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THE INTERNATIONAL DEVELOPMENT ASSOCIATION

AND

THE INTERNATIONAL FINANCE CORPORATION

COUNTRY ASSISTANCE STRATEGY

FOR

SERBIA AND MONTENEGRO

November 19, 2004

South East Europe Country Unit
Europe and Central Asia Region, ECA

Southern Europe and Central Asia
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(Exchange Rate Effective October 7, 2004)
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CSD 1.00 = US$0.173
US$1.47 = SDR 1.00

GOVERNMENT'S FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Assistance
AML	Anti-Money Laundering
BIDFacility	Balkan Infrastructure Development Facility
BRA	Banking Rehabilitation Agency
CAS	Country Assistance Strategy
CIDA	Canadian International Development Agency
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
CPOT	Costanza-Pancevo-Omisalj-Trieste (pipeline development)
CPPR	Country Portfolio Performance Review
DFID	Department for International Development
DM	Deutsche Mark
DPC	Development Policy Credit
DREPR	Danube River Enterprise Pollution Reduction Project
EA	Extended Arrangement
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
ERTP	Economic Reconstruction and Transition Program
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FIU	Financial Intelligence Unit
FRY	Federal Republic of Yugoslavia
FSAP	Financial Sector Assessment Program
GDLN	Global Development Learning Network
GDP	Gross Domestic Product
GEF	Global Environment Facility
IBRD	International Bank for Reconstruction and Development
ICA	Investment Climate Assessment
ICTY	International Criminal Tribunal for the former Yugoslavia
IDA	International Development Association
IDF	Institutional Development Fund
IDPs	Internally Displaced Persons
IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
JPR	Joint Portfolio Review
MDG	Millennium Development Goals
MEM	Montenegro Economic Memorandum
MESTAP	Montenegro Environmentally Sensitive Tourist Areas Project
MIGA	Multilateral Investment Guarantee Agency

MOF	Ministry of Finance
NBFI	Non-Bank Financial Institutions
NGO	Non-governmental Organization
OECD	Organization for Economic Cooperation and Development
PDPL	Programmatic Development Policy Loan
PEIR	Public Expenditure and Institutional Review
PFM	Public Financial Management
PFSAC	Private and Financial Sector Adjustment Credit
PIO	Pension Fund
PIU	Project Implementation Unit
PMU	Portfolio Management Unit
PRSP	Poverty Reduction Strategy Paper
PSAPT	Private Sector Advisory Service
PSD	Public Sector Development
SAC	Structural Adjustment Credit
SAA	Stabilization and Association Agreement
SaM	Serbia and Montenegro
SAP	Stabilization and Association Process
SEE	South Eastern Europe
SEED	Southeast Europe Enterprise Development
SEM	Serbia Economic Memorandum
SFRY	Socialist Federal Republic of Yugoslavia
SIEPA	Serbia Investment and Export Promotion Agency
SME	Small and Medium-Sized Enterprises
SMECA	Serbia and Montenegro Export Credit Agency
SOSAC	Social Sector Adjustment Credit
STIs	Sexually Transmitted Infections
TA	Technical Assistance
TB	Tuberculosis
TFFRY	Trust Fund for Federal Republic of Yugoslavia
TSS	Transitional Support Strategy
TTFSE	Trade and Transport Facilitation in Southeast Europe
UN	United Nations
UNDP	United Nations Development Program
UNEP	United Nations Environment Program
UNICEF	United Nations Children's Fund
UNMIK	United Nations Mission in Kosovo
USTDA	United States Trade and Development Agency
UVB	Udruzena Vojvodjanska Banka
VAT	Value Added Tax
VB	Vojvodjanska Banka
VLE	Virtual Learning Environment
WBI	World Bank Institute
WTO	World Trade Organization
ZOP	Clearing and Settlements Bureau

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SERBIA AND MONTENEGRO: COUNTRY ASSISTANCE STRATEGY

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EXECUTIVE SUMMARY

i. **The proposed FY05-07 CAS builds on FY02-04 Transitional Support Strategy (TSS) program and is designed to support the implementation of the European Union (EU) Stabilization and Association process (SAP) and the Poverty Reduction Strategy Paper (PRSP).** Serbia and Montenegro (SaM) – formerly the Federal Republic of Yugoslavia (FRY) – succeeded to the membership of the former Socialist Federal Republic of Yugoslavia (SFRY) in the Bank in May 2001. Since then, Bank Group assistance has been provided through a TSS program, supporting the Government's efforts to transform SaM into a market economy and to lay the foundation for sustainable medium-term growth. Building on the TSS program, the new CAS supports the implementation of two complementary government strategies: the SAP and the PRSP. Together, these strategies present a comprehensive reform agenda designed to achieve sustainable long-term growth and poverty reduction, with the ultimate goal of European integration. While the issues and challenges are presented in different ways in the two strategies, this reform agenda can be summarized in the three broad, inter-related medium-term country (and republican) goals around which the CAS is built:

- Goal 1: creating a smaller, more sustainable, more efficient public sector;
- Goal 2: creating a larger, more dynamic private sector; and
- Goal 3: reducing poverty levels, and improving social protection and access to public services.

ii. **While SaM has made good progress on macroeconomic stabilization and structural reform over the past four years, further fiscal adjustment and renewed efforts on structural reforms are necessary to bolster macroeconomic stability and lay the foundation for sustainable growth.** Building on earlier reform efforts, particularly in Montenegro, the country launched an ambitious reform program in early 2001 aimed at macroeconomic stabilization, rapid transition to a market economy, the normalization of relations with foreign creditors, and integration with regional, EU and world markets. Although progress in some areas was slower than desired, implementation of this reform program, together with substantial donor support, has helped to sustain positive economic growth since 2000. At the same time, however, there is cause for concern, particularly with respect to the growing current account deficit (which has increased from 3.9 percent of GDP in 2000 to a projected 10.7 percent of GDP in 2004) and the resurgence of inflationary pressures in 2004 (inflation is projected at 12-13 percent in 2004). Addressing these issues and meeting the three country goals on which the CAS is built will require a high quality fiscal adjustment (with cuts in the public sector wage bill, subsidies and net lending, and transfers) coupled with an acceleration and deepening of structural reforms, including restructuring and privatization.

iii. **Against this background and consistent with SaM's goals, the CAS will support far-reaching structural reforms in the public and private sectors, while seeking to ensure that poverty is reduced, social protection is adequate and appropriately targeted, and access to social services by the poor and vulnerable is improved.** To ensure a self-sustaining economy and fiscally sustainable public sector in the medium and long term, the CAS program strives to help the republican Governments to strengthen institutions (with institution and capacity building embedded in all planned activities) and to reduce the weight of the public sector in their economies. This is a prerequisite for giving the private sector room to grow, thereby stimulating productive activity,

domestic private and public savings, and export growth. In Serbia, the Bank's efforts will concentrate on parallel Programmatic Development Policy Loan (PDPL) programs, one focused on public sector reform (including public administration reform and pension reform) and the other on private sector development (including enterprise and financial sector restructuring and privatization and energy sector reform). The measures envisaged under the PDPL programs, and development policy support in Montenegro, together with other assistance from the World Bank Group (WBG) and complementary assistance from other development partners, should, if implemented effectively, translate into economic growth and employment creation.

iv. **In recognition of the unusual country circumstances and the success of the IDA program to date, SaM's exceptional and temporary eligibility for IDA resources on modified terms has been extended to FY05-07 to allow for the establishment of creditworthiness for limited IBRD borrowing, thereby facilitating a smooth transition from IDA to IBRD.** At the same time, however, the amount of IDA resources allocated to SaM over the CAS period is envisaged to be much lower than the US$540 million three-year TSS envelope, making the establishment of creditworthiness for limited IBRD borrowing essential to ensure adequate lending resources to assist SaM in meeting the three country goals on which the CAS is built. The IDA envelope for the FY05-07 CAS period is expected to be US$225 million. If creditworthiness is established, these funds would be supplemented by US$175 million of IBRD lending under the base case and US$325 million under the high case, bringing the total base and high case IDA/IBRD lending envelopes to US$400 million and US$550 million, respectively.

v. **In addition to lending and AAA from the Bank (IBRD and IDA), the CAS program envisages continued strong support from IFC.** IFC's program will complement the Bank's program by focusing on development of the financial sector, post-privatization support to selected enterprises, private sector participation in infrastructure, and private sector investments in selected sectors. In infrastructure, for example, IFC will work closely with the Government and the Bank to explore opportunities for private sector financing through public private partnerships, provide technical assistance and pre-privatization support, and help public sector entities attract private investment through its Balkans Infrastructure Development Facility. IFC will also continue its large donor-supported technical assistance program that aims to enhance the development impact of its investment activities; improve the business environment for SMEs; assist domestic companies in meeting EU standards; facilitate the development of domestic financial markets through institution-building and the use of innovative financial products; and provide restructuring and privatization support.

vi. **While SaM is vulnerable to exogenous shocks, the main risk over the CAS period is slippage on the reform agenda, which could, in turn, complicate the medium-term macroeconomic and growth outlook.** The political will to implement difficult reforms in both republics remains highly vulnerable to the shifting relations within the respective ruling coalitions, as well as to relations between the two republics. This political commitment will be tested over the CAS period in both republics by the need to undertake measures that result in durable cuts in non-interest current expenditures, while increasing public investment. Compounding the impact of SaM's complex political economy on the pace of reforms are significant capacity constraints on implementation of economic legislation and regulations. Against this background, guarding against "reform fatigue," while maintaining strong progress on reforms necessary to underpin fiscal sustainability and sustainable medium-term export-led growth, will be essential to maintain the momentum on the reform agenda. Other factors that could complicate the reform process over the CAS period include a potential referendum on the continuation of the state union, developments in Kosovo and southern Serbia, failure to satisfy key partners on the depth and pace of cooperation with

the International Criminal Tribunal for the former Yugoslavia, vested interests at all levels of government (including local and municipal governments), and additional complexities arising from new, constitutionally-mandated, state-level structures.

vii. **These risks notwithstanding, SAM's impressive track record of solid policy performance in the wake of important political events bodes well for the outcome of the overall reform program during the CAS period and for building the level of confidence essential to fostering growth and investment.** Based on this experience, despite formidable challenges ahead, slippage on major components of the reform agenda is considered unlikely. Ongoing engagement of the international community, especially in the form of an increasingly robust portfolio of long-term lending, will help to ensure continued progress. At the same time, focusing WBG assistance at the republican level is appropriate given the uncertainties surrounding the duration of the state union of Serbia and Montenegro.

SERBIA AND MONTENEGRO

Memorandum to the Executive Directors of the IDA and IBRD
Country Assistance Strategy (FY05 – 07)

I. Introduction

1. **Serbia and Montenegro (SaM) - formerly the Federal Republic of Yugoslavia (FRY) - succeeded to the membership of the former Socialist Federal Republic of Yugoslavia (SFRY) in the Bank[1] in May 2001.**[2] Initial Bank Group support was provided in two stages. The first phase provided pre-membership support of US$30 million through the World Bank Trust Fund for FRY (TFFRY). The second phase, outlined in a Transitional Support Strategy (TSS), provided a three-year program of support for the Economic Reconstruction and Transition Program (ERTP), financed through a temporary and exceptional IDA allocation of US$540 million.[3] In addition, over this period, IFC provided commitments of US$43 million in support of private sector development. TSS Updates in 2002 and 2004[4] described progress on implementation and laid out annual lending plans.

2. **The proposed FY05-07 CAS is built on the two complementary government strategies (shared by both republics): the European Union (EU) Stabilization and Association process** (SAP) **and the Poverty Reduction Strategy Paper (PRSP).** With a shared ultimate objective of EU integration, these two strategies present a comprehensive reform agenda designed to achieve sustainable long-term growth and poverty reduction. This reform agenda can be summarized in three broad, inter-related medium-term country goals: (i) creating a smaller, more sustainable, more efficient public sector; (ii) creating a larger, more dynamic private sector; and (iii) reducing poverty levels and improving social protection and access to public services. The CAS aims to support the authorities in achieving these goals through a carefully selected mix of Bank (IBRD and IDA) and IFC financing and other World Bank Group (WBG) activities.

II. Country Context—Progress since the Transitional Support Strategy

A. Political Background and Recent Developments

3. **In February 2003, FRY completed a constitutional transition to the state union of Serbia and Montenegro**. In line with the February 2002 Belgrade Agreement and the 2003 Constitutional Charter (Charter), a state union composed of the Republic of Serbia and the Republic of Montenegro was established with a common presidency, parliament, council of ministers, and foreign and defense policies. The union provides for republican autonomy in most areas of economic policy, including currencies, central banking, and tax regimes. Also, it was anticipated that the republics would implement separate, but partly harmonized, trade and customs regimes with a view towards eventual integration with Europe.

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[1] The "Bank" refers to the IBRD and IDA; the "World Bank Group" refers to the Bank, IFC, FIAS and MIGA.
[2] On March 14, 2002, an accord ("Belgrade Agreement") setting out the general framework for a union between the Republic of Serbia and the Republic of Montenegro was signed by federal and republican authorities. Under this accord, on February 4, 2003, the Federal Republic of Yugoslavia (FRY) completed a constitutional transition to the union of Serbia and Montenegro (SaM). All historic references to FRY may be considered to refer to SaM. This CAS does not cover the province of Kosovo, which remains under UN administration according to UN Security Council Resolution UNSC-1244.
[3] See *Transitional Support Strategy* (R22090-YU, June 26, 2001).
[4] See *Transitional Support Strategy Updates* (R24476-YU, July 18, 2002, and R27048-YU, February 18, 2004).

4. **The requisite union-level institutions were reconfigured or established, including a parliament, and the union has been operational since the Charter was effected.** The provisos of the Belgrade Agreement allow for a referendum on continuation of the union after three years of implementation, and some key figures have indicated a desire to put the issue to a referendum. To date, union-level parliamentarians were elected by party representation. Direct elections for the parliament are slated for early 2005, but various constituencies advocate advancing a referendum on union continuation, rather than holding union-level elections.

5. **Since March 2003, the Republic of Serbia has undergone a series of elections (three presidential, two parliamentary, and one municipal legislative and mayoral).** In June 2004, in a third round of presidential elections, Boris Tadic, a pro-western reformer, was elected President of the Republic of Serbia. Since then, President Tadic has set about realizing his pledge to get Serbia ready for EU membership, stressing the need for broad-based reforms to stimulate private sector development and encourage foreign direct investment. Although President Tadic's Democratic Party (DS) has not joined the ruling four-party minority coalition, it has maintained generally good working relations with the coalition, supporting some key elements of the reform agenda in parliament. However, early in the fall, differences of views on the question of ethnic Serb participation in the October elections in Kosovo strained relations between the DS and Prime Minister Vojislav Kostunica's Democratic Party of Serbia (DSS). Despite a difficult political backdrop and weak administrative capacity, the governing coalition has managed to maintain remarkably strong policy performance.

6. **At the local level, voters went to the polls on September 19, 2004, to elect deputies for 148 municipalities.** Mayors of Belgrade, Novi Sad, Nis, and Kragujevac were contested for the first time through direct elections. These elections were particularly significant given the increased autonomy and power that the new Law on Self Administration grants to the municipalities. The DS and the Serbian Radical Party (SRS) received the highest shares of the votes. Serbia's new Constitution is in the final drafting stages and is expected to be submitted for parliamentary approval in early 2005 (the adoption process could be protracted, however, as a two-thirds majority in parliament is required as well as a referendum). Serbian parliamentary elections are expected to be held after the adoption of the new Constitution, but could be advanced.

7. **Since 2002, Montenegro's ruling coalition has held a dominant position, while the opposition parties have boycotted parliament. Since early fall, there has been some movement toward the opposition's return to the legislature.** Despite the Government's strong parliamentary base in 2004, the reform agenda has advanced more slowly than expected. While some important pieces of legislation have been enacted, policy has tended to be formulated on an ad hoc basis. Most domestic attention has been focused on harmonization disputes with Serbia and independence prospects, with some political leaders calling for early negotiations with Serbia on the future of the state union. Montenegro's new constitution is scheduled for parliamentary submission in 2005.

8. **In addition to the question of the durability of the state union, other pressing challenges during the CAS period include realizing significant progress on the SAP.** This process has stalled due to problems with the functioning of the state union and lack of action on the internal Market and Trade Action Plan (see Annex 1), as well as political uncertainty stemming from the parliamentary and presidential elections in Serbia. Recently, the EU endorsed a "twin track" approach to SaM, indicating willingness to deal directly at the republican level on issues relating to trade, customs, and economic and sectoral policies, within the overall framework of the state union. This should help to reinvigorate progress on the SAP agenda (see paragraphs 23-24). SaM faces two additional challenges. First, the depth and pace of cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY) is currently considered inadequate by some key

partners, leading to some delays and reductions in donor assistance programs. Second, the challenge of Kosovo's final status remains to be determined, all the more pressing in view of the resurgence of violence in Serbia and Kosovo in March 2004.

B. Recent Economic Developments

9. **SaM began the 1990s relatively well integrated with the world economy, and with a higher standard of living than many other transition economies.** However, armed conflicts, international sanctions, and trade shocks stemming from the break-up of the Socialist Federal Republic of Yugoslavia (SFRY) during the 1990s had a detrimental effect. Combined with economic mismanagement, these events resulted in hyperinflation and a virtual collapse of the economy. By 2000, recorded per capita GDP had fallen to below one half of its 1989 level. Foreign trade volumes also fell noticeably, while the country experienced chronic high inflation. Real earnings declined significantly, with absolute poverty roughly doubling since 1990; social protection and health services deteriorated as available financing fell below entitlement levels; and external debt grew to 132.6 percent of GDP in 2000 (reflecting both arrears accumulation and the fall in GDP discussed above).

10. **Progress on structural reforms has generally been good.** By early 2001, both republics had embarked on strong reform programs. Indeed, in January 2001, the country launched an ambitious program aimed at a rapid transition to a market economy, the normalization of relations with foreign creditors, and integration with regional, EU, and world markets. The Government's (SaM) economic program rested on three pillars: (i) prudent macroeconomic policies; (ii) market-oriented structural reforms; and (iii) the mobilization of significant financial and technical support from donors. In addition to establishing macroeconomic stability, progress made on this agenda includes opening the economy, restructuring the banking sector, and adopting legislation in many areas aimed at harmonization with the EU. Nonetheless, the remaining reform agenda is substantial. Indeed, a report, entitled "Recent Progress on Structural Reforms," prepared by the Bank for the Donor Coordination Meeting in November 2003, identified the following areas where progress has been slower than desired: (i) improving the private sector incentive framework; (ii) strengthening the productive, financial, and infrastructure sectors; and (iii) reforming the public sector.

11. **Macroeconomic stability, good progress on structural reforms, and significant donor support have helped to sustain positive economic growth since 2000.** Following a sharp contraction in 1999, owing mainly to the Kosovo conflict, SaM's GDP grew by 5.5 percent in 2001 and 4 percent in 2002.[5] However, real GDP growth slowed to 3 percent in 2003 (compared with a program target of 3.5 - 4.5 percent) for two main reasons. First, implementation of structural reforms and overall economic activity were adversely affected by political uncertainty resulting from the assassination of Serbian Prime Minister Zoran Djindjic in March 2003 and the decision to hold early elections in December 2003. Second, agricultural output suffered because of the drought in northern Serbia, while industrial output growth was dampened by pre-privatization uncertainties, coupled with insufficient investment and a general lack of competitiveness. GDP growth is expected to recover to around 6 percent in 2004, bolstered by a recovery in industry (due to accelerated privatization in 2003), strong growth in services, and a rebound in agricultural output.

12. **Despite positive growth, unemployment in Serbia has increased.** Similar to the experience of other countries in transition, Serbia has experienced the problem of "jobless growth." This phenomenon mainly reflects labor hoarding during the 1990s that, as a result of ongoing

[5] Serbia accounts for about 93 percent of SaM's economy.

privatization and restructuring efforts, has been converted into open unemployment. The Labor Force Survey (LFS)-based unemployment rate increased slightly from 9.6 percent in 2000 to 11.1 percent in 2002.[6] Based on preliminary data from the LFS for 2003, this increase appears to have been sustained. Registered unemployed is much higher than suggested by the LFS, reflecting incentives to register at the Labor Market Bureau. Importantly, registered unemployment started declining in 2003 for the first time since the late 1980s.

13. **The exchange rate-based stabilization program has been very effective in reducing inflation, but inflationary pressures increased in 2004.** Retail price inflation declined from 113.5 percent in 2000 to 14.2 percent in 2002 and further to 7.6 percent in 2003. Although the nominal exchange rate of the dinar to the DM/Euro remained broadly stable and unified during 2001 and 2002, it depreciated (appreciated) against the Euro (USD) by 11.1 percent (7.4 percent) in 2003 compared to end-December 2002. As a result of higher electricity prices, more flexible exchange rate policy,[7] rising oil prices, and increases in excise taxes, inflation is projected at 12-13 percent in 2004. The credibility of program implementation will determine whether the adverse impact of the one-off factors will be permanent or temporary.[8]

14. **Fiscal performance – gauged by meeting the program targets under the IMF supported economic program – has been favorable** (see Table 1). The consolidated budget deficit of 1.4 percent of GDP in 2001 was considerably lower than the program target of 6.1 percent of GDP. The target of 5.7 percent of GDP for 2002 was also comfortably met. SaM's 2003 fiscal deficit of 3.2 percent of GDP was 1.3 percent of GDP below the target under the IMF program, due to slower than expected disbursement of grants and foreign financed projects.

Table 1: Evolution of Consolidated Fiscal Deficit (% of SaM GDP)[a]

	Serbia		SaM	
	Program Target	Actual	Program Target	Actual
2001	5.7	1.0	6.1	1.4
2002	5.3	4.3	5.7	4.6
2003	4.1	2.8	4.5	3.2

a/ Before grants.

15. **Between 2001 and 2004, the country has experienced large current account deficits following the resolution of the regional conflict and removal of international sanctions.** The combined effect of disappointing export performance and rapidly growing imports (which grew by an average of 28.7 percent per year in US dollar terms during 2001-03) led to an increase in SaM's current account deficit (after grants) from 3.9 percent of GDP in 2000 to an estimated 9.6 percent of GDP in 2003.[9] During this period, capital inflows were larger than the current account deficit, particularly in 2003 when net foreign direct investment (FDI) inflows, driven largely by privatizations, were exceptionally large. As a result, foreign exchange reserves rose to US$3.6 billion (4.4 months of projected 2004 imports) in 2003 from a negligible level 3 years earlier.

[6] The unemployment rate in Serbia is still above the levels of well-performing economies, such as Hungary, Slovenia, and the Czech Republic, and also above the average for OECD and EU countries. Moreover, the surveyed unemployment rate is likely to be somewhat underestimated, as it does not cover redundant workers who perceive themselves as employed and declare accordingly in surveys.

[7] In nominal terms, the dinar depreciated by 14 and 4.1 percent in October 2004 (year-on-year) against the Euro and the USD, respectively.

[8] In response, the National Bank of Serbia raised its mandatory reserve requirement for commercial banks from 18 percent to 21 percent starting from August 11, 2004.

[9] SaM's exports in 2000 were less than 43 percent of 1989 levels, suggesting that exports are clearly well below potential levels. In spite of this significant catch-up potential, export growth has been sluggish.

SaM's external and public debt position has also improved primarily due to Paris and London Club agreements (achieved in 2002 and 2004, respectively) and an increase in dollar GDP. Public debt declined to a projected 65 percent of GDP in 2004 from 123.2 in 2001 (see paragraphs 114-116).

16. **As a result of the combination of higher oil prices, a surge in imports, and slow growth of exports during the first eight months of 2004, the current account deficit projection for 2004 is revised to 10.7 percent of GDP**. In response to unfavorable external developments and rising inflationary pressures, the Parliament of Serbia adopted a re-balanced budget for 2004 in October, which represents an important step towards reducing public consumption. Primarily as a result of expenditure cuts, these revisions reduced Serbia's planned central government budget deficit in 2004 to 2.5 percent of Serbia GDP from 3.9 percent in 2003. The draft budget for 2005 suggests that fiscal policy will continue to remain tight in 2005. The shift to taxing consumption instead of income will be continued with the introduction of the VAT in January 2005 and the removal of some small taxes. Measures will also be taken to improve compliance and taxpayer services. Finally, the size of the Government will be reduced also by cutting, and improving the efficiency of, current expenditures, while allowing higher capital spending and a lower tax burden.

C. Medium-Term Economic Outlook and External Financing Requirements

17. **Under the base case scenario, SaM's medium-term prospects are favorable, with continued progress on key reforms leading to projected GDP growth averaging 5.1 percent per annum in 2004-07** (see Table 2). The base case scenario assumes: (i) a high quality fiscal adjustment (based on durable non-interest expenditure cuts) that enhances macroeconomic stability and boosts confidence in the policy framework, thereby stimulating private investment; and (ii) an acceleration of policy efforts aimed at improving efficiency, including privatization and enterprise restructuring, along with measures directed at improving competition and the investment climate.

18. **Non-interest current expenditures in relation to GDP are projected to decline from roughly 41.3 percent in 2004 to 35.5 percent in 2007** (just under 2 percentage points of GDP per annum). In addition to reductions in purchases of goods (around 0.3 percentage points of GDP per annum), this decline primarily reflects reductions in the wage bill, subsidies, net lending, and transfers (see paragraphs 28-30). The wage bill as a share of GDP could be reduced by around 0.3-0.5 percentage points per annum, supported by public administration reform and reforms in the main sectors of public employment, including health, education, defense, and internal security. Roughly half of the remaining 1.2 percentage point per annum decline in non-interest current expenditures as a share of GDP could come from cuts in subsidies and net lending, with the other half coming from reductions in transfers. Cuts in subsidies and net lending will result from, among other things, restructuring and, where appropriate, privatization of large loss-makers, including railways, and from reforms of budget-financed lending institutions such as the Development Fund. Reductions in transfers are expected to result from a variety of measures, including those designed to improve the financial sustainability of the pension and healthcare systems.

Table 2: SaM - Medium-term Macroeconomic Prospects

	Act. 2000	Act. 2001	Act. 2002	Est. 2003	Proj. 2004	Proj. 2005	Proj. 2006	Proj. 2007
National Accounts								
Real GDP growth (%) 1/	5.0	5.5	4.0	3.0	6.0	4.6	4.8	5.0
Investment (% of GDP)	14.2	13.6	16.2	15.9	16.5	17.8	20.4	21.0
Gross domestic savings (% of GDP)	-2.7	-7.2	-7.2	-6.6	-8.6	-7.3	-3.3	-1.3
Public Sector Balance (as % of GDP)								
Expenditures	37.6	40.3	47.8	46.3	45.3	43.5	43.0	42.3
o/w public investment	3.1	1.6	3.5	2.3	2.6	2.3	4.8	4.9
Revenue before grants	36.7	38.9	43.3	43.1	43.3	42.8	42.0	41.2
Deficit before grants	0.9	1.4	4.6	3.2	2.0	0.7	1.0	1.1
External Accounts (as % of GDP)								
Exports of goods and services	29.6	23.7	20.9	19.9	24.2	27.3	29.9	31.7
Imports of goods and services	46.5	44.6	44.3	42.4	49.4	52.4	53.5	54.0
Current account balance (US$ million) 2/	-339	-528	-1,383	-1,960	-2,492	-2,372	-2,049	-1,861
Current account balance 2/	-3.9	-4.6	-8.9	-9.6	-10.7	-10.2	-8.7	-7.6
Indebtedness (external debt)								
TDO/XGS 3/	307.1	266.2	219.6	205.9	143.8	125.2	113.8	105.8
TDO/GDP	133.2	103.2	76.5	69.9	57.8	56.4	54.4	52.6
TDS/XGS 3/	1.5	2.4	3.4	6.7	11.2	13.3	13.1	14.9
Prices								
Retail price inflation (e.o.p.)	113.5	39.0	14.2	7.6	12.6	9.6	5.7	4.1

1/ GDP estimates exclude Kosovo. 2/ After grants. 3/ Exports include workers' remittances and factor incomes.

19. **Together with adjustments on the revenue side and an increase in public investment, these cuts in public expenditure as a share of GDP will contribute directly to promoting growth and redressing macroeconomic imbalances.** During the CAS period, further efforts to improve tax collection (supported, among other things, by implementation of bankruptcy legislation) and increase transfers from profitable state-owned enterprises should boost public revenues. As the current high tax burden (tax revenues as a share of GDP) remains a barrier to private sector-led growth and to formalization of economic activity, any such gains in revenues are expected to pave the way for corresponding reductions in tax rates, particularly on labor. Together with the adjustment in public expenditure discussed above, this should have a positive impact on expectations about the future stance of fiscal policy, thereby lowering the risk premium and paving the way for higher private investment. By the same token, public investment, which has been low, is expected to increase during the projection period. In this way, the projected fiscal adjustment will be the cornerstone of the country's efforts to lay the foundations for enduring growth and macroeconomic stability over the medium term.

