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PROGRAM DOCUMENT

OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE EXECUTIVE DIRECTORS

ON A PROPOSED

SECOND STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF SERBIA)

IN THE AMOUNT OF SDR 30.1 MILLION (US$45 MILLION EQUIVALENT)

TO

SERBIA AND MONTENEGRO

November 15, 2004

South East Europe Country Unit
Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of October 30, 2004)

Currency Unit = Dinar
US$1 = CSD 59.77

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

APAD	Agency for Public Administration and Development
BEEPS	Business Environment and Enterprise Performance Survey
CAD	Current Account Deficit
CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CLDS	Center for Liberal-Democratic Studies
CSC	Civil Service Council
DFID	Department for International Development
EA	Extended Arrangement
EAR	European Agency for Reconstruction
EC	European Commission
ECA	Europe and Central Asia
ECSEE	Energy Community of South East Europe
EPS	Electric Power Industry of Serbia
ERTP	Economic Recovery and Transition Program
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
HBS	Household Budget Survey
IBRD	International Bank for Reconstruction and Development
ICA	Investment Climate Assessment
ICRC	International Committee of the Red Cross
IDA	International Development Association
IDP	Internally Displaced Person
ILO	International Labor Organization
IMF	International Monetary Fund
LFS	Labor Force Survey
MIER	Ministry of International Economic Relations
MLESP	Ministry of Labor, Employment and Social Policy
MOF	Ministry of Finance
MOME	Ministry of Mining and Energy
MOP	Material Assistance to Families
MOSA	Ministry of Social Affairs
MPALSG	Ministry of Public Administration and Local Self Government
NBS	National Bank of Serbia
OECD	Organization for Economic Co-operation and Development
PA	Public Administration
PAR	Public Administration Reform
PFSAC	Private and Financial Sector Adjustment Credit
PFSAC 1	First Private and Financial Sector Adjustment Credit
PFSAC 2	Second Private and Financial Sector Adjustment Credit
PICS	Productivity and Investment Climate Survey
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Analysis
REM	Regional Energy Market
RIA	Regulatory Impact Analysis
RSO	Republican Statistical Office
SAC	Structural Adjustment Credit
SAC 1	First Structural Adjustment Credit
SAC 2	Second Structural Adjustment Credit
SAI	Supreme Audit Institution
SAM	Serbia and Montenegro
SDR	Special Drawing Right
SEE	Southeast Europe
SFRY	Socialist Federal Republic of Yugoslavia
SIDA	Swedish International Development Cooperation Agency
SLS	Survey of Living Standards
SME	Small and Medium Enterprises
SOSAC	Social Sector Adjustment Credit
TSS	Transitional Support Strategy
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
CSD	Yugoslav Dinars

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SERBIA AND MONTENEGRO
SECOND STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF SERBIA)

CREDIT SUMMARY

Borrower:	Serbia and Montenegro (SaM)
Amount:	SDR 30.1 million (US$45 million equivalent)
Terms:	Modified IDA terms with a 20-year maturity, including a 10-year grace period and no acceleration clause.
Objectives and Description:	The proposed credit is a Second Structural Adjustment Credit (SAC 2) to support the Government of the Republic of Serbia in the implementation of structural reforms necessary to lay the foundations for enduring growth and macroeconomic stability over the medium-term. The reform program to be supported by the proposed operation aims at achieving these objectives through implementing specific policy actions—in line with the priorities set out in the Serbia Poverty Reduction Strategy Paper—directed at (i) improving the business climate; (ii) enhancing the performance in the energy sector; (iii) strengthening social protection; and (iv) improving public administration.
Benefits:	The proposed SAC 2 would support the Republic of Serbia to deepen the reform process necessary to place the economy on a sustainable growth path and move closer to European structures. Successful implementation of these policy measures would support the Government's efforts to (i) enhance fiscal discipline; (ii) encourage a strong private sector response and employment creation; (iii) set the stage for deeper reforms aimed at improving public administration; (iv) address the problem of low-coverage and under-funding of Serbia's well-targeted social assistance programs; and (v) mitigate the adverse impact of the energy sector reform measures on the poor.
Risks:	The formation of a fragile but functioning minority coalition in early March 2004 ended two months of political deadlock in Serbia following the legislative elections on December 28, 2003. Serbian Presidential elections were concluded in June 2004, bolstering stability. There are, however, a number of issues to be sorted out among ruling coalition partners and the party of the newly elected President, which has not joined the coalition. The challenges of ruling as a minority coalition could undermine the Government's cohesiveness and effectiveness, without which commitment to reforms would diminish and the capacity for policy implementation would weaken.

The envisaged fiscal adjustment and macroeconomic performance could be adversely affected by slippages in program implementation. More specifically, failure to attain durable cuts in non-interest current expenditures could undermine the credibility of the fiscal adjustment, thereby jeopardizing the implementation of the overall reform program. In addition, Serbia's exports are concentrated in unskilled and natural resource intensive products, which increases the economy's exposure to terms of trade shocks. A severe deterioration of terms of trade or lower-than-expected foreign investment flows coupled with higher-than-expected oil prices might adversely affect economic activity and macroeconomic stability, thereby undermining the implementation pace of the reform agenda.

Schedule of Disbursements:	Single tranche.
Poverty Category:	Not applicable.
Project ID Number:	P078457
Map	IBRD No. 31506R2

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INTERNATIONAL DEVELOPMENT ASSOCIATION
PROGRAM DOCUMENT
ON A PROPOSED SECOND STRUCTURAL ADJUSTMENT CREDIT
(REPUBLIC OF SERBIA)
TO SERBIA AND MONTENEGRO

Contents

ANNEXES:

Annex 1:	Key Economic Indicators
Annex 2:	Key Exposure Indicators
Annex 3:	Timetable of Key Processing Events
Annex 4:	Letter of Development Policy
Annex 5:	Program Policy Matrix
Annex 6:	Serbia and Montenegro at a Glance
Annex 7:	Fund Relations Note

INTERNATIONAL DEVELOPMENT ASSOCIATION
PROGRAM DOCUMENT
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TO SERBIA AND MONTENEGRO

1. This Report constitutes the Program Document on a proposed Second Structural Adjustment Credit (SAC 2) to Serbia and Montenegro (SaM)[1] in the amount of SDR 30.1 million (US$45 million equivalent) to support Serbia's structural reform program.[2] The Credit would be on modified International Development Association (IDA) terms, with a final maturity of 20 years and a grace period of 10 years, and would be disbursed in one tranche immediately after Credit Effectiveness. This Report should be read in conjunction with the joint World Bank-IFC FY05-07 CAS for Serbia and Montenegro, which is being presented to the Board together with the proposed SAC 2.

I. INTRODUCTION

2. Serbia started the 1990s relatively well integrated with the world economy and with higher standards of living compared to many other transition economies. The country's economy, however, was devastated as a result of armed conflicts, international sanctions, and trade shocks stemming from the break-up of the Socialist Federal Republic of Yugoslavia (SFRY). 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 coupled with accumulation of large domestic and external debts, with the latter reaching 132.6 percent of GDP in 2000.

3. Although cash deficits of the consolidated government were contained, this was achieved largely through unsustainable expenditure compression, accumulation of budgetary arrears, non-servicing of public debt, and toleration of quasi-fiscal deficits. The real sector became largely inefficient due to the lack of market oriented ownership structures, the loss of markets, lack of access to working capital, delayed investment and maintenance, and repressive and complicated taxation and regulation. This resulted in a decrease in real earnings, with absolute poverty roughly doubling since 1990 and deterioration in social protection and health services, as available financing fell below existing entitlement levels.

4. Serbia embarked on an ambitious economic program in January 2001 with the objective to reverse the trends of the past—through ensuring a rapid transition to an open market economy and normalizing relations with international financial markets—and

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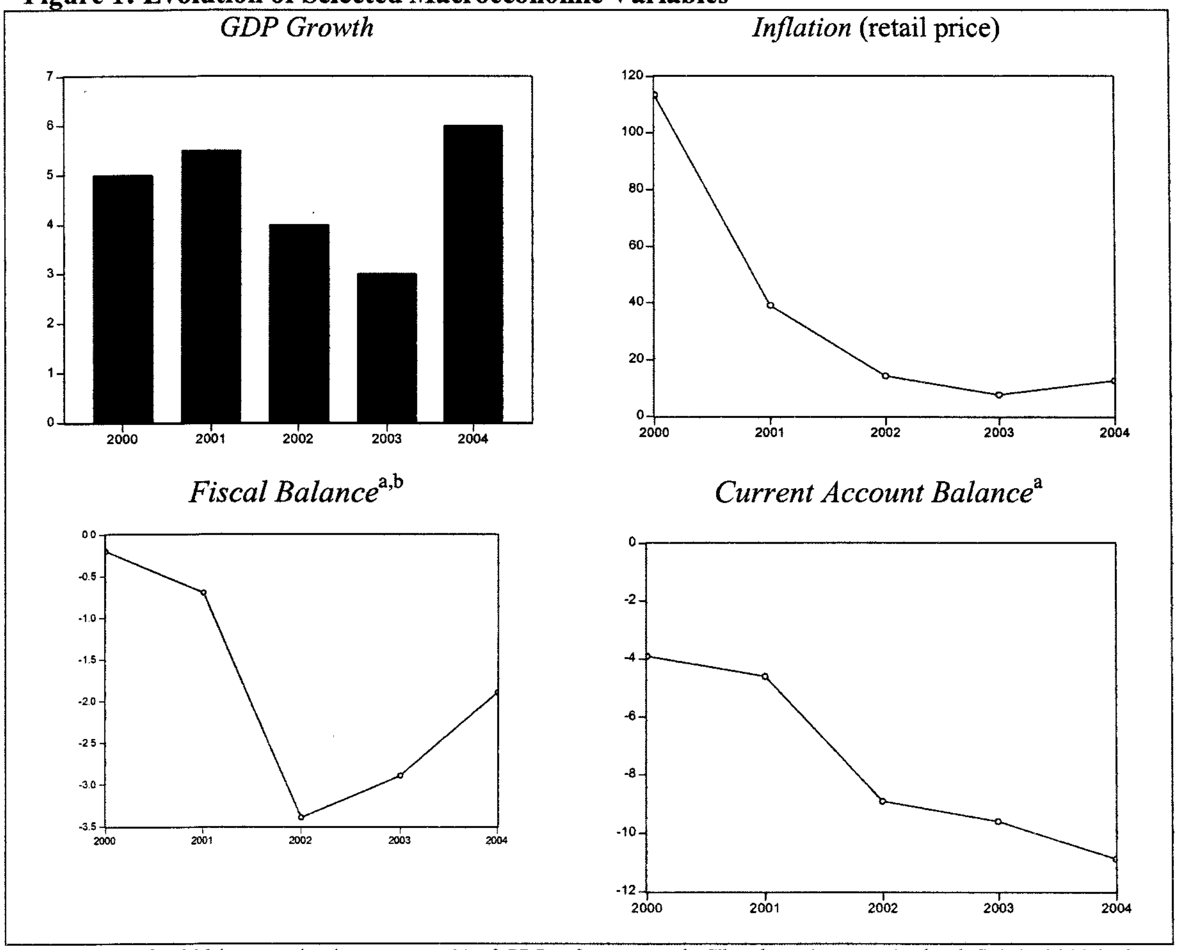
[1] Formerly known as "the Federal Republic of Yugoslavia" (FRY). The Constitutional Charter of Serbia and Montenegro was enacted by the Parliament of Serbia, the Parliament of Montenegro and the Parliament of the Federal Republic of Yugoslavia effective February 4, 2003 and, as of that date, the Federal Republic of Yugoslavia has changed its name to "Serbia and Montenegro." In this document, all references to SaM which predate the change of name should be understood to refer to FRY.

[2] As a result of the highly devolved nature of SAM—most areas of economic policy are in the competence of the two Republican member states—and the different starting points, needs and pace of reforms in the two member states, the Bank's assistance program for SAM is designed primarily around member state-specific operations. Therefore, for the purposes of this document, the term "Government" would designate the Government of Serbia, unless otherwise specified.

integrate the economy with the European Union. The implementation of the economic program has been successful in bringing down inflation, stabilizing the exchange rate, and in establishing macroeconomic stability (Figure 1).

