THE REPUBLIC OF SERBIA

COUNTRY PARTNERSHIP STRATEGY

I. INTRODUCTION

1. **Serbia has made significant progress since beginning a wide ranging program of democratic and economic reforms in 2001.** Macro-economic stability has been restored, and incomes have risen strongly. GDP per capita, estimated at $2,200 in 2002, is now approaching $5,400. Poverty has fallen from 14.6 percent of the population to about 8.8 percent. Serbia is now well placed to move forward toward integration with Europe, having completed technical discussions on a *Stabilization and Association Agreement*. At the time of Serbia's accession to Bank membership in 2001, analysis was focused on the importance of breaking with the past. Now, however, the theme of this partnership strategy might more appropriately be seizing the future.

2. **A challenging reform agenda remains if Serbia is to fulfill its potential**. Increasing competitiveness and attracting further investment is key to creating more jobs while maintaining strong growth. Serbia was one of the last countries in the Western Balkans to embark on the transition agenda. Progress has been significant, as evidenced in the major improvements in the business environment that saw Serbia ranked as the top reformer globally in *Doing Business 2006,* for reforms in 2004-2005. This reform program has helped to underpin the country's strong economic performance and reductions in poverty. Still, further reforms to strengthen the environment for sustained private sector led growth – including structural reforms and privatization - will be vital to ensure living standards continue to converge with those in Europe. Particular efforts will be required to ensure that all people in Serbia have the opportunity to participate in and benefit from growth, including the large number of poor in rural areas, among minority groups, and in depressed regions formerly home to large industrial and mining industries. Further strengthening democratic institutions, public spending, the rule of law, and overcoming remaining political legacy issues will also be required.

3. **The proposed Country Partnership Strategy (CPS) builds on the experience of the World Bank Group in supporting Serbian Government led reform efforts since 2001**. The CPS aims to harness all parts of the World Bank Group, including IFC and MIGA, to support Serbia build on the progress of the past few years. Reflecting Serbia's strong economic progress, this CPS comes at a time of Serbia's graduation to IBRD. This will require the Bank to work even more closely with the Authorities to ensure that the Bank program is demand driven and focused on supporting the Government's own reform program. Over time, all parts of the Bank Group, including IFC, MIGA and WBI, are likely to play an increasingly central role in the Bank Group's program. The CPS aims to support the Government's key priorities, and is focused around the key, and inter-related, themes of (i) convergence with EU living standards through private sector led growth, (ii) broadening participation in growth; and (iii) managing emerging environmental and disaster risks.

II. COUNTRY CONTEXT

A. Political Background and Recent Developments

4. **The past few years have seen a degree of relative political stability in Serbia**. Parties from the 'democratic bloc' – in varying combinations – have provided the foundation for government since President Milosevic was forced to step aside in 2000. Democratic institutions have been strengthened. The current Government includes President Tadic's Democratic Party (DS), Prime Minister Kostunica's

Democratic Party of Serbia (DSS) and the G17+. This followed Presidential elections in 2004, and Parliamentary elections in January 2007. The Government is based on a new Serbian Constitution, adopted by national referendum in November 2006, following the dissolution of the State Union of Serbia and Montenegro in June 2006. Reflecting a growing political maturity in the Balkans, the dissolution of the State Union itself followed a democratic process, was generally smooth, and entirely peaceful – unlike the break-up of the former Yugoslavia in the 1990s. Under the terms of the new Constitution, Presidential elections need to be called before the end of 2007, and this could result in a degree of political uncertainty in the short term.

5. **Still, political differences remain evident**. The formation of a Government in early 2007, for instance, took several months of difficult negotiations between the parties. Similarly, although President Tadic and Prime Minister Kostunica have each been in their current offices since elections in early 2004, the changing formation of the governing coalition over the past few years (this is now the fourth Government since 2000), highlights the differences between the parties of the 'democratic bloc'. Divisions in society are also reflected in overtly nationalist parties continuing to win a significant minority of seats in Parliament, with the Serbian Radical Party the largest single party in Parliament.