20. **Greater confidence will help to reverse the projected increase in inflation in 2004, while an improved public savings-investment balance, coupled with structural reforms, is expected to have a favorable impact on the current account balance.** With greater confidence in the policy framework (reflecting, among other things, the envisaged fiscal adjustment) and prudent monetary policy, inflation is projected to decline steadily to 4 percent in 2007. At the same time, improvements in the public savings-investment balance and in the competitiveness of the economy should help to reduce the current account deficit (after grants) from 10.7 percent of GDP in 2004 to

7.6 percent by 2007. Gross domestic savings as a percentage of GDP would rise to –1.3 percent in 2007 from –8.6 percent in 2004.

21. **SaM's financing requirements under the base case scenario are projected to remain high, partly because of rising debt service payments** (see Table 3 and paragraph 114-116). Between 2004 and 2007, gross external financing requirements are projected at about US$12.8 billion. These resources are required to finance: (i) large but declining current account deficits (excluding grants and official transfers) amounting to roughly US$8.8 billion; (ii) an increase in international reserves of US$1 billion; and (iii) amortization of external debt amounting to US$3 billion. With the envisaged improvement in the fiscal balance during the projection period, these financing needs will shift from the public to the private sector, as the expected fiscal retrenchment will leave more room for the private sector to tap domestic and foreign markets at favorable terms. FDI is projected to finance 33 percent of total needs in 2005-07, while long-term loans from multilateral, bilateral, and other creditors are projected to account for 35.7 percent. The remainder will be covered by other capital inflows (short-term credits, capital not-elsewhere included, and errors and omissions[10]).

22. **While good policy performance is expected under the base case, based on strong implementation of ambitious reform plans, both republics expect to move to a high case scenario in terms of policy performance as early as possible in the CAS period** (in addition to strong policy performance, access to IBRD lending would depend on establishment of creditworthiness for limited IBRD borrowing – see paragraphs 107-108). Under this scenario, the growth rate in 2006 and 2007 would accelerate to 5 percent and 5.5 percent, respectively, as broader and deeper reforms lead to a stronger private sector response. This scenario also foresees deeper cuts in non-interest current spending in 2006 and 2007. These developments would also be consistent with stronger export performance and a more favorable external position. Overall, under this scenario, SaM would be in a stronger position to achieve a virtuous cycle of higher investment, savings, productivity, and hence GDP growth.

Table 3: Financing Requirements (US$ million)

	Act.	Est.	Proj.	Proj.	Proj.	Proj.
Financing requirements	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Financing Requirements (incl. IMF)	**2,242.0**	**3,085.7**	**3,071.8**	**3,348.5**	**3,061.0**	**3,288.3**
Current account deficit (after grants)	1,383.0	1,959.7	2,492.0	2,372.1	2,048.9	1,860.8
Long term amortizations (excl. IMF)	43.0	204.0	412.5	625.0	830.8	1,077.5
Reserves Changes of Monetary Auth.	1,111.0	1,270.0	173.3	424.3	141.5	239.5
IMF Credit (net)	-295.0	-348.0	-6.0	-73.0	39.8	110.5
Financing sources	**2,242.0**	**3,085.7**	**3,071.8**	**3,348.5**	**3,061.0**	**3,288.3**
Private investment (net)	562.0	1,395.0	966.0	1,181.0	988.4	1,034.9
Long-term disbursements	421.0	911.0	1,414.4	1,085.7	1,125.2	1,249.9
Adjustments to scheduled debt service	32.0	121.0	0.0	0.0	0.0	0.0
Other capital flows	1,227.0	658.7	691.4	1,081.7	947.4	1,003.5

[10] The large errors and omissions of around US$ 400 million in 2002 and 2003 reflect the combination of the following factors: (i) under/over-invoicing of recorded trade, unrecorded trade; (ii) private flows that have not been assigned to remittances; (iii) measurement errors coming from Kosovo and Montenegro; (iv) remonetization flows stemming from previously unrecorded cash entering the banking system (as occurred on a large scale when the DM/Euro changeover happened); and (v) exchange rate valuation effects.

III. Medium-Term Challenges

A. The Governments' Programs

23. **The republican Governments' reform programs are built on implementation of two complementary strategies: the SAP and the PRSP.**[11] With a shared ultimate objective of EU integration, these two strategies present a comprehensive reform agenda designed to achieve sustainable long-term growth and poverty reduction. While the issues and challenges are presented in different ways in the two strategies, **the reform agenda envisaged under the SAP and the PRSP – and, hence, the Governments' programs – can be summarized in the three broad, inter-related medium-term country (and republican) goals:**

- **Goal 1: creating a smaller, more sustainable, more efficient public sector;**
- **Goal 2: creating a larger, more dynamic private sector; and**
- **Goal 3: reducing poverty levels, and improving social protection and access to public services.**

24. **SAP.** The SAP agenda is very broad, encompassing political as well as economic criteria and reforms (see Annex 1). SaM is in the early stages of the process. Among other things, this reflects difficulties in resolving harmonization issues between the two republics, including the creation of a single internal market. The "twin track" approach recently endorsed by the EU is intended to break this logjam by dealing with each republic individually on economic and trade policies, while dealing with the union on issues such as international political obligations and human rights, all within the context of an eventual single agreement with SaM. A Feasibility Study on the opening of negotiations on a Stabilization and Association Agreement is expected to be completed in early 2005. Deepened regional cooperation is also an important element of the SAP (see Box 1).

25. In addition to maintaining macroeconomic stability, the SAP envisages economic reforms in the following key areas.

- **Public sector reform**: Ensuring effective functioning of the state and financial viability of state institutions; reform of the army and electoral law, public administration reform including reform of the civil service pay system, and preparation of comprehensive anti-corruption strategies; formalizing the grey economy, and broadening the tax base and implementing the tax reform package, including VAT; establishing an effective public procurement regime; and developing reliable statistics.
- **Private sector development**: Liberalizing remaining prices and removing administrative controls; speeding up restructuring, privatization and/or liquidation, developing a stable and functioning land/real estate market, and developing and implementing a comprehensive strategy to promote employment and combat unemployment; abolishing export duties and import levies and modernize customs; and improving business registration.

[11] The PRSP, which was completed in late 2003, comprises a union-level overview and a PRSP for each of the two republics and builds on the Interim PRSP for FRY (presented to the Boards of IDA and of the IMF in August 2002 – Report No. 24490-YU and EBD/02/118, 7/24/02). The republican PRSPs contain detailed policy matrices indicating the time frame for implementing reforms and are broadly consistent with other Government strategic plans. For Montenegro, this includes the *Agenda of Economic Reforms*, while, for Serbia, it includes *Serbia on the Move*.

Box 1: SaM and South Eastern Europe

A regional perspective on trade, energy, transport, environment, water resource management, and other areas of potential mutual interest can benefit all South Eastern Europe (SEE) countries, especially through improved prioritization of infrastructure investments (see Annex 2). Deepened regional co-operation is also an essential element of the SAP. Over the past few years, considerable progress has been achieved in this area as indicated by the increasing number of bilateral trade agreements between the countries of SEE, as well as the detailed agreements on the integration of the region's energy systems. SaM is actively engaged in a number of regional initiatives and programs, foremost among them the Stability Pact,[12] including the Working Tables on democratization and human rights; security issues; and economic reconstruction, development, and cooperation. The Bank is actively involved in the latter. The development of regional infrastructure in SEE – connected and compatible with existing and planned trans-European networks within the EU – is important to support overall economic growth, improvement in the quality of life, and social cohesion in the region. The Infrastructure Steering Group for SEE (ISG), overseen jointly by the EC and the Bank, aims to ensure that both the SEE countries and the international community take a regional strategic approach to infrastructure development. The ISG addresses particular needs in the areas of transport, energy, water, the environment, and cross-border or trade facilitation. This CAS supports regional cooperation through numerous Bank studies, initiatives, and activities undertaken at the regional level.

26. **PRSP**. The SaM PRSP lays out an overall strategy for poverty reduction aimed at improving living standards for the poor through reforms focused on establishing the conditions for dynamic, equitable growth (see Box 5 on SaM's poverty profile). Within this overall framework, in addition to eventual accession to the EU and World Trade Organization (WTO) membership, the republican-level PRSPs share core objectives in line with the three medium-term country goals outlined above: (i) public sector reform consistent with macroeconomic stability and development of a market economy; (ii) development of the private sector through further privatization of financial and productive assets and improvements in the business environment; and (iii) poverty reduction (based on strong poverty diagnostics), improvements in the effectiveness of social programs, and attainment of the Millennium Development Goals (MDGs, see Annex 4).

27. In addition to the overall policy challenges involved in implementing the Governments' programs and country goals discussed below (see paragraphs 28-62), PRSP-specific implementation challenges include improving costing, establishing clear linkages with the republics' budget processes, and strengthening the framework for PRSP implementation, monitoring, and evaluation (including identifying indicators for reporting on progress). While implementation progress since the PRSPs were completed in late 2003 has been slow in both republics, recent developments are more promising, in part because of development of stronger links with the SAP (see Box 2). Building on this momentum will require renewed interest in the PRSP on the part of the international community, including provision of financial support for PRSP implementation.

[12] The Stability Pact was formed by more than 40 countries and organizations at the initiative of the EU after the Kosovo crisis. It encourages SEE countries to develop common perspectives in numerous social, political, and economic areas.

Box 2: PRSP Implementation in Serbia and Montenegro

Serbia. After a strong start, implementation languished for several months following the parliamentary elections. Recently, however, momentum was restored when the Deputy Prime Minister's Office assumed responsibility for the PRSP function, which is to be coordinated with EU integration, allowing for improved linkages in policy formulation. Near-term priorities include: (i) developing the linkages with the SAP – in particular, development of a joint action plan for five to six sectors aimed at fostering improved intra-ministerial communications; (ii) developing a framework for monitoring and evaluation, including a template of objectives and indicators for public discussion and use; (iii) continuing the participatory process through local level activities with civil society organizations; and (iv) organizing of a PRSP Conference aimed at, among other things, better public dissemination of the PRSP.

Montenegro. The Government has been active in promoting the PRSP concept in the media, and there is interest in improving the budgetary linkages. There have also been favorable developments in terms of better linkages between the SAP and the PRSP. Near-term plans include: (i) reactivating the Expert Task Force to work with the Ministry of Finance on budget linkages; (ii) holding participatory conferences aimed at strengthening prioritization and disseminating lessons from experiences; and (iii) organizing consultations with other regional PRSP teams.

Financial Support. While adequate during the development phases, financing for PRSP implementation is proving problematic in both republics. In addition to support from DFID and UNDP, PRSP preparation was financed through a Multi-Donor PRSP Trust Fund, administered by the Bank. In Montenegro, the two donor grants supporting implementation have been depleted and the sole bilateral grant will not be extended. The Montenegrin Ministry of Labor and Social Affairs, which oversees the effort, has been able to cover short-term operational costs, but lacks resources to provide the expertise necessary to start the prioritization process and to link the PRSP to the annual budget. UNDP continues to support the process through its on-the-ground presence. Although a request for a second grant from the Multi-Donor PRSP Trust Fund to support implementation in both republics is planned, increased support from the international community will be necessary to sustain the process over the medium term.

B. Challenges in Meeting Country Goals

28. Both republics will face considerable challenges in implementing their reform programs and meeting the three country goals. The discussion below highlights the main issues under each of the three goals.

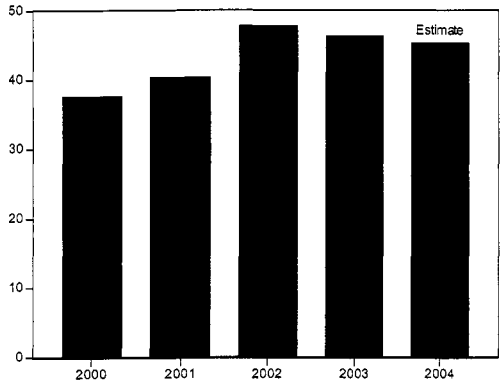
Goal 1: Creating a smaller, more sustainable, more efficient public sector

29. **The overall challenge in terms of public sector reform in SaM is to reduce public expenditure as a share of GDP while ensuring adequate levels of public investment.** While SaM has made good progress in containing the accumulation of hidden fiscal deficits (particularly budgetary arrears and losses in the energy sector), consolidated public spending has steadily increased, reaching a projected 45.3 percent of GDP in 2004 (Box 3).[13] This threatens growth and macroeconomic stability by: (i) keeping taxes and interest rates high, thereby crowding out private activity, discouraging private investment and encouraging the informal sector; and (ii) reducing fiscal flexibility. SaM therefore needs to implement fiscal adjustment based on durable cuts in non-interest expenditure while ensuring adequate public investment (which is currently low as a share of GDP and often used as an in-year balancing item).

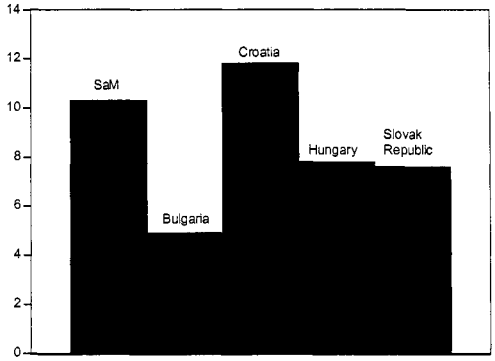
[13] Increases in wages and transfers were the key contributing factors to the rapid expansion of government expenditure.

Box 3: An Overview of Selected Fiscal Figures (% of GDP)

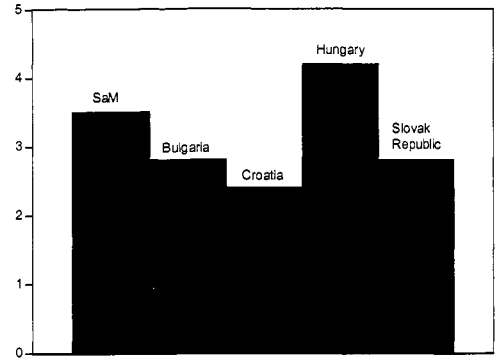
Evolution of Consolidated Public Spending in SaM



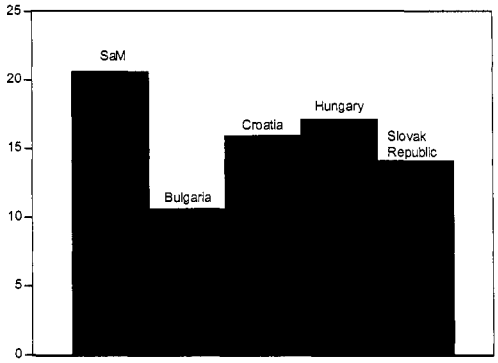
Wage Bill: SaM vs Selected Countries [1]



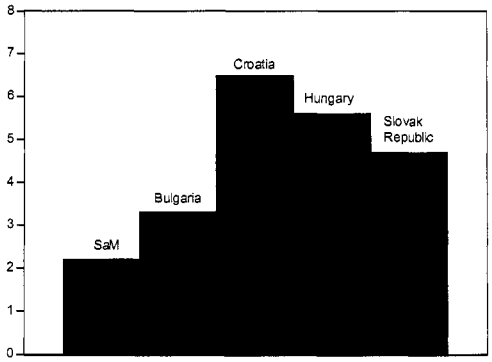
Subsidies: SaM vs Selected Countries [1]



Transfers: SaM vs Selected Countries [1]



Capital Spending: SaM vs Selected Countries [1]



Source: World Bank and IMF staff reports, GFS-2001.

[1] *Averages for 1995-2002, except SaM for which preliminary figures for 2003 as a percentage of SaM's GDP are presented*

30. **Efforts to reduce public expenditures as a share of GDP should focus on: the public sector wage bill; subsidies and net lending; and social transfers; particularly pensions and healthcare.** The level of spending as a share of GDP on each of these underlying structural components is higher in SaM than for other countries in the region (Box 3). The public sector wage bill, which has been growing rather than declining since 2001, accounted for 10.5 percent of GDP or 22.6 percent of total spending in 2003. As core wages are low, this high level of spending primarily reflects the large number of public employees. Budget subsidies and net lending, both of which increased in 2003, are also significant contributors to the high level of public expenditure at around 4.3 percent of GDP in 2003. While the level of subsidies in the budget has increased since 2001, this reflects the introduction of more transparent budget management with a shift away from off-budgetary expenditures. Social transfers at around 20 percent of GDP are close to the level of wealthier countries, raising affordability concerns. Within social transfers, the two most important areas are the pension and healthcare systems.

31. **Addressing these underlying structural sources of high expenditure will require strong progress on structural reforms.** Reducing the public sector wage bill will require public administration reform, together with deep reforms in the main sectors of public employment, including health, education, defense, and internal security. Reducing subsidies and net lending will require accelerated progress on restructuring and, where appropriate, privatization of large loss makers, particularly railways. Reducing social transfers will require bold measures to improve the sustainability of the pension and healthcare systems. Against this background, the key structural reforms to be addressed under Goal 1 of the CAS are: (i) public administration reform; and (ii) pension reform. Restructuring and privatization will be addressed under Goal 2, and healthcare, including financing issues, will be addressed under Goal 3.

Public administration reform

32. **Progress on public administration reform in Serbia has so far been limited.** [14] Lack of political consensus on administrative reform measures has stymied necessary institutional reforms, resulting in continued major distortions in staffing numbers in individual sectors, politicization of key positions (often down to head of department level in ministries), a highly compressed and inadequate remuneration system based on years on service and ad hoc benefits, and reliance on donor-funded temporary expert staff to overcome capacity constraints. These weaknesses in public administration, which have been further exacerbated by implementation of the Belgrade Agreement and the Constitutional Charter, affect the quality of state administration and the continuity of its work over time, and create a strong disincentive for highly quality staff to stay in the civil service. Overcoming these weaknesses will improve the efficiency and effectiveness of public administration, and contribute to macroeconomic stability by reducing the public sector wage bill and to private-sector led growth by building a strong independent regulatory management system. In addition, public administration reform is essential to facilitate much-needed economic and social sector reforms.

33. **The medium-term agenda in Serbia is substantial.** Necessary medium-term reforms include: (i) right-sizing the administration through a comprehensive review of the needs of individual sectors; (ii) de-politicization; (iii) reform of the pay and benefits system; (iv) modernizing the legal basis for operation of the civil service and public administration; (v)

[14] It is generally recognized that weaknesses in the institutional systems in both republics will seriously affect the design and implementation of economic and social reform programs if a substantial improvement in the quality of public administration systems is not achieved. Furthermore, unreformed administrative systems will continue to impose a high fiscal burden, as salary and wage costs as a percentage of GDP remain among the highest in Europe, especially in Montenegro. Finally, the objective of integration into European structures of both republics requires radical progress in institutional reform if institutional capacity criteria for EU membership are to be met in the medium to long term.

modernizing the regulatory management system; (vi) enhancing accountability in the public administration; and (vii) re-allocating functions across levels of government. The new Constitution, currently under preparation, will help to set the framework for some of these reforms by clarifying the administrative structure of the republic, settling some key issues in central-local government relations, and creating the basis for the adoption and implementation of key administrative reform legislation. Given fiscal constraints, the reform of the salary system will need to be accompanied by retrenchment efforts.

34. **The Government of Montenegro launched an ambitious, comprehensive public administration reform process in 2003**, in response to growing distortions in public administration, which led to wage costs as a share of GDP spiraling to among the highest levels in Europe. Significant progress has been made, particularly in terms of the legislative framework. Laws on State Administration and Inspection Scrutiny were enacted in mid-2003. The former foresees the reform of the structures of ministries, with policy-making functions to be separated from service delivery and regulatory functions, while the latter sets out modern principles and procedures of inspection oversight of public administration, private companies, and citizens. In addition, Laws on General Administrative Procedures and on Administrative Disputes (Judicial Review) were enacted in October 2003, and Laws on Civil Service and on Salaries were adopted in April 2004. The latter two laws provide the legal basis for establishment of a professional, merit-based civil service system, including de-politicization of appointments below the level of Assistant Minister and Secretary-General, and de-compression and modernization of the pay system.

35. **While good progress has been made over the past year, the agenda remains substantial and continued efforts will be required over the medium term**, as demonstrated by the number and scope of initiatives currently under way. These include gradual implementation of the new salary system beginning with the 2005 budget, including initial steps on wage de-compression; implementation of the new human resource management system (including performance-based assessment); mandatory regulatory and policy fiscal impact analysis with a plan to expand coverage to include environmental, economic, and social impact analysis; and, with the aim of reducing abuse of office and corruption and creating a more responsive client-oriented administration, establishment of an Ombudsman's office and an administrative court and special appellate court.

Pension reform

36. **Further pension reform is also essential to improve fiscal sustainability in both republics and to make room for better targeted social protection programs.** Social protection spending in both republics is dominated by pensions (accounting for more than 12 percent of GDP in Serbia). The pension system in Serbia, which is supposed to be financed by employer and employee contributions, requires budgetary transfers to cover more than half of its expenditures, while less than two-thirds of the elderly are even receiving pensions and an even smaller percentage of the current labor force is contributing to the pensions system. Pension expenditures in Montenegro are 13 percent of GDP and contributions cover less than 60 percent of expenditures, given the 2004 reduction in contribution rates. This level of expenditure distorts labor market decisions and jeopardizes fiscal sustainability, as well as crowding out other forms of social expenditure that could be more targeted towards the poor. Both republics undertook significant pension reforms in 2002-03: raising the retirement age, widening the calculation period, lowering accrual rates through a points-based formula, tightening the indexation mechanism, eliminating non-pension benefits, tightening disability eligibility, and eliminating temporary disability. However, these reforms notwithstanding, the pension systems continue to carry significant deficits.

37. **This is particularly true in Serbia, where the Government is looking for additional ways to improve the sustainability of its pension system.** Over a five year period, the reforms already being implemented are expected to reduce the burden of the pension system by 2 percentage points of GDP, leaving a deficit that will need be financed from the central budget in the absence of increases in contributions or further reforms. Expenditures are expected to decrease the pension to GDP ratio below 10 percent in the next 7-10 years due to a slower inflow of new pensioners, less generous indexation, and the impact of expected real wage growth coupled with declining inflation. Further improvements in financial sustainability will require additional parametric reforms, improvements in both collections and enforcement, and, at a minimum, administrative consolidation of Serbia's three pension funds. It is important to note, however, that, while extremely important, these measures will not have a substantial positive impact on the pension deficit in the near term. Together with the measures already taken, improvements in collections and enforcement, coupled with parametric reforms such as moving to inflation indexation of pensions after retirement and raising the retirement age for women, could lower the deficit from its current level of more than 5 percent of GDP to less than 2 percent of GDP by 2020. Efforts to establish the legislative, administrative, and supervisory framework for a multi-pillar system should also be continued alongside the measures discussed above with a view to introducing second and third pillars in the medium to long term.

38. **Additional pension reform may also be necessary in Montenegro.** The pension deficit as a share of GDP was slightly lower than in Serbia at 3.9 percent of GDP in 2002. As outlined above, significant reforms were introduced in late 2003. These changes could lower the pension deficit to less than 1 percent of GDP in 2006 and could eliminate the pension deficit by 2009. However, the impact of these reforms is somewhat uncertain due to the lowering of the contribution rate in 2004 and the envisaged transfer of collection responsibilities to the Department of Public Revenues in 2005.

Goal 2: Creating a larger, more dynamic private sector

39. **Achieving Goal 2 will require progress in a number of difficult areas.** First, a package of reforms – including continued privatization, enforcement of hard budget constraints, improvements in the business environment, and continued financial sector reform – is required to reduce the size of the public sector in economic activity (thereby also contributing to Goal 1), create a favorable environment for the development of the private sector, and improve the competitiveness of domestic companies. Second, restructuring, and eventually privatization, of the energy sector is needed to address financial sustainability (thereby also contributing to Goal 1) and improve the reliability of energy supplies. Third, reforms are required to boost agricultural production and improve the competitiveness of farmers and agro-processors, particularly in EU markets. Fourth, further progress on cleaning up and protecting the environment is necessary to ensure quality economic growth over the medium term.

Enterprise and financial sector reform

40. **Good progress has been made in both republics on enterprise and financial sector reform since 2001.** Despite a difficult sales environment, the tender and auction privatization of socially-owned enterprises has made good progress. The authorities have also made substantial improvements in the legal and institutional framework aimed at efficient entry, operation, and exit of enterprises. In parallel, important steps have been taken towards rebuilding the financial architecture through liquidation of deeply insolvent banks, restructuring of banking sector arrears, privatization of state-owned banks, and updating of the regulatory framework for the banking and insurance sectors. Despite these achievements, however, SaM is near the bottom on indicators of enterprise sector reform progress, such as the Bank's "Cost of Doing Business," suggesting that

much remains to be done. Similarly, the financial sectors in both republics remain underdeveloped by regional benchmarks, with the existing level of financial intermediation being unable to fully contribute to the economic growth agenda.

41. **Resolution of state- and socially-owned enterprises to be completed.** Enterprise data show that new private and privatized firms clearly outperform state-owned enterprises. Firms in pre-privatization limbo face little incentive to search for new markets, restructure their production, or create new and more secure jobs. Financial and organizational restructuring and subsequent sale of troubled industrial conglomerates, or viable parts thereof, needs to be speeded up. Unsaleable loss-making conglomerates should be subject to bankruptcy procedure under the new insolvency laws in the respective republics.

42. **Financial discipline needs to be strengthened to enhance restructuring and to attain permanent fiscal adjustment.** This is crucial to: (i) encourage poorly performing firms to push ahead with restructuring, thereby releasing factors of production (non-core assets) to higher productivity users; and (ii) encourage viable enterprises to actively search for new markets and reduce costs (including maintaining wage increases in line with productivity growth). These objectives can be achieved through: (i) phasing out direct and indirect subsidies, including the Development Fund and forbearance of arrears; (ii) effective implementation of bankruptcy legislation; (iii) continuation of the unbundling and restructuring (workforce and debts) of public utilities; and (iv) establishment of an adequate regulatory framework in infrastructure sectors, paving the way for private sector participation in management, financing, and ownership of infrastructure. Sustainable fiscal adjustment is impossible without permanent restructuring and privatization of the real sector (in parallel with public administration reform) because, as experience in ECA shows, un-restructured large ("too big to fail") enterprises continue to lobby for subsidies and crowd out the private sector.

43. **The business environment needs to be further improved.** This will facilitate the smooth movement of the factors of production from low to high productivity enterprises, allowing these firms (including foreign-owned firms) to expand their production. The main challenges in improving the business environment are: (i) strengthening contract enforcement by updating relevant legislation and enhancing the capacity of courts; (ii) improving access to credit by establishing an institutional and legal framework conducive to lending operations; (iii) reducing the regulatory burden on enterprises through public discussion of draft laws and removal of overlapping functions of various state authorities; (iv) improving access to land by changing the constitutional treatment of urban land, removing administrative barriers, resolving the issue of restitution, and establishing a modern cadastre system; and (v) improving infrastructure, particularly water, energy supply, and solid waste disposal.

44. **Accelerated reform and modernization of financial sector should proceed in parallel with reforms of the real economy and business environment.** The current domination of Serbia's financial system by inefficient and problem-laden local banks, many of which are state-owned, presents significant risks and limits the potential for intermediation for the real sector on a sustainable and affordable basis. Based on the experiences of other transition economies, Serbia needs speedy, yet transparent, privatization of state-owned banks to strategic investors through open tenders. Those banks that cannot be sold and/or are unlikely to compete effectively even if their balance sheets could be cleaned up will need to be merged or liquidated. The challenges for Montenegro include the completion of divestiture of state-owned banks and the resolution of non-performing assets accumulated in the system. In parallel to the resolution of state-owned and non-performing assets, authorities in both republics need to establish and enforce stronger regulatory and supervisory discipline across the whole of the banking sector, with a view to minimizing vulnerabilities and promoting further consolidation. Finally, legal and institutional foundations

should be laid for development of viable non-bank financial institutions, with a particular focus on insurance sector reform.

Energy sector reform

45. **Improving the performance of the power sector is also essential to underpin fiscal sustainability and encourage private sector-led growth** (see Box 4). Good progress has been made in this regard in Serbia since early 2001. First, tariffs have been steadily increased – accompanied by appropriate social welfare measures – and now cover operating costs plus debt service and depreciation. Average (residential, commercial, and industrial) power tariffs were increased from 0.9 US c/kWh in January 2001 to 4.2 US c/kWh in July 2004. Second, residential collection rates have increased to around 92 percent and efforts are being made to improve collections from industrial consumers through restructuring and privatization. Third, a new Energy Law was passed in July 2004. This law will unlock the industry reform process, most notably through enabling the establishment of an energy regulator and the restructuring of energy companies. Fourth, progress has been made on commercialization of the electricity utility Elektroprivreda Srbije (EPS) by spinning off non-core assets (including coal mines).