5. SaM has also made significant progress in the implementation of **structural reform measures** outlined in the medium-term Economic Recovery and Transition Program (ERTP),[3] but not evenly across all areas. More specifically, there has been considerable progress in opening the economy, restructuring the banking sector, and adopting legislation in many areas aimed at harmonization with the European Union. In many areas, however, the reforms are still incomplete, and in several areas the reform process has hardly initiated. As was underscored in *Recent Progress on Structural Reforms*—a document prepared by the World Bank for the Donor Coordination Meeting in November 2003—progress in the following policy areas 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.

Figure 1: Evolution of Selected Macroeconomic Variables



Notes: Figures for 2004 are projections; a: as a % of GDP, after grants; b: The sharp increase in the deficit in 2002 is due largely to the acknowledgement of the hidden fiscal liabilities.

[3] See *Breaking With the Past: The Path to Stability and Growth*, World Bank, (2001) for more on the medium-term ERTP.

II. ECONOMIC BACKGROUND AND RECENT DEVELOPMENTS

6. **Economic context**. The implementation of the economic reform program, which was launched in early 2001, has marked a sea change in policy in Serbia. The stabilization program, which was supported by the IMF, World Bank, and European Union, contained four pillars[4] (i) implementation of prudent fiscal and monetary policies to achieve macroeconomic stability; (ii) rapid liberalization of most prices, removal of most quantitative restrictions on foreign trade, and rationalization of import tariffs; (iii) policy actions to establish effective institutions of macroeconomic policy;[5] and (iv) implementation of a set structural reform measures in the labor market, competition policy, bank restructuring, pension and social policy reform, public administration, judicial system, privatization—all of which aimed at improving the efficiency and flexibility of the economy.

7. The reduction of fiscal deficits towards levels financeable from non-inflationary sources constituted the crux of the stabilization efforts owing to the need to confront and manage the hidden liabilities that arose from the unsustainable policies in the past. The noted policy efforts have been supported by three successive arrangements with the IMF—most recently by a three year long Extended Arrangement of SDR 650 million spanning the period through end-March 2005.

8. A highly concessional November 2001 debt restructuring agreement with the Paris Club enhanced medium term fiscal sustainability. This agreement involved, inter alia, a phased 66 percent reduction in the net present value of commercial obligations and a rescheduling of the remaining stock over 22 years with a 6-year grace period. In July 2004, the Government 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 net present value write-off, and reschedules the rest over the next 20 years with 3.75 percent interest rate in the first five years and 6.75 percent interest during the remaining 15 years.

9. The World Bank has been supporting the Serbian Government's reform agenda as was outlined in a Transitional Support Strategy (TSS) produced on June 26, 2001, which was updated in August 2002 and in February 2004. A multi-sectoral Structural Adjustment Credit (SAC, approved in January 2002) was designed to enhance fiscal sustainability through reforms of public expenditure management, the energy sector, social protection, labor markets, and health care. A Social Sector Adjustment Credit (*SOSAC*, approved in April 2003) aimed at supporting reforms in pensions, health and labor, while enhancing the focus on social assistance and poverty monitoring. Two Private and Financial Sector Adjustment Credits (*PFSAC 1 and 2*, approved in May 2002 and June 2003) aimed at promoting growth through (i) strengthening the financial system

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[4] See Economic Recovery and Transition Program and various IMF performance reviews of the Stand-By Agreement for more on this.

[5] These actions included consolidation of fiscal and quasi fiscal activities into single federal, republican and local budgets, rationalization of the tax system, creation of a treasury and modern payments system, and removal of the central bank and state bodies—excluding the Ministry of Finance and Economy—from fiscal and quasi fiscal activities.

via the liquidation of troubled banks and an improved policy and regulatory environment; (ii) privatizing and restructuring socially-owned enterprises; and (iii) improving the investment and business climate.

10. **Recent progress in structural reforms**. Structural reforms in Serbia have advanced slower-than-desired in certain areas since late 2003 owing mainly to political uncertainties. However, the implementation pace has picked up since mid-July 2004 as was evidenced by the approval of a package of 17 economic reform laws by the Parliament of Serbia including those on bankruptcy, VAT, and energy. Moreover, enterprise privatization has resumed with the issuance of tenders for eight socially-owned enterprises and 191 auctions. Financial sector reform has also gained some momentum with the issuance of tenders for three banks, which, once completed, should reduce the share of the state in total bank assets significantly.

11. **Recent economic developments**. The strong implementation of stabilization and reform program was accompanied by solid economic recovery following the sharp contraction in 1999: SaM's GDP grew by 5.5 percent and 4 percent in 2001 and in 2002, respectively (Table 1).[6] By 2003, however, the initially buoyant recovery slowed down: real GDP growth declined to 3 percent—lower than the program target of 3.5-4.5 percent due mainly to two reasons. First, the assassination of the Serbian Prime Minister Zoran Djindjic in March 2003 coupled with the decision to hold early Serbian parliamentary elections in December 2003 led to political uncertainty, thereby adversely affecting both the implementation of key structural reforms and overall economic activity. Second, the drought in northern Serbia and pre-privatization uncertainty, coupled with insufficient investment and general lack of competitiveness, led to the unsatisfactory performance in industry and agriculture, thereby negatively affecting growth.

12. SaM's GDP is expected to grow by about 6 percent in 2004, reflecting a strong recovery in industry (due to accelerated privatization in 2003) strong growth in services, and a rebound in agricultural output. Available data is in line with the noted growth projection. Against the backdrop of a strong recovery in manufacturing, industrial production in SaM grew by 7.2 percent year-on-year in the first eight months of 2004. Concurrently, retail sales in the first eight months increased by 14.2 percent year-on-year, reflecting a pick up in economic activity.

[6] Serbia accounts for about 93 percent of SaM's economy. In this document, all references to GDP should be understood to refer to SaM's GDP unless otherwise indicated.

Table 1: Evolution of Economic Activity, 2001-04

	GDP Growth (constant prices)				Share in GDP			
	2001	2002	2003	2004[a]	2001	2002	2003	2004[a]
Real GDP Growth	5.5	4.0	3.0	6.0	100.0	100.0	100.0	100.0
Domestic Demand	12.1	10.1	4.4	9.6	120.9	123.4	122.5	125.2
Consumption	12.4	7.5	4.5	9.2	107.2	107.2	106.6	108.6
Investment	9.2	34.4	3.6	13.1	13.6	16.2	15.9	16.5
Exports	8.6	12.3	4.3	38.0	23.7	20.9	19.9	24.2
Imports	30.0	26.3	7.2	29.7	44.6	44.3	42.4	49.4

a: Estimate

13. **Prices.** The exchange rate-based stabilization program has been very effective in reducing inflation in Serbia. Retail price inflation declined from 113.5 percent in 2000 to 14.8 percent in 2002 and further to 7.8 percent in 2003. Following the liberalization of the foreign exchange market and unification of the exchange rate in October 2000, the dinar initially remained close to 30 dinar to the deutschmark, later 60 dinar to euro. 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 (7.4 percent) percent in 2003 compared to end-December 2002.

14. As a result of higher oil prices, more flexible exchange rate policy,[7] increased electricity prices, and higher excise taxes, the inflation rate is projected to be between 12-13 percent in 2004 (compared to 7.8 percent in 2003).[8] The credibility of program implementation will determine whether the adverse impact of the noted *one-off* factors on inflation will be permanent or temporary.

15. **Fiscal balance**. The performance on the fiscal side—gauged by meeting the program targets under the IMF supported economic program—has also been favorable.[9] 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. The 2004 budget was not adopted until end-March and thus fiscal policy was tightened in the first quarter of the year as temporary financing arrangements automatically restrained expenditure.

16. In response to unfavorable external developments and rising inflationary pressures, the Republic of Serbia Parliament adopted a re-balanced budget for 2004 in October, which represents an important step towards reducing public consumption. More specifically, the re-balanced budget for 2004, which relies mainly on expenditures cuts, envisages a reduction of the budget deficit from CSD 45.3 billion (3.5 percent of Serbian

[7] In nominal terms, the dinar depreciated by 14 and 4.1 percent in October 2004 (y-o-y) against the Euro and the US$, respectively.

[8] In response to the noted development, 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] The consolidated budget deficit of 1.4 percent of GDP in 2001 turned out to be noticeably lower than that the program target of 6.1 percent of GDP. The target of 5.7 percent of GDP for 2002 was also comfortably met, although the outcome was significantly higher than that of 2001 as a result of the acknowledgement of hidden fiscal liabilities.

GDP) to CSD 32.7 billion (2.5 percent of Serbian GDP). The draft budget for 2005 suggests that fiscal policy will continue to remain tight in 2005.

17. **External balance**. Following the ending of regional conflicts and removal of international sanctions, the country experienced large current account deficits. More specifically, the combined effect of low and slowly growing exports[10] and rapidly growing imports of goods and services (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 US$339 million (3.9 percent of GDP) in 2000 to an estimated US$1.96 billion (9.6 percent of GDP) in 2003.

18. 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 projected current account deficit (after grants) for 2004 is revised upwards from 9.6 percent of GDP to 10.7 percent. As was underlined previously, the noted external developments, coupled with increasing inflationary pressures, led the authorities to adopt tighter fiscal and monetary policies to ensure external viability and price stability.

III. THE COUNTRY'S ADJUSTMENT PROGRAM

19. The overall economic reform strategy, as was outlined in the Serbia PRSP, rests on three main pillars (i) dynamic economic growth and development, with an emphasis on job creation; (ii) prevention of new poverty that will stem from the modernization and restructuring of the economy; and (iii) efficient implementation of existing programs and development of new programs, measures, activities directly targeting the poorest and the most vulnerable groups, particularly in the least developed regions.

20. Guided by the above-noted strategic directions, the authorities are determined to maintain macroeconomic stability and place the country on the road of sustained growth, better living standards and integration into European structures. To achieve these goals, the Government is resolute to address two key challenges:

- **Fiscal Adjustment**. Although Serbia has made good progress in reducing hidden fiscal imbalances, particularly budgetary arrears and losses in the energy sector, consolidated public spending (including net lending) has steadily increased to a very high 46.5 percent of Serbian GDP in 2003, very little of which goes to the public investments which are crucial for growth.[11] The resulting high tax burden and budget deficits crowd out private activity and encourage informality, while also raising macroeconomic vulnerability. Set against this backdrop, the country needs to give top priority to measures to achieve a credible fiscal consolidation without which key policy goals of ensuring macroeconomic stability and sustainable growth cannot be achieved. Credible fiscal adjustment will need to be

[10] 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.

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

attained through sustainable changes in fiscal policy, as opposed to drastic and unsustainable cuts in public investment and non-wage current expenditures. A successful fiscal adjustment will lead to an increase in national savings and buttress macroeconomic stability, thereby creating a conducive environment for sustainable economic growth.

- **Sustainable economic growth** will require the implementation of economy-wide structural reforms, including those in the four policy areas supported by the proposed operation (i) *reforms of the business enabling environment;* (ii) *institutional development and improving performance in the energy sector*; (iii) *strengthening social protection*; and (iv) *improving public administration*. The proposed operation will include reform measures aimed at supporting the Government's efforts to alleviate the social consequences of the reform measures and encourage a robust private sector response—all of which lay the foundations of an economy that would produce a more rapid and durable growth of living standards over the medium-term.

21. The authorities are committed to continue progress on economy-wide structural reforms to address the noted challenges and cooperate with international financial institutions towards successful implementation of the reform agenda. To this end, the Government has successfully implemented series of important structural reform measures supported by the World Bank's previous operations (see para 9). Concurrently, the Government, in cooperation with the IMF and the World Bank, formulated a medium-term stabilization and reform program for 2002-05, which has been supported by a three-year Extended Arrangement (EA). *Attaining sustainable growth and improved living standards, low inflation, and a viable external position* constitute the main objectives of the EA.