6. **Advancing European integration is a stated priority of the Government, and major progress was made with the initialing of a Stabilization and Association Agreement (SAA) in early November 2007**. European integration is an objective supported by almost two thirds of society. The initialing of the SAA follows almost two years of negotiations, which started in October 2005. European Foreign Ministers initially set out principles for a European future for the Western Balkan countries at a Summit in Thessaloniki in 2003. Ministers reiterated this vision in Salzburg in June 2006, although noting that the European perspective for the Western Balkans needs to be considered in light of the European Union's absorptive capacity. Nevertheless, the political situation and the EU accession process in Serbia remains influenced by recent history. While an SAA has been initialed, signing and ratification will still take several months, and is likely to require Serbia to demonstrate even closer cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY). Still, Serbia's strong administrative capacity may allow quick progress towards candidacy status once political issues are resolved.

7. **Serbia is taking an active role in a range of international and regional initiatives**. At the regional level, Serbia is a signatory to Energy Community of South East Europe Treaty, which creates legal framework for an integrated energy market in the region. Serbia has recently ratified the Central Europe Free Trade Agreement (CEFTA), which replaces 32 bilateral free trade agreements and aims to establish a free trade zone in the region by the end of 2010. Serbia participates in the Stability Pact for South Eastern Europe. At the global level, Serbia has recently ratified the Kyoto Protocol, and is expected to have completed requirements to join the World Trade Organization in 2008

8. **The status of Kosovo has become an increasingly prominent issue in political discourse in Serbia**. Under United Nations Security Council Resolution 1244, Kosovo is a province of Serbia under the autonomous administration of the United Nations (Throughout the CPS the province is referred to as "Kosovo"). Efforts to reach a long term negotiated solution to Kosovo's status are currently being conducted under the auspices of the Contact Group, with a troika of negotiators from Germany (on behalf of the EU), the United States, and Russia. At this stage, the Kosovo and Serbian sides appear to have fundamental differences of views on how the situation should be resolved. Achieving a negotiated solution is likely to be extremely difficult. All parties in the Serbian governing coalition remain united that independence for Kosovo is not appropriate.

B. Recent Economic Developments in Serbia

9. **After significant declines in the economy during the late 1980s and 1990s, reforms in Serbia since 2000 have resulted in renewed growth and the restoration of macro-economic stability.** In the past five years, growth has averaged approximately 5.5 percent per annum, and should reach 7.0 percent in 2007. Growth has been driven primarily by strong domestic demand. Consumption has particularly underpinned growth over the past five years, although the rate of increase is starting to slow. More recently, strong export performance has also supported growth. Investment has remained about 22 to 23 percent of GDP – a relatively solid performance, although below the level of the fast-growing transition economies, where investment shares have been about 30 percent (Bulgaria, Croatia, Slovakia) or higher (Estonia). Service sectors have particularly grown strongly. Growth in agriculture and industry was volatile and on average slower. Key macro-economic figures are set out in Table 1.

10. **Renewed growth has been underpinned by significant reform.** Stabilization measures introduced after 2000 have brought the hyper-inflation of the 1990s under control. A series of tax reforms since 2001 (including introduction of VAT in 2005) have created a more efficient and simpler tax system which has strengthened the revenue base. Extensive restructuring of the banking system has helped to improve the allocation of capital, and access to credit. The privatization of about 1,800 socially owned enterprises has given new life to sometimes moribund companies, and reduced the demand for state subsidies. Reflecting progress, Serbia was rated by the Bank's *Doing Business 2006* report as the top reformer in 2004-2005. Gains are particularly evident in major reductions in the time and cost required to start a business, which resulted in 40 percent more businesses being registered in 2005 compared to 2003, as well as a new civil procedure code that halved the time required to resolve business disputes. Serbia's rating slipped slightly in the 2008 report, as the reform agenda slowed in the lead up to elections and as other countries pushed ahead with reform. Governance indicators for Serbia also continue to improve, although from a low base, particularly perceptions of strengthened rule of law and control of corruption[1]. There was significant public sector reform including much improved public expenditure management with the passage of a number of critical laws including on budget systems, procurement and debt management and strengthening of institutions notably in Treasury. A public administration reform strategy is being implemented that lays the foundation for a shift to a merit-based and de-politicized civil service and for the rationalization of government structures. A reform of the pension system moves the system towards long run sustainability, and the ongoing health sector reform is one of the best in the region.