Box 4: SaM Electricity Sector and ECSEE

An important development is the EC-sponsored, and Bank-supported, initiative to establish the Energy Community of South Eastern Europe (ECSEE), focusing on electricity and natural gas. SaM is a signatory of the "Athens Memorandum," which launched the process for the establishment of ECSEE, together with Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, the former Yugoslav Republic of Macedonia (FYR Macedonia), and Turkey. The EC and the Stability Pact also signed the Memorandum as its sponsors. The participants have agreed to adopt rules relating to the organization and functioning of the electricity and gas markets designed to facilitate competition and ensure that access to networks is non-discriminatory, transparent, and fairly priced. The markets are to be based on the principles set out in the Electricity Directive, the Gas Directive, and other legislation relating to the operation of the EU's Internal Energy Market, including environmental legislation.

A recent Bank-sponsored study has shown that electricity shortages could develop in the region unless significant investments are made in installing new generation capacity, rehabilitating existing aging capacity, and upgrading transmission networks. SaM could benefit significantly from the creation of ECSEE. Its participation in the regional energy market will improve the reliability of supply, reduce the need for additional generation capacity, increase security of energy supply, and strengthen incentives to connect the Balkan region to Caspian and North African gas supplies.

The on-going Serbia Emergency Electric Power Reconstruction Project, co-financed by nine donors, supports SaM's participation in ECSEE. In particular, investments under this project have included transmission network rehabilitation and installation of cross-border meters, both of which were part of the technical requirements for the regional market. In addition, generation rehabilitation under the project will ease the near-term capacity deficit, thereby also supporting the evolution of competition. The institutional components of the project have supported reforms, including development of an energy law and restructuring of the power utility, both of which will help Serbia to comply with the requirements of the Athens Memorandum.

The Bank intends to continue to play an important role in supporting SaM's efforts to participate in ECSEE beyond the completion of the EEPP project, as well as through the Montenegro Emergency Power LIC, by providing strategic advice and preparing regional projects to finance relevant priority investments. For example, deficiencies that constrain SaM's participation in ECSEE will be addressed under the planned Regional Energy APL in Serbia in FY05 and in Montenegro in FY06.

46. **Looking forward, the challenge is to implement the new Energy Law, including restructuring of EPS.** Two key components of the Energy Law are the establishment of a sector regulatory framework and restructuring of EPS's core business. The latter will involve separating ownership of power generation, distribution, and transmission, together with labor restructuring

(EPS is currently overstaffed, as evidenced by low levels of labor productivity). There is also a need for further improvements in payments discipline. Performance here (both as regards collections and commercial losses) remains poor relative to Western European standards. Necessary actions to support improvement in this area include power distribution network re-metering; the development of a billing, collection, and disconnection manual; and implementation of the existing Ministry of Energy/EPS plan for reduction of commercial losses. Further increases in tariffs are also likely to be needed to finance investments in the medium term.

47. **Good progress has been made in power sector reform in Montenegro; the big challenge is implementation.** Most notably, an Energy Law was enacted in June 2003 and an independent regulator, which has already issued licenses for various energy companies, was subsequently established. Tariffs have been increased to an average of almost 5 US c/kWh (sufficient to cover operating costs). Going forward, the challenge is to build on this progress through implementation of the Energy Law, particularly as it relates to Elektroprivreda Crne Gore (EPCG) restructuring. The Law envisages that EPCG will be unbundled in the first quarter of 2005 and that power generation, transmission, and distribution will function as separate entities. While there is a need to reform tariffs for large customers, the overall focus should be on improved payments discipline through increased collections, reductions in losses, and, in the case of commercial customers, an eradication of payments through offsets. To ensure that tariffs cover operating costs on an ongoing basis, the regulator needs to develop secondary legislation on tariff methodologies. In addition, the Government should undertake an energy affordability study and introduce social protection measures as required to protect poor and vulnerable groups.

Agriculture

48. **A number of difficult issues need to be tackled to realize the agricultural sector's full potential, particularly in Serbia.** The contribution of agriculture to GDP has increased over the last 10 years. Primary agricultural production and agro-processing currently account for around 25 percent of GDP, and agricultural products comprise about 26 percent of Serbia's exports. At the same time, however, while farm land is largely privately owned (86 percent), agricultural reform has been relatively slow and there are significant barriers to realizing the sector's full potential. In particular, public and private institutions associated with agriculture need to be strengthened; the necessary private markets for land, rural finance, and agricultural produce and inputs need to be developed; reform of trade and incentive policies needs to continue; agricultural competitiveness needs to be improved, particularly in terms of food quality and production costs; and the authorities need to continue to tackle land registration and titling.

49. **In 2004, the Government of Serbia initiated several new programs of rural assistance.** The agricultural credit scheme aims to encourage rural lending by commercial banks and to help rural borrowers access financing by establishing credit histories. However, early feedback suggests that there is scope for increasing the effectiveness of this program. The rural development grant fund seeks to enhance the sustainability of primary agricultural production, develop the rural economy, and improve the livelihoods of rural households through improved diversification of income sources.[15] These schemes have been accompanied by introduction of a farm registry, with the eventual aim of building, in line with EU standards, a single payment agency. While registration is voluntary, only registered farms are eligible for rural development grants, subsidies, and rural credits, and for receiving agricultural advice from the state agricultural extension system. With EU funding, the Government also began a program of upgrading veterinary, phyto-sanitary,

[15] The fund provides partial grants (20 – 50 percent of the value of investments) for farm and marketing improvements and village community development through non-agricultural economic activities, such as agro-tourism.

and food safety laboratories, training laboratory staff, and establishing a network of regional animal health, local food safety and phyto-sanitary laboratories.

50. **Looking forward, the Government of Serbia is expected to focus its efforts on increasing agricultural competitiveness and improving natural resource management.** Agricultural advisory services have an important role to play in improving competitiveness. In particular, farmers need advice on: (i) technical, management, and marketing skills; (ii) EU food safety standards; and (iii) access to finance. In the short run, the Government intends to improve the rural credit system and rural development grant fund (based on the EU model) and to reorient the agricultural advisory system to focus on the needs of farmers and agro-processors in a competitive, open market economy. Efforts to improve natural resource management, including flood and drainage management, agricultural pollution reduction, and agro-biodiversity are also expected. However, improvements in water resource management are essential to increase agricultural productivity through rehabilitation of the irrigation and drainage system; reduce land, crop, property, and infrastructure damage through rehabilitation of flood management infrastructure; and strengthen the associated institutions.

Environmental management and protection

51. **While considerable progress has been made in Serbia, the institutional and regulatory framework needs to be strengthened and core environmental problems need to be tackled.** Environmental management continues to suffer from limited institutional capacity, overlapping competencies, an inadequate legal framework, and a lack of investment funds for core problem areas. Completion and implementation of the National Environmental Action Plan (NEAP) and four Local Environmental Action Plans, along with a new set of laws governing environmental protection, environmental impact assessment, and pollution prevention and control, should help to address some of these weaknesses and lay the groundwork for overcoming core environmental problems. The latter include solid and hazardous waste management; pollution of surface and groundwater sources by industrial, municipal, and agricultural sources; localized severe air pollution near mines and power plants; deteriorating drinking water quality and lack of adequate sewerage (especially in poor urban settlements and rural areas); energy inefficiency; inadequate forest and biodiversity management; and a threat to forests from uncontrolled cutting. Enforcement of new laws will be a significant challenge requiring stronger political commitment and institutional capacity.

52. **In Montenegro, effective landscape and watershed management, including flood and erosion control, are key to sustainable development of tourism.** Achieving this would, however, require an improvement in institutional capacity, the legislative framework, and enforcement, as would overcoming important environmental problems. The latter include air, water, and soil pollution by a few large hotspot industries, mines, and plants; lack of satisfactory waste and waste water management; and unsustainable natural resource and coastal zone management. As in Serbia, efforts, supported by donors, are underway to develop environmental legislation in line with EU standards, but strong political commitment will be required for effective enforcement.

Goal 3: Reducing poverty levels, and improving social protection and access to public services

53. **As outlined in the PRSP, in addition to robust sustainable economic growth, there are three key challenges under Goal 3**: (i) combating rural poverty; (ii) improving social protection (excluding pension reform – discussed under Goal 1); and (iii) improving access to quality, affordable health and education for all citizens, including poor and vulnerable populations. As

described in Box 5, poverty in both Serbia and Montenegro is relatively shallow with a sizeable portion of population living "at risk" of poverty (50 percent above the poverty line). This profile, together with experience from other countries in Europe and Central Asia (ECA), suggests that robust, sustainable economic growth is essential to reduce poverty. At the same time, however, special attention is required to address growing regional disparities; to improve the coverage, targeting, and reliability of transfers for social protection; and to improve the quality and financial sustainability of health and education for all citizens (see Box 6 for a discussion of Roma issues).

Box 5: Poverty in Serbia and Montenegro

PRSPs and Poverty. Bank work on poverty in SaM follows a programmatic approach geared towards supporting the PRSP processes within each republic. This work has several aims: (i) collecting and analyzing representative data on living standards; (ii) arriving at a diagnosis of poverty shared by the authorities and the Bank; and (iii) establishing adequate baseline data to monitor changes in poverty over time. The first output of the Bank's poverty program in SaM was the *Poverty Assessment Report* released in June, 2003 (Report No. 26011 YU). This report is being followed by a series of analytical studies (covering rural poverty, ethnic dimensions of poverty, and poverty and the environment) and ongoing data collection to trace the evolution of the risk of poverty as well as its specific characteristics and dimensions.

Poverty Incidence. In mid-2003, material poverty (defined as a consumption level below the country-specific absolute poverty line) affected around 10 percent of the population of both Serbia and Montenegro. However, this favorable poverty profile reflects the Governments' decisions to use the bottom of the estimated range of the poverty line in order to focus their policies on the neediest. When the top of the range is used (in line with common practice in Central and Eastern Europe), around 20 percent of the population of SaM is poor. In addition, proper accounting for marginalized groups (including Roma and internally displaced persons - IDPs), who are under-represented in the regular household sample surveys, further raises the estimates of poverty. Poverty in SaM is also relatively shallow: the economic recovery experienced by Serbia in 2002-03 reduced absolute poverty by one-third.

Poverty Dimensions. The proportion of the population "at risk" of poverty (those living just above the poverty line) is relatively high in both republics at around 20 percent. This suggests even small economic shocks can have potentially large effects on poverty. At the same time, non-income dimensions of poverty are relatively good, including decent housing, access to water and sanitation, and basic education, all of which are within the reach of the majority of the poor. There are, however, important pockets of poverty in which the population faces multiple deprivations, notably the poor in rural areas and in new urban slums, as well as ethnic minorities and IDPs. Moreover, poor households face serious problems accessing the healthcare system due to the burden of informal payments and the lack of full health insurance coverage.

Who are the poor in SaM?

- Two-thirds of the poor have only primary (elementary) education. Multivariate analysis of poverty risks suggests that lower education attainment is the key background factor explaining the higher incidence of poverty for rural households and jobless households.
- Jobless households (families with working age members where no one works) have more than twice the average poverty incidence and are prone to chronic poverty. Working households (families with at least one employed member) account for 75 percent of the poor – "the working poor."
- Rural households have a higher incidence of poverty than urban ones. Poverty incidence is double the national average in southern Serbia (and did not benefit from the 2002-03 recovery, thereby widening the gap with the rest of the country). In Montenegro, poverty incidence in the north is twice the level in the center/south.
- Households with IDPs, refugees, or ethnic minorities, especially Roma, experience high levels of poverty. Roma households are likely to experience high levels of poverty on all dimensions and suffer from persistent chronic poverty.
- While the risk of poverty is the roughly the same for male- and female-headed households, the latter are more prone to the risk of chronic poverty. Multivariate analysis suggests that this reflects less active participation and fewer years of experience in the labor market, as well as lower pay.

Rural poverty

54. **Rural poverty in SaM is high and increasing.** Rural poverty rates have doubled since 1990. As of 2003, 75 percent of all poor in Serbia live in rural areas, despite the fact that the rural share of the total population is less than 45 percent. The problems of rural youth are particularly acute. Surveys indicate limited opportunities, a widespread pessimistic attitude (with a gap existing between reality and expectations, and the risk of anti-social behavior), a perception of corruption in education systems, and participation in a grey economy, often including human trafficking.

55. **In addition, deteriorating rural infrastructure is contributing to public health risks and rising costs of transport for rural communities.** Of particular concern is the quality and reliability of the water supply; surveys have indicated that the great majority of rural water supply systems do not comply with bacteriological standards and that nitrate pollution, caused by both domestic waste water and agricultural activity, is of serious concern. Rural water supply services are currently confronted with an institutional and legal vacuum, relying entirely on a tradition of self-reliance. Moreover, about 45 percent of solid waste in rural areas is inappropriately disposed of or dumped. As villages are often grouped with larger urban municipalities, local government spending priorities may reflect urban, rather than rural, priorities.

56. **While active assistance programs for the agricultural sector will help, a more broad-based approach to rural development will be required in the poorest regions.** Encouraging agricultural production and improving the competitiveness of the agricultural sector will play an important role in alleviating rural poverty, particularly in Vojvodina and Central Serbia (see paragraphs 48-50). In the poorest areas of the two republics, southern Serbia and northern Montenegro, however, a more broad-based approach to rural development is required to boost rural livelihoods, improve access to services, and build an awareness and appreciation for the environment and biodiversity.

Box 6: The Roma Decade in SaM

Roma constitute a large and vulnerable minority group in both Serbia and Montenegro. According to the 2002 Serbian census, Roma constituted 1.4 percent of the population, while estimates by NGOs and international organizations place the Roma population at about 4 percent of the population. Approximately 20,000 Roma are estimated to live in Montenegro. Roma in both republics are significantly poorer than the general population. Estimated poverty among Roma in 2003 was 68 percent in Serbia, or 8 times higher than the total population, and 52 percent in Montenegro, or 4 times higher than the total population.

Roma poverty is multi-faceted; more Roma are out of work and more Roma children out of school than in the rest of the population. In 2003, only 7 percent of Roma children were in school. Housing conditions are also poor and many Roma live in illegal settlements. Many Roma in SaM are IDPs from the Kosovar conflict. According to UNHCR, some 40,000 to 50,000 Roma were forced to leave Kosovo in 1999. Living conditions for displaced Roma are extremely poor and some municipalities have been reluctant to accept Roma IDPs.

In July 2003, Serbia and Montenegro participated in the first high level regional conference on Roma. Federal Minister of National and Ethnic Communities, Rasim Ljajic, and Milo Djukanovic, Prime Minister of Montenegro, participated and committed Serbia and Montenegro, along with seven other Central and South Eastern European Countries to launch a Decade of Roma Inclusion from 2005-2015. Working groups at the republican and federal level, comprising government officials and Roma NGO leaders, have worked on select goals in the areas of education, employment, health, and housing that the republics will try to achieve during the Decade. The Decade is being coordinated with the Ministry for Minorities' National Strategy for Roma, which was adopted in April 2004, and the PRSPs.

Sources: Serbia Roma 2003 Poverty Survey, ISSP Household Survey of Roma, Ashkaelia and Egyptians, Refugees and Internally Displaced Persons, 2003

Social Protection

57. **Further measures are needed in both republics to strengthen the social safety net to protect the poorest households, including improved coverage and targeting of cash benefits and a modernized system of social services for vulnerable groups.** Both republics have moved beyond addressing immediate humanitarian needs of refugees and IDPs to systemic reforms designed to support fiscal sustainability while continuing to provide core benefits and services to the population. While some progress has been made, areas for further reform include: (i) improving coverage through increased spending on some of the more effective and better targeted programs (especially, Material Support to Families (MOP)); (ii) improving in the targeting and administration of other programs that transfer resources to vulnerable groups (such as child allowances, caregiver's allowance, veterans and disabled allowances, and parental allowances); and (iii) improving the effectiveness of social services for vulnerable groups (including the development of standards, regulations, and monitoring and evaluation mechanisms, and of special approaches for specific groups – children without parental care, young with behavioral problems, disabled, elderly, and Roma). In addition, there is a need to build capacity in local governments and non-governmental organizations (NGOs) in developing and delivering services, thereby improving access for poor and vulnerable groups, including Roma, IDPs, and refugees.

58. **In Serbia, recent legislative reforms to extend the coverage of MOP need to be accompanied by administrative reform and efforts at improving social service delivery.** The MOP program in Serbia is well-targeted but coverage is low. Recently completed legislative reforms are designed to improve MOP coverage: (i) establishing a uniform national eligibility threshold for MOP; (ii) indexing benefits to the cost of living; and (iii) increasing benefit levels. However, the results of these changes will need to be monitored to ensure that they improve the welfare of the poorest households. Moreover, these legislative changes need to be supported by further administrative reform, including building the capacity of local governments to deliver benefits and services and improving efficiency by consolidating the MOP program and child benefits (currently delivered by different agencies). Improving the effectiveness and quality of social services, and shifting away from over-reliance on institutional care, is a core element of the republic's PRSP. The Social Innovation Fund (SIF) is a key instrument in this respect – it is a fast-track social reform mechanism that aims to support innovative social service projects at the local level and feed the results into policy development.

59. **Montenegro introduced reforms in 2001 that improved coverage of the MOP, but overall coverage remains low, targeting is poor, and there are also serious problems with payments arrears** (around Euro 10 million, in addition to around Euro 6.5 million of old arrears on child allowances). The Government is aiming to expand local government and NGO involvement in social services – particularly to further the development of alternative, community-based mechanisms for social care.

Health and Education

60. **While recent progress in Serbia has been encouraging, reforms are needed to improve the financial sustainability and affordability of healthcare, as well as service delivery.** Despite high public and total spending on healthcare (around 7 and 11 percent of GDP, respectively), the publicly-financed health system suffers from chronic arrears[16] and other signs of financial distress, and access to healthcare by the poor is limited by high out-of-pocket costs (in the 2003 Poverty

[16] Net accumulated arrears by the end of 2001 were CSD 6.7 billion (1 percent of GDP). Deficits have been met through a combination of commercial loans, delays in payments to suppliers and providers, artificially low reimbursement prices, and contractual revenues levels that do not ensure full cost recovery.

Assessment, over 30 percent cited high costs and lack of insurance coverage as principal reasons for lack of access to healthcare services). Despite reductions in contribution and co-payment exemptions, the level of revenues to the Health Insurance Fund (HIF) is low because of the large informal economy and administrative weaknesses, while budget transfers to cover healthcare for vulnerable groups and refugees have been grossly inadequate and poorly executed.[17] Issues in service delivery include deficiencies in clinical and patient registration practices in primary healthcare and capitation-based payments for primary health care providers.

61. **In particular, further progress on establishing the legislative and institutional foundations for health reform** (including the development of new framework laws on healthcare, health insurance, and pharmaceuticals) **and on reforming the health insurance system are necessary– a major challenge given weak institutional capacity**. These measures can be expected to provide a basis for addressing many of the key challenges facing the sector, including: a mix of public and private healthcare provision; a gate-keeping role for primary care doctors; patient choice of provider; a licensing system for doctors; autonomy for the HIF; new provider payment methods; a more rational approach to identifying health benefits on the basis of cost-effectiveness; better monitoring of prescriptions; and a pharmaceutical regulatory and procurement system based on principles of competition, cost-effectiveness, and quality. However, the institutional capacity to carry out this work is limited, both in terms of personnel and information systems.

62. **Montenegro has taken important first steps toward reform of the health sector, but measures are required to improve both quality and financial sustainability.** In 2003, Parliament endorsed a health strategy that set the overall direction for reforms in the organization, financing, and provision of healthcare services. Framework laws on health care and health insurance were subsequently adopted in 2004, and a revised law on medicinal products is currently under public discussion. However, as in Serbia, total health spending is high (about 11 percent of GDP) and Montenegro's HIF runs arrears (accumulated arrears in 2003 totaled Euro 12 million). This reflects high pharmaceutical expenditure, an unaffordable benefits package, and provider payment methods that lack efficiency incentives. Health insurance contributions – until recently the mainstay of health finance – were reduced in 2003 as part of the Government's efforts to improve the investment climate for SMEs, thereby increasing reliance on budgetary transfers.[18] Improving the reliability and timeliness of budget execution is therefore critical to reform efforts and essential to the financial stability of the HIF. Failure to improve financial sustainability could result in an increase in out-of-pocket payments and deterioration in access, which would disproportionately affect poor and vulnerable populations. To address these issues, the authorities are preparing a medium-term finance program for the health sector for 2005-2007. Although the recent strengthening of financial and technical capacities in the HIF,[19] together with the ongoing promotion of a comprehensive, technically sound primary health care reform agenda, portend well, full implementation of reforms is necessary to ensure quality, affordable healthcare.

63. **As outlined in the PRSP, fighting poverty means providing people leaving the education system with better skills and targeting education sector resources in favor of disadvantaged groups in both republics.** The key challenge is to improve the overall efficiency and quality of

[17] The amounts required for covering vulnerable groups in 2004 was estimated at CSD 5.9 billion, while the budgetary allocation was only CSD 2.83 billion. Data from Q1 2004 showed that actual transfers were running 75 percent below budgeted amounts for the quarter, raising concerns about the timeliness and completeness of budget execution.

[18] The 2003 cuts were compensated by a combination of expenditure cuts by the HIF and the promise of increased budget transfers from the Ministry of Finance. The reliability of budget transfers to the HIF has historically been poor, especially on behalf of refugees and vulnerable groups.

[19] A number of expenditure control measures have been successfully introduced over the past 18 months, including a tightening of dental, sick leave, and treatment-abroad benefits; a new pharmacy information system; and a first attempt at international tendering for drugs.

education, while improving the financial sustainability of recurrent expenditure. In addition, improving the skills and knowledge of those leaving education (especially those leaving at the end of secondary education given the high rates of unemployment among this group) and developing incentives to increase adult education and training will make a significant contribution to Goal 2, the creation of a larger, more dynamic private sector.

64. **Effective leadership is key to tackling education reforms in both republics.** Some of the key issues in one or both of the republics include: exceptionally high arrears (estimated as high as 50 percent of the total public education budget in Montenegro); administrative inefficiencies (including a large number of small schools in Montenegro); emerging but under-utilized information systems; ineffective professional development practices; secondary education programs that provide only limited vocational training; inadequate infrastructure and equipment; and a fragmented higher education system characterized by low rates of on-time graduations. Moreover, the considerable challenges facing the sector are made more complex by the presence of strong teachers' unions advocating for higher wages and benefits. In Serbia, progress on education reform has slowed since late 2003 because of political uncertainty and policy disagreements. In Montenegro, by contrast, the Government is pursuing a strong reform strategy, including staff reductions and measures to address Roma issues.

IV. World Bank Group Assistance Strategy

A. Progress Under the TSS Programs and Lessons Learned

65. **The FY02-04 TSS for FRY provided a substantial program of support to the new democratic Government elected to office with a mandate to pursue modernization, market economy reforms, and international reintegration.** The TSS set out an overarching framework for a three-year country assistance program and presented pre-membership support and a detailed FY02 program. Subsequent annual programs were outlined in annual TSS Updates (July 2002 and February 2004). Despite the considerable changes that took place during the TSS period, including the February 2003 constitutional transformation from FRY to SaM, the TSS assistance program was implemented largely as anticipated with only slight deviations in response to changing country circumstances. While a formal review has not been undertaken, a preliminary assessment of implementation performance and lessons learned is laid out below.

- While the FY02-04 TSS objectives were appropriate, the future program should pay greater attention to the poverty impact of Bank activities and to regional linkages.

- Given its transitional nature and the urgency of program development, the TSS relied primarily on outputs as indicators of success. The future program, by contrast, should be built on outcome indicators, linked to the PRSP (and MDGs) and the SAP.

- While the TSS program unfolded largely as planned, many additional areas requiring support emerged during implementation. Moreover, in some instances, insufficient selectivity was exercised and trade-offs were not sufficiently defined, evaluated, and effected. Given limited resources, increased selectivity should be applied during both future program formulation and implementation.

- Despite well-intended plans and successes in some areas, capacity building was more limited than envisaged, largely due to frequent changes in the responsibilities and governing structure of the federal and republican programs, and in ministerial and agency staffing. Against this background, the future program should include substantial capacity building and institutional strengthening.

- The decision to maintain separate lending programs by republic, including adjustment lending, worked well. The two union-level projects, while now beginning to show some improvement, have proven particularly problematic in implementation. The CAS should continue to focus on activities at the republican level, supplemented by select regional activities.

- The high share of development policy lending under the TSS program proved an extremely effective mechanism for assisting the Government in undertaking difficult policy reforms and in coordinating and catalyzing donor support. In part, this reflects the fact that development policy lending was generally accompanied by significant institutional reform. The investment portfolio has proven less successful overall, suffering from implementation delays (many related to the constitutional transition and the complex state union and republican legal framework) and, from time to time, weak government support. This experience suggests that the CAS should continue to provide substantial development policy support and that new investment operations should, where possible, be more closely linked to the reform agenda being pursued under the development policy operations to ensure a stronger and more consistent focus to the Bank's policy dialogue.

- Strong donor coordination proved important in delivering results during the TSS implementation period, but the extensive time and costs to the Bank required to support effective donor coordination and partnerships were insufficiently recognized and planned for in the TSS. The best results were achieved when IDA and other donors worked on well-defined, properly targeted, adequately resourced multi-year programs of cooperation. Particularly strong examples were seen in energy, social assistance, and private and financial sector development. Active efforts to accelerate harmonization and improve donor coordination should be part of the CAS program. Government coordination of donor assistance has improved in Serbia, but will need to be strengthened in both republics over the CAS period.

- Strong analytical work must continue to underpin Bank activities. The multi-year poverty analysis program, the Public Expenditure and Institutional Review (PEIR), the Country Financial Accountability Assessment (CFAA), and the Country Procurement Assessment (CPAR) were particularly successful in enhancing and informing the adjustment lending program during TSS implementation. These tasks proceeded in parallel with the preparation of development policy lending often with the same teams participating in both, allowing the preliminary results of AAA to feed quickly and seamlessly into policy discussions.

- Within SaM's complex political economy, flexibility is critical to program and implementation success. The TSS program had sufficient flexibility to allow the Bank to provide just-in-time advice, including policy notes for the new Serbian Government.

- The Bank's Country Office was instrumental in implementing the TSS. An expanded work program under the CAS will require strengthened expertise in procurement, financial management, and legal services, as well as additional sectoral technical expertise.

B. Proposed World Bank Group Program

66. **The proposed CAS for FY05-07 reflects SaM's track record over the past four years and is anchored in the SAP and the PRSP.** All activities envisaged under the CAS will contribute to meeting one or more of the three country goals that summarize the overall economic objectives and reforms envisaged under the SAP and the PRSP, and around which the CAS is built:

- **Goal 1: creating a smaller, more sustainable, more efficient public sector;**
- **Goal 2: creating a larger, more dynamic private sector; and**
- **Goal 3: reducing poverty levels, and improving social protection and access to social services.**

67. **Consistent with SaM's goals, the CAS will support far-reaching structural reforms in the public and private sectors, while seeking to ensure that poverty is reduced, social protection is adequate and appropriately targeted, and access to social services by the poor and vulnerable is improved.** To ensure a self-sustaining economy and fiscally sustainable public sector in the medium and long term, the CAS strives to help the Governments to strengthen institutions (with institution and capacity building embedded in all planned activities) and to reduce the weight of the public sector in their economies. This is a prerequisite for giving the private sector room to grow, thereby stimulating productive activity, domestic private and public savings, and export growth. The WBG will support government efforts to increase efficiency in the public sector (including in the delivery of pro-poor social and economic services), while significantly improving governance in both the private and public sectors and encouraging the development of a vibrant private sector. In Serbia, the Bank's efforts will concentrate on parallel Programmatic Development Policy Loan (PDPL) programs, one focused on public sector reform (including public administration and pension reform) and the other on private sector development (including enterprise and financial sector restructuring and privatization and energy sector reform). The measures envisaged under the PDPL programs, and development policy support in Montenegro, together with other assistance from the WBG and complementary assistance from other development partners, should, if implemented effectively, translate into economic growth and employment creation. The anticipated major outcomes of the CAS program are summarized in Table 4 below.

Goal 1: Creating a smaller, more sustainable, more efficient public sector

68. **The key objectives and expected outcomes during this CAS period under Goal 1 include:** (i) fiscal consolidation; (ii) a leaner and more efficient public administration; (iii) better delivery of state services; and (iv) improved financial sustainability of pensions, healthcare, and education. Specific outcomes that the Bank would contribute to over the CAS period are shown in Table 4.

69. **Support from ongoing WBG projects.** In Serbia, Goal 1 is supported by two ongoing investment projects. The Serbia Employment Promotion Project seeks to improve the efficiency and cost-effectiveness of government-financed labor programs by piloting and testing innovative labor redeployment programs and employment services for the unemployed. The Serbia Health Project has two main components: health services restructuring and health finance, policy and management reform. It is the second of these components that relates specifically to Goal 1 in that it seeks to build the government capacity to develop, communicate, and implement health financing mechanisms, health policy, and health sector regulation.