22. The Government has requested this Second Structural Adjustment Credit (SAC 2) to deepen its earlier reform efforts described above and to support its medium-term structural and institutional reform program. The SAC 2 financing will allow a smoother adjustment and more time and resources to implement the Government's structural program. It will also complement the authorities' macroeconomic framework supported by the IMF's EA.

IV. THE COMPONENTS OF THE PROPOSED CREDIT

23. **Main Reform Objectives**. The proposed operation would support the country's efforts to place the economy on a more solid basis for enduring growth, enhancing fiscal discipline, and integration into European structures. This will be accomplished through implementation of reform measures directed at the following objectives:

- *Improving the business climate*, which is required to create an environment that is conducive to attracting investments both domestic and foreign, thereby promoting a strong private sector response and employment creation.

- *Institutional development and improving performance in the energy sector*, which will entail, inter alia, improving financial and operational sustainability of the power sector as well as supporting industry commercialization—all of which will encourage growth and enhance fiscal discipline.
- *Strengthening social protection* is needed not only for alleviating the adverse consequences of the reform measures envisioned in the Government's structural reform program, but also for improving social protection of the poor.
- *Improving public administration* is a prerequisite for attaining further progress in the implementation of much needed economic and social reforms as well as for achieving a permanent fiscal adjustment.[12]

Box 1: The Proposed SAC 2 and the Serbia PRSP

The key tenets of the proposed operation are consistent with the main thrust of the recent **Poverty Reduction Strategy Paper (PRSP)** for Serbia which considers dynamic, sustainable growth and development, with emphasis on job creation, as one of the three strategic main directions in the implementation of the poverty reduction strategy. As was underscored in the PRSP, *creation of a business environment conducive to the development of entrepreneurship and faster development of small and medium enterprises as well as rendering the Serbian economy more hospitable to foreign and domestic investment* are among the key elements of ensuring dynamic and equitable growth. Since the unemployed face the greatest risk of deep and severe poverty, successful implementation of reform measures directed at these objectives will also stimulate employment, thereby mitigating poverty.

Energy sector reform measures will contribute to realization of PRSP goals through improved overall efficiency and strengthened fiscal discipline through addressing the problem of implicit subsidies.
Improving the efficiency of social protection is one of the key PRSP objectives. As was highlighted in the PRSP, the Government's objective in social protection is "the alleviation of poverty in the population as a whole and especially in vulnerable groups such as children, the elderly and infirm, the Roma, persons with disabilities, poverty-stricken refugees, and internally displaced persons." The PRSP underlines that the existing social protection system aimed at the alleviation of poverty is basically sound and modern. Further strengthening of the social protection of the poorest will be ensured by the implementation of recent amendments to the Law on Social Protection and Social Security of Citizens, which will, inter alia, increase the number of beneficiaries and the amount of benefits. In this respect, the full implementation of the noted amendments will hinge on ensuring the allocation of adequate funds.

Finally, the PRSP views *a well organized and competent public administration* as a key precondition for successful integration into the European Union. To this end, it identifies the creation of a dynamic, efficient and transparent public administration in line with the new role of Government in the market economy, as well as with private sector development and stable legislation as the key policy objective in this area.

Source: Poverty Reduction Strategy Paper for Serbia (2003).

24. The reform measures in the noted policy areas—except for the public administration reform—constitute a continuation and deepening of the reform efforts initiated by the World Bank's previous adjustment operations in Serbia and are in line with objectives of Serbia's PRSP (Box 1). The focus on these areas is also supported by

[12] Weaknesses in the institutional systems in Serbia 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 would continue to impose a high fiscal burden, as salary and wage cost as a percentage of GDP would remain too high.

the Bank's economic sector work[13] and intensive dialogue with relevant counterparts—all of which will promote successful implementation of the reforms supported by the proposed operation.

25. The authorities recognize that implementation of policy actions in the noted areas represent a central part of their overall reform efforts in improving Serbia's growth prospects and buttressing macroeconomic stability, which will need to be supported by far-reaching reform measures aimed at attaining a permanent fiscal adjustment and deepening the reform process in improving public administration. The Government is committed to continue its collaboration with the World Bank and other international partners in attaining these objectives.

A. Improving the Business Climate

Context

26. Since late 2000, the Government of Serbia, supported by the Bank and other donors, has taken a number of significant steps to improve the business environment. Notwithstanding the challenging political environment, important policy steps aimed at improving the business climate were taken between 2000 and 2003, including liberalization and deregulation of foreign trade and investment, simplification of the tax regime, and modernization of the labor legislation. However, as was underscored in the recent Investment Climate Assessment (ICA), increasing foreign direct investment, domestic investment, and entry of new firms along with restructuring of the old ones will require greater progress in reforming the institutional environment for investment.

27. The Government's efforts to improve the investment framework mainly focused on further upgrading the legal foundations and institutional capacity for a sound investment climate through (i) promotion of sustainable economic growth and enabling private sector employment opportunities with a special focus on Small and Medium Enterprises (SMEs); (ii) establishment of the necessary financial market institutions through the development of an environment where the rule of law is respected and property rights and claims are recognized, economic agents can enforce their contracts, and lenders can feel secure; (iii) establishment of a regulatory framework that is conducive to the development of competitive market structures; and (iv) improving institutional capacity for regulatory reform.

Reform Objectives and SAC Measures

28. This component of the reform program will deepen the policy actions initiated by the PFSAC 2 and support the Government's objectives to (i) *facilitate efficient corporate*

[13] Recent analytical background work includes the following studies carried out by the World Bank: Serbia Investment Climate Assessment (2004), Serbia and Montenegro: Poverty Assessment (2003), Serbia and Montenegro Public Administration Development: Creating the Conditions for Effective Economic and Social Reform Policy Note (2004), Recent Progress on Structural Reforms (2003), and Serbian Energy Sector: Status, Key Issues and an Agenda for Action (2003).

governance and entry and operations of business through adopting a new Law on Economic Entities (Enterprise Law); (ii) *remove legislative and other barriers to efficient contract enforcement through the adoption of a new Law on Enforcement Procedures*; and (iii) *lower the cost of doing business and improve regulatory reform by enhancing the authority and capacity to assess the need for and quality of regulations and market impacts of proposed rules on business.*

29. **The Enterprise Law**. The Government is committed to changing the Enterprise Law, which constitutes an important component of the commercial law system and provides the basis for other laws, such as privatization, business registration, bankruptcy, accounting, capital markets and investment funds that have either been passed recently or will be passed in the near future.[14] The new Law introduces significant reforms in generic subjects such as duties of directors and other persons in control of a company; lawsuits by investors, mergers and other acquisitions; and liquidation of a company outside bankruptcy. After a public consultation process, the new Law was adopted by the Government in October and was subsequently enacted by the Parliament of Serbia in November 2004. The most important improvements of the new Law, which is consistent with the requirements of EU Company Law Directives, can be summarized as follows:

- *The limited liability company provisions of the law are more flexible* (the minimum capital requirement is reduced from USD5,000 per company to 500 Euros per company and there is no longer a requirement of capital maintenance).
- *The law introduces two types of joint stock companies, namely closed and open.* The new closed company will be free of capital maintenance requirements and will be free to impose restrictions on the transfer of its shares, but cannot offer its shares publicly and may not have more than 100 shareholders unless it adopts and agrees to follow the rules and requirements for an open company.
- *A large number of changes are made to encourage good corporate governance.* The law expands and clarifies a director's legal duty of care and duty of loyalty to the company, introduces the concept of "personal interest", simplifies the structure of the board, makes the establishment of a supervisory board optional and provides for directors to be elected only by the shareholders and to have only one-year terms.
- The new law also has detailed provisions for merger, division, and conversion of a company from one form to another; it imposes new disclosure and other requirements on companies and persons who control a company and it provides new rules for the liquidation of a company outside bankruptcy.

30. **Law on Execution Procedures**. Contractual compliance and enforcement mechanisms constitute the key elements of a country's investment climate. Evidence suggests that better contract enforcement is an important component of policy efforts directed at encouraging investment and creating jobs. Progress in this area (and in improving the business climate in general) is especially important for small and medium-

[14] The Bank has provided support for the development of a new draft Law under PFSAC 2.

sized firms and farms, which are key to job creation and to raising the living standards of the rural poor.

31. As is the case in many other transition economies, the general perception in Serbia is that the courts do not function well and that the administration of justice is slow and inefficient. This is confirmed by the recent Investment Climate Assessment (ICA) survey, which revealed an extremely low level of confidence in the judicial system: *only 8 percent of enterprises included in the survey believe that their contracts enjoy full legal protection*. This particular survey result is consistent with the evidence showing that the proportion of sales paid in cash as pre-payment (20-23 percent) in Serbia is significantly higher than any other Eastern European country (Table 2).

32. As a result of the inefficient system of dispute resolution, most enterprises require advance payment before delivery. Evidence suggests that the percentage of firms using pre-payment (65-70 percent) is higher than in any other country in the region (Table 2). Pre-paid transacting, in turn, thwarts the dynamism of the market and slows down the expansion of business.

Table 2: Pre-payments

	Average share of sales paid in advance by clients in percent	Share of the firms that use pre-payment
Bulgaria	6.47	30.8
Croatia	6.63	49.5
FYROM	9.27	41.5
Slovenia	8.10	49.5
Poland	4.99	38.7
Romania	5.77	42.7
Serbia PICS 1	**23.7**	**72.2**
Serbia BEEPS 2	**22.9**	**69.8**
Serbia PICS 2	**20.0**	**66.1**

Source: Productivity and Investment Climate Survey (PICS) 2001 and 2003 for Serbia; Business Environment and Enterprise Performance Survey (BEEPS) 2002 for other countries.

33. The Cost of Doing Business exercise also indicates that Serbia is lagging significantly behind other countries in the area of contract enforcement: it would take almost three years (1,028 calendar days), and 40 steps to bring a relatively straightforward lawsuit to an end in Serbia.[15] As can be seen from Table 3, Serbia has far more procedures than any other country in the region, and is among the 10 countries with the highest number of procedural steps worldwide.

34. The previous Law on Execution Procedures was enacted in June 2000 with the objective to improve the collection capacity of banks and other creditors as an incentive to increase lending and to reverse the traditional bias in favor of debtors. Major problems, however, remain: there is no procedure for the examination of a judgment and no requirement for the debtor to disclose assets to facilitate execution.[16] In addition, as was

[15]The methodology was developed in Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, (2003) "Courts" Quarterly Journal of Economics, 453-517. It assumes a hypothetical transaction, where a client reneges on the payment of a fulfilled contract, amounting to 50 percent of country's GNI per capita.
[16]The World Bank, "FR Yugoslavia - Legal and Judicial Diagnostic" (2002).

demonstrated in several studies,[17] even creditors who have fought their way through the execution procedure are not sure to collect or otherwise enforce the judgment in their favor. The enforcement of judgments is made difficult by the inaction and inefficiency of the courts' bailiffs and lack of support from the authorities.

Table 3: Enforcing Contract Indicators

	Number of procedures	Duration (days)	Cost (% GNI per capita)	Procedural Complexity Index[a]
Bulgaria	26	410	6.4	69
Croatia	20	330	6.6	50
Macedonia FYR	27	509	43.0	67
Poland	18	1,000	11.2	65
Germany	26	154	6.0	61
Romania	28	225	13.1	60
Serbia	40	1,028	20.0	61

[a] Index of the procedural complexity of contract enforcement measures substantive and procedural statutory intervention in civil cases in the courts, and is formed by averaging the following sub-indices: use of professionals, nature of actions (written or oral), legal justification, statutory regulation of evidence, control of superior review and other statutory interventions. The index varies from 0 to 100, with higher values indicating more procedural complexity in enforcing a contract.
Source: The World Bank "Doing Business in 2004 – Understanding Regulation".