11. **Growth has flowed through to improvements in living standards for most Serbians.** In USD terms, GDP per capita has risen from about $2,700 in 2003 to just under $4,300 in 2006, with GDP per capita projected to be over $5,400 in 2007. Latest World Bank poverty measures suggest that the proportion of the population living below an absolute poverty line (roughly $2.15 per day) has fallen significantly during the CAS FY05 period, from 14.6 percent in 2004 to 8.8 percent in 2006. Nevertheless, poverty remains a persistent problem in rural areas, which are home to about two thirds of all poor people in Serbia. This is particularly evident in depressed regions that used to be home to major industries (often extractive and industrial) during the Yugoslav period. Poverty also remains very high among minority groups, with over half of the Roma population estimated to live in poverty. Real gains in poverty reduction, however, are accompanied by continued pessimism among much of the population, in part because average incomes are just returning to the high point reached during the late 1980s. Unemployment also remains a continuing problem, at about 20 percent of the labor force.

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[1] World Bank Institute, *Governance Matters 2007: A Decade of Measuring the Quality of Governance*, July 2007.

Table 1: Serbia – Key Economic Indicators

Key Economic Indicators					Estimated	Projected
Indicator	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Economy						
GDP, bln USD	15.8	20.3	24.5	26.2	31.8	40.8
GDP per capita, USD	2,107	2,719	3,285	3,511	4,245	5,435
GDP real growth	4.2	2.5	8.4	6.2	5.7	7.0
National accounts (%GDP)						
Consumption	102.3	96.2	100.1	99.6	97.9	98.6
Investments	17.2	22.6	23.6	22.5	21.9	22.1
Export of goods and services	18.7	21.4	22.7	25.2	27.0	28.2
Import of goods and services	38.3	40.2	46.3	47.3	46.8	49.0
Public finances						
Public Revenues, %GDP	39.1	40.5	41.4	41.3	40.7	41.2
Public Expenditures, %GDP	43.4	43.7	41.4	40.6	42.3	42.5
Fiscal balance, as %GDP	-4.3	-3.2	0.0	0.7	-1.5	-1.3
Prices						
Inflation (eop)	14.8	7.7	13.7	17.7	6.6	8.8
Core inflation (eop)	5.9	5.4	10.3	14.5	5.9	4.5
Balance of Payments						
Export, mln USD	2,420	3,150	4,082	4,971	6,487	8,585
Import, mln USD	5,440	7,340	10,551	10,260	12,716	17,086
CAD after grants, as %GDP	-8.8	-7.0	-11.7	-8.5	-11.5	-14.6
FDI, as % GDP	3.0	6.7	4.0	5.9	13.7	3.7
Gross official reserves, mln USD	2,280	3,550	4,245	5,843	11,888	13,700
Debt						
External debt, %GDP	70.9	66.7	57.5	59.0	61.3	59.6
Public debt, as %GDP	76.4	68.4	53.7	46.4	39.6	35.8
Monetary						
M2, as %GDP	12.1	11.4	11.2	11.8	14.2	..
Net domestic credit as %GDP	18.1	19.5	24.4	28.0	23.8	22.3
Credit to private sector, as %GDP	17.8	20.3	23.9	29.6	28.5	28.0
Average exchange rate, RSD/USD	64.4	58.8	58.4	66.7	66.9	..
Average exchange rate, RSD/EUR	60.7	65.1	72.7	83.2	84.1	..

Source: IMF, World Bank staff and authorities' estimates.