Table 4: Summary of Results Matrix

Long-term country goals	Principal problems	Outcomes that the Bank and IFC (Goal 2) will influence in the CAS period	Selected ongoing or proposed Bank and IFC (Goal 2) activities
Goal 1: Creating a smaller, more sustainable, more efficient public sector			
A smaller, more sustainable, more efficient public sector ❑ Maintain macroeconomic stability ❑ Improve fiscal sustainability ❑ More efficient public administration	* Fragile macroeconomic stability * High public expenditures as a share of GDP (47% in 2004), reducing fiscal flexibility and keeping taxes and interest rates high * High spending on public sector wage bill, subsidies, and social transfers, particularly pensions and health	+ Reduction in non-interest current expenditures to GDP by around 4-6 percentage points + Leaner, more efficient public administration as measured by reduction in the public sector wage bill as a share of GDP by 1-1.5 percentage points and progress on wage decompression + Improved financial sustainability of pensions, measured by increase in collections and a lower pension deficit as a share of GDP by 1 percentage point	**Lending** Serbia: Employment Promotion, Health New – *SAC 2, Pensions (05), PDPL 2 (06), PDPL 4 (07)* Montenegro: SAC 2, Pensions System Administration, Health System Improvement *New – DPC 3 (07), Education (05)* **AAA** PEIR Update (06), Serbia Economic Memorandum (04), Montenegro Economic Memorandum (05), Debt Sustainability Update (05)
Goal 2: Creating a larger, more dynamic private sector			
A larger, more dynamic private sector ❑ Improve the business environment ❑ Accelerate privatizatior and restructuring of rea and financial sectors ❑ Develop financial mark ❑ Improve agricultural output and exports ❑ Increase private sector involvement in infrastructure	* No effective bankruptcy or contract enforcement mechanisms * Limited access to EU markets for agricultural products * Poor access to finance * Large state subsidies to loss-making enterprises * Inadequate legislative and regulatory framework for private sector participation in infrastructure	+ Accelerated privatization, with at least 25 tender privatizations + Increased restructuring and resolution of large loss-making state- and socially-owned enterprises, measured by a reduction in subsidies and net lending as a share of GDP by 1.1-1.4 percentage points + Improved access to finance, particularly for SMEs + Restructuring in the energy sector, measured by the separation of ownership of generation, distribution, and transmission, as well as a reduction in EPS staffing + Farmers and agro-processors more competitive, with more farmers meeting EU standards + Improved land titling	**Lending & other financing** Serbia: Privatization and Restructuring of Banks and Enterprises TA Credit, Private Sector TA Grant, Financial Sector TA Credit, Export Finance Facilitation, Employment Promotion, TTFSE, Real Estate Cadastre and Registration, Energy Efficiency, Electric Power Reconstruction, Transport Rehabilitation; IFC support for bank and insurance restructuring and privatization, development of non-bank financial sector *New – SAC (05), PDPL 1 (06), PDPL 3 (07), Regional Energy (05); Bor Regional Development (06), Irrigation and Drainage (06), Rural Business Environment (07); IFC support to Telekom Srbija, Secondary Privatization Pilot* Montenegro: SAC 2, TTFSE, Export Finance Facilitation, Emergency Power Reconstruction, Environmentally Sensitive Tourist Areas; IFC support for bank restructuring and privatization *New – DPC 1 (07), Regional Energy (06), Tourism and Agriculture (06); IFC support to Telekom Montenegro, bank restructuring and privatization* **AAA** PEIR Update (06), Serbia Economic Memorandum (04); Montenegro Economic Memorandum (05); Private Sector Note (05, FSAP (05), Agricultural Competitiveness Study (06), Labor market policy note (06) IFC Advisory and BIDFacility, regional infrastructure projects, SEED

Goal 3: Reducing poverty levels, and improving social protection and access to public services			
Reducing poverty levels, and improving social protection and better access to public services ❑ Mitigate social impacts of economic modernization and restructuring ❑ Improve delivery of social services especially for the poor and vulnerable ❑ Improve access to quality health and education services ❑ Reduce poor and "at risk" populations	* High and increasing rural poverty * Poor coverage and targeting of social protection, and poor reliability of budget transfers for social protection * Limited access, especially for poor and vulnerable populations, to affordable, quality healthcare and education	+ Improved coverage and targeting of social protection + Improved quality, access and financial sustainability of healthcare and education	**Lending** Serbia: Health, Education Improvement *New – PDPL, Bor Regional Development (06), Rural Business Environment (07), Primary Health Care (07)* Montenegro: SAC 2, Health System Improvement *New – DPC 1 (07)* **AAA** Programmatic poverty activities, Serbia Economic Memorandum (04), Montenegro Economic Memorandum (05), Poverty Assessment (07), PRSP implementation

70. In Montenegro, Goal 1 is supported by the three recently approved projects. SAC 2 is a multi-sectoral project that will contribute to each of the three country goals. In terms of Goal 1, the main contribution of SAC 2 is public administration and health sector reform. The Pensions System Administration Investment Project seeks to improve the financial position of the pension fund by increasing tax and contribution compliance; restructuring and modernizing the key institutions of the pension system; and strengthening capacity for evaluation and analysis of the pension system and pension reforms. The main objectives of the Health System Improvement Project are to improve the financial sustainability of the healthcare system by strengthening institutional capacity and information systems and to improve quality, efficiency, and access to primary healthcare services.

71. **New WBG projects.** In Serbia, Goal 1 will be supported primarily through development policy lending, initially through continuation of the SAC program (SAC 2 Serbia, FY05), and then through programmatic development policy support (PDPL 2 under the base case lending program and PDPLs 2 and 4 under the high case). These operations will form a multi-year program of assistance to the Government in addressing the key institution building and reform challenges described in Section III. The program will likely focus on reforms in: (i) public finance; (ii) public administration; (iii) pensions; and (iv) healthcare. The PDPL program in privatization and restructuring of real and financial sector assets described under Goal 2 (see paragraph 82) will also support rationalization of the public sector. In terms of investment lending, under both the base and high case lending programs, the public sector PDPL program under Goal 1 will be supported by a Pension Administration Reform Project in FY05. Like the recently approved pension project in Montenegro, this project offers an opportunity for scaling up and will target improvements in collections and enforcement under the mandatory first pillar, provide assistance in building capacity for policy analysis in the pensions sector, and seek administrative consolidation of the three pension funds.

72. In Montenegro, Goal 1 will also be supported through policy-based lending. Building on SAC 2, DPC 1 (FY07) will likely be a multi-sectoral operation incorporating measures designed to assist the authorities in meeting all three of the country goals. With reference to Goal 1, DPC 1

will likely focus on deepening reforms and capacity building in the areas of public finance and public administration.

73. **Analytical, Advisory and Other Activities**. The analytical foundation for both Serbia and Montenegro for the restructuring of public finances envisaged under Goal 1, particularly the PDPL program, is provided by the 2003 PEIR, which will be updated in FY06, and the 2002 CPAR and Country Financial Accountability Assessment. Over the CAS period, the Bank's knowledge base on public financial management (PFM) will be strengthened as necessary. Building on the CPAR and the CFAA, a limited Fiduciary Assessment focused on Serbia's budgetary resource management system is planned in FY05 to support PDPL 1. This will be followed by an integrated PFM report for SaM in FY06, alongside the PEIR update, that will deepen the Bank's financial management and procurement analysis.

74. Further analytical support will be provided by the Serbia Economic Memorandum (SEM FY04) and the Montenegro Economic Memorandum (MEM FY05). The recently completed SEM covers macroeconomic issues (particularly public expenditure), trade, labor market reform, private and financial sector development, and education. The MEM will be completed in FY05 and is expected to focus on macroeconomic issues (particularly public expenditure), labor market reform, infrastructure, and the business climate. A debt sustainability analysis update for SaM is also planned for FY05. Additional support for improving the efficiency and effectiveness of the public sector in Montenegro will be provided through an Institutional Development Fund (IDF) grant that aims to strengthen the capacity of the Central Bank of Montenegro in term of internal audit and internal controls.

Goal 2: Creating a larger, more dynamic private sector

75. **The key objectives and expected outcomes during this CAS period under Goal 2 include:** (i) continued progress on restructuring and privatization of real and financial sector assets; (ii) restructuring and resolution of large loss-making state- and socially-owned enterprises; (iii) improved access to finance, particularly for the SME sector; (iv) energy sector restructuring; and (v) where appropriate, private participation in infrastructure. Specific outcomes that the Bank and IFC would contribute to over the CAS period are shown in Table 4.

76. **Support from ongoing WBG projects.** The Bank and IFC are providing substantial ongoing support for the privatization and restructuring of real and financial assets in Serbia. The main pillar of the Bank's program is the Privatization and Restructuring of Banks and Enterprises Technical Assistance Credit. This Credit supports the launching and implementation of the restructuring and privatization process of some of the most problematic, large socially-owned enterprises and implementation of the Government's banking sector restructuring strategy. There are also two other ongoing projects in this area. The Private Sector Development Technical Assistance Grant primarily supports the Government's tender and auction enterprise privatization program, and also funds a legal consultancy for the drafting of a regulation on the conditions and procedure for defining the liability of the state for past environmental damage caused by enterprises under privatization.[20] The Financial Sector Development Technical Assistance Project primarily supports the Government's bank rehabilitation and privatization program. The Serbia Employment Promotion Project is designed to support the privatization and restructuring process through efficient and effective labor re-deployment and active labor market programs. In Serbia, IFC has facilitated an agreement between a regional investment fund and the Privatization Agency (PA) to pilot a secondary privatization scheme. This scheme could foster a wholesale approach to

[20] This will allow for clarity during the privatization process as to who will be legally responsible for environmental damage that occurred prior to privatization. Such clarity will help attract more reputable and strategic investors.

secondary privatization, whereby a special equity fund re-privatizes a large number of companies with limited access to capital. In the banking sector, having reached agreement on the restructuring of Udruzena Vojvodjanska Banka (UVB) arrears to IFC, IFC is supporting the restructuring and privatization of UVB successor banks. (Additional information on IFC's current program is provided in Annex 3.)

77. Assistance in this area is also being provided to Montenegro by both the Bank and IFC. In particular, the Bank, together with IFC, is supporting financial sector reform through SAC 2, particularly the privatization of Podgoricka Banka and the carving out and subsequent resolution by the Ministry of Finance of bad loan assets from the banking sector. The recent signing of a protocol with the Government of Montenegro on IFC's claims on Montenegrin enterprises and banks should pave the way for additional support for privatization and restructuring from IFC.

78. In the area of trade and export promotion, the Bank is providing support through two credits, both of which cover Serbia and Montenegro. The Trade and Transport Facilitation in Southeast Europe Project (TTFSE) is one of eight parallel country projects under the regional Trade and Transport Facilitation Program, which aims to lower non-tariff costs of trade and transport, reduce smuggling and corruption at border crossings, and strengthen regional partnerships and expand trade. In SaM, TTFSE supports modernization of the Customs Administration of the two republics, establishment of modern information systems shared across border agencies (with the ultimate objective of establishing a single electronic window for traders), transparency of information on official requirements, and implementation of new customs procedures at selected border crossings. The Export Finance Facilitation Project supports the efforts of the Serbia and Montenegro Export Credit Agency (SMECA) to facilitate and expand cross border trade by offering political risk insurance, working capital loans and guarantees, and export performance and credit insurance.

79. The Bank also has ongoing projects in both Serbia and Montenegro that are designed to foster sustainable private sector development through improvements in land registration and infrastructure, notably energy, transport, and solid waste management. In the energy sector, there are two projects in Serbia and one in Montenegro. The Serbia Energy Efficiency Project seeks to promote energy efficiency through investments and capacity building, while the Serbia Electric Power Emergency Reconstruction Project seeks to improve system security, financial management of EPS, and institutional capacity of EPS and the Ministry of Mining and Energy. The Montenegro Emergency Power Reconstruction Project seeks to improve payment discipline and reduce losses. In transport, the Serbia Transport Rehabilitation Project supports highway rehabilitation, winter and routine maintenance, and capacity building in the Serbia Road Directorate. In solid waste management, the Montenegro Environmentally Sensitive Tourist Areas Project (MESTAP) supports the development of the tourism sector by developing ecologically and commercially sustainable solid waste collection and disposal services in Montenegro coastal municipalities. Finally, the Serbia Real Estate Cadastre and Registration Project will contribute to the development of effective property markets by developing an efficient property registration and cadastre system.

80. IFC is also active in Serbia in the energy sector, solid waste management, and the water and waste water sectors. IFC is supporting the Ministry of Mining and Energy with three technical assistance projects focused on project development in the energy sector: (i) preparation of the required legal framework and feasibility assessment for the Constanza-Pancevo-Omisalj (CPOT) oil pipeline project;[21] (ii) development of a restructuring and privatization strategy for Naftna Industrija Srbjie; and (iii) development of a cogeneration study to survey market potential and

[21] IFC expects this pipeline to offer an environmentally safe alternative to bring high quality crude oil from Central Asia and Russia to Southern Europe.

identify opportunities for private sector participation. In addition, IFC is providing technical assistance on pre-privatization and restructuring measures to Elektronska Industrija and financing an advisor to the PA. In solid waste and water and waste water, IFC has provided advice on the restructuring of the Belgrade municipal solid waste management system (including the development of public-private partnerships and the preparation of a tender for private participation) and, together with EBRD and European Agency for Reconstruction (EAR), has supported the City of Belgrade in its efforts to encourage private sector participation in water and waste water services.

81. MIGA's outstanding guarantee portfolio in SaM consists of fourteen guarantee contracts: twelve in the financial sector, one in the services sector, and one in the manufacturing sector, with a total gross exposure of US$296.3 million and a net exposure of US$151.7 million. In addition, MIGA is currently considering two guarantee projects totaling US$35.7 million that are expected to be completed by end-2004 – one each in the financial and services sector. MIGA also provides TA (institutional development and capacity building) on investment promotion to both Serbia and Montenegro. An initial project benefiting the Serbia Investment and Export Promotion Agency (SIEPA) is nearing completion. A comprehensive follow-on project with a two- to three-year time horizon is expected to be launched in early 2005; this project will be implemented by MIGA on behalf of the EAR. In Montenegro, also with financial support from the EAR, MIGA is currently implementing an initial capacity building project in support of the new Montenegrin Investment Promotion Agency. MIGA's TA activities in SaM are feeding into a new, regional FDI outreach and marketing initiative for the Western Balkans which MIGA launched in summer 2004 (that is, the European Investor Outreach Program for the Western Balkans). Annex 10 provides additional information on MIGA's activities.

82. **New WBG projects.** In Serbia, support to Goal 2 will include substantial development policy lending, initially through continuation of the SAC program (SAC 2 Serbia) and then through programmatic development policy support (PDPL 1 under the base case lending program and PDPLs 1 and 3 under the high case). These operations will form a multi-year program of assistance to the Government in addressing the key institution building and reform challenges described in Section III. The PDPL program will likely focus on: (i) resolution of state holdings in the banking sector; (ii) development of the non-bank financial sector, including an appropriate regulatory and supervisory framework; (iii) restructuring and resolution of large loss-making state- and socially-owned enterprises, including the railways; and (iv) further improvements in the business environment.

83. IFC's program complements the Bank's program by focusing on development of the financial sector, post-privatization support to selected enterprises, private sector participation in infrastructure, and private sector investments in selected sectors (the pharmaceutical, mechanical, and paper sectors). In the financial sector, IFC will provide assistance in development of insurance and leasing, bank and insurance company privatization, and the participation of foreign strategic investors in the sector. Also, to support the development of housing finance in Serbia, IFC is considering financing a few banks, accompanied by substantial technical assistance. In the real sector, IFC will focus on post-privatization support to export-oriented companies with a view to enhancing their competitiveness in EU markets. In infrastructure, IFC will work closely with the Government and the Bank to develop projects that can attract private sector financing through public private partnerships (PPP). In Serbia, IFC will consider technical assistance to Telekom Srbije and stands ready to discuss the possibility of pre-privatization investment with the Government. In addition, IFC is establishing the Balkans Infrastructure Development Facility (BIDFacility) in cooperation with USAID and European donors to help public sector entities in the region attract private investment, particularly in energy, transport and sanitation.

84. The Bank's development policy lending program in Serbia will be supported by a number of new investment operations. The Bor Regional Development Project (FY06) will support the Government's efforts to restructure and resolve the state's share in the copper mining and processing conglomerate, RTB Bor, and to encourage diversified growth and job creation in the Bor region by improving the local business climate, supporting development of small and medium-sized enterprises, developing labor redeployment and active labor market programs, and improving environmentally damaged areas. Bor is one of the poorest regions of Serbia and the restructuring of RTB Bor is likely to lead to a large number of redundancies in an already severely depressed regional labor market (RTB is the largest employer with a work-force of around 8,000).

85. In addition, four Bank projects in Serbia will support the development of a strong and sustainable agricultural sector, which is very important given the still relatively high share of agriculture in GDP and the potential of Serbia's food processing industry. The Rural Business Environment Project (FY07) will seek to assist farmers in accessing EU markets by providing advice on access to finance, EU quality standards, and modern production techniques, as well as improving applied agricultural research and dissemination. The Danube River Pollution Reduction Project (FY05), funded by the Global Environment Facility (GEF), seeks to reduce nutrient pollution by helping farmers and slaughterhouses develop and implement more environmentally friendly production techniques. The Agro-biodiversity Conservation Project (FY06), also funded by the GEF, will help to conserve the globally important eco-system of the Stara Planina Nature Park by encouraging farmers to favor locally adapted animal breeds. The Irrigation and Drainage Rehabilitation Project (FY06) will seek to boost agricultural output through pilot irrigation schemes, particularly in Central and Southern Serbia, clearing drainage channels to improve drainage and reduce flooding, emergency rehabilitation of dykes to reduce flood risks, and institutional capacity building. IFC is also supporting the development of the agricultural sector through technical assistance to Agroziv, a large private meat processing company, in its efforts to modernize and meet international standards.

86. Projects in Montenegro in support of Goal 2 will include development policy lending and a number of investment operations. Building on the progress made under SAC 2, DPC 1 (FY07) will likely seek to support private sector development through reforms in the energy sector and in the business environment. The Tourism and Agriculture Development Project (FY06) will seek to encourage economic growth by further developing the infrastructure base required for successful tourism development. Two projects focused on improving the environment, funded by the GEF, will also help to boost tourism in the poorer northern part of the country and around Lake Shkoder and to ensure quality private sector growth. The Tara and Lim Basins Flood Hazard Management Project (FY06) will seek to improve flood management and mitigation capacity, including potential impact of dam failure in mine tailing ponds, and to promote sustainable forest and land management practices. The Lake Shkoder Integrated Ecosystem Management Project (FY06) will assist the Governments of Albania and Montenegro in implementing the Lake Shkoder Strategic Action Plan aimed at achieving more sustainable use of the natural resources of Lake Shkoder and its watershed. IFC will focus on institution building in the financial sector (including micro-credit institutions), tourism, and telecommunications. With respect to the latter, IFC is considering a pre-privatization investment in Telekom Montenegro.

87. Finally, support for Goal 2 also includes two regional energy projects, one in Serbia (FY05) and the other in Montenegro (FY06). These projects will help both republics integrate into the regional energy market (including harmonizing market rules and technical operations) and give consumers access to competitive suppliers from across the region (see Box 4). This will reduce energy costs for large industrial consumers, thereby boosting competitiveness, and compel national utilities to be more efficient by subjecting them to competitive pressures.

88. **Analytical, Advisory and Other Activities.** In Serbia, the analytical base for activities under Goal 2 related to restructuring and privatization of banks and enterprises, development of an appropriate supervisory framework for the banking sector, and development of a favorable business environment is provided primarily by the recently completed Investment Climate Assessment (ICA) and Financial Sector Note – the findings of which are synthesized in the SEM (see paragraph 74). Going forward, this analysis will be supplemented by a Private Sector Note, a Financial Sector Assessment Program review (FSAP, FY05), and a Labor Market Policy Note (FY06). The latter would support the PDPL program and could include analysis of the constraints to job creation and of informal labor markets. Similarly, in Montenegro, the analytical base for these activities, together with reforms in energy and infrastructure, will be provided by the forthcoming MEM, which will synthesize the findings of supporting studies of energy, infrastructure, and business environment constraints (see paragraph 74). The MEM will also include some analysis of the labor market.

89. The Serbia Rural Business Environment Loan will reflect the findings of Serbia Agriculture Report (2003) and a new piece of analysis in FY06 looking at the constraints to the development of the agricultural sector and the broader challenges in rural development. In FY05, the Bank is carrying out a sub-regional study, including SaM, on the capacity to carry out Environmental Impact Assessments and environmental management in general. The study will also explore business environment aspects related to environmental management. SaM would also be part of a regional study on weather/climate forecasting agencies and strategies to adapt to climate change, which may be responsible for increased variation in extreme climatic events, including the severe drought that caused a significant fall in agricultural production in 2003 and severe floods in the previous year in Serbia. The outcome of the study may be identification of a GEF co-funded project concept that aims to introduce loss mitigation measures. Technical assistance will be provided to the Government of Serbia in FY05 to review the draft Water Law from the point of view of compliance with the EU Water Framework Directive.

90. As noted in Section III, one of the main challenges under Goal 2 is the development of an effective legal and judicial system. In 2002, the Bank conducted a comprehensive legal and judicial diagnostic. This was followed in 2003 by approval of an IDF grant for strengthening the court administration system in Serbia (including training and an assessment of problems in court administration and case management). The remaining funds under this grant are expected to be used to assist the authorities in developing a comprehensive medium-term judicial reform strategy and institutional strengthening of the Ministry of Justice in the area of donor coordination.

91. IFC's large donor-supported technical assistance program is intended to support the development of a pipeline of potential investments in SaM by helping entities in target sectors or subsectors become bankable projects. Around US$4 million in donor funds has been mobilized to support institutional development, restructuring, and project preparation, mostly from the Swedish and Italian Governments. Looking forward, IFC will continue to provide significant technical assistance through a variety of instruments, ranging from broad sector analyses and capacity building programs to highly specialized restructuring and privatization assistance. IFC's technical assistance in SaM will focus on enhancing the development impact of its investment activities, improving the business environment for SMEs, assisting domestic companies in meeting EU standards, facilitating the development of domestic financial markets through institution-building and the use of innovative financial products, and restructuring and privatization support, particularly in the financial sector and infrastructure.

92. IFC will also continue to provide support to SMEs through its well-established Southeast European Enterprise Development (SEED) facility (see Box 7). Full integration of SEED's technical assistance with IFC's investment work is being pursued in order to further develop a joint

approach to project development. SEED will be working on linkage programs designed to integrate SMEs into the supply chains of large companies and IFC will seek to provide appropriate financing. In agri-business, SEED is working with business associations to support herbal and food-processing companies, as well as working with farmers on supply chain management to a large vegetable oil producer and with food processors supplying a large supermarket chain.

Box 7: SEED in Serbia and Montenegro

SEED is a multi-donor partnership, led by IFC, in support of SME development in the region. In 2004, SEED was fully integrated into IFC's regional strategy. SEED is currently planning programs supporting SMEs and private sector development in: (i) access to finance; (ii) linkages; (iii) business membership organizations; and (iv) EU standards.

The **access to finance** pillar addresses SME financing issues through the development and advocacy of new financing solutions. For example, leasing has been introduced by SEED to supplement conventional lending. Looking forward, IFC is planning to develop alternative dispute resolution mechanisms (ADR) by increasing the number of courts using mediation. In addition, a corporate governance program that targets selected enterprises is being prepared and, in 2005, IFC will explore the possibility of a housing program.

The **linkages** pillar, which is based on SMEs that function in a supply chain, will be more sharply focused on specific sectors. Currently, IFC is developing a program to address the role of Roma in supplying recycled scrap (glass, steel, paper, and plastics) to processors in the region. With an estimated 60,000 working in recycling, this will offer Roma considerable opportunities to strengthen their business, while also strengthening the overall environment for recycling.

The successful **business membership organization** pillar will be extended to additional organizations, while continuing to focus on improving general and advocacy capacities of new organizations and on providing training and consultancy services to the growing number of companies that rely on these organizations.

In recognition of the growing need for exporters to meet **EU standards** to access EU markets, a program is being designed to develop the requisite knowledge base at the local level and supporting organizations.

93. FIAS is providing support on improving the business enabling environment. In particular, FIAS has assisted the government with a self-assessment of administrative procedures for doing business, following up on earlier FIAS study on the general investment climate in Serbia.[22] While many of the recommendations of the first study were already adopted, the second study was initiated in response to continued weak foreign direct and domestic investment. The first study identified land acquisition and land development as the most important investment constraints, while the second study identified three major areas of concern. These are: (i) start-up procedures (with improvements needed in expatriate employment conditions, company registration, licensing, and institutional and intellectual property rights); (ii) locating procedures (acquisition of land, real estate registration, construction permits, infrastructure, leasing, and privatization practices); and (iii) operating procedures (tax reform, improving the foreign exchange regime, customs inspections, payment operations, and standardization). The Government subsequently prepared an Action Plan to strengthen the Regulatory Council in its efforts to improve the overall regulatory environment.

94. WBI will continue to support WBG efforts to advance private sector development in the region, including SaM. Workshops on improving export promotion, including support to the Serbian export promotion agency, will be carried out in FY05, complementing implementation of ongoing Bank projects and the CAS program. WBI will also provide training and institution

[22] The first FIAS study undertaken in SaM, "Republic of Serbia – The Climate for Foreign Direct Investment", was completed in January, 2002. The survey accompanying the second study on administrative procedures is based on interviews with 408 firms, of which 49 percent were small, 34 percent medium, and 17 percent large enterprises and covers the conditions, regulatory costs, and productivity of doing business in the country. The survey was finalized in June 2003.

strengthening as a part of the Bank's broader program of support for the development of SMEs and enterprise restructuring and privatization, building on GDLN video conferences on the main findings of the ICA. WBI staff also recently led a small team that prepared a series of knowledge economy assessments for the Balkan countries and will remain engaged in subsequent program development and implementation. Looking forward, WBI will seek to expand the regional focus of its support to measures related to Goal 2, seeking to encourage an exchange of lessons and knowledge in a region with significant potential for closer economic ties. The full scope of WBI's activities planned in support of this CAS is provided in Annex 7.

Goal 3: Reducing poverty levels, and improving social protection and access to public services

95. **The key objectives and expected outcomes during this CAS period under Goal 3 include** improvements in: (i) support for rural communities; (ii) the coverage, targeting, and reliability of transfers for social protection; and (iii) the quality, access, and financial sustainability of health and education for all citizens.

96. **Support from ongoing WBG projects.** In Serbia, Goal 3 is supported by two ongoing investment projects. The Serbia Health Project has two main components: health services restructuring and health finance, policy, and management reform. It is the first of these components that relates specifically to Goal 3. Under this component, the project supports planning and implementation of the Government's strategy for improving the efficiency of healthcare delivery while maintaining quality. This support includes restructuring and rehabilitation of physical and human capacity at four regional hospital centers, which should lead to a visible improvement in both the availability and quality of secondary healthcare services in these four areas. The Serbia Education Improvement Project also has two main components: building capacity and information to promote education reform, and improving teaching and learning in schools, and empowering local communities to take responsibility for their schools. In addition to helping to design and implement an information system, the project provides small innovation grants to schools, supports the development of capacity for measuring student performance, and promotes decentralization.

97. In Montenegro, Goal 3 is supported by SAC 2, which seeks to improve the reliability of transfers to the pension and health funds and to assist the Government in developing a medium-term financing framework for both pensions and healthcare services. In addition, Goal 3 is supported by the recently approved Montenegro Health System Improvement Project. As explained under Goal 1 (see paragraph 69), the main objectives of this project are to improve the financial sustainability of the healthcare system by strengthening institutional capacity and information systems and to improve quality, efficiency, and access to primary healthcare services.

98. **New WBG projects.** In Serbia, support for Goal 3 will be provided through both development policy lending and investment operations. In terms of development policy lending, the public sector reform PDPL program (see paragraph 71) will likely target both improvements in social protection and reforms in health and education. Policy-based lending will be accompanied by three projects that will have direct impact on the objectives outlined above.

99. As noted earlier, the Bor region is one of the poorest areas of Serbia and the proposed Bor Regional Development Project (FY06) is specifically designed to assist the authorities in alleviating poverty by encouraging the growth of the regional economy (see paragraph 84). In addition to providing support to farmers to improve agricultural competitiveness (see paragraph 48-50), the Rural Business Environment Project (FY07) will seek to address the challenges to alleviating rural poverty described in Section III (see paragraphs 54-56), including the

disillusionment of the youth. In doing so, the project may seek to build on the Government's rural development grant scheme by providing matching grants for selected activities designed to boost employment and improve access to services in rural communities. The Primary Health Care Project (FY07) will seek to address the challenges to providing quality primary healthcare outlined in Section III (see paragraphs 60-62).

100. In Montenegro, support for Goal 3 will also be provided through both policy-based lending and investment operations. DPC 1 (FY07) is expected to include a component designed to improve the coverage and targeting of social protection and, perhaps, a component designed to further improve the financial sustainability of the pensions and health systems. The Montenegro Education Development Project (FY05) will also support the achievement of the objectives of Goal 3. This project seeks to improve: (i) the efficiency of public spending on education (thereby also contributing to meeting Goal 1); (ii) management of the education sector through capacity building; and (iii) the quality of education by focusing on developing teachers' skills.