35. In order to address the noted problems, the Government, in consultation with numerous stakeholders, prepared a new Law on Execution Procedures. After a public consultation process, the new Law was adopted by the Government in October 2004 and was subsequently enacted by the Parliament of Serbia in November 2004. The most important improvements of the new Law can be summarized as follows:[18]

- The law introduces new system of protective measures, including the new types of injunctions, especially in commercial matters that will strengthen the position of the creditor.
- The new law contains a summary enforcement procedure in commercial matters and also introduces a special regulation for enforcement in commercial matters.
- The new law introduces significant changes in legal remedies (introduction of appeals, precise definition of reasons for both legal remedies and short time limits provided for decisions on legal remedies).
- The law contains the possibility to postpone enforcement but only for narrowly enumerated reasons.
- The new law also has new provisions to (i) deal with enforcement against chattels and real estate for compensation of money claims; (ii) regulate the role of public registries (real estate, lien on chattels, securities, etc.); (iii) deal with delivery and court imposed time limits; and (iv) provide a clearer regulation of the position and responsibilities of court officials (bailiffs).

36. Successful implementation of the new law will depend upon other reforms in this area including reform of the courts. USAID is providing a major multi-year program of

[17] Foreign Investors Council White Book (2003).
[18] Center for Liberal-Democratic Studies (CLDS) "New Law on Enforcement Procedure" (2004).

assistance (US$12.8 million) that will focus on the reform of the Commercial Court system.[19] Commercial Courts are in charge of enforcement of not only the Enterprise Law and the Law on Execution Procedures, but also the Law on Bankruptcy.

37. **Regulatory Impact Analysis**. Available surveys (e.g., the ICA survey and FIAS Administrative Barriers Study) show that the regulatory burden is one of the key constraints to long-run growth and competitiveness in Serbia. Excessive regulation can lead to lower investment and innovation, more corruption and informality, less formal entry, and reduced income and employment growth. The burden firms face in complying with regulations, the quality of the services provided by these regulations and the extent to which corruption is associated with the procurement of such services affect firms' productive activities.

38. The network of government bodies with control functions in Serbia is complex, and their responsibilities are often vaguely defined and overlapping. In addition, pervasive and confusing business regulations impose high costs on formal businesses. A high degree of inconsistency in the application of the rules, strong discretionary powers of public servants in making decisions on minor issues that affect the issuance of permits, licenses and certificates emerge as key factors adversely affecting the business environment.

39. To improve the quality of regulatory environment and reduce the cost of doing business, the Government will introduce a Regulatory Impact Analysis (RIA) program—a practice widely utilized by OECD (Organization for Economic Co-operation and Development) countries.[20] Although the central Secretariat for Legislation—established by the Republic Law on Ministries—reviews all laws and Government decrees to ensure consistency with the constitution, with other laws, and with drafting standards, *there is no corresponding review for economic, business, or SME impacts.*

40. To implement the RIA, the Government will adopt amendments to the Rules of Operation of the Government, which will provide that for each new law, and other regulatory instruments such as decrees and orders, the responsible ministry will prepare a justification statement containing the OECD RIA recommendations. More specifically, for each new law and other regulatory instrument such as decrees and orders, the responsible ministry will be required to prepare a justification statement which will answer the key relevant questions. To this end, the Government has prepared amendments to the Rules of Operation of the Government and identified the entity (the

[19] The USAID project is a three years effort to provide technical assistance to improve the efficiency and reliability of mechanisms for resolving commercial disputes. The project introduces standards consistent with EU and international standards and the needs of modern economy. The project aims at strengthening institutions and improving the operation of the courts by (i) introducing performance measures and statistics (ii) establishing special operational procedures for each court; (iii) modernizing the IT network for case tracking; (iv) supporting Judicial Training Center and provision of individual professional development and training; and internal and external outreach programs to explain the courts to the public and to ensure communication within the court system; and supporting legal regulatory reform by drafting of laws, regulations and court rules.

[20] Although only a few OECD countries were using RIA in 1980, by 1996, more than half of OECD countries had adopted RIA programs. By October 2000, 14 out of 28 OECD countries had adopted universal RIA programs, and another six were using RIA for some regulations.

Regulatory Reform Council) that will carry out RIA. The amendments were adopted by the government in October 2004, which will be followed by a proposal for a plan of a training program on preparation of the RIA Justification Statement.

41. **Medium-term Reform Objectives**. The adoption of the Company Law and Law on Execution Procedures, together with the Business Registration Law in May 2004 and the Bankruptcy Law in July 2004 under PFSAC 2, should lay the foundations for an improved entry and exit regime in Serbia. These measures, however, are necessary but insufficient as un-restructured socially owned enterprises hinder entry of SMEs, crowd out their access to credit, and block competition in their sectors due to their political power. Addressing these obstacles will require (i) continuation with the tender and auction privatization; (ii) acceleration of the resolution of remaining companies in the restructuring program and readiness to exercise the companies' public debt restructuring (iii) sale of minority state stakes; (iv) movement of the unsaleable loss-making conglomerates or parts to bankruptcy procedure. The new Law on Execution Procedures Law will facilitate foreclosure and enforcement, thereby leading to more initiations of bankruptcy.

42. The enactment of the new Law on Execution Procedures will need to be followed by policy efforts directed at (i) strengthening the performance of bailiffs;[21] (ii) improving court resources; (iii) improving information sharing systems; (iii) developing and using court statistics in an effective manner;[22] (iv) removal of non-dispute cases from the courts.

43. Efforts to improve the regulatory framework for enterprises—in which the introduction and use of RIA will play an important role—will need be followed and supported by (i) improvements in the inspections system; (ii) adoption of EU standards for the national system for accreditation and certification; and (iii) introduction of public consultation on new laws as a rule, not as an exception.

B. Energy Sector: Institutional Development and Performance Improvement

Context

44. Power outages in the winter of 2000-1 constrained economic growth. Although outages have been less of a problem in the intervening years, power balance is by no means guaranteed. Power imports were required in the winter of 2003-04 following low rainfall in the preceding summer. The system will become increasingly strained as demand grows, and further tariff increases will be required to ration existing capacity and

[21] In this respect, education of judges should be a priority. As the new legislation will broaden the competences of the commercial courts their enforcement benches should undergo additional training. In addition, the state of the Serbian court system is such that urgent resources for training of judges and court personnel in the area of case filing and tracking systems, etc. are needed.

[22] Empirical data are necessary to identify bottlenecks in court performance and give policymakers information where reforms are needed most. This would improve court administration and case management systems.

to finance investments/imports. From a social perspective, energy poverty is likely to remain an important policy issue in Serbia as power tariffs are further increased.

45. The power sector has been a fiscal liability given historically low tariffs, and will remain so unless tariffs are set at cost recovery levels on a sustained basis. Power tariff reform was a key challenge when the Bank resumed work in Serbia several years ago. Tariff increases would improve the financial viability of the power industry, reducing the need for fiscal support, and improving power balance through providing adequate cash flow for urgent investments and imports. Much progress has been made in the past 30 months. Average (residential/commercial/industrial) power tariffs have been increased from USD 0.9 c / kWh in January 2001 to 3.7 c / kWh in July 2003. A further 10 percent increase has taken place in July 2004. Tariffs now cover operating costs plus debt service and self-finance components of the investment program, though further increases are likely to be needed to finance investments in the medium term.

46. In order to build on the recent progress already made in tariff reform, international experience points to the benefits of developing an independent regulatory framework; this should ensure that tariffs continue to cover costs on a sustainable basis. Serbia has made limited progress in developing an independent regulatory framework. Given these circumstances, power industry financial viability remains precarious because tariff-setting decisions may be subject to political considerations.

47. In addition, as is the case in other countries, power tariff reform is likely to have adverse affordability impacts on vulnerable groups in Serbia. Until recently, protection was offered in the form of several targeted subsidies, together with a block tariff system under which the first 600 kWh of power consumption per month were charged at a discounted rate. Although this may have protected poor groups using electric space heating, it was a poorly targeted subsidy.

48. Finally, power industry commercialization is important both from macroeconomic and affordability perspectives. An industry operating commercially will supply power at a lower price, thus supporting competitiveness of industrial consumers. Lower prices will also benefit residential consumers and ease affordability constraints. EPS—the vertically integrated power utility in Serbia—has made some progress in commercialization through spinning off of non-core assets, most notably underground coal mines, and reducing the level of barter payments. Much remains to be done, however, if EPS is to provide competitively priced power to its customers, with key challenges outstanding in the areas of accounting standards, core and non-core restructuring, and payments discipline.

49. Under the Athens Memorandum, signed by SaM together with other countries in South East Europe, a regional energy market—the Energy Community of South East Europe (ECSEE)—will begin operation from 2005. Tariff reform and industry commercialization are priorities if Serbia is to benefit from participation in the ECSEE.

Reform Objectives and SAC Measures

50. The energy sector reform objectives under SAC 2 are threefold (i) *improving financial and operational (security of supply) sustainability of the power sector on a stand alone (off budget) basis*; (ii) *supporting industry commercialization*; and (iii) *ensuring that risks associated with potential adverse affordability impacts are mitigated.* These goals are fully consistent with the core objectives for the operation to promote economic growth and strengthening fiscal discipline, while ensuring that the poor are adequately protected.

51. Realization of these objectives would ensue through tariff/regulatory reform, together with power industry commercialization. Enactment of the Energy Law—consistent with the best practice for ECSEE in July 2004—is expected to unlock all aspects of the reform process, particularly as regards regulatory development, tariff reform, EPS restructuring, and energy market liberalization. This, together with adoption of a supporting strategy explaining the vision behind the law, constitutes one of the key ingredients of the energy sector reform agenda and a prerequisite for benefiting from participation in the ECSEE.

52. **Improving financial and operational sustainability**. In order to maintain financial/ operational sustainability in the short term, the Government will ensure that tariffs cover operating costs plus the self financed components of the investment program and debt service through 2004 and thereafter. These cost categories are not expected to increase in real terms in 2004, thus a tariff increase to offset inflation in 2004 should allow ongoing cost recovery. With this objective in mind, the authorities increased tariff level to maintain an approximately constant real tariff in July 2004 relative to 2003. Concurrently, the Government reformed the existing tariff structure by reducing the first block tariff to 350 kWh—a level that would be closer to regional standards (e.g. the first block is 250 kWh in Bulgaria, and 80 kWh in Romania).

53. The Government recognizes the importance of the development of *an independent regulatory framework* for longer-term financial/operational sustainability, which will be supported by the adoption of the new *Energy Law*. The new law contains specific articles relating to institutional aspects of the regulatory framework (e.g. the regulatory body will be governed by a commission comprising members with fixed term appointments) together with broad regulatory rules (e.g. tariffs will be set to cover costs). Following passage of the law, an independent regulator should be established, with appointment of key personnel and adoption of a charter.

54. **Supporting industry commercialization**. The Government will continue to press ahead its efforts to maintain/improve payments discipline. The bulk of non payment stems from state-owned large industrial—rather than residential or commercial—consumers: collections from industrial consumers averaged 84 percent for the first six months of 2004, relative to 92 percent for residential consumers.

55. In order to increase collections from industrial consumers, political will is required, particularly where enforcement of payments discipline requires disconnection. Evidence from elsewhere in the region suggests that payments problems of this nature are best tackled through restructuring and privatization of large industry. Guided by this principle, the Government has offered four of the largest 15 debtors to EPS for privatization and sold two of them or viable parts thereof.

56. In addition, the authorities took corrective measures with a view to maintain residential collections—defined as cash collected divided by invoices—for the first six months of 2004 at or above the level for the corresponding period in 2003. Thereafter, the six-month rolling average will be at least as high as the corresponding period in the previous year.

57. Recognizing that commercial losses are a problem, EPS and the Ministry of Mining and Energy have worked together to develop an *Integrated Operative Program for the Reduction of Non-Technical Losses*. The Government will implement this program through establishment of expert teams and identification of areas within the network where commercial losses are high.

58. On other aspects of EPS' commercialization, the key reform as regards performance improvement is industry unbundling; separation of generation, transmission and distribution provides a good basis for strengthening of management incentives and—further in the future—industry liberalization. The enactment of the Energy Law will pave the path for the industry unbundling process.

