are assumed to finance US\$9.4 billion, or about 46 percent of the financing needs, through agreements that restructure and reduce outstanding debt stocks, and capitalize, restructure and in some cases, reduce arrears. With good progress on reforms, foreign direct investment is expected to grow rapidly from a low base, and to cover about 14 percent (US\$2.9 billion) of the financing needs over the period 2001-2005. With the assumed improvement in FRY's creditworthiness and the stabilization of the macroeconomy, other private sector finance will grow from current low levels to total around US\$3.3 billion over this period, meeting about 16 percent of financing needs. In addition, around US\$0.5 billion (around 2 percent) of these needs are expected to be met by disbursements for urgent needs which were already announced at the December 12, 2000 Donor Coordination meeting.

5.32 Even with substantial debt restructuring, rising FDI inflows, and other private finance, FRY's remaining financing requirements would still be substantial, about US\$4.6 billion (22 percent of total needs) over the five year period 2001-2005. These financial resources will need to come from official bilateral and multilateral sources. They will be crucial for FRY to meet the two equally important challenges of undertaking critical reconstruction and public investments to support growth, and of promoting macroeconomic sustainability in the difficult initial period. For this reason, the Economic Recovery and Transition Program, as outlined in Volume 2 of this report, recommends a level of commitments equal to of US\$3.9 billion during the next 3-4 years and a composition of assistance that balances these two noted objectives.

5.33 Of the estimated requirements for disbursements totaling US\$4.6 billion to close the financing gap for the five year period 2001-05, US\$1.03 billion is projected to be required in **2001**.³¹ This gap is expected to be further reduced by an amount of some US\$281 million provided by the International Monetary Fund under its Stand-by Arrangement and from structural adjustment lending from the World Bank. Of the remaining gap of some US\$750 million, more than one-half would need to be fast disbursing balance of payments/budgetary support, because given the slow pace of disbursement of project financing, only limited volumes of such financing can be expected to be disbursed in 2001.³² If this balance of payments and budgetary support were not forthcoming, the government would be forced to further compress expenditures, with obvious consequences for critical social expenditures, or to delay the pace of restructuring, with future consequences for growth.

5.34 Under this illustrative scenario, overall debt exposure indicators would decline to marginally manageable levels. For example, the ratio of debt to GDP would fall from 136 percent in 2000 to 78 percent in 2004. The ratio of debt to exports of goods and services would fall from 480 percent in 2000 to 290 percent in 2004. Furthermore, the composition of debt stock will become more favorable in terms of the degree of concessionality of the debt.

³¹ An alternative presentation which excluded the assumed US\$210 million of disbursements from support announced earlier in 2001 (discussed below), would show this financing gap as US\$821 million.

³² This US\$750 million includes some support already announced in early 2001.

Table 5.3: Federal Republic of Yugoslavia: Balance of Payments, 2001-2005 (US\$ million)

	2001	2002	2003-05 (Ann. Avg.)	2001-05 (Total)
I. Financing needs	11354	2250	2347	20645
1. Current account deficit excl. interest and official transfers	1295	1334	1127	6011
o/w deficit of resource balance	2233	2304	2198	11130
private transfers, net	890	915	977	4737
2. Debt service 1/	199	666	953	3726
a. interest	187	525	669	2720
b. principal	11	142	284	1006
3. Arrears clearance/rescheduling 2/	9643	0	0	9643
4. Change in gross reserves (+ = increase)	217	250	266	1266
II. Financing sources	10323	1150	1540	16093
1. Arrears accumulation/debt relief	9413	0	0	9413
2. Foreign direct investments	160	450	750	2860
3. Disbursements for urgent needs phase	340	160	0	500
4. Other private flows /3	410	540	790	3320
				0
III. Financing gap /4	1031	1100	807	4552
o/w IMF SBA/World Bank structural adjustment loans	281			
o/w Other donor support	750			

1/ Based on cash accounting. A presentation based on accrual accounting of debt service during the moratorium period would show higher financing needs with an equally higher level of financing sources, leaving the financing gap unchanged.

2/ Assumes Naples flow rescheduling of Paris Club debt with capitalization of moratorium interest to end-March 2002. Other official and commercial bilateral creditors, including the London Club, are assumed to provide comparable treatment. Multilateral debt is assumed to be refinanced without forgiveness.

3/ Includes commercial lending, trade credits and unrecorded capital transfers, as well as any debt restructuring of commercial credits which mature beyond 2001.

4/ From end-March 2002 onwards, the financing needs include resumption of debt service payments to bilateral official and commercial creditors. Additional debt relief beyond this period would be one source of additional financing, while debt relief on less favorable terms than assumed here would further increase the financing gap.