101. **Analytical, advisory and other WBG activities.** In both Serbia and Montenegro, the primary analytical base for activities under Goal 3 is the PRSP, the 2003 PEIR, and the 2003 Poverty Assessment. Going forward, this analytical base will be updated (a PEIR update is planned in FY06 and a Poverty Assessment in FY07) and deepened through regular poverty monitoring, as well as monitoring of, and reporting on, PRSP implementation. In Serbia, activities in poverty monitoring and analysis over the CAS period include notes on rural poverty and Roma poverty and a social protection study. In Montenegro, regular poverty monitoring will be supplemented by reports on the targeting and efficiency of social programs and on health and poverty.

102. Activities under Goal 3 in Serbia and Montenegro will also reflect the findings of the SEM and MEM, respectively (see paragraph 74). Studies are also under way or planned on youth in SEE (FY05), social capital in Serbia (FY06), and on social protection for poor and vulnerable groups, including Roma, IDPs, and refugees, in Montenegro (FY06/FY07). The latter will assist in the preparation of DPC 1. Activities under the Roma Decade of Inclusion (see Box 6), including the development and implementation of the associated action plans, will also help to assist in meeting Goal 3.

103. To support the PRSP process, WBI has led a series of development debates and seminars open to all Balkan countries, including a well-attended Second PRSP Forum, enabling participants to exchange experiences and derive lessons learned. In FY05, follow-up activities will focus on a Third PRSP Forum and similar related events, and a Basic Poverty Measurement and Diagnostics course, all intended to further engage participants from previous events as well as new stakeholders. Other activities planned for FY05 will focus on regional training on select topics including a course on Social Accountability and Monitoring; support of Roma participation in various activities; and support for the development of websites and virtual learning environments promoting regional networking with special emphasis on education issues and Roma women. For both the country-specific and regional/global programs, the GDLN Network will be used as appropriate to ensure cost efficiency and maximum knowledge sharing and dissemination. WBI activities will also actively support partnerships particularly in the area of private sector development. Annex 7 elaborates upon WBI's role in the delivery of the SaM CAS program.

C. Lending Scenarios and Triggers

104. **The proposed lending program envisages a gradual transition from IDA to IBRD beginning in FY06.** In recognition of the unusual country circumstances and the success of the IDA program to date, SaM's exceptional and temporary eligibility for IDA resources on hardened

terms has been extended to FY05-07 to allow for the establishment of creditworthiness for limited IBRD borrowing, thereby ensuring a smooth transition from IDA to IBRD. At the same time, however, the amount of IDA resources allocated to SaM over the CAS period is envisaged to be much lower than the US$540 million three-year TSS envelope, making the establishment of creditworthiness for limited IBRD borrowing essential to ensure adequate lending resources to assist SaM in meeting the three country goals on which the CAS is built.

105. **The IDA envelope for the CAS period is expected to be US$225 million (subject to policy performance – meeting the lending triggers for the base case discussed below), supplemented by IBRD funds, if creditworthiness for limited IBRD borrowing is established.** In addition, US$20 million of regional project funds under IDA14 has been requested to support the two regional energy projects.[23] Planned IDA lending is front-loaded to allow the establishment and strengthening of creditworthiness, with US$100 million available in FY05, US$75 million in FY06 and US$50 million in FY07. SaM's IDA envelope for FY05 was reduced by US$18 million because of IDA's constrained commitment authority (these funds were originally part of the FY04 envelope). The ECA region is exploring the possibility that these funds could be allocated in FY06-07 and used to increase the size of planned investment operations. A debt sustainability update is planned for end-FY05 as an input into an assessment of SaM's creditworthiness for borrowing from IBRD. If creditworthiness for limited IBRD borrowing is established, the IDA envelope of US$225 million would be supplemented by US$175 million of IBRD lending under the base case and US$325 million under the high case, bringing the total base and high case lending envelopes to US$400 million and US$550 million, respectively. Lending to Montenegro is expected to account for roughly 10 percent of total envelope under the base and high case scenarios. In light of the importance of the regional agenda (see Box 1) and the possibility of generating positive externalities through a regional approach, the creation of incentives for participation in regional projects, in addition to the country-specific allocations, will remain an issue with SaM's envisaged transition from IDA to IBRD borrowing.

106. **The level of lending will be closely linked to policy performance at the republican level.** Defining lending triggers for SaM as a whole is neither possible nor appropriate, since the responsibility for economic policy lies at the republican level and the policy challenges facing the republics, while covering the same basic areas, are different. Having separate lending triggers for each republic will allow flexibility to respond to pace of reforms at the republican level. While both republics are currently in the base case, in practice, this means that one of the republics could move to the high case program while the other remains in the base case. In addition to satisfactory portfolio performance, the triggers for remaining in the base case for both republics target continued macroeconomic stability and steady progress on key elements of the structural reform agenda (see Table 6, and Section III for the main challenges). The proposed base case lending program is strongly performance-oriented and is centered around development policy support in both republics targeting public sector reform and private sector development. Development policy lending would account for around 50 percent of base case lending, in view of the authorities' emphasis on significant structural reforms over the CAS period. However, as noted above, in addition to meeting the base case triggers, access to IBRD funds under the base case will depend on establishment of creditworthiness for limited IBRD borrowing.

[23] Future availability of regional project funds from IDA (implemented on a pilot basis since FY04) is contingent on the outcome of the ongoing IDA 14 (FY06-08) replenishment negotiations and on a forthcoming review of the guidelines for regional projects. The current guidelines enable two-thirds of the credit amount for eligible regional projects to be financed from regional project funds, with the remaining one-third being met from the country allocation.

Table 5: SaM – Bank Lending Program, FY05-07 (US$ million)

FY05 – Base Case – All IDA

Serbia	
Structural Adjustment Credit 2	45
Regional Energy [1]	7
Pensions	25
Montenegro	
Education	5
Structural Adjustment Credit 2	18
FY05 Total IDA	***100***

FY06

Base Case	IDA	IBRD	Total	High Case	IDA	IBRD	Total
Serbia				***Serbia***			
Prog. Development Policy Loan 1	41	14	55	Prog. Development Policy Loan 1	41	14	55
				Prog. Development Policy Loan 2	0	55	55
Irrigation and Drainage Rehabilitation	25	0	25	Irrigation and Drainage Rehabilitation	25	0	25
Bor Regional Development	0	30	30	Bor Regional Development	0	23	23
Montenegro				***Montenegro***			
Tourism and Agriculture	6	6	12	Tourism and Agriculture	6	9	15
Regional Energy [1]	3	0	3	Regional Energy [1]	3	0	3
FY06 Total	***75***	***50***	***125***	***FY06 Total***	***75 (+6)***	***100***	***175***

FY07

Serbia				***Serbia***			
Prog. Development Policy Loan 2	46	44	90	Prog. Development Policy Loan 3	46	54	100
				Prog. Development Policy Loan 4	0	100	100
Primary Health	0	35	35	Primary Health	0	26	26
Rural Business Environment	0	40	40	Rural Business Environment	0	27	27
Montenegro				***Montenegro***			
Development Policy Credit 3	4	6	10	Development Policy Credit 3 [2]	4	18	22
FY07 Total	***50***	***125***	***175***	***FY07 Total***	***50***	***225***	***275***
Total FY05-07			*400*				*550*

Global Environment Facility -- FY05: Serbia Danube River Enterprise Pollution Reduction Project (US$9 million); FY06: Serbia Agro-biodiversity Conservation Project (US$5 million); Montenegro Lake Shkoder Integrated Ecosystem Management Project (US$5 million); Montenegro Tara and Lim Flood Hazards Mitigation Project (estimated US$ 3-6 million).

[1] Funding from regional project funds has been requested for these projects. Future availability of such regional funds, however, is contingent on the ongoing IDA 14 replenishment negotiations and on a forthcoming review of the guidelines for regional projects. In FY06, IDA regional funds would be sought to support both the Serbia Regional Energy Project, as supplement to the country IDA allocation proposed for FY05, and the Montenegro Regional Energy Project, in the amount of US$14 million and US$6 million, respectively.
[2] Depending on the Government's priorities and projected financing requirements, some or all of these funds may be used for investment lending in support of activities in environment and/or agriculture.

107. **High case lending triggers are linked to accelerated and deepened progress on structural reforms, which will strengthen creditworthiness and lay the foundation for sustainable growth over the medium term.** The triggers indicate the areas of the Governments' programs that will be monitored in order to make a judgment on the pace and depth of policy reform during the CAS period (see Table 6, which also presents some indicators that will be used in making such a judgment). In addition to the areas covered by the base case triggers, the assessment of policy performance under the high case will focus on reforms in public administration; the enterprise and financial sectors and the business environment; and the energy sector. Consistent with a scenario of strong progress on structural reform, the high case lending program, particularly in the case of Serbia, envisages a high level of development policy lending in support of the Governments' reform efforts.

Table 6: Lending Triggers

Serbia	
To stay in the base case	To move to and stay in the high case
➢ Continued satisfactory portfolio performance - *No more than two problem projects* ➢ Continued satisfactory macroeconomic performance (including improved external balances, as appropriate) - *Durable reductions in public expenditure as a share of GDP* - *Staying on track with the IMF program* ➢ Continued satisfactory progress on resolving government holdings in the banking sector and on enterprise restructuring and privatization - *Reduction in budget subsidies* - *Reduction in the state's share in economic activity* ➢ Continued satisfactory implementation of the PRSP - *Progress on the PRSP action plan* - *Establish and maintain periodic poverty monitoring and analysis*	All base case triggers plus: ➢ Implementation of the public administration reform strategy agreed with the Bank - *Reductions in the number of civil servants* - *Introduction of new pay and grading system* - *Increase in the compression ratio to at least 1:6* ➢ Accelerated progress on: (i) resolving government holdings in the banking sector, large state- and socially-owned large loss makers, and insolvent insurers; and (ii) improving the business environment - *Progress in resolving state shares in large banks and non-performing assets held by the BRA* - *Restructuring of state debt that impedes enterprise restructuring* - *Privatization of viable enterprises and bankruptcy of those that cannot be sold* - *Restructuring of the railways* - *Improvement in contract enforcement indicators* ➢ Implementation of energy sector reform - *Strong progress on EPS restructuring* - *Establishment and then strengthening of the energy regulator with a view to moving to full tariff-setting authority*
Montenegro	
To stay in the base case	To move to and stay in the high case
➢ Continued satisfactory portfolio performance - *No more than two problem projects* ➢ Continued satisfactory macroeconomic performance - *Durable reductions in public expenditure as a share of GDP* - *Staying on track with the IMF program* ➢ Continued satisfactory progress towards completing resolution of government holdings in the banking sector - *Completion of the sale of Podgoricka Banka* - *Steady progress in resolving non-performing loan assets held by the MoF* ➢ Continued satisfactory implementation of the PRSP - *Progress on the PRSP action plan* - *Establish and maintain periodic poverty monitoring and analysis*	All base case triggers plus: ➢ Implementation of the public administration reform strategy - *Adoption and application of merit-based recruitment and promotion* - *Gradual increase in the compression ratio to at least 1:6* - *Conversion of management-level posts to career civil service posts* ➢ Accelerated efforts to resolve government holdings in large enterprises - *Reduction in the state share in economic activity* - *Resolution of the state share in KAP* ➢ Aggressive implementation of energy sector reform - *Strong progress on EPCG restructuring* - *Signature of an acceptable PPA between EPCG and KAP)*

108. **Both republics expect to move to the high case scenario in terms of policy performance as early as possible in the CAS period. However, access to IBRD funds would also depend on the establishment of creditworthiness for limited IBRD borrowing.** Specific measures that would indicate such strong policy performance in the near term are listed below. In Serbia, in addition to passage by Parliament of a budget for 2005 that envisages a high quality fiscal adjustment (including a cut in the public sector wage bill of around 0.4 percentage points of GDP and cuts in subsidies of around 0.5 percentage points of GDP, including the Development Fund and the railways), policy performance consistent with the high case in the near term would be

demonstrated by achievement of at least 3 of the following: (i) enactment of core public administration legislation, including the Law on State Administration and the Law on Salaries; (ii) completion of the ongoing sales of 3 state banks and launching the tender for privatization of another large bank in which the state has a majority share (which in total account for more than 20 percent of the assets of the banking system); (iii) completion in FY05 of 10 tender privatizations and resolution of a further 5 companies, or parts thereof, through restructuring (these 5 companies are expected to account for around 10 percent of the total workforce in companies on the Government's restructuring list); and (iv) legal unbundling of EPS (creation of separate generation and distribution subsidiaries and a separate transmission company). Similarly, in Montenegro, in addition to passage by Parliament of a satisfactory budget for 2005 specific measures that would contribute to a favorable assessment of progress on reform are: (i) implementation of the new Law on Salaries in the 2005 budget; and (ii) conclusion of an acceptable power purchase agreement between Kombinat Aluminijuma Podgorica (KAP) and EPCG.

109. **In the event that the base case triggers are not met, lending will shift to a low case.** Bank lending under the low case would be around US$50 million per annum – less than half the amount envisaged under the base case – and would be focused on capacity building, social sector service delivery, and regional projects. These projects would seek to alleviate the impact of the changing country circumstances on poor and vulnerable populations, while also seeking to capture externalities from regional projects.

D. Implementing the CAS

Partnerships and Donor Coordination

110. **The Bank works closely with multilateral and bilateral donors providing support for the overall reform program**, particularly through the Country Office. The European Commission (EC) is the Bank's key partner, promoting reforms linked with the SAP and sharing the mandate with the Bank to facilitate coordination of donor assistance to SaM.[24] The Bank and the EC are working jointly with the SaM authorities, and other donors, particularly DFID, towards harmonization, including procurement and financial management policies. Aiming at closer economic, political, and social ties amongst SEE member countries, the Stability Pact and its various Working Groups provide a useful platform for dialogue and cooperation with donors (see Box 1). The Bank also works closely with the EBRD and EIB to foster private sector development, and with UNDP and bilateral donors, including DFID, in assisting the Governments' in PRSP implementation and monitoring, as well as on integration of the MDGs and the PRSP. During the CAS period, the Bank will also continue to work with the IMF to address the underlying structural causes of macroeconomic imbalances. As described in Sections III and IV of the CAS, World Bank activities under Goals 1 and 2 in particular will support the Government's efforts to reduce non-interest current expenditures in a sustainable manner and to increase competitiveness. Given the close link between successful implementation of reforms designed to meet these goals and fiscal and external sustainability, continued close collaboration between the Bank and the IMF is essential. Donor involvement by sub-sector in SaM is highlighted in Annex 9.

111. **As part of their harmonization efforts, both Serbia and Montenegro intend to strengthen donor coordination capacity.** In tandem, the international community (IC) needs to work towards greater complementarity and selectivity within and among programs – a significant challenge given the continued shift in assistance from post-conflict reconstruction to deepened support for growth and equitable development, and the projected decline in the volume of donor

[24] Between 2000 and 2003, the Bank and the EC together coordinated 3 donor conferences, raising some US$4.1 billion in pledged donor assistance on behalf of SaM's economic reform program.

assistance. A good example of this collective effort by the IC to intensify donor coordination is the multi-donor (GTZ, WB, USAID, EBRD, EAR, SIDA, Switzerland, and WTO) working group that supports the development of the financial sector. The Serbian Ministry of International and Economic Relations is progressively assuming more responsibility and accountability for coordinating and reporting donor assistance, but faces substantial capacity constraints. Overcoming capacity constraints also represents a major hurdle in Montenegro, and donors, including the Bank, are working to achieve improved complementarity in terms of both programming and implementing assistance in order to reduce the burden of coordination on the authorities and to maximize program outcomes. In both republics, the PRSP process has significantly enhanced opportunities for new and ongoing consultation and partnership with civil society and the donor community.

Portfolio Management

112. **The SaM portfolio has grown rapidly since 2000.** A total of 29 operations have been approved over the last four years. Total commitments to date amount to US$603.6 million (including US$30 million in grants from IBRD net income and a further US$33.6 million in trust funds and cofinancing) of which US$401 million has been disbursed. The current SaM portfolio consists of 20 projects with an undisbursed balance of US$223 million. Given the relatively large portfolio compared to the level of commitments envisaged over the CAS period, effective portfolio implementation will be key to achieving the three country goals around which the CAS program is built (see Results Framework in Annex 8).

113. **Continued efforts will be required to strengthen portfolio implementation.** There are currently two problem projects (Serbia Education Improvement Project and Serbia Health Project). Detailed action plans for improving performance have been developed for both of these projects and the results to date are encouraging. There are currently no projects at risk. Continued close portfolio monitoring will be necessary to maintain, and improve, SaM's implementation track record – in this respect, it is important to remember that the SaM portfolio is very young, with an average age of just 1.5 years. While the FY04 JPR highlighted a number of cross-cutting project issues, particularly in Serbia (which accounts for 13 of the 18 projects currently under implementation), most of the delay in project implementation experienced to date are project-specific and relate primarily to political changes and associated policy uncertainties. In terms of cross-cutting issues, the key issue raised in both republics was the need for a focal point within the Ministry of Finance empowered to oversee the Bank's portfolio on behalf of the Ministry and to act as a liaison for Project Implementation Units (PIUs). Both republics have now appointed focal points and all PIUs have been informed accordingly. In view of the need to build capacity in procurement and financial management, a Technical Services Unit was recently established in Montenegro under the Deputy Prime Minister to handle these aspects of project implementation for Bank projects. Responsibility for all other aspects of project implementation remains with the Ministry/ies concerned. This separation of responsibilities should enable effective implementation of the Montenegro portfolio. The decentralization of responsibility for portfolio management to the Country Office should also help to support implementation in both republics.

V. Creditworthiness and Risk

A. Creditworthiness and Debt Sustainability

114. **SaM's external debt to GDP ratio has declined from over 103 percent in 2001 to a projected 57.8 percent in 2004** (see Table 7). This improvement reflects the normalization of relations with Paris and London Club creditors, as well as an increase in dollar GDP. In November 2001, SaM secured a highly concessional debt restructuring agreement with the Paris Club. This agreement involved, among other things, a phased 66 percent reduction in the net present value of Paris Club obligations and a rescheduling of the remaining stock over 22 years with a 6-year grace period. In July 2004, SaM also reached an agreement with the London Club of commercial creditors settling Serbia's outstanding US$2.7 billion debt. The agreement implies roughly a 62 percent net present value write-off, and reschedules the rest over 20 years at an interest rate of 3.75 percent during the first 5 years and 6.75 percent during the remaining 15 years.

Table 7: Key Sustainability, Liquidity, and Exposure Indicators

	Act.	Est.	Proj.	Proj.	Proj.	Proj.
	2002	2003	2004	2005	2006	2007
PUBLIC DEBT						
Solvency ratios						
TDO/GDP	85.5	79.9	65.1	57.7	56.3	54.1
TDO/Revenue	197.6	185.4	150.4	134.8	134.2	131.3
FOREIGN DEBT						
Solvency ratios						
TDO/GDP	76.5	69.9	57.8	56.4	54.4	52.6
TDO/XGS	219.6	205.9	143.8	125.2	113.8	105.8
Liquidity ratios						
TDS/XGS	3.4	6.7	11.2	13.3	13.1	14.9
INT/XGS	2.6	3.7	4.3	5.3	5.4	5.2
TDS/GDP	1.2	2.3	4.5	6.0	6.3	7.4
TDS/gross official reserves	8.1	13.0	28.1	33.4	34.4	40.2
WORLD BANK EXPOSURE INDICATORS						
DO to IDA (US$ million)	167.0	282.0	446.3	564.7	650.1	699.6
DO to IBRD (US$ million)	2175.0	2607.0	2607.0	2590.9	2550.8	2544.1
share of IDA in TDO (%)	1.4	2.0	3.3	4.3	5.1	5.4
share of IBRD in TDO (%)	18.4	18.2	19.4	19.8	19.9	19.6
DS to WB (US$ million)	75.5	105.5	125.8	143.5	182.0	201.6
share of DS to WB in TDS (%)	41.1	22.8	12.0	10.3	12.3	11.1
Interest to IBRD	75.0	104.5	122.7	116.2	114.9	112.0
Principal to IBRD	0.0	0.0	0.0	19.1	56.7	75.2
Repayment o IBRD	75.0	104.5	122.7	135.3	171.5	187.3
Repayment to IBRD as % TDS	40.8	22.6	11.7	9.8	11.6	10.3
DS to IBRD as % XGS	1.4	1.5	1.3	1.3	1.5	1.5
DS to IBRD as % of public DS	56.0	36.0	23.4	23.3	29.5	23.0

115. **External debt to GDP is projected to decline further over the CAS period, but the outlook for liquidity indicators is less favorable.** External debt to GDP is projected to decline to 52.6 percent by 2007, suggesting that the base case macroeconomic framework satisfies the long-run sustainability condition. However, the picture in terms of liquidity indicators is less favorable, reflecting a combination of expiration of grace periods on new and restructured debts and rising short-term borrowing (see Table 7). For instance, the ratio of TDS to exports is projected to fluctuate between roughly 11 and 15 percent between 2004 and 2007, well above its 2002 and 2003 levels of 3.4 percent and 6.7 percent, respectively. All other things being equal, this less favorable outlook renders the country more vulnerable to adverse external shocks, including slower than expected export growth due to weak foreign demand for SaM's products and services and faster real exchange rate depreciation.

116. **While IBRD's current and projected exposure to SaM is high, SaM has established a strong record of servicing Bank debt since 2001 and exposure indicators are projected to improve over the CAS period.** IBRD exposure is high measured on a per capita basis or as a share of GDP or exports, and IBRD debt accounts for a large share of SaM's total debt outstanding.[25] Debt service ratios are more favorable, however. IBRD debt service to exports of goods and services is projected to increase moderately over the CAS period but remains low at less than 2 percent. Bank debt service as a share of total public debt service is projected to decline from its current level of 23.4 percent in 2004 to 23 percent in 2007. The share of IBRD debt in SaM's total debt outstanding is projected to remain at around 19 percent during the period of consideration. SaM is not currently considered creditworthy for IBRD lending, and all IBRD loans to SaM are in non-accrual status.

B. Risks

117. **Both republics continue to face tremendous political, policy, and implementation capacity pressures that could lead to slippage on the reform agenda, thereby complicating the medium-term macroeconomic and growth outlook.** The establishment of the state union, together with the heightened partisan debate that followed the assassination of Serbian Prime Minister Djindjic, led to temporary delays in legislative and economic reforms, and slippages in day-to-day economic management. Since early 2004, however, the Government of Serbia has demonstrated remarkably strong policy performance, responding by deepening and accelerating the economic reforms, thereby mitigating – at least temporarily – the risks to reform program implementation.

118. **Nonetheless, the political will to implement difficult reforms in both republics remains highly vulnerable** to shifting relations within the respective ruling coalitions (both faced with approving new republican constitutions in the near future), as well as to relations between the two republics. This political commitment will be tested over the CAS period in both republics by the need to enact measures that result in durable cuts in non-interest current expenditures, while increasing public investment. Compounding the impact of SaM's complex political economy on the pace of reforms are considerable capacity constraints on implementation of economic legislation and regulations. Against this background, guarding against "reform fatigue," while maintaining strong progress on reforms necessary to underpin fiscal sustainability and sustainable medium-term export-led growth, will be essential to maintain the momentum on the reform agenda. Other factors that could complicate the reform process over the CAS period include a potential referendum on the continuation of the state union, developments in Kosovo and southern Serbia,

[25] The noted high share of IBRD debt in the total was inherited from SFRY. At the end of 2000, the share of IBRD debt in the country's total debt was 15.6 percent. As a result of the dollar/euro exchange rate developments, debt to IBRD increased both in terms of its share in the total debt (to 18.2 percent at the end of 2003) and in US$ terms—from US$ 1.8 billion at the end of 2000 to US$ 2.6 billion at the end of 2003.

failure to satisfy some key partners on the depth and pace of cooperation with ICTY, vested interests at all levels of government (including local and municipal governments), and additional complexities arising from new, constitutionally-mandated, state-level structures.

119. **SaM's ability to maintain a sustainable macroeconomic framework, achieve a recovery of growth, and deepen economic competitiveness could be adversely affected by exogenous shocks.** The projected resurgence in exports, which is important for debt sustainability (liquidity ratios) as well as the broader economic growth agenda, may not materialize in the event of weaker than anticipated foreign demand associated with potential slowdown in economic activity amongst key trading partners. Similarly, SaM's medium-term financing picture relies on a marked rebound in foreign direct investments that may not materialize in the event of unfavorable development in global and/or EU markets. Economic growth could also be affected by poor agricultural output (agriculture accounts for around 25 percent of GDP) in the event of adverse weather.

VI. Concluding Remarks

120. **SaM's impressive track record of solid policy performance in the wake of important political events bodes well for the outcome of the overall reform program during the CAS period and building the level of confidence essential to fostering growth and investment.** Based on this experience, despite formidable challenges ahead, slippage on major components of the reform agenda is considered unlikely. Ongoing engagement of the international community, especially in the form of an increasingly robust portfolio of long-term lending, will help to ensure continued progress. At the same time, the risks associated with continuation of the state union will be mitigated by focusing the WBG's assistance at the republican level.

Relations with the European Union and Progress on the Stabilization and Association Process

Relations between the EU and the countries of the Western Balkans, including SaM, have been developing since 1999 within the broader context of the SAP. The SAP calls for far-reaching political and economic obligations by prospective member countries in exchange for assistance in achieving closer integration with the European Union. The SAP framework includes a potential contractual relationship, or Stabilization and Association Agreement (SAA), and an assistance program (CARDS) to help participating countries to progress, at their own pace, towards EU membership.[26] The EU's goal of full integration of the Balkans was reaffirmed at the Feira Council in May 2000, and again in Zagreb in November 2000, when the countries of the region committed themselves to SAP conditions and objectives.[27] Here, the EU offered the prospect of full accession based on the Treaty of the European Union (Maastricht Treaty) and the Copenhagen criteria.[28]

The EU's efforts to continue the SAP with full speed were reaffirmed at the Thessaloniki Council in 2003, when it introduced the so-called Thessaloniki Agenda. Through this agenda, SAP was expanded to include the creation of two new instruments: European Partnerships and a set of tools based on the EU's enlargement methodology. The European Partnership identifies specific priorities and obligations to be fulfilled by each country in the short and medium term. These obligations, grouped into four categories which follow the format of the Copenhagen criteria, predicate the EC's financial assistance through the CARDS program. For SaM, an Enhanced Permanent Dialogue (EPD) was established in July 2003 to build on the work of previous Consultative Task Force meetings in providing a framework for technical and policy dialogue. The recommendations ensuing from the EPD serve as guidelines and benchmarks for relevant reform measures.[29] Furthermore, the Thessaloniki agenda stipulates: political cooperation in the area of Common Foreign and Security Policy (CFSP); enhanced support for institution building; promoting economic development; and opening the EU community programs to the Western Balkans countries.

In recent years, relations between SaM and the EU have followed a generally positive trend. The EU High Representative for Common Foreign and Security Policy, Javier Solana, witnessed the signing of the "Belgrade Agreement" in March, 2002. Immediately following the assassination of Serbian Prime Minister Djindjic, Javier Solana and Chris Patten, the EU external affairs commissioner, flew to Belgrade not only to express their condolences, but also to show their support for the tremendous efforts that SaM has put into securing their stability.

The progress of SaM in the SAP has been charted annually through three consecutive Stabilization and Association Reports for 2002, 2003 and 2004. The first annual report from 2002

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[26] SAA are very similar to the Europe Agreements, which the European Union introduced for the countries of Central Eastern Europe (CEE) in the beginning of 1990s.

[27] FR Yugoslavia Country Strategy paper 2002-2006, The European Commission.

[28] The European Council in Copenhagen 1993 spelled out the Copenhagen criteria, by which candidate countries would be judged for accession: 1) stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; 2) existence of a functioning market economy, as well as capacity to cope with competitive pressure and market forces within the EU; and 3) ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union – *i.e. acquis communautaire.* .

[29] *Serbia and Montenegro, Stabilization and Association Report 2004,* the European Commission.

dealt with issues prior to the adoption of the SaM Constitutional Charter, notably the fragility of, and lack of clearly defined roles for, the State institutions. The second report, produced shortly after the adoption of the Constitutional Charter in February, 2003, accentuated the need for further implementation of the Constitutional Charter and capacity building on the State level. According to the report, only with full commitment and co-operation within the state, and decisive action to pick up the pace of reform, would the state be able to make the necessary progress.[30] This emphasis on the functioning of the state union remained as the central issue of the third EU annual report, where progress has been classified as mixed at best. It noted that, although the Constitutional Charter had been adopted, which according to the EC is an achievement in its own right, the implementation of reforms has been slow and incomplete. The EC also noted with alarm that the lack of consensus on the union level was weakening joint institutions and policies, which are sine qua non for progress on political and economic reforms and for developing relations between SaM and the EU.[31] This slow process on implementing the necessary reforms has, to date, prevented SaM from establishing a contractual relationship with the European Union.