59. In November 2004, the Government has adopted a decision on EPS restructuring consistent with requirements under the Athens Memorandum establishing the ECSEE (which largely mirrors the revised EC Power Directive). In this respect, the decision requires that EPS is unbundled through separation of generation, transmission and distribution, and that transmission is established as a separately owned and operated legal entity (or entities). EPS unbundling will be supported further through the introduction of transfer prices between generation/transmission and distribution companies. The Government recognizes that transfer prices are a necessary condition for industry unbundling, and can help to strengthen management incentives.

60. In view of the relatively low labor productivity in EPS, reduction of the labor force constitutes one of the key components of the overall restructuring efforts. According to EPS' estimates, a 30-35 percent reduction in labor is required for efficient performance. It is likely that radical labor restructuring will take place after EPS unbundling (following which management incentives will be strengthened). In the meantime, the Government will support efforts to improve labor productivity through maintenance of a net hiring freeze which, given that there will be staff leaving EPS, should result in a reduced labor force.

61. In addition to core restructuring, there is a need to spin off non-core companies as part of the EPS' commercialization process. This process has started with spin off of

underground mines from EPS. The next step is to consolidate this spin off through underground coal mine restructuring, separating the industry into viable and non viable, developing business plans for the former, and labor restructuring plans/social programs for the latter. To this end, the Government will draft an underground mine restructuring plan.

62. EPS currently still owns a number of other non core companies which should be spun off as part of the commercialization process; this will remove any current cross subsidies, and strengthen management incentives in the non core companies. EPS has established an additional twelve companies and transferred ownership of eight existing non-core companies to the Ministry of Mining and Energy.

63. **Medium-term Reform Objectives**. The reforms described above are important near-term steps in a longer-term program with the ultimate objective of attaining a financially sustainable and operationally efficient power industry. Future policy efforts need to focus on the further development of a modern regulatory framework that allows for cost recovery, while providing incentives for EPS (or its successor companies) to perform efficiently in comparison with other participants in the evolving regional energy market. Such methodologies should support ongoing security of supply (outages in line with Union for the Co-ordination of Transmission of Electricity norms) as well as competitively priced power when compared to other countries in SEE.

64. On the payment side, recently improved performance in raising collections needs to be further deepened to achieve collections in the range 95-98 percent by the end of 2007. Improving payments performance in this manner would allow EPS to be financially viable on an ongoing basis without unduly high and uncompetitive/unaffordable power prices.

65. EPS restructuring is expected to take place through 2005. More specifically, transmission should be taken out of EPS and established as a separate Government-owned entity. Generation and distribution should be legally and functionally separated, possibly within a holding company structure under the terms of the agreement establishing the regional energy market and the related EC directive. The presence of a competitive power price in Serbia in comparison with other countries participating in the regional energy market will constitute an important indicator of improved performance of the power sector.

C. Strengthening Social Protection

Context

66. Since the inception of the reform program, the Government has undertaken critical and systemic social sector reforms, including pension reforms, targeting of child benefits, and the introduction of programs to assist employment restructuring. The current system, however, remains limited in its ability to cover the poor—primarily

because of fiscal constraints, but also due to issues related to the design of benefit programs and ineffective social services.

67. The recent joint Poverty Assessment finds that absolute material poverty affects every tenth person in Serbia.[23] At the same time vulnerability—or exposure to negative shocks and inability to cope with them—threatens every fourth currently non-poor individual. Even though some of Serbia's cash benefit programs are among the best-targeted programs in the region, the social protection system as a whole suffered from large exclusion errors. As a consequence, addressing these gaps has been one of the Government's priority objectives.

68. Concurrently, the Government aims at alleviating the adverse consequences of its efforts to strengthen incentives for energy efficiency. As was discussed previously, power tariffs will continue to increase in the future. In this situation, it is important to understand related adverse affordability impacts on the poor, and to mitigate these to the extent possible.

69. In an attempt to assess whether power affordability is a problem, an analysis of the Serbian Survey of Living Standards (SLS) was carried out. SLS data shows that rising real incomes and energy savings induced by increasing tariffs have helped to preserve power affordability for the *average* household. On the other hand, the *poor* have suffered a significant increase power bills relative to income, particularly those poor using power for heating, thought to number around 80,000. The SLS found that poor consumers using power for heat spent more than 10 percent of their cash income on energy. Amongst the poor, the SLS identifies particularly vulnerable groups—single farmer pensioners, families relying on social transfers, unemployed—where affordability ratios are well in excess of critical thresholds.

70. While it is estimated that substantial 45,000 households receive electricity discounts/energy related cash transfers in Serbia, only 10 percent of beneficiaries were poor. The leakage to the non-poor was substantial, while most poor were excluded, thereby leaving many poor without any protection against price increases.[24,25]

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[23] Serbia and Montenegro: Poverty Assessment, World Bank (2003).

[24] Currently, the following targeted subsidies are in place for power/heating:

(i) 30 percent Relief for MOP (Material Support to Families program) recipients on bill up to 450 kWh/month: households eligible to receive MOP are granted a 30 percent reduction on active energy payments, up to a limit of 450 kWh per month (i.e., up to a limit of €8 per month) and are also eligible for a 30 percent reduction in the fixed monthly charge (i.e., €¢60 per month);

(ii) 100 percent Relief of Fixed Monthly Charge to consumers who are either recipients of Child Allowance, or whose household income is less than 6,000 YUD, and whose consumption is less than 70-300 kWh per month. These consumers are eligible for 100 percent relief of the fixed monthly charge (€2) for the period July-September 2003; and

(iii) An Electricity Heating Subsidy has been employed as a form of ad-hoc electricity social protection in past years. In the 2002 heating season, the Serbian Government introduced a subsidy for vulnerable consumers who were dependent on electricity for heating. To receive the basic CSD400-600 per month subsidy (around €6-8), recipients had to fulfill several well-designed but fairly stringent criteria. Only

(iv) 5,000 households in Serbia (0.02 percent of the total) were granted this subsidy in 2002, largely due to financing constraints.

Reform objectives and SAC Measures

71. In light of the above discussion, the findings of the recent Poverty Assessment, and the PRSP, the following issues emerge as priorities (i) *enhancing effectiveness of the safety net through expanded coverage, greater adequacy of benefits and improved targeting*; (ii) *mitigating the adverse impact of changes in the level and structure of electricity tariffs on the poor*; (iii) *strengthening coordination between social protection programs and energy-related subsidies*; and (iv) *improving the monitoring of social impact to achieve better targeting and efficiency*.

72. **Improving effectiveness of the safety net.** The main social assistance benefits provided by MOSA are family benefits (child allowances, maternity leave, birth grants) and the Material Support to Families program (MOP). MOP is the main social assistance benefit targeted to poor households. Its effectiveness is limited by insufficient financing and low coverage of the poor.

73. According to the poverty assessment and the PRSP, the MOP benefit is well targeted. Although 2002 data shows that nearly 70 percent of the benefit is received by poor households, the MOP suffers from low coverage. In 2002, only 0.09 percent of GDP was spent on MOP benefits and only 4 percent of the poor received benefits. This level of spending and coverage is low in comparison with other countries in the region.[26,27]

74. In order to address the noted problems, the government passed a revised Social Welfare Law on July 23, 2004 which was supported by the SOSAC operation. The main changes under the new Law include (i) a uniform national eligibility threshold for MOP; (ii) indexing benefits to the cost of living; and (iii) increasing benefit levels for MOP and the caregivers' allowance to at least one-half of the poverty line.

75. Analysis carried out for the PRSP[28] found that adjustments to the benefit formula taking into account economies of scale would increase the number of beneficiaries by about 11 percent. This would require the increase of expenditures by about 25 percent. Combining the change in the benefit formula with raising the eligibility threshold by 20 percent to fix it at the level at least one-half of the poverty line for equivalent adult would require approximately doubling the MOP expenditure to 0.2 percent of GDP.

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[25] Given the confluence between those in energy poverty and those receiving MOP/child benefit, strengthening the latter, coupled with the expansion of existing sector safety net, and providing better information about the availability of energy benefits, would help improve energy affordability for the poor.

[26] Social assistance expenditures in Bulgaria in 2000 were 1.1 percent of GDP; 0.9 percent in the Czech Republic in 1997; 0.4 percent in Poland in 1999; and 1.2-1.4 percent in Slovakia in 1999 (Murthi, 2001).

[27] The MOP is also plagued by problems in benefit design, which limit its adequacy and effectiveness. Decentralized eligibility thresholds, based upon the average municipal wage, lead to low benefit levels and coverage rates in poorer areas. In 2001 and 2002 the Ministry of Social Affairs (MOSA) addressed this through temporary measures by providing additional benefits for households, which fall between the Republican and municipal average wage levels.

[28] Bogićević B., G. Krstić, B. Mijatović and B. Milanović. (2003) Siromaštvo i Reforma Finansijske Podrske Siromašnima (Poverty and Reform of the Financial Assistance to the Poor). Belgrade: Center for Liberal-Democratic Studies and Ministry for Social Affairs, 2003.

76. The previous allocation of resources for MOP program did not take into account the policy changes included in the amendments, which will lead to greater coverage (an additional 13,000 families) and increased benefit levels.[29] According to the data provided by the Ministry of Labor, Employment and Social Policy (MLESP), an additional CSD330 million (4.7 million euros) will be necessary for the full implementation of the Social Welfare Law in the last quarter of 2004. Approximately two thirds of these additional funds would go to new MOP beneficiaries, while the rest would cover the cost of increased caregivers' allowances.

77. To ensure the full implementation of the Social Welfare Law upon its effectiveness in September 2004, the Government has made adequate provisions in the budget for the remaining period of 2004, and remains committed to do so thereafter.[30]

78. **Mitigating the affordability impacts of the reform measures in the energy sector**. The Government is determined to take targeted measures to alleviate the adverse consequences of reducing the first block in the block tariff structure from 600 kWh to 350 kWh per month for poor groups. Simulation results indicate that reduction of the first tariff block would increase bills for the poor using power for heat no more than 10 percent. Analysis based on household budget data and a simulation exercise suggest that around 80,000 poor households rely on power for heating and that among this group, the most vulnerable as regards change in the block tariff structure are single pensioners and families with small children.

79. In practice, it will be difficult to identify all 80,000 poor households using power for heating. The analysis carried out by the background paper on Poverty and Social Impact Analysis of energy tariff reform, however, suggests that a significant proportion of the affected households receive either (existing and reformed) MOP, (reformed) child allowance, or minimum pension. This, in turn, provides a rationale for the noted discount scheme to be extended to recipients of MOP, child allowance, and minimum pension.

80. In order to protect these groups in the face of the change in the first block, the Government has introduced a new mitigation scheme to support the poor and vulnerable population, whereby recipients of child benefit, minimum pension and MOP are entitled to a discount of no less than 30 percent of the monthly bill on consumption up to 300 kWh.[31, 32]

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[29] The delay in passage of the legislation created problems in the financing of MOP for 2004. Since the amendments were not passed until July 2004, the 2004 Budget Law has allocated financing for MOP based on actual expenditures in 2003. The funds allocated for the MOP program 2004 at around 1.8 billion dinars will be sufficient to cover approximately 43,000 households in Serbia.

[30] In addition, MLESP has reached an agreement with the International Committee of the Red Cross (ICRC) for the inclusion of up to 6,000 of the most vulnerable IDP households into the MOP, provided that these families meet the necessary eligibility criteria. It is expected that by the end of 2004, the MOP program will cover around 60,000 families in total. This is in line with the overall reform goals and policy recommendations on improved coverage and increase in social assistance spending.

[31] In view of the tight fiscal situation in Serbia, the envisaged discount scheme will be financed from EPS' cash flows, at least for an interim period. In this respect, financial analyses on the operational/financial viability of EPS incorporated the proposed discounts when calculating the residual tariff increase for EPS (i.e., the increase required after the change in the block tariff structure to make the target 10 percent overall increase).