12. **Despite Serbia's strong growth performance, significant challenges remain.** External weaknesses are apparent in double-digit and expanding current account deficits. External debt remains about 60 percent of GDP, despite past London and Paris Club debt write downs. Although public debt has declined significantly, private external liabilities continue to grow quickly. Surging capital inflows and large current account deficits have unsettled the focus of monetary and exchange rate policies, which have alternated between disinflation and exchange rate objectives. Although policy action will be

required to address external weaknesses, Serbia's reserves position is currently very comfortable as a result of strong private sector inflows including foreign direct investment. FDI averaged 6.7 percent of GDP over the last 5 years, resulting in Serbia being among the top countries in Europe and Central Asia with respect to attracting such investment. FDI was especially strong in 2006, as a result of several large privatization deals, including the sale of a mobile telephone operator. Nevertheless, the privatization agenda remains unfinished. Greater greenfield FDI would also be useful.

C. Developments in Poverty Reduction, Social Issues and MDGs

13. **Poverty has fallen over the past four years, from about 14.6 percent of the population in 2004, to 8.8 percent in 2006.** Serbia is on track to meet the target, set out in its 2003 Poverty Reduction Strategy (PRS), to reduce poverty to 6.5 percent by 2010. Despite the significant decline in poverty, however, this needs to be seen in the context of Serbia only recently returning to the income and poverty levels enjoyed in the late 1980s. Partly because of this, a degree of pessimism is still evident[2].

14. **Serbia seems well-placed to meet most, if not all, the MDG targets by 2015.** Primary school completion rates are over 95 percent, and in terms of statistics do not differ significantly by gender. The proportion of the population with access to an improved water source is higher than the average for ECA countries, as is the share of the country's population with access to sanitation systems. Infant and child mortality rates in Serbia were quite low to start with in 1990 and have continued to fall since then, indicating the country is on track to achieve this MDG.[3] Finally, with regard to the arresting the spread of communicable diseases, prevalence rates of diseases like malaria, tuberculosis, and HIV/AIDS are quite low, though warrant close monitoring, particularly for vulnerable and high-risk groups.

15. **Regional differences in poverty, with particularly high levels of unemployment in former industrial centers, remain a particular challenge.** Unemployment remains stubbornly high at about 20 percent of the labor force, and poverty and unemployment are closely linked. Despite high economic growth in the country overall, poverty remains especially evident in rural areas (such as parts of Vojvodina and Central Serbia) and in depressed former mining and industrial regions (such as Bor and Resavica). As well as high unemployment, there appears to be a significant number of "working poor" in such regions. A large number of people in low wage jobs, often in the gray economy, remain just above the poverty line, and vulnerable to unexpected economic shocks (such as loss of employment). Poverty is also strongly correlated with education: highly educated workers enjoy considerable wage advantage compared to those with less education and lower skills. Raising employment rates, and worker productivity and wages, through a comprehensive approach, including by promoting mobility of workers from declining to growing sectors, and upgrading the education and training system to produce a highly-skilled and flexible workforce, are important challenges facing policymakers in the country.[4] Other challenges include very high levels of poverty among minorities, especially Roma, as well as a rapidly aging population, which will have implications for the healthcare system and the fiscal sustainability of the pension system.

III. COUNTRY DEVELOPMENT AGENDA AND OUTSTANDING PRIORITIES

16. **The key economic priorities of the new Government are set out in the *Memorandum on the Budget and Economic and Fiscal Policy for the Year* (July 2007) and the 2008 Budget (November 2007).** Priorities outlined in these documents are set within the Serbia's strategy for EU integration,

[2] In Serbia, for instance, only 20 percent of the population currently feels that the economic situation is better than in 1989, compared to almost 40 percent in other Eastern European transition economies.
[3] See http://www.prsp.sr.gov.yu/download/mdg_2002_eng.pdf The MDGs: How much is Serbia on track?
[4] World Bank 2006: Serbia Labor Market Assessment, Report No. 36576-YU, World Bank, Washington DC.