Nonetheless, as a result of the adoption of the Constitutional Charter and the Internal Market and Trade Action Plan in early 2003, the European Union commenced work on a Feasibility Study, a necessary prelude to the possibility to open negotiations on a SAA. The Feasibility report for SaM considers of a number of criteria: the degree of compliance with SAP political and economic conditions, the overall functioning of the State Union, the existence of a single trade policy and a single market, progress on sectoral reforms and on those institutions at the state level necessary to implement the possible SAA.[32] Subsequently, however, attempts to complete the Feasibility Study were delayed due to the lack of agreement within the country on how to proceed towards an Agreement and because of the ICTY issue. It was not until October 2004, following a visit by Messrs. Patten and Solana to Belgrade that the EC decided to re-start its work on the Feasibility Study, as a result of political decision-makers in SaM agreeing to the so-called "twin track approach". Under this approach, the EU would deal with the republics on policies that each conducts separately, including trade, economic and sectoral policies. Simultaneously, it would continue to work with the Union of SaM where it is the competent authority, including, for example, on matters of international obligation and human rights, with a view to an eventual single SAA with SaM. It is currently anticipated that the Feasibility Study could be completed by spring 2005.

The 2004 European Partnership for SaM, identified the most pressing near-term priorities with further work on the Feasibility Study dependent upon fulfillment of these priorities. In the area of democracy and the rule of law, SaM was advised to continue implementing the Constitutional Charter, to establish the State Court as well as to adopt the State Parliamentary rules of procedure. Significant weight is given to the adoption of defense strategy and military doctrine. Emphasis was also placed on Serbia completing the ongoing electoral law reform, adopting a comprehensive strategy on public administration reform, and continuing the preparations for the implementation of the Criminal Code and Criminal Procedure Code, as Serbia is unequivocally lagging behind Montenegro in these areas. Montenegro was advised to continue implementing the strategy on public administration reform. Finally, both republics were advised to prepare a comprehensive anti-corruption strategy and adopt law on conflict of interests.

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[30] *Serbia and Montenegro Stabilization and Association Report, 2003* p.2

[31] *Serbia and Montenegro Stabilization and Association Report 2004* p.1

[32] The Feasibility Report was postponed in order to give the authorities more time to address the remaining key issues, including in particular political conditionality, constitutional issues and the Action Plan. *Serbia and Montenegro, Stabilization and Association Report 2004,* The European Commission.

In the area of human rights and protection of minorities, the EU encourages establishing a Human Rights Ombudsman Office in Serbia, while strengthening the administrative capacities of Ombudsman office in Montenegro. Both republics are urged to adopt legislation on property restitution. The most important obligation in terms of regional and international cooperation relates to full cooperation of the State with the International Criminal Tribunal for former Yugoslavia.

In the area of market economy and structural reform, SaM is encouraged to sustain its macroeconomic stability. This would entail continuing a prudent monetary policy stance, backed up by appropriate exchange rate policy, and establishing more efficient monetary instruments with a view to improving the targeting of monetary aggregates. Furthermore, SaM is advised to accelerate the restructuring and privatization, as well as liquidation of large, socially and state-owned enterprises, while fully liberalizing prices and removing administrative controls.

Both entities are strongly advised to accelerate further alignment of the national legislature with the acquis communautaire[33] especially in the field of trade (domestic and foreign), customs administration, public procurement, anti-trust measures and the protection of intellectual property rights. Attention is also focused on cooperation in the field of justice and home affairs, especially in the areas of border management, combating organized crime, human trafficking, illicit drugs trafficking, money laundering and terrorism.

Medium term priorities also address issues of capacity building of the State and local governments including: strengthening the European integration offices within the government, adopting the civil service and public administration laws and strengthening the economic policymaking process and promoting local governments, i.e. accelerating decentralization. Moreover, SaM is recommended to continue the sustainable macroeconomic policies, but also to introduce new reform measures, including the reduction of state subsidies, transfers and public service wage bill.

[33] This is the body of EU legislation, policies and court precedents to which future EU members must subscribe.

South Eastern Europe Regional Studies and Initiatives

In the past few years, greater attention has been paid to ensuring an integrated regional approach to common challenges. Within the Bank, the **Regional Framework Paper for South Eastern Europe** provides the structure for the formulation of individual country assistance strategies to ensure that programs are designed to have optimal impact at both the country and regional level. The Framework identifies areas of activity with cross-border externalities, economies of scale, or opportunities for "scaling up" successful interventions across borders. It also identifies opportunities to encourage regional cooperation within the ambit of Bank activities, and a common reference for supporting SEE countries on the path toward integration in European structures. Within this conceptual umbrella, the Bank is engaged in a variety of regional programs, initiatives and studies including the following.

- A **Framework for the Development of the Regional Transport System in the Balkans** was commissioned to synthesize the contents, conclusions, and recommendations of a series of sector reports in the road, railway and inland water transport sectors, together with other related initiatives focusing on trade and transport facilitation and road safety. The main objective is to identify and describe, in actionable terms, measures of regional importance that: (i) are considered necessary to promote the efficiency and effectiveness of the transport sector; and (ii) would promote trade in goods and transport services among the Balkan countries and between these countries and the EU. The Framework is scheduled for completion in FY05.

- The **Trade and Transport Facilitation Program for South Eastern Europe** aims to reduce non-tariff costs to trade and transport, reduce smuggling and corruption at border crossings, and strengthen customs and border control agencies in the region. It includes all eight countries of South Eastern Europe (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR FYR Macedonia, Moldova, Romania and Serbia and Montenegro) with a focus on Customs and road transport. Details about the program, including performance measurement, can be found at www.seerecon.org/ttfse. At the request of South East European countries, the Bank has initiated the preparation of a larger scale trade and transport facilitation program building on the achievements of the first program. The new program, TTFSE II, would focus on the development of trans-european transport networks (road, rail, maritime transport modes, data integration), and integrated border management for freight to increase the competitiveness of firms in SEE and their ability to access markets.

- A **Regional Energy Strategy for the Balkans,** covering the South Eastern Europe regional energy market, which is set to open from 2006, lays out the Bank's approach to supporting institutional reform and investment in the power and gas sectors of SEE with a view to increasing energy trade. The regional context for the strategy and its implications for implementing the SaM CAS are described in Box 4 on page 16.

- **Trade Policies and Institutions in the Countries of South Eastern Europe in the EU Stabilization and Association Process**. This study (dated May 2003) reviews the economic performance of Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro with a focus on international trade. It covers the current status of each country regarding participation in the WTO and relations with the EU, with each other, and with other countries in Central and Eastern Europe. The study contains an institutional and policy

analysis covering trade in goods and services, including the main challenges these countries face in global integration.

- **Building Market Institutions in South Eastern Europe: Comparative Prospects for Investment and Private Sector Development.** This study, published in May, 2004, was prepared in collaboration with the EBRD. It carried out a major empirical review of the institutional barriers to investment and growth in the eight SEE countries. The study focuses on four areas: competition and economic barriers to entry/exit; corporate governance and finance; dispute resolution; and the regulatory regime governing utilities.

- **Regional Study on Public Expenditure Policies in South Eastern Europe.** Public expenditure policies have in general lagged behind the reform needs in SEE. Public expenditures as a share of GDP have remained relatively high in the past decade, though there is significant variance across countries. The main objective of the study, underway, is l to distill the lessons learned that emerge from select SEE countries' efforts to reform their expenditure policies, in order that they may be applied to increasing the effectiveness of interventions across the region. In particular, the study will highlight the successful efforts to consolidate public expenditures and reduce public expenditures as a share of GDP. The study also aims to generate debate and explore the scope for a region-wide approach to select public expenditure issues.

- The **Priorities for the Early Prevention of HIV/AIDS in the Western Balkans** study, underway, reviews the HIV/AIDS situation in the western Balkan countries, assessing the need for further policy development and investments in this area. This study also reviews the situation regarding sexually-transmitted infections (STIs) due to the overlap between the diseases.

- The **Social Development Initiative for South Eastern Europe** aims at promoting the design of policies and programs that: (i) support social cohesion through improved integration of ethnic minorities and youth as agents of social change and development: and (ii) reduce social tensions at the country and regional level. Advice to SEE governments and donors is provided in this process, and includes capacity-building for institutions and social analysis. The Initiative has been supported by the Italian Government and the Bank's Post-Conflict Fund.

- The study **Young People in South Eastern Europe**: **From Risk to Empowerment** provides a roadmap for youth development in SEE to assist governments, donors, and multi-lateral financial institutions better align public expenditures and investments, respectively, with the needs and priorities of youth in the region. The study outlines an integrated approach to the social, economic, and political participation of young people in society and identifies priority areas. It has been disseminated to governments and youth groups for feedback, after which it will be finalized for publication.

- A **Regional Water Management Study** reviews experience with water resource management in the Europe and Central Asia region since the transition. In light of water resources constraints, broader economic considerations, and regional and corporate goals, it also defines a framework within which the Bank would prioritize its support in this sector.

- An **Integrated Regional Environment Project for the Protection of the Adriatic, Ionian and Aegean Seas** (Adaptable Lending Project - APL) will focus on assisting countries

bordering the Adriatic, Ionian and Aegean Seas[34] to address the challenges of complying with Land-Based Sources and Activities Protocol (LBS) of the Barcelona Convention, thereby contributing to the sustainable protection and use of the Seas and their watersheds. The program is also designed as a pilot which could be replicated in other Mediterranean countries. Depending upon the availability of financing, the APL will support: (i) institutional development and knowledge sharing; (ii) pollution control and integrated management; (iii) water supply improvements; and (iv) protection of ecologically sensitive areas.

- The World Bank and UNDP are proposing a **GEF Strategic Partnership for the Mediterranean Sea Large Marine Ecosystem** to assist countries in implementing policy reforms and priority investments that address transboundary pollution reduction priorities in hotspots as identified in two Strategic Action Plans for the Mediterranean Sea. The Partnership would support: capital investments; economic instruments; implementation of policy reforms, strengthening of public institutions and public participation through two elements: a regional technical assistance project, implemented by UNEP and an Investment Fund for Pollution Reduction in the Mediterranean Sea, implemented by the World Bank. The Investment Fund – supported by a US$60-70 million, multiple-tranche GEF grant and other donors' contributions – is proposed as a vehicle for catalyzing investments and accelerating urgent actions that are necessary for reducing pollution in the Seas, especially the Mediterranean and Adriatic.

[34] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Greece, Italy, Serbia and Montenegro, Slovenia and Turkey.

IFC Strategy and Activities

Introduction

SaM is a major IFC priority in South East Europe. During FY02-03 IFC committed about US$43 million in 5 projects, three in financial markets and two in manufacturing. Donor-supported technical assistance has been an important component of the IFC strategy to develop a pipeline of potential investments in SaM. During the last two years IFC has mobilized about US$4 million of trust fund resources for TA that have been used to conduct more than twenty assignments. IFC has developed a strong TA program on institutional strengthening in the insurance sector, leasing, and banking. Also, in order to position itself in strategic sectors and generate more investment opportunities, IFC has supported, through its TA program, project preparation in the energy sector, electronics, information technology, and hotels. Its results will materialize in the future depending on the pace of policy reforms and liberalization in sectors still controlled by the Governments such as insurance, telecommunications, and energy, all of which are good candidates for pre-privatization investments.

Though foreign investors' country risk appetite remains modest, opportunities for new IFC investment projects are being actively pursued in both the financial and manufacturing sectors. IFC's program development, however, depends on further implementation of the Governments reform agenda, the creation of a favorable business climate, and the acceleration of the privatization process. While in the short term IFC will continue to expand its activities in general manufacturing and the financial sectors, in the longer term IFC will look for opportunities to support SaM with investments in the energy and telecommunication sectors, as well as in the infrastructure sector.

Financial Sector

Overall the financial sector in SaM has made impressive progress over the past three years. The government's reform agenda to date has been concentrated on stabilization and urgent first stage restructuring in the banking sector and parallel but also incomplete reforms in the regulatory and institutional framework for financial sector operations. The country's financial sector remains severely underdeveloped and the existing level of financial intermediation is still unable to contribute fully to the economic growth agenda. The current government's stated commitment to accelerating the reform of financial sector gives hope that SaM could see rapid financial re-deepening rather than an extended period of financial sector stagnation that has haunted some economies in the region.

Today's status quo is one in which many banks, primarily those in state ownership, are seriously fettered by their backlogs of non-performing loans to large socially-owned enterprises. At the same time, most private and foreign banks find the alternative of servicing the emerging private SME sector unattractive in the present, imperfect legal and institutional environment. The banking system is overpopulated and segmented, dominated by local banks with their historic problems, and characterized by an unsustainably high level of state ownership. A handful of larger majority state-owned banks have relatively good effectiveness ratings, despite their problems with historic loans. Their revival through speedy privatization to strategic investors would help to introduce more viable competition at the top end of a market that today appears to be supply constrained.

The currently limited access to finance and the high cost of banking services present a major challenge as well as an opportunity for non-bank financial institutions (NBFI) in expanding their clientele base and serving the needs of the economy. As in many other transition economies, the NBFIs sector (capital markets, leasing, mortgage providers, pension funds) in SaM is lagging behind the developments in the banking sector both in terms of its size and market share of all financial services, as well as in terms of quality of services and its public recognition. The sector faces a number of legal, regulatory, and institutional constraints. The experiences of other transition countries show that poorly regulated NBFIs can easily become breeding grounds for serious financial malpractice and even systemic crises. Hence, although the NBFIs are currently small relative to the banking sector, a sound framework for their expansion needs to be put in place as soon as possible to ensure their sound development in the future.

Strengthening financial intermediation through both investments and advisory services is critical to IFC's strategy to enhance local investments and reach a large number of businesses. IFC has contributed to strong foreign strategic investor interest in the financial sector and to establishing viable financial institutions. Through its equity investments, IFC supported the first Microfinance Bank and the establishment of RaiffeisenBank in the country. In Montenegro, IFC approved an investment in Opportunity Bank Montenegro for a line of credit of up to Euro4 million to fund micro-enterprise and SME lending.

IFC has been working to support the Government of Serbia with restructuring and the privatization of the banking sector. IFC is supporting the restructuring and privatization of UVB successor banks. The Government of Serbia and IFC have already agreed on restructuring of UVB arrears to IFC. This agreement will facilitate the initial stage of the bank privatization process in Serbia, including the privatization of Vojvodjanska Banka. Also, the recent agreement between IFC and the Government of Montenegro on the restructuring of IFC's claims on Montenegrin enterprises and banks, should pave the way for additional IFC restructuring and privatization support. This includes IFC's support for Podgoricka Banka, one of the largest banks in Montenegro, through restructuring of its arrears, pre-privatization investments, and a broad-ranging technical assistance program.

Despite strong demand, the development of non-bank financial intermediaries is still modest in SaM, mainly because of the weak system for registration of collateral security and court enforcement procedures. IFC is looking for opportunities to develop and support housing, leasing, and securities market development, through both investment and TA. To support the development of housing finance, IFC is considering financing to a few banks in Serbia complemented by the provision of substantial TA. IFC's SEED has provided extensive assistance to the institutional development of leasing and is preparing a leasing market survey to feed into the preparation of a multi-country leasing facility aimed at a more extensive outreach to eligible leasing operators.

The ability to issue equity in the primary market is not yet an option for companies, until further reforms are implemented to strengthen the institutions needed to create a liquid secondary market. Very few companies are listed in the Belgrade stock exchange and banks cannot be listed. The PA in Serbia has contributed to the development of the stock market through the launching of auction privatizations with the mandatory listing in the stock exchange. The PA is planning to launch the first initial public offerings on a few private companies with stronger business fundamentals, by placing the shares of the State Share Fund and State Pension Fund. IFC would consider supporting the PA to prepare the first IPOs.

To target investment opportunities in the privatization process in South Eastern Europe, including in SaM, IFC has invested US$40 million in two regional equity funds, Bancroft and Poteza. In addition, IFC has facilitated an agreement between Bancroft and the PA to pilot test a new privatization scheme. Bancroft is screening potential companies in the Share Fund portfolio to select a first candidate to buy enough stock to reach a majority equity package, combined with large minority stakes held in the State Share Fund's portfolio, and then jointly sell it to qualified buyers. If the pilot case is successful, it may facilitate a wholesale approach by setting up a special equity fund to re-privatize a large number of selected companies with limited access to capital because of their unclear corporate governance.

IFC has already provided extensive due diligence to the Serbian Insurance Supervisor on drafting a new law and recommending actions to improve regulation and the supervisory function capacity. Also, IFC has conducted a preliminary due diligence on the restructuring and privatization of Dunav Insurance Company. Its findings and recommendation, together with a pre-privatization investment proposal, have been submitted to the Government.

Corporate Sector

Despite major progress to date, enterprise sector reform still has a long way to go. Serbia's private sector share of GDP was only 52 percent in 2002 compared to 74 percent in Bulgaria. IFC's investment opportunities in the corporate sector are limited by state ownership in large companies, weak corporate governance, employee and management shareholding in larger manufacturing companies, lack of financial discipline, and weak accounting standards in most of local businesses. Also, private ownership is concentrated and channeled through less than transparent offshore holding vehicles, and potential exposure to reputation risk with some local individual sponsors is relatively high. FDI has yet to play an important role in investment. FDI per capita in Serbia in 1989-2002 was $200, compared to $1,400 in Croatia, $560 in Bulgaria, and $460 in FYR Macedonia.

Within these constraints, IFC has been working to develop investment opportunities in retail-distribution, tourism, agribusiness, electronic industry, paper, and pharmaceuticals. IFC has achieved good results investing Euro 20 million in Tigar Michelin Holding, a leading regional producer of high quality car tires. The financing was accompanied by extensive TA to the company and its suppliers, supported by IFC trust funds and SEED linkages program, resulting in high development impact. IFC intends to replicate this successful model in other manufacturing companies. Moreover, IFC pays particular attention to potential regional investment opportunities with the capacity to enhance regional economic integration.

IFC is providing an innovative TA program to Elektronska Industrija, a Serbian manufacturer of consumer electronic products and home appliances, to help the company with pre-privatization restructuring and to facilitate the joint ventures and/or direct sales to foreign investors. With targeted TA, IFC has also supported private initiatives in food and consumer goods, textile apparel industry, rubber industry, paper, light mechanical industry, and packaging industry. The early TA projects had identified a few potential IFC investment candidates, most of them, however, ultimately did not qualify under IFC credit quality criteria or reach the minimum investment threshold. Nonetheless, the relevant preparatory work has been useful to the beneficiary company to find locally alternative sources of commercial financing.

Infrastructure

The quality of key infrastructure services in SaM is poor and the sector requires fundamental reform and restructuring, as well as investments to meet the directives on infrastructure of the European Union, associated with the SAP[35] (see Annex 1). The infrastructure sector would play a critical role for sustained economic growth and international competitiveness, and IFC foresees potentially significant opportunities for expanding its products and services in the sector. For these reasons, the IFC strategy in SaM will complement the Bank's program of support for establishing the proper regulatory and institutional foundation in the infrastructure sector. In tandem with the Bank's program of support, IFC will be committed to supporting the restructuring and preparation for privatization of the sector, as well as facilitating private sector participation in sector related management, financing, and ownership.

Through its Balkans Infrastructure Development Facility (BIDFacility), IFC will help public sector entities in the South East Europe region, including SaM, to attract private sector participation and investments in infrastructure, primarily in the energy, transport and water and sanitation sectors (Box 1). IFC focus will be to explore, facilitate, and support public-private partnership (PPP) opportunities, particularly in solid waste and water management services (city of Belgrade), oil and gas transport and distribution (Constanza-Pancevo-Omisalj-Trieste pipeline and pre-privatization of Naftna Industrija Srbije), and the power cogeneration sector.

Annex 3 - Box 1: Balkan Infrastructure Development Facility

A poor and unreliable infrastructure continues to discourage private investors and hinder economic growth in the Balkan region. In turn, slower economic growth reduces the availability of government funds to improve infrastructure. To break this cycle, IFC is establishing the Balkans Infrastructure Development Facility in cooperation with USAID and European donors. The facility will help public sector entities in the Southern Europe region (including SaM) to attract private sector investments in infrastructure, focusing on the energy, transportation, and water and sanitation sectors. The facility reflects the World Bank Group strategy to broaden engagement in this sector to ensure efficient, affordable, and sustainable delivery of infrastructure services. The facility will help identify, develop, structure, and reach financial closure on infrastructure projects, so that committed public sector entities can engage more effectively with the private sector and attract investments critical to the region's economic development. IFC will launch the Facility in FY05.

Since March 2002, IFC has been working on the restructuring of the Belgrade municipal solid waste system, to prepare the tender for the concession to the private sector of the solid waste management services and to introduce a public-private partnership (PPP). This is expected to be the first major municipal infrastructure privatization in SaM. In 2003, IFC signed a mandate to advise the City of Belgrade in the development and implementation of a PPP for its water sector concession in cooperation with the EAR and EBRD.

In the area of information and communication technology, IFC will explore investment opportunities in the sector. IFC is willing to help the Governments of Serbia and Montenegro with the privatization of Telecom Srbija and Montenegro Telecom, respectively. IFC is now considering a pre-privatization investment opportunity in Telekom Montenegro. IFC intends to provide TA to Telekom Serbia and to help the company to prepare a strategy for further sector liberalization. IFC is open to discuss with the government a potential pre-privatization investment. A TA project has also been completed to identify potential opportunities for

[35] Some 29 percent of sampled water supplies in Serbia do not meet bacteriological standards; 56 percent of Serbian roads are classed as in "very bad conditions"; and there is a 20 percent forced outage rate in electrical supply.

investing in the Internet sector development in Serbia. The findings of the study have been disseminated by IFC during a seminar targeted to potential investors.

In the energy sector, IFC has been active supporting an advisory assignment to prepare a restructuring and privatization strategy of the Serbian oil company Naftna Industrija Srbije (NIS), as well as launching a Power Cogeneration study to survey the market potential and identify opportunities for private sector participation and PPP. As part of its strategy in the energy sector, IFC is helping the institutional effort to develop PPP opportunities in Costanza-Pancevo-Omisalj-Trieste (CPOT) Oil pipeline project. CPOT is a cross border oil transportation pipeline which is expected to offer an environmentally safe alternative route to bring high quality Central Asian and Russian crude oil to Southern and Western Europe, crossing Romania, Serbia and Montenegro, and Croatia. This pipeline is strongly supported by the governments of these countries. The United States Trade and Development Agency (USTDA) has financed a feasibility study with a grant to the Croatian Government on behalf of the three interested countries. IFC is supporting a second phase of a TA assignment, focused on providing capacity building to the three country Interstate Committee. This Committee is responsible for the pre-development strategy and coordination of early institutional efforts to assess feasibility and prepare the project legal framework and to promote the project with potential investors and users. IFC will consider the possibility of financing this project, subject to the pipeline's economic indicators and business interests from strong sponsors.

Social Sectors

IFC will explore opportunities to bring a strategic investor and to finance the establishment of the MBA School for the University of Belgrade, as well as for a private polyclinic in Belgrade. Another foreseen opportunity exists with respect to the restructuring of the Igalo Health Center.

SME Sector

SaM is still far from having a business environment attractive to entrepreneurs and investors. Consequently, the number of SMEs is far below the CEE average; Serbia is even lagging behind within the more geographically limited SEE region. The weak interest in SME lending is due largely to the high fixed costs of loan processing, the practice of informal accounting, and the reliance on mortgages which are difficult to enforce. Lines of credit funded by international financial institutions (e.g. EAR, EIB, KfW) and supported by TA for credit risk assessment and management have prompted some progress in lending to SMEs. However, the majority of credit applications are rejected because of the lack of transparency in financial statements, inadequate collateral, incomplete business plans, or insufficient capitalization of the borrowers. IFC is developing new investment opportunities for intermediary lending operations with selected commercial banks aimed at increasing access to finance for SMEs.

IFC is supporting the SME sector through the Southeast Europe Enterprise Development (SEED) facility, a multi-donor partnership led by IFC, operating in Albania, Bosnia and Herzegovina, Serbia and Montenegro and FYR Macedonia. SEED continues to focus its efforts on supporting: (i) increased competitiveness of SMEs in the region: (ii) strengthened business development services (BDS) markets: and (iii) improvements in the business environment for SMEs. To better position itself on fulfilling its mandate, SEED has recently introduced a new integrated and demand-driven approach, targeting four major strategic objectives as indicated in the CAS text Box 7. This approach ensures integration of SEED's products with the needs of the local key partner by mobilizing internal and external resources to act as a local implementer. This has

brought significant scope to SEED's activities allowing it to operate on several levels including consulting,
training, capacity building programs and business enabling environment interventions. In 2004, SEED came under the direct management of IFC's SECA hub in Istanbul. Existing ties have been strengthened to enable a fully inclusive investment and TA strategy to evolve in the region. A clearer set of deliverables to our host country is now punctuated by a fully integrated approach to addressing the need to tie technical assistance more closely to IFC's investment work.

Annex 3 - Box 2: Some Notable Achievements of SEED

IFC's SEED facility has been operating in Serbia and Montenegro since 2001. Since then the country program has had some notable achievements, including the following.

1. The financial leasing law was passed with the help of SEED in May 2003. Twelve leasing companies have been established. Also, SEED helped to broker an agreement between all the leasing companies to form the Association of Leasing Companies in Serbia. The value of leasing contracts reached Euro150 million in the first year of business. Estimates show that growth of 30 percent per annum is expected and by 2008 the leasing industry may account for as much as Euro 500million a year.

2. Following up on the investment made by IFC into the Tigar Tyre Plant, SEED developed an extensive program to advise the company on critical linkage projects: (i) provided assistance on identification of its non-core assets and plans to spin them off; (ii) advised on the development of a franchised retail and distribution system in the country to support its core tire manufacturing function; and (iii) trained and advised Tigar AD and its distribution staff on the dynamics of a modern supply chain.

3. IFC's SEED and Corporate Citizenship Facilities joined up to support an Herbal Business Association based in southern of Serbia, an economically depressed region. SEED's program follows its tested business association model and achieved the following: (i) the association has engaged the government to establish a quote system for collection and as a result an improved licensing mechanism to control the collection of wild herbs has been introduced; (ii) provided 13 different training modules to 300 collectors in co-operation with local NGOs; and (iii) in one year, increased more then three times the membership of the association.

4. IFC SEED has been undertaking additional assessments for commercial loans to qualify for a risk reserve scheme established by Austria Wirtshaftsservice GmbH (AWS). To date, the scheme has contributed Euro8 million to fourteen SMEs. Each loan is unique in the market for its lowered collateral coverage, longer tenor and pricing. SEED intends to further extend this successful project.

Millennium Development Goals (MDGs)

MDGs	Situation in ECA	Current Situation in SAM	Projections by 2015
Halve between 1990 and 2015 the proportion of people in extreme poverty and who suffer from hunger	From 1990 to 1999 the proportion of ECA's people living on less than US$1 a day increased from 1.4 percent to 5.1 percent, and for those living on less than US$2 from 6.8 percent to 20.3 percent.	In 2002, the proportion of the population living in absolute poverty (consumption per capita below the national absolute poverty line based on SLS data) was 10.6 percent in Serbia (it would be more accurate to use the interval from 9.4 to 11.8 percent, since certain groups are not covered by the survey). In Montenegro the relevant number is 9.2 percent, while with the inclusion of the most vulnerable groups may be revised upward by as much as a fifth from 9.4 to 12.2 percent.	Currently too few data to comment on poverty trends.
Achieve universal completion of primary education by 2015 for both boys and girls	In 2002, the primary education completion rate for ECA region was 93 percent.	In 2000 the primary education completion rate for SAM was 96.1 percent (Net enrollment data is not available because of the inability to disaggregate the Kosovo population in the data.).	Following war in the region, the accuracy of data is uncertain. However, SAM is expected to re-attain nearly 100 percent primary completion rate within few years. The MDG target is likely to be met.
Eliminate gender disparities in primary and secondary education by 2005 and for all levels by 2015.	In 2001/02, girls' enrollments in primary and secondary education as percentage of boys accounted for 97 percent.	In 2001/02, ratio of girls' to boys in primary and secondary education was 100.7 percent.	MDG target is likely to be achieved.
Reduce infant and child mortality rate by two-thirds between 1990 and 2015.	Under-5 mortality rate per 1,000 live births decreased from 44 in 1990 to 37 in 2002.	Modeled estimates of U5MR have decreased from 30 in 1990 to 19 in 2002.	U5MR is trending downwards and MDG appears likely to be met. However, while U5MRs fell dramatically in the 90s, progress seems to have slowed over the past few years. This needs to be watched carefully and could result in a downgrade to 'maybe' in the next 1-2 years.
Reduce maternal mortality rate by three-quarters between 1990 and 2015.	In 2000 the estimated number of maternal deaths for the region was 58 per 100,000 live births.	Modeled estimates of MMR have decreased from 15 in 1995 to 11 in 2000	Based on official data and modeled estimates, MMRs are already similar to those of other industrialized countries and as such the MMR MDG is considered to have already been achieved
Halt and reverse by 2015 the spread of HIV/AIDS and other diseases	The number of HIV-infected people increased from 30,000 in 1998 to 1,5 million in 2003	.HIV infection rates have remained relatively constant (below 10 per million population) over recent years. Similarly, TB incidence has remained pretty constant at around 40 per 100,000 population over the last decade	Too hard to tell if MDG target will be met. Low and stable incidence figures are encouraging but various social and demographic factors put Serbia at a risk of a rapid rise in HIV/AIDS and its weak surveillance system makes the reliability of reported incidence figures difficult to judge.
Reduce by half the proportion of people without sustainable access to safe drinking water.	In 2000 about 96% of ECA's urban population had access to improved water source, and about 83% of ECA's rural population. Average figures for ECA for sanitation are not registered.	Trend 1995-2000 shows stable 99% (urban) and 97% (rural) in Serbia; and 99% (urban), 90% (rural) for Montenegro For sanitation around 10%-20% of population is still relying in traditional pit latrines in both countries	Population with access to improved water source is higher in Serbia & Montenegro than in ECA. There are problems with interruptions of water supply: around 25%-30% of population experiences interruptions, of which 5%-10% daily and 13%-20% during the summer. In general, water supply systems are deteriorating due to lack of investments but not as fast as in other ECA countries. This is also valid for sanitation systems. In rural areas, problem lays with proper treatment of the sewerage
Integrate the principles of sustainable development into country policies and programs; reverse loss of environmental resources.	• 0.45 kgoe per GDP • 6.7 metric ton per capita • Forest area is 39.7% • Protected areas are 6.8% • 1%	• n.a. • C02 declining from 12 to 4 metric ton per capita in1990-1999 • Land area covered by forests amounts to 27% • Protected areas amount to 3.3% • Ranges between 20%-70% in Serbia	There are no quantitative targets set for any of the indicators of sustainable development at present. Energy information has not yet fed into international databases, but energy intensity is higher than in other ECA countries. Indicators for forest area and protected areas are lower than the average of ECA, and high percentage of population uses solid fuels. Majority or rural communities live in or around forests and have direct access and therefore use fuel wood for their energy requirements.
Achieve improvement in lives of at least 100 million slum dwellers, by 2020	No systematic data collection	Based on the different indicators for slums the estimates for Serbia & Montenegro are as follows: Lack of water 3% Lack of Sanitation 12% Lack clean heating 46% Overcrowding N/a Poor housing quality 30% No secure tenure 20%-33%	Target is worldwide and not specified per regions, there is no specific country target at this moment. Trends in degrading housing quality, problems with heating and IDPs and refugees are not properly monitored.