81. As part of the Government's efforts to the efficiency of social protection, a working group consisting of representatives from MoME, MLESP, and EPS was established. The main objective of the working group will be to improve coordination between social protection programs and energy related subsidies to ensure that the new energy mitigation scheme is carried out in an effective manner.

82. **Improved monitoring of the social impact of reforms** will play an important role in enhancing efficiency of social protection through better targeting of both existing and proposed programs. Although the reformed Household Budget Survey (HBS) was revised to address most of the relevant issues in PRSP monitoring, there is a need to officially entrust the Republican Statistical Office (RSO) with this work, which needs to be accompanied with a program of technical assistance.

83. To this end, the proposed operation will support the authorities' reform efforts by ensuring the use of the most recent household budget survey data to assess the dynamics of living standards for the population as a whole and for the most vulnerable groups. At the initial stage, poverty monitoring will be supported by technical assistance activities under the on-going Programmatic Poverty Assessment with a view to put in place a mechanism for periodic updates of such monitoring by the RSO.

84. **Medium-term Reform Objectives**. The reforms described above represent important steps towards the objectives laid out in the Serbia PRSP. The increased coverage of MOP and regularization of benefit payments will need to be followed by further policy measures aimed at improving the targeting of other social programs and extending the coverage of the poor through child allowances and better protection against poverty of the elderly through the pension system.

85. Regular monitoring and updates on poverty situation constitute critical elements of policy efforts directed at improving the coverage and efficiency of social protection programs. In this respect, the envisaged involvement of the RSO in the poverty monitoring will need to be complemented by institutional mechanisms that utilize poverty data in designing economic and social policies and by timely revisions of the social programs. This will require further efforts in strengthening the capacity of institutions responsible for social policy design and implementation.

D. Improving Public Administration

Context

86. A decade of isolation and political turmoil adversely affected key Serbian Government institutions. The previous regime left Serbia with a legacy of politicized and fragmented administration, ill-suited to performing the framework-setting role that public administrations are expected to play in modern democracies. The system of public

[32] Measures aimed at strengthening the effectiveness of the safety net discussed previously will also buttress social protection vis a vis energy affordability by raising the income of the poor and by increasing eligibility for power bill discounts.

administration has suffered from weak institutional capacities of the ministries and Government support structures, significant lack of horizontal coordination mechanisms, a lack of alignment between policy priorities and staffing levels in individual institutions, and an underpaid and under-qualified civil service, constantly facing the problem of a 'brain drain' by the best experts.

87. After the change of regime in 2000, the new Government of Serbia voiced its interest in the reform and modernization of public administration. The Government established the Civil Service Council (CSC) to design the reform process, and the Agency for Public Administration and Development (APAD) to provide operational support to public administration and civil service reform and development. At a later stage, the Government established a Ministry of Public Administration and Local Self-Government (MPALSG), with a key task of unification and coordination of the public sector reform activities.

88. However, despite numerous initiatives during the first three years of democratic transition, progress with public administration reform in Serbia has been slower than desired. As a result, weak public administration capacity continues to pose a serious threat to the effective implementation of government policies. Two main causes for the lack of progress in this period are:

- A general lack of a concept of the role of the state in economic and social transformation, and hence a failure to define the strategy of public administration reform.
- A lack of coordination between the activities of numerous institutions involved in public sector reform management. This greatly impeded the decision-making process in this area. In addition, a great number of sectoral donor projects were not mutually coordinated and failed to address the key issues of public sector reform, such as overall restructuring of the machinery or Government and building a professional civil service system.

89. Growing difficulties in governance processes as well as problems of post-federal transition with the transfer of the former federal competencies to the Republican level, have triggered an urgent need to develop a holistic approach to public sector reform issues. Furthermore, the current salary and incentive system is opaque and inadequate, providing few incentives to young qualified staff to stay in the administration, which raises a serious issue of sustainable capacity building of Serbian civil service. Donor resources to hire specialists on an ad hoc basis, which have been used extensively to design the substance of economic and social sector reforms, are becoming increasingly scarce, making the development of indigenous capacities all the more urgent.

Reform Objectives and SAC Measures

90. Addressing the above highlighted issues requires a comprehensive approach to reform, which presupposes the existence of a clear vision of the role of the Serbian public administration in transitional social-economic processes to be formulated in a public

administration reform strategy. There is also an urgent need to create new, effective reform management structures, as the previous key public administration reform stakeholders were not able to coordinate their activities effectively and push the reform forward.

91. Reform goals supported under the proposed operation aim at setting the stage for the implementation of a medium-term Public Administration Reform (PAR) agenda. The proposed objectives should therefore not be seen in isolation, but rather as the start-up conditions for the implementation of a substantive medium-term reform agenda. In this respect, the following three key sets of actions elaborated below constitute immediate policy priorities in the PAR agenda.

92. **Formulation and adoption a PAR strategy and action plan.** The complexity of the PAR agenda in Serbia is such that addressing individual elements in isolation is unlikely to bring the desired results. The improvement of employment conditions of civil servants, for instance, can only be achieved if the size of the Civil Service is reduced, as reform measures will have to be largely fiscally neutral. Therefore, the design of options for pay reform needs to take into consideration the speed and direction of planned reforms in organizational structures in the state administration. The latter is again dependent on decisions on the re-allocation of functions between levels of government.

93. By the same token, efforts to build capacity in the Civil Service through training and staff development will only deliver results if the level of politicization in senior positions is reduced. Therefore, a comprehensive medium-term strategy and associated action plan is needed to ensure that different aspects of the reform process are implemented at the right time and in the right order. Furthermore, the existence of a broadly agreed reform strategy and action plan would help creating the conditions to keep reforms on track in the medium term.

94. To this end, the MPALSG has prepared a Strategy covering the reform of the central state administration and reforms in the system of local self-government. The Strategy also clarifies the future direction of reform, which is to move service delivery and regulatory management functions out of the central ministries and vest them in local authorities and public agencies respectively. This, in turn, will allow for a more client oriented and efficient form of public service delivery.

95. After incorporating comments from various stakeholders, the Strategy and the related Action Plan were first endorsed by the PAR council in October 2004, and adopted by the Government of Serbia in November.

96. **The creation of effective PAR management structures** is essential, as without an effective horizontal management structure the design and adoption of any significant reforms will remain elusive. The design of reform management structures should include a clear allocation of responsibility for reform policy design to an adequately staffed reform secretariat, a clear assignment of decision-making authority and of responsibility for monitoring reform implementation.

97. Significant progress has been made with the rationalization of the previously convoluted PAR management structures, which created severe blockages in the reform process. The development and implementation of the PAR strategy has been assigned to the MPALSG. Its capacity has been strengthened through an accelerated recruitment effort by the new minister and by the integration of the former Agency for PA Development in the structure of the Ministry. The drafting work on PAR legislation has been taken over by the Office for Legislation at the Government, which is building up the technical capabilities to ensure that draft laws will have the appropriate quality. A small group of experts has been assigned with the responsibility for the drafting work. Therefore, at the level of conceptual development and in relation to the legislative agenda, a clear structure has been established, which has the appropriate resources to manage the PAR process.

98. Furthermore, a specialized high-level political decision-making body on PAR issues, including the Prime Minister and Deputy Prime Minister, the Minister of Finance, the Minister of Public Administration and Local Self-Government and other key ministers, was created in June 2004. This Council will be in charge of the political consideration of strategy documents and draft legislation, among other things.

99. **The design of the reform of the civil service wage system**. The reform of the wage system is a key issue in terms of determining the ability of the Civil Service to attract qualified staff in the future, among other things. This requires a change from the current convoluted system, based mainly on bonuses that bear no relation to merit and performance, to a one that rewards excellence and provides more attractive career opportunities, including increased protection against politically motivated staffing changes at senior management and expert level. Furthermore, the reform of the systematization process, which underpins the wage system, is essential to re-allocate resources in the public sector wage bill to those areas which most urgently need budget funding, rather than providing for incremental year on year changes.

100. Designing a comprehensive reform of the wage system is a complex and time-consuming process, which therefore has to be started urgently if a program for reform is to be put in place in a prompt manner as dictated by the need to attain sustainable cuts in non-interest current spending. To this end, a review of the Civil Service wage system was carried out, which was supported by the World Bank, EAR and DFID (Box 2). The purpose of the review was to highlight systemic weaknesses and propose options that would lead to the creation of a merit and performance based remuneration system. Based on the review, the MOF and MPALSG have prepared a joint policy statement, which was subsequently endorsed by the PAR Council, outlining the direction of reforms in (i) the pay and grading system; (ii) development of a performance appraisal system linked to the salary system; (iii) the systematization process; (iv) de-politization; and (v) integrating staff development with career advancement.

101. **Medium-term Reform Objectives**. The reforms outlined above represent the first steps in a very long reform program. The ultimate policy objective in this area is to build a public administration system that meets European standards, which is at the same

time competitive on the labor market and affordable in fiscal terms. The progress in attaining this objective will be captured by a baseline assessment of the Serbian civil service in 3-4 years time, which should therefore be positive on three of the five benchmarked areas[33] (the EU-8 scored between three and four out of five on the last assessment).

102. A competitive civil service system requires a transparent salary system based on performance. In this respect, the authorities are committed to implement a phased increase in the compression ratio from the current level of 1:4.9, have a performance allocation in the salary budget that would allocate at least 5 percent of the total wage bill based on performance assessment results, and raise management level salaries to at least 70 percent of private sector average wages (currently 60 percent). This would need to be implemented in a fiscally affordable way with the objective to reduce the current ratio of central government wages to GDP (around 5 percent of GDP) in a sustainable manner.

Box 2: A Brief Overview of the Pay and Benefit System in the Serbian Civil Service

A recent review of the civil service pay and benefit system underscores the following priority areas for action:

A new pay and grading system which (i) uses a job evaluation approach to define a structure of job grades that reflects differences in the levels of responsibility, complexity, and outputs of different job levels; and (ii) has a salary range for each job level that provides different salaries to recognize different levels of individual experience and performance at that job level.

Development of a performance appraisal system which (i) sets clear performance targets for every staff member in line with the goals of the State organ and its Sectors and Departments; (ii) assesses individual performance in relation to those targets; and (iii) is supported by a system of pay differences and bonuses to reflect different levels of performance, and a training system to develop staff skills.

Reform the systematization process to allocate budgetary resources to state organs based on a realistic and objective analysis of the functions and staffing requirements of each state organ.

De-politicization and professionalization of the senior management structure, particularly at the level of Head of Sector (Assistant Minister), to (i) ensure that key senior management positions are filled by long-term career civil servants who can develop the long term expertise and functional knowledge relevant to their sector; and (ii) allow long-term stability in the planning and execution of the functions and services of each state organ.

Develop a comprehensive training strategy and training facilities to (i) provide basic training of all civil servants to a common standard, thereby building the skills necessary to deliver effective and efficient public services; and (ii) provide continuous professional and management development of civil servants throughout their careers.

Clearly, action on the noted priority areas will take time to achieve results. The development and implementation of the new pay and grading system, for example, would take 12 – 18 months. Some actions are therefore needed in the short term to address critical problems in the present system, in particular (i) the generally low pay levels; (ii) the lack of adequate pay progression as a person moves up the rank system; and (iii) the low pay levels for mid/senior professionals and managers by comparison with market rates, particularly in State organs other than the higher paying organisations.

The review proposes policy options and suggests that a high level Steering Group be set up to assess these options in the light of budget constraints and make an appropriate recommendation to government.

Source: Serbia Civil Service: Assessment of Pay and Benefits System (2004).

[33] These areas include legal status of civil servants, clear definition in Law of the level of responsibility and accountability of public servants, degree of impartiality and integrity in the civil and public service, efficiency in management of public servants and in control of staffing, professionalism and stability of public servants.

V. MEDIUM-TERM PROSPECTS AND FINANCING REQUIREMENTS

103. Following the economic slowdown in 2003 from arising from the unsatisfactory performance in industry and agriculture, recorded real GDP is expected to grow about 5 percent average rate between 2004 and 2007—a level closer to the country's growth potential. The envisaged growth trajectory is based on a strong private sector response engendered by reforms to improve the business climate, accelerated privatization, and the permanent fiscal adjustment (see para 20).