E. RISKS

5.35 The above scenario of a sustained rebound in growth and living standards assumes three factors working in tandem to restore FRY's creditworthiness and its access to international capital markets:

- a) government elaboration of, commitment to and delivery on a coherent, well-prioritized, and well-sequenced and medium-term program of reform and institutional strengthening;

- b) generous, promptly delivered, and well-targeted donor support for this program, including the envisioned levels of debt restructuring and relief, and financial and technical assistance;³³ and
- c) a relatively favorable external environment.

5.36 Under this scenario, however, FRY would have very little cushion to absorb any significant downside deviation in one or several of these areas. For this reason, FRY's projected recovery is associated with substantial risks. Were the daunting reform and stabilization effort to falter,³⁴ were the levels of debt restructuring/relief, donor support and inflows of private capital to fall much below projected levels, or were the external environment to deteriorate (the latter resulting in slower growth of demand for FRY exports), prospects for growth and the restoration of creditworthiness would be significantly poorer.

5.37 A number of internal risks could cause the reform effort to be delayed, for example by the relatively untested implementation capacity of the new governments, or resistance to reforms from vested interests. In the case of a delayed or weaker-than-expected reform effort, the policy framework would stagnate, and donor programs could be expected to be less generous and have a smaller impact. Real GDP growth under this scenario would be slower. Private investment would be cut as enterprise restructuring prospects decline, and exports would fall. Debt indicators, in particular, would worsen, due to lower GDP and export growth, and FRY's debt burden could become unsustainable.

5.38 On the other hand, a low case could also arise from developments exogenous to FRY, such as a inadequate levels of external financing or an economic slow-down in key trading partners. This would be likely to lead, despite the government's best reform efforts, to reduced demand for FRY's exports and reduced foreign investment. In such a scenario it would be doubly important to ensure donor support is provided. If not, imports would fall, reflecting the smaller amount of external financing. Real GDP growth could be expected to slow as under the previous scenario. A low capacity to import capital and equipment would lead to reduced investment in industry and infrastructure. Lower overall levels of investment would slow the increase in employment, creating more persistent poverty. Lower donor spending on social programs would exacerbate this effect. These illustrative scenarios indicate the importance of both a sustained reform effort and strong donor support – and the extent to which the effects of both are inter-linked.

³³ See Volume 2 of this report for a discussion of financial and technical assistance needs, and of the particular need to coordinate such assistance, both within FRY and among donors.

³⁴ This effort is daunting both in the near-term and medium-term. In the near-term, fiscal and external resources are particularly constrained in the middle of 2001, as urgent needs assistance is being phased down while new donor programs are yet to fully come on stream. More medium-term risks reflect the sustained and difficult nature of the agenda of reforms and fiscal consolidation. The delayed transition and decrepit state of physical assets will require going much beyond quick first-generation reforms and rehabilitation. As described in Section V.B, new sources of fiscal pressures will emerge as old ones are resolved. For example, even under the assumed indicative levels of debt restructuring and relief, foreign debt service is projected to rise from nearly zero to over US\$500 million in the space of one to two years.

5.39 The high sensitivity of the described economic scenario to such changes can be demonstrated by slight changes to key assumptions. First, under the assumption that debt rescheduling is on non-concessional (graduated Houston) terms, it is clear that FRY's debt burden would be unsustainable. The ratio of external debt to GDP would reach 100 percent in 2010, which is about 30 percentage points above the level in the indicative scenario above. In that same year, the debt service ratio would reach about 30 percent of exports of goods and services, which is over 11 percentage points higher than under the indicative scenario above.³⁵

5.40 Second, under the assumption that a weaker reform effort and/or a more unfavorable external environment would cause GDP to grow by 2 rather than 4 percent per year during the period 2002-2010, the ratio of external debt to GDP would actually begin to rise over time, reaching 85 percent of GDP in 2010, which is about 14 percentage points above the level in the indicative scenario above. In that same year, the debt service ratio would reach about 23 percent of exports of goods and services, which is about 5 percentage points higher than under the indicative scenario above.

5.41 The fragility of FRY's recovery under the proposed program reinforces the fact that the ERTF represents a very minimum of required reform effort and donor support. Providing a greater cushion for FRY's recovery would require additional levels of donor support, either through further debt relief or through additional new financial support. Finally, it needs to be noted that the levels of risk described above are well below those which would characterize scenarios of lower reform effort and donor support, and should thus not obscure the important contribution made by the joint efforts of the FRY authorities and the donor community in implementing the ERTF.

³⁵ The actual impact would be even greater, as these simulations assume unchanged real growth rates. In fact, the resulting lower level of creditworthiness would be expected to cut the levels of GDP and exports, which would further worsen the described ratios.