Core Labor Standards

Both Serbia and Montenegro have ratified (or re-ratified the conventions which were ratified by ex-Yugoslavia) all 8 ILO core labor conventions. These conventions are: Forced Labor (No. 29), Abolition of Forced Labor (No. 105); Minimum Age (No. 138), Worst Forms of Child Labor (No. 182); Equal Remuneration (No. 100), Discrimination in Employment and Occupation (No. 111); Freedom of Association (No. 87), Right to Organize and Collective Bargaining (No. 98). In recent years, national legislation was largely updated with respect to provisions in the above named conventions.

In Serbia, the legislative framework of collective bargaining and social dialogue includes the following laws and agreements: the Labor Act (2001), the Employment and Unemployment Insurance Act (2003), the General Collective Agreement (2001), and the Founding Agreement of the Socio-economic Council of the Republic of Serbia (2001). In Montenegro, the legal framework is based on the new Labor Law (2003), the Law on Terms and Conditions of Employment (2002), the General Collective Agreement (2003), and the Government Decree On the Establishment of the Economic and Social Council (2001).

The key event in the development of social dialogue in Serbia was the establishment of Socio-economic Council in August 2001. Regional Socio-economic councils were also established in 26 industrial centers in Serbia. The experience with the work of the Council has been mixed. Shortly after the setting up of the Council its work was broken down by the leave of one of the union representatives. The Council remained blocked till April 2002 when a new mutual "Agreement on Improving the Work of the Social Economic Council" was concluded by the parties involved and the work restarted.

The new Labor Act defines some criteria for representativeness of trade unions and employers' organizations: a trade union affiliating at least 15 percent of all the employees of an employer is considered a representative trade union for the conclusion of the collective contract with the employer, and an affiliation of at least 10 percent of the employers in the Republic or in the branch or activity for which the collective contract is being concluded is considered a representative employers association. The following organizations may qualify as representative organizations of social partners: from the trade unions' side, Association of Free and Independent Trade Unions, Federation of Autonomous Trade Unions of Serbia, United Branch Trade Union "Nezavisnost" (Independence), and from the employers' side, Union of Serbian Employers and Serbian Association of Industry and Entrepreneurs.[36] However, while collective agreements at the national level have a long tradition in both Serbia and Montenegro, the strategy for development of collective agreements at other levels of the society, and especially at the enterprise and local levels need to be created.

One of the features of the Serbian labor legislation is that by the new Labor Act from 2001, and similar to few other countries in Europe, the minister in charge of labor may expand the application of the special collective agreements to include the non-members of the employers association. The minister is obliged to request the opinion of the signatories to the collective contract before deciding about such expansion. The possibility was not provided by the previous legislation.

[36] The MoLSP is in the process of determining organizations that can be considered nationwide as the representative trade unions and the representative employers' associations respectively.

In Montenegro, while the Ministry of Labor and Social Protection is cooperating with other employers' organizations, such as Union of Employers of Montenegro, Montenegro Business Alliance, and Montenegro Business Market, by the Labor Law the General Collective Agreement can be signed only by the Chamber of Commerce as the only representative of employers. Companies are obliged to pay a contribution to the Chamber of Commerce (0.32 percent of gross salaries of every worker). This violates ILO recommendations (in particular, Recommendation No 113 and 152 and Convention No 144), which suggest that the social partners can only be the voluntary organizations of workers and employers, and not the chambers of commerce that exist on the basis of the legal obligations of the companies to pay the contributions to them. Trade unions are represented by one union – the Federation of Independent Trade Unions of Montenegro. All workers, with no regard to their membership, have to pay a contribution to the union (0.2 percent of their gross salaries).

Representation of worker voice through unions and collective bargaining tend to reduce discrimination. Unions are also known to reduce wage disparities within their members; ensure management abides by collective agreements and the law; and improve working conditions in firms. But unions can also impose efficiency costs.

Also successful development of the system of collective bargaining depends on proper the interactive confidence among the main actors involved. In Serbia, however, due to the difficulties the social partners have faced the level of confidence among them has not reached yet the necessary level. Consequently reestablishing the confidence constitutes serious challenge for further development of collective bargaining.

The new Labor Act of Serbia and the Labor Law of Montenegro provide protection against discrimination of any employee in the workplace based on gender, birth place, language, race, national identity, religion, marital status, family responsibilities, political or any other viewpoint, social background, personal wealth, membership in particular political organization, Unions or any other personal trait. The integration of disadvantaged persons in the labor market is important to prevent social exclusion, to raise employment rates and to provide for sustainability of social protection system.

Despite an updated legislation, recent labor market analyses in SaM have revealed that there are individuals and/or groups of individuals that are currently facing difficulties in accessing and remaining in the labor market. Some of the difficulties identified are explicit or hidden forms of gender, disability or ethnic discrimination. While in the formal sector of the economy, core labor standards are basically enforced, not much is known about relevant labor relations in the informal sector. Calculations based on the Serbia LSMS suggest that informal employment is very significant and accounted for 31 and 35 percent of the total employment in 2002 and 2003, respectively. In Montenegro, around 30 percent of employed people are believed to work without contract.

The World Bank is engaged in a number of activities that promote good practice related to core labor standards. Bank efforts to enhance the participatory process of PRSPs specifically involve trade unions. The Bank has already engaged in some efforts to enhance the capacity of the social partners in Serbia as well, including involvement in regional PRSP training events along with other members of civil society and training events specifically geared for trade unions active in the PRSP process.

The Bank was actively involved in preparation of the new Labor Act in Serbia and the Labor Law in Montenegro. In Serbia, the Bank has also provided technical assistance or financially supported the preparation of other relevant labor legislation, via SOSAC loan and SPEAG Grant, including the Employment and Unemployment Insurance Act; and the following laws still in draft: on Employers' Associations; on Trade Unions, on Socio-Economic Council; and on Strikes.

Anti-Money Laundering and Combating the Financing of Terrorism

Attention to money laundering and terrorist financing has increased because these activities are recognized not only as serious risks to security, but they also seriously affect a country's ability to improve financial stability and establish a level playing-field for private sector (particularly SME) development. Serbia and Montenegro have made notable efforts over the past two years to lay the legal foundations necessary for the implementation of international standards for anti-money laundering. This is important as organized criminal groups, engaging in the illegal smuggling of drugs, humans and other commodities, are believed to be active in the region

The first law on anti-money laundering adopted by the FRY Parliament in July 2002. This law made money laundering a criminal activity, and authorized the creation of a Financial Intelligence Unit (FIU) at the national level. Due to the constitutional transition to the Union of Serbia and Montenegro, and subsequent autonomy agreements between the two republics the AML law was adopted by the Serbian Republic Parliament and the FIU became an agency of the Serbian government. Montenegro has since adopted its own AML law and is in the process of establishing a separate FIU. Thus, Serbia has progressed farther in implementing international AML standards than Montenegro, and is laudably serving as a 'mentor' to both Montenegro[37] and Bosnia[38] in their AML/CFT efforts. Serbia and Montenegro are (jointly) a member in the Council of Europe's Anti-Money Laundering Committee (MONEYVAL), however, only Serbia has to date met standards for membership in, and been accepted as a member of the Egmont Group.[39]

Although the AML/CFT regimes in Serbia and Montenegro are gradually developing, laws in both republics which criminalize terrorist financing are still needed, as are various amendments to the Criminal Code and Criminal Procedure Code in order to meet international standards. Due to the international nature of money laundering and terrorist financing,[40] autonomous territories in which enforcement of national laws may be weaker provide attractive havens for money launderers, organized crime groups and financiers of terrorism to profitably thrive and evade authorities. This situation also makes it relatively easy for criminal groups to conduct profitable activities in territories where AML/CFT enforcement is stronger, yet hide their profits and proceeds in the territories where enforcement may be weaker. This critical problem can only be addressed by a high degree of coordination and cooperation between financial sector supervisors and law enforcement authorities of these adjacent countries and territories. Among the Republics and territories of Serbia and Montenegro, such coordination and cooperation is improving but work is still needed on the (sub-) regional level. In both Serbia and Montenegro, resources are needed to build capacity, and for technical assistance and training particularly for analysts in the FIU, as well as for Ministry of Justice officials, prosecutors and judges who handle money laundering and terrorist financing cases.

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[37] Serbia FIU officials have assessed the FIU in Montenegro in the context of its application for membership in the Egmont Group. Serbia plans to sponsor Montenegro's application for membership in Egmont (see footnote 3.)

[38] Serbian FIU officials have been providing a limited amount of advice and technical assistance to the Bosnian FIU which will become operational on 28 December 2004. Serbia FIU officials will make an on-site visit to the Bosnia FIU in January, 2005.

[39] The Egmont Group is the recognized international network of FIUs, the goal of which is to enhance mutual legal assistance and coordination in AML/CFT activities.

[40] Most money laundering and terrorist financing activities involve cross-border transactions.

WBI activities in Serbia and Montenegro, FY05 - FY07

Summary: Significant capacity constraints pose a risk that the three broad goals identified in the CAS will not be reached to the extent hoped for. Weak institutional capacity is a common problem in the public, private and social sectors. The current and proposed WBI programs will complement the Bank Group's AAA activities in Serbia and Montenegro intended to address the challenges to making progress towards meeting these goals.

Capacity constraints: The CAS identifies three goals: (i) a more efficient public sector, (ii) a more dynamic private sector and (iii) lower poverty levels and improved social protection/access to key public services as key objectives. Supporting Bank activities would include a substantial non-lending program to which WBI would contribute.

In designing and implementing the AAA programs, a key issue to address is that institutions generally remain weak despite relatively high education levels. There is significant capacity constraints associated with the CAS objectives:

- *Economic and public sector management:* Institutional reform priorities include strengthening arrangements for budget planning and execution, developing multi-year planning mechanisms and improving accountability. Key targets include containing items of public spending (wage bills, social transfers, subsidies), expanding the share of budgetary transactions covered by the treasury systems, and strengthening of the internal audit functions of the Ministries of Finance. Institutional strengthening is needed to implement policies for sustained macro-economic stability and the external balance, and to build effective union and republican institutions able to support both economic and judicial reform.

- *Private sector development*: Within the broader capacity objective of building institutions that are able to foster a stable business environment, specific capacity gaps include the ability to pursue the privatization agenda and support the growth of exports (and trade in general). In addition, there remains a need to establish the proper "division of labor" between the public, civil and private/corporate sectors of society, and strengthen the institutions that implement the policies behind this.

- *Social sector development:* Capacity gaps include weak institutions responsible for the broad poverty reduction agenda and, more specifically, improving the social well-being of the most vulnerable groups. Legislation and regulations related to health, education and pensions are either in place or will be so in the foreseeable future, but appropriate implementation remains a challenge. The 2003 PRSP pledges for government to do more for vulnerable groups, including the Roma.

Current and future activities: Current and future WBI supported activities address issues which are linked primarily with the CAS Goals 2 and 3 and include the following.

Goal 2: Private sector development: Two countries specific and one regional activity are currently supported by WBI.

(i) Export promotion: Workshops on improving export promotion and support to the Serbian export promotion agencies are being carried out during FY05, and complement related ECSPF activities.

(ii) Small and medium enterprises development and restructuring/privatization: This program focuses on training and institution strengthening of the Serbian PA and also complements ECSPF's work in this field. Activities in FY05 include two 2-day workshops with emphasis on contract enforcement and private sector regulation, respectively, complemented by GDLN video conferences on the main findings of the recently completed Serbia and Montenegro Investment Climate Assessment.

(iii) Knowledge economy: WBI staff recently led a small team which prepared a series of knowledge economy assessments for the Balkan region and countries. There is now a proposal for ECSPF to develop a more focused and project oriented output with emphasis three specific thematic areas and the linkages between them: (i) enhancing applied R&D, knowledge transfer and innovation in the enterprise sector, (ii) increasing telecom density and internet penetration, and (iii) scaling up of e-government services. WBI would stay involved in follow-up activities as requested by ECSPF, including the development of policy recommendations and further involvement of and discussions with relevant stakeholders in SaM and the other countries.

As the current country specific activities are completed (2005), WBI would consider shifting its PSD work further to regional activities, possibly to promote private participation in, and regional integration of, infrastructure (transport, energy).

PRSP Process: Activities supporting the PRSP process have focused on a series of development debates and seminars open to all Balkan countries, including SAM, where participants involved in their country's PRSP process exchange experiences. The latest round of development debates took place in early 2004, mainly through video conferencing, and was followed by a well-attended Second PRSP Forum in Thessalonica, Greece. Follow-up activities may include a Basic Poverty Measurement and Diagnostics course in mid FY05 with clinics on topics determined by the participating countries' PRSP teams, and further development debates and a Third PRSP Forum. WBI's evaluation group could also offer learning events on monitoring and evaluation based on Bank supported projects"

In the field of *social sector development*, WBI support focuses on regional follow-up activities to the Roma conference, including policy dialogue and capacity building through country and regional training. Main activities planned for FY05 include regional training on select topics including a course on Social Accountability and Monitoring, and support of Roma participation in various activities. Websites and virtual learning environments would be supported to promote regional networking for on-going dialogues and on-line information exchanges with special emphasis on education issues and Roma women.

In addition, SAM delegates would continue to be invited to other regional and global WBI programs throughout the planning period. The scope of and audience for such invitations would be determined jointly with the Bank's Country Office in Belgrade. For both the country specific and regional/global programs, the GDLN Network will be used as appropriate to ensure cost efficiency and maximum knowledge sharing and dissemination.

Partnerships: WBI activities are developed in collaboration with local and international counterparts and donors, and coordinated with the Country Offices and relevant task teams in ECA. The PSD activities are supported by an Italian Trust Fund and Universita Cattaneo

Castellanza and Chamber of Commerce in Milan. Privatization activities are done through the PA under the Republic of Serbia Ministry of Economy and Privatization (MOEP). The export promotion activities are done through the Serbian Export Credit Agency. The Roma conference follow-up activities are done in partnership with the Open Society Institute.

WBI sponsored activities in Serbia-Montenegro
A: Ongoing country specific activities
(i) Export promotion – see above
(ii) Small and medium enterprises development and restructuring/privatization – see above
B: Ongoing and tentative future regional activities
A: Public sector management
Intergovernmental Fiscal Relations and Local Financial Management Course for ECA (Budapest, participants from all ECA countries)
B: Private sector development
Regulating the Private Sector: Corporate Governance and Compliance, FYR Macedonia, Serbia, Bosnia and Russia in partnership with ECA GDLN
ECA Cross-Regional GDLN Policy Dialogue on Investment Climate Issues
Hazard Risk Management in ECA workshop (to be delivered in Turkey, 60 participants from ECA countries)
Knowledge economy – see above
Urban and City Management for SEE (conditional upon donor funding, proposal to Italian TF) Albania, Bosnia and Herzegovina, FYR Macedonia, Serbia and Montenegro
C: Poverty alleviation, Social sector development/ social monitoring and accountability
Mainstreaming Gender aspects into the PRSP process, Balkan countries
Basic Poverty Measurement and Diagnostics Courses; Balkan countries
PRSP related clinics, under consideration; Balkan countries
Development Debates and 3rd PRSP Forum for the Balkan countries
Regional Flagship Course on Health Sector Reform for ECA
Advanced Flagship Course on Poverty, Equity, and Health for ECA
Roma Leadership Capacity Building (Serbia and Montenegro, FYR Macedonia, Croatia, Bulgaria, Romania, Hungary, Czech Republic, Slovakia)

Results – Oriented Framework for Serbia and Montenegro Country Program

Goal 1: Creating a smaller, more sustainable, more efficient public sector				
Longer-Term Development Agenda for SaM		Outcomes Influenced by the CAS Program During the 3 Year Period		
Strategic and Longer Term Country Outcomes	**Key Issues and Obstacles**	**CAS Outcome(s) that the Bank expects to influence through its interventions and Outcome Level Indicators**	**Intermediate indicators to track implementation towards expected CAS outcome (s)**	**Bank Activities**
❑ Maintain macroeconomic stability ❑ Improve fiscal sustainability ❑ More efficient public administration ❑ ❑ More effective public approach to mitigating impacts of restructuring and privatization	* Fragile macroeconomic stability, with a worsened current account balance * High public expenditures as a share of GDP (45% in 2004), reducing fiscal flexibility and keeping taxes and interest rates high * High spending on public sector wage bill, subsidies and social transfers, particularly pensions and health. * Official labor programs fall short of meeting actual needs *Corruption impedes effective customs administration	+ Reduction in public expenditures to GDP from 48% (2002) to 43% (SaM) + Improved cost-effectiveness and efficiency of labor programs (Serbia) + Progress on wage decompression ratio [from baseline of X to 1:6] (SaM) + Improved financial sustainability of pensions; education + Increased capacity of HIFs to support a sustainable health care system (S) and (M) • Reduction in drug prices paid by HIF (for agreed list of high cost and high volume indicator drugs; baseline Euro 25.4 million (2002) • HIF annual deficit reduced; baseline 9 million Euro (2003) + Reduced corruption at border crossings (S) and (M)	+ Public sector wage bill cut by 9.3% in 2005 + Administrative structure(s) for pilot Labor Redeployment Program operational (S) + New menu of ALMPs developed and tested + Performance information and management system to monitor labor market trends developed (S) + Increased % of pension contribution collections: up to 5% by end 2006 (M) + Reduction in the ratio of staff to processed registrations (M) + Actuarial model utilized by MOL +Expenditures on pensions as a share of GDP decline from 2004 to 2005 (SaM) + Annual analysis of growth of pharmaceutical expenditures by price, volume, mix by HIF (M) + Variance between projected and actual HIF disbursements reduced in each quarter + Adoption of proposed new laws on health insurance, health care, pharmaceuticals (M) +Increased number of HIF/MOH staff trained in health policy, finance and management (S) + Annual monitoring by MOH/HIF of the revenue, expenditures and arrears (S) + Restructuring design plans prepare for four pilot hospitals (S) + Annual number of declarations/customs staff systematically increased: from baselines of 148 (S) and 138 (M)	**Lending** Serbia: Employment Promotion, Health *New – SAC 2; Pensions Project (05) PAL 2 (06), PAL 4 (07)* Montenegro: – SAC 2, Pensions System Administration Improvement, Health System Improvement *New: Education (05); SAC 3 (07)* **AAA**: PEIR; PEIR Update (06), Serbia Economic Memorandum (04) Montenegro Economic Memorandum (05) Debt Sustainability Update (05); (S) and (M) CFAA Updates (06); CPAR Update (06); Social Protection Study (M) (06)

Results – Oriented Framework for Serbia and Montenegro Country Program

Goal 2: Creating a larger, more dynamic private sector				
Longer-Term Development Agenda for SaM		**Outcomes Influenced by the CAS Program During the 3 Year Period**		**Bank Activities**
Strategic and Longer Term Country Outcomes	**Key Issues and Obstacles**	**CAS Outcome(s) that the Bank expects to influence through its interventions and Outcome Level Indicators**	**Intermediate indicators to track implementation towards expected CAS outcome (s)**	
❑ Improve the business environment ❑ Accelerate privatization an structuring of real and financial sectors ❑ Develop financial markets ❑ Improve agricultural output and Exports Make space for greater private sector involvement in infrastructure	* No effective bankruptcy or contract enforcement mechanisms * Limited access to EU markets for agricultural products * Poor access to finance * Large state subsidies to loss-making enterprises * Too many barriers to trade and transport	+ Increased restructuring and resolution of large loss-making state- and socially-owned enterprises + Increased level of privatization + Improved access to finance + Reduced non-tariff costs to trade and transport + Export activities expanded with support of Serbian and Montenegrin Export Credit Agency (SMECA) + Increased competitiveness of farmers and agro-processors + Improved road transportation, including more safe roads + Reduction in illegal use of electricity and increased payments + Improved land titling + More ecological and commercially sustainable solid waste collection and disposal services in Montenegro coastal municipalities coastal area	+ Increased number and/or value of large conglomerates restructured and business units and assets sold, and/or put into bankruptcy + At least 3 large SOEs offered for sale/three majority state-owned banks offered for sale + Reduced transport cost principal commodity traded with the three main trading partners (from base of US$100) (S) + Increased trade volume/staff sustained (from baseline of 1.8) (S) + Increased volume of finance available for exports increased (SaM) + Increased value of insurance for political risk, import credit and exporter performance (SaM) + Reduction in roughness of road segments from 6 in baseline to 4 (S) + Reduction in number of deaths per 10,000 vehicles (S) + SRD's IC database computerized and operational + Reduced drop out rate for electricity consumers in DSM programs (M) + Reduction of the share of O&M costs and wages in the price of electricity form 1.8 c/KWh in 2001 to 1.5 c/KwH in 2004 without cuts in the maintenance scope and quality (M) + Lowered property market transactions costs (S) + Increased % of solid waste collected and properly disposed, baseline 0%; Wild dumps closed (baseline 0, up to 4 in medium term) (M)	**Lending** Serbia: Privatization and Restructuring of Banks and Enterprises TA Credit; Export Finance Facility; Employment Promotion Project, Trade & Transport Facilitation in SEE, Real Estate Cadastre and Registration; Energy Efficiency; Electric Power Reconstruction; Transport Rehabilitation. IFC support for: privatization and Bank restructuring; non-bank financial institutions (housing, leasing, and securities market); Insurance sector pre-privatization; IFC secondary privatization pilot test; IFC's SEED support to SMEs. *New: SAC (05), PDPL1 (06), PDPL 3 (07) Regional Energy (05), Irrigation and Drainage Rehabilitation (06), Rural Business Environment (07),* IFC: Proposed Telekom Pre-privatization; BIDFacility; Proposed PPP approach; Support for infrastructure sectors. Montenegro – SAC 2, TTFSE; Export Finance Facilitation Project; Emergency Power Reconstruction; Environmentally Sensitive Tourist Areas. *New: SAC 3 (07), Regional Energy (06), Tourism and Agriculture (06).* **AAA:** PEIR; PEIR Update (06), Serbia Economic Memorandums (04), Montenegro Economic Memorandum (05), Debt Sustainability Update (05), Agriculture Competitiveness Study (06), IFC Advisory and BIDFacility, regional infrastructure projects, SEED.

Results – Oriented Framework for Serbia and Montenegro Country Program

Goal 3: Reducing poverty levels, and improving social protection and access to public services				
Longer-Term Development Agenda for SaM		Outcomes Influenced by the CAS Program During the 3 Year Period		Bank Activities
Strategic and Longer Term Country Outcomes	**Key Issues and Obstacles**	**CAS Outcome(s) that the Bank expects to influence through its interventions and Outcome Level Indicators**	**Intermediate indicators to track implementation towards expected CAS outcome (s)**	

❑ Mitigate social impacts of economic modernization and restructuring
 	
❑ Improve delivery of social services especially for the poor and vulnerable
 	
❑ Improve access to quality health and education services
 	
❑ Reduce poor and "at risk" populations including the unemployed
	* High and increasing rural poverty
	
	* Poor coverage and targeting of social protection, and poor reliability of budget transfers for social protection
	
	* Poor results in the timely return of workers to productive employment
	
	* Capacity of education system to modernize and assure quality curriculum is constrained
	
	* Limited access, especially for poor and vulnerable to affordable, quality healthcare
		* Improved coverage and targeting of social protection
		
		* More effective labor market interventions and more innovative employment services
		
		* Reduction in rural poverty
		• Increased growth of Bor economy
		• Increased agricultural competitiveness
		
		*** Improved quality & management of education in Serbia**
		• Systematic information supports education reforms (S)
		• Schools more engaged in designing school development plans (M)
		  ◦ Management capacity of primary and secondary schools strengthened (M)
		  ◦ Effective operation of internationally recognized system for assessment
		
		*** Improved health care service delivery**
		• Increased utilization rates for primary health care (PHC) especially by the poor (including the Roma and IDPs)
		• Increased utilization of day care services by the elderly
		• Increased effectiveness of health insurance
			+ Improved assessments of demand for labor redeployment are undertaken in targeted enterprises undergoing deep restructuring and privatization (S)
			+ Initial cadre of public staff are trained in assessment procedures, and replicate training internally
			
			+Increased access to agricultural support services
			+ Increased alignment with EU food processing standards
			
			+ Education Information System operational
			+ School dvlp. plans approved for increasing number of primary and secondary schools (S)
			+ Increased no. of school level officials trained in governance and management (S)
			+ *Independent assessment service formally established and standards set for selected grades based on curriculum objectives (S)*
			+ Reduced waiting time between arrival and consultation in PHC (M)
			+ Increased duration of average PHC consultation (M)
			+ Increased % of patients registered with chosen PHC provider (M)
			+ Hospital masterplan and planning standards and guidelines adopted (S)
			+ Reduction in nos. of beds, patients to tertiary care realized in four pilot hospitals (S)
			+ Policy adopted for financing, resource allocation and provider payment methods for public health services (S)
			+ Licensing body is established, staffed and operating for health professionals S)
			+ New HIS national standards and data-bases established
			+ Two new elderly day care service established
				Lending:
				Serbia: Employment Promotion, Health Project, Education Improvement Project
				New: PAL, Bor Development Project (06), Rural Business Environment Project (07), Primary Health Care Project (07)
				
				Montenegro: SAC 2 (05); Health System Improvement Project (05)
				New: SAC 3 (07)
				
				AAA: PEIR (03); Poverty Assessment (03); Programmatic poverty activities; Serbia Economic Memorandum; Support for PRSP implementation.
				
				New: Ongoing Programmatic poverty activities; Poverty Assessment (07); Ongoing Bank and WBI support for PRSP implementation.

Donor Support to Serbia and Montenegro

Republic of Serbia

	EBRD	EIB	EU	ECHO	USAID	Canada	DFID	France	Germany	Greece	Netherlands	Norway	Italy	Sweden	Switzerland	Japan
Agriculture			X										X	X		X
Banking	X				X		X		X							X
Civil Society Development			X		X	X	X	X	X	X	X			X		
Culture/Media			X		X								X	X		X
Education		X	X			X		X	X	X			X		X	X
Macro support			X							X					X	
Finance					X		X		X	X						X
Health		X	X	X		X		X	X				X	X		X
Privatization			X				X									
Budget support										X						
Police						X	X		X				X	X		
Energy	X	X	X		X	X			X	X		X	X	X	X	X
HIV/AIDS							X									
Transport	X	X	X			X				X				X	X	X
Judiciary			X		X	X	X		X							
Municipal Development	X		X		X		X	X					X	X	X	
PSD	X	X			X	X				X	X			X	X	
Property Rights (cadastre project)			X		X				X			X		X		X
Public Administration			X				X	X			X				X	
SME	X	X			X	X							X		X	
Wood Industry																
Science and Technology																
Humanitarian			X	X	X	X			X	X	X		X	X	X	X
Water	X	X							X						X	
Public Transport										X					X	X
Forestry																
Urbanism									X							X
Telecommunications																
Environmental protection		X	X										X	X	X	X
Social sector		X	X	X	X	X	X	X	X	X	X			X	X	X

Donor Support to Serbia and Montenegro

Republic of Montenegro

	EAR	USAID	DFID	Germany	Luxembourg	EBRD	EC
Agriculture and Veterinary	X						
Banking	X	X	X	X			
Civil Society Development	X						
Culture	X						
Economic Development	X	X		X			
Education	X						
Finance	X	X					
Privatization	X					X	
Budget support		*					
Police	X						X
Energy	X		X				
Judiciary	X	X					
Municipal Development	X	X					
PSD	X	X					
Public Administration	X						
Transport	X						
SME	X	X		X		X	
Wood Industry	X						
Water	X			X			
Forestry					X		
Urbanism				X			
Telecommunications	X						

* to be confirmed if USAID will continue with budget support

MIGA in Serbia and Montenegro

SaM has been a member of MIGA since 1993. MIGA is a key partner for the government of SaM through the provision of guarantees and technical assistance, to help the country attract foreign investment.