104. The envisaged fiscal adjustment, which relies on sustainable cuts in non-interest current spending, will directly contribute to promoting growth and redressing macroeconomic imbalances. More specifically, current expenditures (excluding interest payments) in relation to GDP are projected to decline from roughly 41 percent in 2004 to 35.5 percent in 2007, reflecting reductions in the wage bill and subsidies as well as transfers. Sustainable cuts in non-interest current spending will have a positive impact on expectations about the future stance of fiscal policy and thus lower the risk premium, thereby paving the path for higher private investment.

Table 4: 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, (millions of US$) 2/	-339	-528	-1,383	-1,960	-2,492	-2,372	-2,049	-1,861
Current account balance, as % of GDP 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.

105. By the same token, public investment, which has been noticeably low in the past, is expected to increase significantly during the projection period. The noted policy shift should further enhance the country's growth prospects since this type of activity is likely to boost the productivity of the private sector.

106. The projected increase in the inflation rate in 2004 (see para 14), is expected to be reversed in 2005 and thereafter. Greater confidence in the policy framework brought about by, inter alia, the envisaged fiscal adjustment, which would also promote exchange rate stability, coupled with the implementation of a prudent monetary policy would provide the basis for the envisaged decline in inflation to 4 percent by 2007.

107. The combination of the expected improvement in the public savings-investment balance and the implementation of structural reforms is expected to have a favorable impact on the evolution of the current account deficit. The envisaged reform measures would enhance the country's competitiveness, thereby producing a relatively strong export performance (projected export growth of 13 percent period average between 2005-07, in dollar terms) during the same period. The net effect of these trends would reduce the current account deficit (after grants) from 9.6 in 2003 to 7.6 percent of GDP by 2007. Moreover, sound policies and the improved confidence in the policy framework that would foster growth and investment would also promote savings: gross domestic savings as a percentage of GDP would rise to –1.3 percent in 2007 from –8.6 percent in 2004.

Table 5: Financing requirements (US$ millions)

	Act.	Est.	Proj.	Proj.	Proj.	Proj.
Financing requirements (US$, millions)	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	1077.5
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

108. **Financing needs**. Attaining the above-described macroeconomic framework will entail significant financing requirements, particularly in light of the rising payments to service SaM's foreign and public debt due mainly to the expiration of grace periods and the need to begin servicing new borrowing. Between 2004 and 2007, gross external financing requirements are projected at about US$12.8 billion (Table 5). 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. As a result of 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.

109. **Financing sources**. The above noted financing requirements are envisaged to be met from several sources. As a result of the improved macroeconomic environment and more credible policies, foreign direct investment is estimated to finance around 33 percent of total needs in the 2005-2007 period. Long-term loans from multilateral, bilateral, and other creditors are projected to account for 35.7 percent of total financing requirements for the same period. The remaining amount will be covered by other capital inflows, which include, short-term credits, capital not-elsewhere included and errors and omissions.[34] The Bank program generally, and the proposed adjustment operation more specifically, would represent an important share of this financing, and can therefore play a crucial role in ensuring adequate financing for the reform programs in SaM and the Republic of Serbia.

VI. THE PROPOSED CREDIT

A. Rationale and Objectives

110. The proposed US$45 million equivalent credit would support the Government program outlined above, and in the attached Letter of Development Policy and Policy Action Matrix. Specifically, the proposed operation aims at supporting the Government's structural and institutional reform agenda in four policy areas (i) *reforms of the business enabling environment*; (ii) *institutional development and improving performance in the energy sector*; (iii) *strengthening social protection*; and (iv) *improving public administration*. These reforms, if successfully implemented, would place Serbia on a sustainable growth path and buttress macroeconomic stability, thereby allowing smoother and faster convergence towards European structures.

B. Links to the Country Assistance Strategy

111. The Serbia SAC 2 is included in the first joint Bank-IFC FY05-07 CAS for Serbia and Montenegro, which is being presented to the Board in parallel with this Report. Consistent with the overall economic objectives set in the Stabilization and Association process (SAP) and the PRSP, the new CAS rests on three pillars (i) creating a smaller, more sustainable, more efficient public sector; (ii) creating a larger, more dynamic, private sector; and (iii) lowering poverty rates, and improving social protection and access to social services, particularly for poor and vulnerable populations. The proposed SAC 2 supports continuation of structural reforms initiated under the World Bank's previous adjustment operations in Serbia (see paras 9 and 24) and represents a bridge between the Bank's earlier support and the PAL programs envisaged in the new CAS.

[34] At around US$400 million in 2002 and 2003, the magnitude of net errors and omissions in SaM is indeed quite large. This, in turn, reflects 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 arising from Kosovo and Montenegro; and (iv) remonetization flows stemming from previously unrecorded cash entering the banking system (as occurred on a large scale when the DM/euro changeover happened).

112. The reform measures included in the proposed SAC 2 will support the Government's efforts in attaining policy goals outlined in the new CAS by enhancing fiscal discipline, encouraging a strong private sector response as well as employment creation, and setting the stage for deeper reforms aimed at improving public administration. Measures to be supported under the proposed operation are also essential to strengthen social protection and to mitigate the adverse impact of the energy sector reform measures on the poor.

C. Board Conditions and Tranche Triggers

113. Serbia's reform program is highlighted in Section III above and in the Letter of Development Policy (Annex 4), and summarized in the Policy Action Matrix (Annex 5). Towards attaining the reform objectives, Serbia has implemented the key measures and shown the key results in the second column (Actions before Board Presentation). The Credit will be released in one tranche upon approval of the Credit and Development Credit Agreement effectiveness.

D. Poverty Implications

114. As was described in Box 1, the coverage of the proposed operation is fully consistent with the objectives laid out in the Government's Poverty Reduction Strategy Paper. More specifically, the proposed operation will support immediate and longer-term poverty reduction through several channels. First, implementation of measures in the energy sector and public administration reform components will help strengthen fiscal discipline and reduce the risk of shocks, which can adversely affect the living standards of the poor. Second, a more secure supply of energy together with reform measures aimed at improving the business climate will create the basis for investments needed for medium-term growth and employment creation, and thus for more sustained poverty reduction. Third, ensuring the allocation of funds necessary for the full implementation of the new Social Welfare Law will address the problem of low-coverage and under-funding of Serbia's well-targeted social assistances programs. Fourth, introduction of the energy mitigation scheme is expected to alleviate social costs of the reforms in the energy sector and safeguard people who are already disadvantaged.

E. Coordination with the IMF and other Donors

115. The IMF is supporting Serbia's adjustment program through a three-year Extended Arrangement in the amount of SDR 650 million, initiated in May 2002. Both the IMF and the Bank along with the donor community share the goals of achieving a credible fiscal adjustment and placing the Serbian economy on a sustainable growth path through the implementation of structural reforms. During the preparation of this operation, Fund and Bank staff as well as the key donors—EU, DFID, USAID, UNDP, and SIDA in particular—cooperated closely to ensure consistency between stabilization and structural adjustment measures.

F. Financial Arrangements

116. **Credit Amount, Borrower/Beneficiary, Terms, Tranching**. The proposed Credit will be made to Serbia and Montenegro, represented by the union level Ministry of International Economic Relations (MIER). The final beneficiary will be the Republic of Serbia, represented by the Ministry of Finance. The Credit will be on modified IDA terms, with a maturity of 20 years, including a grace period of 10 years. The Credit will be released in one tranche upon approval of the Credit and Development Credit Agreement effectiveness. The MIER will open and maintain a special Deposit Account in the National Bank of Serbia (NBS) on terms and conditions satisfactory to the Association. In December 2001, the NBS was subject to a full IMF Safeguards Assessment. Following completion of the Assessment, a remedial action plan was developed to address a number of weaknesses highlighted by the IMF team. Implementation of the action plan has been monitored by the IMF. Upon notification the Development Credit Agreement effectiveness and submission to IDA of a withdrawal application, the proceeds of the Credit will be deposited by the Association into the Deposit Account of the Borrower. The Borrower will make available to Serbia in Dinar to general budgetary account the equivalent of the proceeds of the Credit under terms and conditions satisfactory to the Association.

117. The Country Financial Accountability Assessment (CFAA) for SaM, published in December 2002, made a series of recommendations for strengthening the public financial management system. A number of these recommendations, e.g. the strengthening of the MOF's Internal Audit function, have been supported under subsequent Bank-financed operations. Other recommendations, e.g., the establishment of a medium term expenditure framework and the establishment of a Single Treasury Account encompassing all ministries and direct spending units, were under implementation at the time of the CFAA and have continued to progress in the subsequent period. A notable omission has been the establishment of a Supreme Audit Institution (SAI), reporting directly to Parliament. An SAI law had been drafted in 2003 but, as a result of dissolution of parliament in December 2003, never made its way onto the legislative agenda. The lack of an SAI weakens the public financial management system. However, other ex-ante and ex-post controls are considered sufficient to reduce financial risks to an acceptable level. The SAI initiative continues to be supported by the donor community and is being discussed with the present government.

118. **Accounting, auditing, and closing date**. The NBS would maintain records of all transactions under the credit in accordance with sound accounting practices. Although routine audits of the Deposit Accounts will not be required, the Association reserves the right to require audits at any time. In such cases, the Borrower should furnish and audit report not later than six months after the date of the Association's request for such an audit. The closing date of the Credit will be June 30, 2005.

119. **Implementation, Monitoring and Supervision.** During the preparation of SAC 2, the Association has assisted the Government of Serbia in achieving the timely implementation of the agreed reforms. Through regular reviews, the Association will monitor the general progress of the Republic of Serbia's reform program, and more

specifically the implementation of agreed benchmarks described in the Development Credit Agreement and Letter of Development Policy. This will require supervision conducted jointly by staff of the Bank Office in Belgrade and headquarters-based staff.

120. **Environmental impact**. This credit focuses primarily on promoting sustainable economic growth and no environmental issues are foreseen. In accordance with the Bank's Operational Directive on Environmental Assessment (Operational Directives 8.60), no environmental category rating is required.

G. Benefits and Risks

121. **Benefits**. The main benefits of the proposed SAC 2 would be to support Serbia to deepen the reform process necessary to place the country on a sustainable growth path and move closer to European structures. To this end, the credit supports a coherent program of structural and institutional reforms encompassing four policy areas, which are in line with the main strategic directions of the PRSP (see para 23 and Box 1). Successful implementation of these policy measures would support the Government's efforts to (i) enhance fiscal discipline; (ii) encourage a strong private sector response and employment creation; (iii) set the stage for deeper reforms aimed at improving public administration; (iv) address the problem of low-coverage and under-funding of Serbia's well-targeted social assistance program; and (v) mitigate the adverse impact of the energy sector reform measures on the poor.

122. In sum, the proposed SAC 2 will help the Republic of Serbia formulate a comprehensive structural reform agenda, which contains measures with a large impact on growth potential, within a consistent macroeconomic framework.

123. **Political Risks**. The formation of a fragile but functioning minority coalition in early March 2004 ended two months of political deadlock in Serbia following the legislative elections on December 28, 2003. Serbian Presidential elections were concluded in June 2004, bolstering stability. There remain a number of issues to be sorted out among ruling coalition partners and the party of the newly elected President, which has not joined the coalition. The challenges of ruling as a minority coalition could undermine the Government's cohesiveness and effectiveness, without which commitment to reforms would diminish and the capacity for policy implementation would weaken.

124. In addition, the durability of the SaM union, which may face a referendum in 2006, together with the final status of Kosovo, and completion of the EU's Stabilization and Association process, which has stalled in the run-up to the recent elections, emerge as additional important political challenges.

125. Nonetheless, Serbia's institutions have proven to be fairly resilient to adverse shocks as was evidenced by their ability to weather the shock of PM Zoran Djindjic's assassination in 2003. Moreover, at the political level, since its 2001 return to democracy, Serbia has completed a far-reaching constitutional transition and formed a workable

union with Montenegro, and managed to form a viable governing coalition through a series of challenging elections.