Guarantees. MIGA currently has fourteen guarantee contracts in SaM: twelve in the financial sector, one in the services sector and one in the manufacturing sector. MIGA's total gross exposure in SaM is US$296.3 million. MIGA is considering two projects in its pipeline for SaM. One is in the financial sector (leasing) and the other in the services sector (retail), with a total potential for MIGA coverage of US$35.7 million. These projects are expected to be underwritten and executed by the end of FY05.

Technical Assistance. MIGA is currently completing its support to a long-term, 18-months capacity building program for SIEPA. The hands-on institutional development program focuses on the preparation of an FDI promotion strategy for SIEPA, the strengthening of necessary investment promotion and facilitation skills in the agency, and the implementation of a series of pilot investor outreach programs in a number of priority sectors. The program is funded under a World Bank Private Sector Development grant to Serbia and benefited from strong cross-links with other economic development programs, such as USAID's competitiveness project and the EAR's export development and SME support programs in Serbia. EAR has asked MIGA to help design and manage a follow-on assistance program that will help further strengthen Serbia's investment promotion capacity. It is expected that the EAR/MIGA program will be launched in early CY05, subject to the Serbian government fulfilling a number of conditions (such as the passing of the law on SIEPA).

In April 2004, with donor funding from the European Agency for Reconstruction, MIGA also launched a new technical assistance program in Montenegro, aimed at assisting the country in establishing a new investment facilitation and servicing unit. The one-year program will support the establishment of the unit, including the development of a start-up strategy and work plan, skills development and training, and support for initial information dissemination activities.

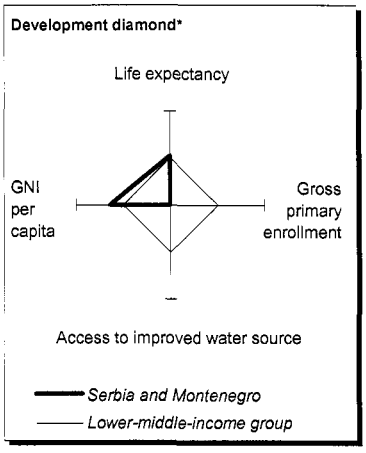
Serbia and Montenegro both also benefit from a new regional initiative that MIGA is launching for the Western Balkan region. Under the European Investor Outreach Program (EIOP), MIGA will implement over the next two and a half years a donor-funded pilot initiative that has been designed to strengthen the capability of Western Balkan countries (Albania, Bosnia-Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro) to attract inward investment from across Western Europe. The goal is to increase investor awareness of the region's potential, encourage investors to undertake site visits to explore investment opportunities, and ultimately to support actual investments in the region.

MIGA's on-line investment promotion services (www.fdixchange.com and www.ipanet.net) feature 270 documents on investment opportunities and the related legal and regulatory environment in SaM. MIGA also has established a content provider partnership for its online services with the Serbian Ministry of Economy and Privatization and with SIEPA.

Serbia and Montenegro at a glance

11/11/04

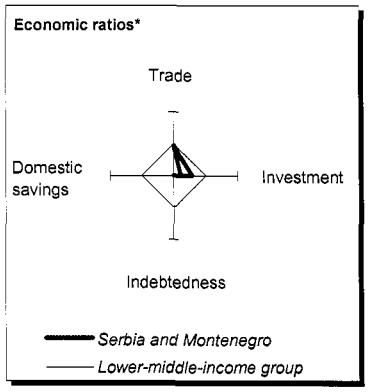
POVERTY and SOCIAL	Serbia and Montenegro	Europe & Central Asia	Lower-middle-income
2003			
Population, mid-year *(millions)*	8.3	473	2,655
GNI per capita *(Atlas method, US$)*	1,900	2,570	1,480
GNI *(Atlas method, US$ billions)*	15.8	1,217	3,934
Average annual growth, 1997-03			
Population *(%)*	..	0.0	0.9
Labor force *(%)*	..	0.2	1.2
Most recent estimate (latest year available, 1997-03)			
Poverty *(% of population below national poverty line)*	10	..	..
Urban population *(% of total population)*	53	63	50
Life expectancy at birth *(years)*	72	69	69
Infant mortality *(per 1,000 live births)*	12	31	32
Child malnutrition *(% of children under 5)*	..	..	11
Access to an improved water source *(% of population)*	..	91	81
Illiteracy *(% of population age 15+)*	..	3	10
Gross primary enrollment *(% of school-age population)*	..	103	112
Male	..	104	113
Female	..	102	111



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

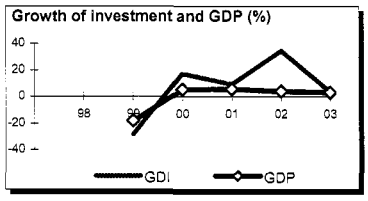
	1983	1993	2002	2003
GDP *(US$ billions)*	..	..	15.5	20.5
Gross domestic investment/GDP	..	..	16.2	15.9
Exports of goods and services/GDP	..	..	20.9	19.9
Gross domestic savings/GDP	..	..	-7.2	-6.6
Gross national savings/GDP	..	..	7.2	6.3
Current account balance/GDP	..	..	-8.9	-9.6
Interest payments/GDP	..	..	0.9	1.3
Total debt/GDP	..	..	76.5	69.9
Total debt service/exports	..	..	3.4	6.7
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	..	..

	1983-93	1993-03	2002	2003	2003-07
(average annual growth)					
GDP	..	..	4.0	3.0	4.7
GDP per capita	..	..	4.3	3.2	5.0
Exports of goods and services	..	..	12.3	4.3	15.5

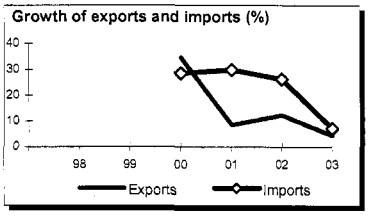


STRUCTURE of the ECONOMY

	1983	1993	2002	2003
(% of GDP)				
Agriculture	..	..	..	..
Industry	..	..	..	..
Manufacturing	..	..	..	..
Services	..	..	..	..
Private consumption	..	..	88.9	88.3
General government consumption	..	..	18.3	18.4
Imports of goods and services	..	..	44.3	42.4



	1983-93	1993-03	2002	2003
(average annual growth)				
Agriculture	..	..	..	..
Industry	..	..	..	..
Manufacturing	..	..	..	..
Services	..	..	..	..
Private consumption	..	..	6.3	5.5
General government consumption	..	..	11.6	1.3
Gross domestic investment	..	..	34.4	3.6
Imports of goods and services	..	..	26.3	7.2



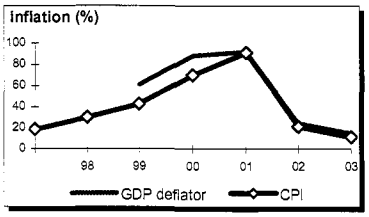
Note: 2003 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Serbia and Montenegro

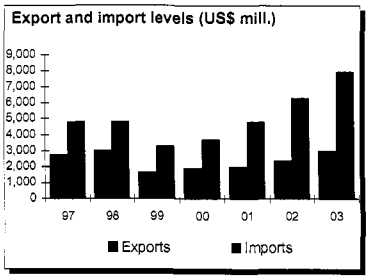
PRICES and GOVERNMENT FINANCE

	1983	1993	2002	2003
Domestic prices				
(% change)				
Consumer prices	..	..	21.2	11.3
Implicit GDP deflator	..	..	24.0	14.9
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	..	43.3	42.7
Current budget balance	..	..	-1.1	-1.3
Overall surplus/deficit	..	..	-4.6	-3.2



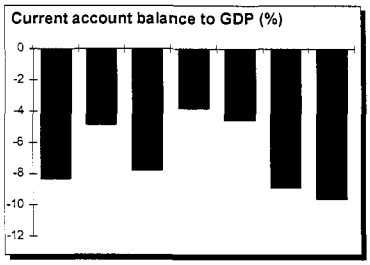
TRADE

	1983	1993	2002	2003
(US$ millions)				
Total exports (fob)	..	..	2,412	3,015
Food	..	..	..	..
Other fuel	..	..	..	..
Manufactures	..	..	..	..
Total imports (cif)	..	..	6,320	7,957
Food	..	..	..	..
Fuel and energy	..	..	..	..
Capital goods	..	..	..	..
Export price index *(1995=100)*	..	..	..	..
Import price index *(1995=100)*	..	..	..	..
Terms of trade *(1995=100)*	..	..	..	..



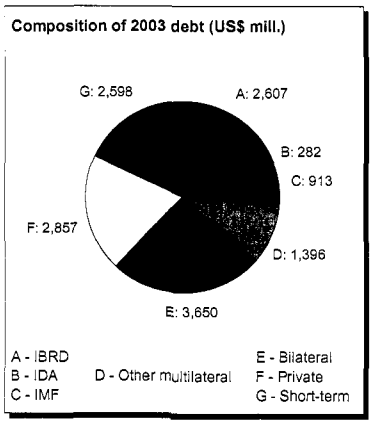
BALANCE of PAYMENTS

	1983	1993	2002	2003
(US$ millions)				
Exports of goods and services	..	..	3,241	4,069
Imports of goods and services	..	..	6,857	8,675
Resource balance	..	..	-3,616	-4,606
Net income	..	..	-111	-249
Net current transfers	..	..	2,343	2,895
Current account balance	..	..	-1,384	-1,961
Financing items (net)	..	..	2,495	3,231
Changes in net reserves	..	..	-1,111	-1,270
Memo:				
Reserves including gold *(US$ millions)*	..	..	2,280	3,550
Conversion rate *(DEC, local/US$)*	..	..	64.3	57.5



EXTERNAL DEBT and RESOURCE FLOWS

	1983	1993	2002	2003
(US$ millions)				
Total debt outstanding and disbursed	..	..	11,768	14,303
IBRD	..	..	2,175	2,607
IDA	..	..	167	282
Total debt service	..	..	184	435
IBRD	..	..	76	106
IDA	..	..	0	1
Composition of net resource flows				
Official grants	..	..	..	..
Official creditors	..	..	..	..
Private creditors	..	..	..	..
Foreign direct investment	..	..	..	..
Portfolio equity	..	..	..	..
World Bank program				
Commitments	..	..	..	..
Disbursements	..	..	159	95
Principal repayments	..	..	0	0
Net flows	..	..	159	95
Interest payments	..	..	75	107
Net transfers	..	..	84	-12



Serbia and Montenegro
Selected Indicators* of Bank Portfolio Performance and Management
As Of Date 11/04/2004

	Fiscal Year			
Indicator	**2002**	**2003**	**2004**	**2005**
Portfolio Assessment				
Number of Projects Under Implementation [a]	8	15	19	18
Average Implementation Period (years) [b]	0.6	1.0	1.4	1.5
Percent of Problem Projects by Number [a, c]	0.0	6.7	15.8	11.1
Percent of Problem Projects by Amount [a, c]	0.0	4.2	27.3	7.0
Percent of Projects at Risk by Number [a, d]	37.5	6.7	21.1	16.7
Percent of Projects at Risk by Amount [a, d]	13.9	4.2	29.1	9.2
Disbursement Ratio (%) [e]	52.9	22.1	13.9	1.2
Portfolio Management				
CPPR during the year (yes/no)		yes	yes	
Supervision Resources (total US$)	330	735	1,375	
Average Supervision (US$/project)	41	49	72	

Memorandum Item	**Since FY 80**	**Last Five FYs**
Project Evaluation by OED by Number	3	3
Project Evaluation by OED by Amt (US$ million)	175.9	175.9
% of OED Projects Rated U or HU by Number	0.0	0.0
% of OED Projects Rated U or HU by Amt	0.0	0.0

a. As shown in the Annual Report on Portfolio Performance (except for current FY).
b. Average age of projects in the Bank's country portfolio.
c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
d. As defined under the Portfolio Improvement Program.
e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.

* All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

Serbia and Montenegro
IDA Program Summary

Proposed IDA/IBRD Base-Case Lending Program FY05-07

Fiscal year	*Project*	*US$(M)*	*Strategic Rewards b (H/M/L)*	*Implementation b Risks (H/M/L)*
2005	STRUCTURAL ADJUSTMENT CREDIT 2	45	H	H
	REGIONAL ENERGY*	7	H	M
	PENSIONS	25	H	M
	EDUCATION (MONTENEGRO)	5	M	M
	STRUCTURAL ADJUSTMENT CREDIT 2 (MN)	18	H	H
	Result	**100**		
2006	PROGRAMMATIC ADJUSTMENT LOAN 1	55	H	H
	IRRIGATION AND DRAINAGE REHABILITATION	25	M	M
	BOR REGIONAL DEVELOPMENT	30	H	H
	TOURISM AND AGRICULTURE (MONTENEGRO)	12	H	H
	REGIONAL ENERGY (MONTENEGRO)*	3	H	M
	Result	**125**		
2007	PROGRAMATIC ADJUSTMENT LOAN 2	90	H	H
	PRIMARY HEALTH	35	H	M
	RURAL BUSINESS ENVIRONMENT	40	H	M
	STRUCTURAL ADJUSTMENT CREDIT 3 (MN)	10	H	H
	Result	**175**		
Overall Result		**400**		

*Reflects regular IDA allocation; additional IDA regional allocations would be sought (see also Table 5 of CAS).

Serbia and Montenegro
IFC and MIGA Program, FY2002-2005

	2002	2003	2004	2005
IFC Commitments (US$m)	32.78	9.04	0.00	0.85
Sector (%)				
Finance & Insurance	25	100		100
Food & Beverages	21			
Plastics and Rubber	54			
Total	100	0	0	0
Investment instrument(%)				
Loans	76	89		87
Equity	13	11		13
Quasi-Equity	11			
Other				
Total	100	100	0	100
MIGA guarantees (US$m)	0	0	196.86	296.26

Note: Source is IFC's MIS; FY05 figures are as of October 31, 2004; IFC's own account only

Serbia and Montenegro - Summary of Nonlending Services, FY02 - 07

Product	Completion FY	Cost (US$000)	Audience [a]	Objective [b]
Recent completions				
SaM CFAA	02	129	G,D,B,PD	KG, PS
SaM CPAR	02	90	G,D,B,PD	KG, PS
SaM PEIR	03	436	G,D,B,PD	KG, PS
SaM Poverty Note & Assessment (rolling prog.)	03	204	G,D,B,PD	KG,PS,PD
Serbia Agriculture Report	03	167	G,D,B,PD	KG,PS,PD
SaM Environment Report	03	52	G,D,B,PD	KG,PS,PD
SaM Debt Sustainability	03	77	B	KG, PS
SaM Diagnostic and Policy Note Public Administrati	04	100	G,D,B,PD	KG,PD,PS
SaM Investment Climate Assessment (ICA)	04	50*	G,D,B,PD	KG,PD,PS
SaM Fiduciary Work	04	50	G,D,B	KG, PS
SaM Administrative Barriers (FIAS)	04	n/a	G,D,B,PD	KG,PD,PS
SaM Investment Diagnostic (FIAS)	04	n/a	G,D,B,PD	KG,PD,PS
Serbia Economic Memorandum	04	317	G,D,B,PD	KG,PD,PS
Serbia Financial Sector Note	05	80	G,D,B,PD	KG,PD,PS
SaM WBG Support for PRSP Implementation	05-07	125		
Underway				
Serbia Private Sector Note	05	90	G,D,B,PD	KG,PD,PS
Montenegro Economic Memorandum	05	80	G,D,B,PD	KG,PD,PS
SaM Programmatic Poverty Work	05-07	200	G,D,B,PD	KG,PD,PS
Montenegro Priv Sector/Fin Note	05	50	G,D,B,PD	KG,PD,PS
Planned				
SaM Debt Sustainability Analysis Update	05	30	G, PD,PS	KG,PD,PS
Serbia FSAP	05	51	G,D,B,PD	KG,PD,PS
SaM Youth in SEE	05	70	G,D,B,PB	KG,PD,PS
Serbia Agriculture Competitiveness Study	06	50	G,D,B,PD	KG,PD,PS
SaM Support for Roma Decade of Inclusion	06	5		
SaM PEIR Update (integrated PFM)	06	5	G,D,B,PD	KG,PD,PS
Montenegro Social Protection	06-07	60	G,D,B	KG, PS
Serbia Labor Market Policy Note	06	80	G,D,B,PD	KG,PD,PS
SaM Poverty Assessment Update	07	200	G,D,B,PD	KG,PD,PS

*also has network financing

a. Government, donor, Bank, public dissemination.

b. Knowledge generation, public debate, problem-solving.

Serbia and Montenegro Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1997-2003	Europe & Central Asia	Lower-middle-income
POPULATION					
Total population, mid-year (millions)	9.3	10.2	8.1	472.7	2,655.2
Growth rate (% annual average for period)	1.0	0.9	-4.5	0.0	0.9
Urban population (% of population)	43.0	48.7	52.0	62.6	49.7
Total fertility rate (births per woman)	2.3	2.2	1.7	1.6	2.1
POVERTY					
(% of population)					
National headcount index	..	..	..	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNI per capita (US$)	..	..	1,910	2,570	1,480
Consumer price index (1995=100)	..	..	..	..	..
Food price index (1995=100)	..	..	1,720	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	..	..	..
Lowest quintile (% of income or consumption)	..	..	..	..	..
Highest quintile (% of income or consumption)	..	..	..	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	6.5	4.3	2.6
Education (% of GDP)	..	..	..	4.3	4.0
Social security and welfare (% of GDP)	..	..	..	..	..
Net primary school enrollment rate					
(% of age group)					
Total	..	..	75	..	91
Male	..	..	75	..	92
Female	..	..	75	..	91
Access to an improved water source					
(% of population)					
Total	..	..	98	91	81
Urban	..	..	99	96	94
Rural	..	..	97	82	70
Immunization rate					
(% of children ages 12-23 months)					
Measles	..	91	92	93	78
DPT	..	89	95	92	84
Child malnutrition (% under 5 years)	..	..	2	..	11
Life expectancy at birth					
(years)					
Total	70	71	73	69	69
Male	68	68	70	64	67
Female	72	73	75	73	71
Mortality					
Infant (per 1,000 live births)	54	36	16	31	32
Under 5 (per 1,000 live births)	72	44	19	37	40
Adult (15-59)					
Male (per 1,000 population)	166	164	180	317	214
Female (per 1,000 population)	121	106	100	137	135
Maternal (modeled, per 100,000 live births)	..	..	11	..	..
Births attended by skilled health staff (%)	..	..	99	..	..

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment rate: break in series between 1997 and 1998 due to change from ISCED76 to ISCED97. Immunization: refers to children ages 12-23 months who received vaccinations before one year of age.

World Development Indicators database August 2004, World Bank

Serbia and Montenegro - Key Economic Indicators

Indicator	Actual		Estimate		Projected			
	2000	2001	2002	2003	2004	2005	2006	2007
National accounts (as % of GDP)								
Total Consumption	102.7	107.2	107.2	106.6	108.6	107.3	103.3	101.3
Gross domestic fixed investment	15.3	13.3	15.9	15.6	16.2	17.5	20.1	20.7
Government investment	3.1	1.6	3.6	2.2	2.6	2.3	4.6	4.7
Private investment	12.2	11.7	12.3	13.4	13.6	15.2	15.5	16.0
Exports (GNFS)[b]	29.6	23.7	20.9	19.9	24.2	27.3	29.9	31.7
Imports (GNFS)	46.5	44.6	44.3	42.4	49.4	52.4	53.5	54.0
Gross domestic savings	-2.7	-7.2	-7.2	-6.6	-8.6	-7.3	-3.3	-1.3
Gross national savings[c]	10.4	9.1	7.2	6.3	5.8	7.5	11.6	13.5
Memorandum item								
GNI per capita (US$, Atlas method)	1,220	1,250	1,400	1,900	2,530	2,770	2,870	2,960
Real annual growth rates (%, calculated from 1998 prices)								
Gross domestic product at market prices	5.0	5.5	4.0	3.0	6.0	4.6	4.8	5.0
Gross Domestic Income	5.1	5.5	4.0	3.1	6.0	5.0	4.8	5.0
Real annual per capita growth rates (%, calculated from 1998 prices)								
Gross domestic product at market prices	5.5	5.7	4.3	3.2	5.9	4.5	4.7	4.9
Total consumption	5.2	13.1	7.8	8.7	10.7	2.3	-0.4	2.3
Private consumption	19.1	15.1	6.6	8.5	11.8	3.0	0.5	2.3
Balance of Payments (US$ millions)								
Exports (GNFS)[b]	2,547	2,743	3,241	4,069	5,623	6,326	7,028	7,808
Merchandise FOB	1,923	2,003	2,412	3,015	3,925	4,493	5,047	5,669
Imports (GNFS)[b]	4,004	5,160	6,857	8,675	11,463	12,138	12,591	13,303
Merchandise FOB	3,711	4,837	6,320	7,957	10,244	10,858	11,221	11,838
Resource balance	-1,457	-2,417	-3,616	-4,606	-5,840	-5,812	-5,563	-5,494
Net current transfers	1,119	1,915	2,344	2,895	3,745	3,970	3,942	4,072
Current account balance	-339	-528	-1,383	-1,960	-2,492	-2,372	-2,049	-1,861
Net private foreign direct investment	25	165	562	1,395	966	1,181	988	1,035
Long-term loans (net)	213	299	378	697	1,059	867	724	706
Other capital (net, incl. errors & omissions)	328	587	1,554	1,138	640	748	478	360
Change in reserves[d]	-227	-523	-1,111	-1,270	-173	-424	-141	-239
Memorandum items								
Resource balance (% of GDP)	-17	-21	-23	-22	-25	-25	-24	-22

(Continued)

Serbia and Montenegro - Key Economic Indicators
(Continued)

Indicator	Actual		Estimate		Projected			
	2000	2001	2002	2003	2004	2005	2006	2007
Public finance (as % of GDP at market prices)[e]								
Current revenues	36.7	38.9	43.3	42.7	43.2	42.7	41.9	41.1
Current expenditures	34.5	38.7	44.3	44.0	42.8	41.3	38.2	37.4
Current account surplus (+) or deficit (-)	2.2	0.2	-1.1	-1.3	0.5	1.5	3.7	3.7
Capital expenditure	3.1	1.6	3.5	2.3	2.6	2.3	4.8	4.9
Foreign financing	0.0	0.0	1.8	1.2	0.9	1.1	1.0	1.0
Monetary indicators								
M2/GDP	8.5	7.8	10.6	10.1	9.9	9.8	10.0	10.1
Growth of M2 (%)	..	83.9	76.2	12.1	14.0	16.5	14.4	10.7
Price indices								
Consumer price index (% change, period average)	69.9	91.1	21.2	11.3	9.5	11.3	6.2	4.0
GDP deflator (% change)	88.5	91.7	24.0	14.9	9.8	11.9	7.1	4.4

a. GDP at factor cost
b. "GNFS" denotes "goods and non-factor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Consolidated general government.

Serbia and Montenegro - Key Exposure Indicators

Indicator	Actual		Estimate			Projected		
	2000	2001	2002	2003	2004	2005	2006	2007
Total debt outstanding and disbursed (TDO) (US$m)[a]	11,460	11,948	11,841	14,302	13,404	13,060	12,805	12,951
Net disbursements (US$m)[a]	353	502	832	1,111	1,188	1,090	812	695
Total debt service (TDS) (US$m)[a]	56	107	184	463	1,047	1,387	1,477	1,819
Debt and debt service indicators (%)								
TDO/XGS[b]	307.1	266.2	219.6	205.9	143.8	125.2	113.8	105.8
TDO/GDP	133.2	103.2	76.5	69.9	57.8	56.4	54.4	52.6
TDS/XGS	1.5	2.4	3.4	6.7	11.2	13.3	13.1	14.9
Concessional/TDO	2.3	2.4	22.1	23.5	27.1	21.5	20.5	19.1
IBRD exposure indicators (%)								
IBRD DS/public DS	..	..	56.0	36.0	23.4	23.3	29.5	23.0
Preferred creditor DS/public DS (%)[c]	..	24.5	74.6	69.0	91.7	97.8	75.0	63.8
IBRD DS/XGS	..	..	1.4	1.5	1.3	1.3	1.5	1.5
IBRD TDO (US$m)[d]	1,781	1,840	2,175	2,607	2,607	2,591	2,551	2,544
Of which present value of guarantees (US$m)								
Share of IBRD portfolio (%)	100.0	100.0	92.9	90.2	85.4	82.1	79.7	78.4
IDA TDO (US$m)[d]	0	0	167.0	282.0	446.3	564.7	650.1	699.6

a. Includes public and publicly guaranteed debt, private non-guaranteed, use of IMF credits and net short- term capital.

b. "XGS" denotes exports of goods and services, including workers' remittances.

c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

d. Includes present value of guarantees.

e. Includes equity and quasi-equity types of both loan and equity instruments.

Status of Bank Operations
Operations Portfolio (IBRD/IDA and Grants)
As Of Date 11/04/2004

Closed Projects 7

IBRD/IDA *

Total Disbursed (Active)	7.98
of which has been rep:	0.00
Total Disbursed (Closed)	325.27
of which has been rep:	25.24
Total Disbursed (Active + Clc	333,240,860.05
of which has been rep:	25,241,158.93
Total Undisbursed (Active)	209.66
Total Undisbursed (Closed)	0.00
Total Undisbursed (Active + (	209,661,352.46

Active Projects

		Last PSR Supervision Rating			Original Amount in US$ Millions			
Project ID	Project Name	Development Objectives	Implementation Progress	Fiscal Year	IBRD	IDA	GRANT	Cancel.
P075189	EDUC IMPRVMT	U	U	2002		10		
P074136	EMG ELEC POWER RE(	S	S	2002			6	
P077473	EMG POWER LIC (MON	S	S	2003		5		
P069374	EMPLYMT PROMO LIL	S	S	2003		2.75		
P075343	ENERGY EFF	S	S	2004		21		
P079116	ENVIRONMENT (MONTI	S	S	2004		7		
P074484	EXP FIN FAC	S	U	2003		11.5		
P074127	FIN SEC DEVT TA	S	S	2001			6	
P077675	HEALTH	S	S	2003		20		
P082223	HEALTH SYSTEM (MON	S	S	2004		7		
P087470	PENSION ADMIN	S	S	2004		5		
P077732	PRIV & REST OF BANK:	S	S	2003		11		
P074145	PRIV SECT DEVT TA	S	S	2001			6	
P078311	REAL ESTATE CADAST	S	S	2004		30		
P074908	SAC 2 (MONTENEGRO)	#	#	2005		18		
P074090	TRADE & TRANSPORT	S	S	2002		6.76		
P075207	TRNSPT REHAB	S	S	2004		55		
Overall Result						210.01	18	

Statement of IFC's Committed and Outstanding Portfolio

As of 10/31/04

In US Dollar Millions

FY Approval	Company	Held				Disbursed			
		Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
2002	MEB Kosovo	0.00	1.11	0.00	0.00	0.00	1.11	0.00	0.00
2002/2003	MFB Yugoslavia	12.79	2.04	0.00	0.00	12.79	2.04	0.00	0.00
2002/2005	Raiffeisen Yug	0.00	3.24	0.00	0.00	0.00	3.23	0.00	0.00
2002	Tigar M.H.	20.46	0.00	4.11	0.00	20.46	0.00	4.11	0.00
Total Portfolio:		**33.25**	**6.39**	**4.11**	**0.00**	**33.25**	**6.38**	**4.11**	**0.00**

Note: Source IFC's MIS; Excludes old projects prior to FY2002

Approvals Pending Commitment

In US Dollar Millions

FY Approval	Company	Approved - IFC					TOTAL	
		Loan	Equity	Quasi	GT	RM	IFC	Partic
2005	Opportunity Bank	4.8	0.0	0.0	0.0	0.0	4.8	0.0
Total Pending:		**4.8**	**0.0**	**0.0**	**0.0**	**0.0**	**4.8**	**0.0**

Source: IFC's MIS

MAP SECTION