126. **Macroeconomic Risks/External Shocks**. The envisaged reforms in improving public finances contain two main risks. First, the much-needed high quality fiscal adjustment involving durable cuts in non-interest current spending—the wage bill in the face of the demands for higher wages and subsidies as well as transfers in particular—may be politically difficult to implement. Policy slippages in attaining the envisioned fiscal adjustment could exert upward pressures on the exchange and increase the use of foreign currency both as a store of value and a medium of exchange. Given the large share of external debt in total public debt, this could severely undermine debt sustainability and trigger a vicious circle of higher depreciation, higher inflation, and higher public debt. Second, were the progress on key reforms to be slower-than-envisioned or to be reversed under social pressure, this could pose a serious threat to the overall reform process as it would undermine efforts to address the underlying structural causes of macroeconomic imbalances.

127. In addition, Serbia's exports are concentrated in unskilled and natural resource intensive products, which increases the economy's exposure to terms of trade shocks. A severe deterioration of terms of trade or lower-than-expected foreign investment flows coupled with higher-than-expected oil prices might adversely affect economic activity and macroeconomic stability.

128. The potential benefits to be obtained through improving the political economy at a critical stage of the reform process by providing the necessary budget support to implement key structural reforms should mitigate the noted risks. More specifically, the implementation of the reform measures included in the SAC 2 program will not only support an improvement in private sector sentiment in Serbia, but also enhance conditions for other donors to continue (and increase) their involvement in the reform process—all of which should improve the scenario for 2005 and thereafter.

Serbia and Montenegro - Key Economic Indicators

Indicator	Actual 2000	Actual 2001	Estimate 2002	Estimate 2003	Projected 2004	Projected 2005	Projected 2006	Projected 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 & ommissions)	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		
Indicator	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
IFC (US$m)								
Loans								
Equity and quasi-equity /c								
MIGA								
MIGA guarantees (US$m)								

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.

Timetable of Key Processing Events

Identification Mission:	October 2003
ICM Review:	November 23, 2003
Technical Preparation Mission:	December 2003
Preparation Mission:	May 2004
ROC Meeting:	September 14, 2004
Appraisal Departure:	September 21, 2004
Negotiations:	November 1-2, 2004
Board Presentation:	December 16, 2004

SERBIA AND MONTENEGRO (SaM)

SECOND STRUCTURAL ADJUSTMENT CREDIT—REPUBLIC OF SERBIA

LETTER OF DEVELOPMENT POLICY

November 10, 2004

Mr. James D. Wolfensohn
President
The World Bank
1818 H Street, N.W.
Washington, D.C., 20433

Dear Mr. President:

1. The Union of Serbia and Montenegro (SaM), which was formed by the Republic of Serbia and the Republic of Montenegro in February 2003 following the Belgrade agreement in March 2002, has made significant progress across range of policy reforms and institutional strengthening. This progress took place against a very challenging background reflecting the legacy of a decade of isolation, conflict, and poor economic management. Our strong commitment to the implementation of the stabilization program has enabled us to lower inflation significantly from over 100 percent in 2000 to below 10 percent in 2003. During this period, our ratios of external and public debt to GDP have declined while our foreign exchange reserves have increased substantially. Initial reforms of the foreign trade regime, ownership relations, the business environment, the financial sector, the labor market, and the education and pension systems, have also begun to lay the foundations for more rapid growth.

2. The Poverty Reduction Strategy Paper (PRSP), which we completed in 2003 and which comprises a union-level overview and a PRSP for each of the republics, presents our overall economic reform program in great detail. With the objective of attaining key policy goals laid out in the Serbia PRSP—namely, ensuring dynamic economic growth, prevention of new poverty that may arise from the restructuring and modernization of our economy, and improving the effectiveness of social assistance—the Republic of Serbia is committed to maintain and continue progress on economy-wide structural reforms. To this end, the Republic of Serbia is requesting support form the Bank through a Second Structural Adjustment Credit (SAC 2) for the implementation of key reform measures for achieving the main policy objectives underlined in the PRSP. The specific reforms under the SAC 2 program will be discussed in greater detail below.

3. As per our constitutional arrangements, which transfers a number of responsibilities to the member states, and different reform challenges and priorities faced by the two constituent member states, we believe that it is more appropriate to seek

World Bank assistance for the two constituent members separately. As a consequence, the implementation of all reforms included in the SAC 2 program would be the responsibility of the Republic of Serbia.

4. We would like to take this opportunity to also present the macroeconomic framework that complements the program, as was underscored in the Extended Arrangement (EA) with the International Monetary Fund (IMF), which was approved by the IMF Executive Board in May 2002.

I. Macroeconomic Framework

5. The macroeconomic framework of our reform program centers on fiscal adjustment, wage discipline, and continued monetary stability to put our economy on a sustainable growth path, and to ensure price stability as well as external viability. We are implementing our reform program in the context of the noted macroeconomic framework supported by the IMF under the EA, which is described in greater detail in a Memorandum on Economic and Financial Policy attached to the Letter of Intent of May 21, 2004.

6. With the objective to ensure continued progress, we have updated our policy targets for 2004-05 and beyond to reflect robust economic growth while addressing higher inflation and safeguarding a sustainable external position. Real GDP is expected to grow by about 6 percent in 2004 reflecting a strong recovery in industry, due to accelerated privatization in 2003, strong growth in services, and a rebound in agricultural output. In 2005, real GDP is projected to grow by 4½ - 5 percent, settling at 5 percent in subsequent years as restructuring-related output losses subside, privatization and enterprise restructuring continue, and cumulative FDI inflows reach higher levels. Due mainly to one-off factors—i.e., higher oil prices, rise in the electricity prices, and increase in excise taxes—the inflation rate is projected to be between 12-13 percent in 2004 but is targeted to fall under 10 percent in 2005, and to gradually decline to low single digits over the medium term.

7. The current account deficit (after grants) projection for 2004 is revised upwards to 10.7 percent of GDP as a result of, inter alia, higher oil prices and a surge in imports. In response to noted developments, the Parliament of Serbia adopted a re-balanced budget for 2004 in October, which constitutes an important step towards reducing public consumption. More specifically, the re-balanced budget for 2004, which relies mainly on expenditures cuts, envisages a reduction of the budget deficit in Serbia from 3.9 percent of GDP in 2003 to 2.5 percent in 2004. Tighter macroeconomic policies, in turn, are expected to lower the current account deficit to 10.2 percent of GDP in 2005. To ensure external sustainability and remain consistent with expected financing, the deficit is projected to decline steadily thereafter based on a recovery of exports as structural reforms promote a supply response and prudent policies strengthen competitiveness.

8. We are committed to maintaining an appropriate medium-term macroeconomic framework for the duration of the program. To ensure enduring growth together with price stability and external viability, we stand ready to take any necessary corrective

policy actions and to update our macroeconomic program in close collaboration with the Staff of the World Bank and the IMF.

II. The Structural Reform Agenda

9. With the support of the World Bank and the rest of the international community, we have made significant progress in many areas. More specifically, the World Bank's first SAC supported our efforts to enhance fiscal sustainability through reforms of public expenditure management, the energy sector, social protection, labor markets, and health care. Social Sector Adjustment Credit (SOSAC), on the other hand, supported our reform efforts in pensions, health, labor, and social protection. Parallel Private and Financial Sector Adjustment Credits (PFSAC 1 and 2) supported our reform efforts directed at promoting growth through: (i) strengthening the financial system via the liquidation of troubled banks and an improved policy and regulatory environment; (ii) privatizing and restructuring socially-owned enterprises; and (iii) improving the investment and business climate.

10. The coverage proposed operation, with the exception of the public administration component, reflects our efforts to deepen the reform process, which has so far been supported by the above noted World Bank credits and to maintain the momentum gained so far. In this connection, we recognize that placing the Serbian economy on a sustainable growth path and prepare its integration into European structures require fundamental reforms aimed at improving: (i) the business climate; (ii) the performance in the energy sector; (iii) social protection; and (iv) public administration. We are confident that our structural reform program addresses the appropriate policy priorities and complements our macroeconomic framework supported by the IMF's EA.

11. The details of our reform program and the specific actions that we will take are presented below.

II.1 Improving the Business Climate

<u>Key objective:</u> To enable easier entry and improve corporate governance.

12. The Government is committed to facilitate efficient corporate governance and entry as well as operations of business. To this end, we have prepared a new Enterprise Law, which constitutes an important component of the commercial law system and provides the basis for other laws, such as privatization, business registration, bankruptcy, accounting, capital markets and investment funds that have either been passed recently or will be passed in the near future. After undertaking a public consultation process, the Government has submitted the new Law to the Parliament of Serbia, which is expected to be enacted in mid-November, 2004. The new Law will support our efforts to promote a strong private sector response and employment creation by engendering a more conducive business environment for enterprises.

Key objective: To improve contract enforcement.

13. The Government recognizes the importance of improving confidence in and the performance of the judicial system through, among other things, strengthening contract enforcement. The current state of the contractual compliance and enforcement mechanisms have an adverse impact on the business climate through, inter alia, leading excessively high proportion of cash payments in firms' activities and very high advance payment before delivery—all of which undermine the dynamism of the market and business expansion. We recognize that the Republic of Serbia lags behind other countries in the area of contract enforcement and that procedural steps to bring to completion even a relatively straightforward lawsuit are extremely cumbersome.

14. As part of our efforts to improve the business climate, we have prepared a new Law on Execution Procedures in consultation with various stakeholders. The new Law is expected to be enacted by the Parliament of Serbia in mid-November, 2004. The Government will remain resolute in its efforts to implement other key reform measures in this area, including steps to implement and monitor the new Law, and general reforms in the judicial sector, which we deem is critical for successful implementation of the new Law.

Key objective: To reduce the cost of doing business and improve the country's regulatory framework.

15. The Government recognizes the importance of reducing the cost of doing business and alleviating the regulator burden on enterprises, which will be crucial for promoting a strong private sector response and employment creation. Since restarting our transition to market economy in late-2000, a significant number of laws have been replaced with modern laws consistent with the needs of a market economy in Serbia. Currently, the central Secretariat for Legislation reviews all laws and Government decrees to ensure consistency with the constitution, other laws, and drafting standards. There is, however, no corresponding review directed at assessing the benefits, costs, and risks of laws and regulations on consumers and the economy.

16. In order to fill this void and following the example of many countries, we are introducing Regulatory Impact Analysis (RIA), which will be carried out by the Regulatory Reform Council. To this end, we have adopted amendments to the Rules of Operation of the Government in October 2004, which will require the responsible ministry to prepare a justification statement in line with the Organization for Economic Co-operation and Development (OECD) RIA recommendations for each new law, and other regulatory instruments such as decrees and orders.

II.2 Energy Sector: Institutional Development and Performance Improvement

Key objective: To adopt an enabling framework for energy sector reform.

17. The Government recognizes the importance of power sector reform for promoting economic growth and enhancing fiscal discipline. Development of an independent

regulatory framework is crucial not only for longer-term financial/operational sustainability of the power sector, but also for Serbia's accession to the regional energy market. In this respect, the adoption of the new Energy Law in July 2004 was central to the power sector reform process, as it will set the stage for regulatory development, tariff reform, energy market liberalization, and industry restructuring. This was followed by the adoption of a supporting Energy Strategy and by the establishment of an independent regulator, with appointment of key personnel in November 2004.

<u>Key objective:</u> To adjust the tariff level and its structure to maintain cost recovery and improve energy efficiency incentives.

18. We are determined to improve energy efficiency incentives and to support operational sustainability of the power sector by ensuring that tariffs cover costs. Consistent with this objective, and building on the progress made in recent years, we have increased the power tariffs to yield a 10 percent revenue increase for EPS in June 2004, which comprised in part reduction of the first block in the block tariff structure to 350 kWh and an increase for all tariff categories. A smaller first block is more in line with regional standards, and better balances objectives related to energy efficiency and social protection.

<u>Key objective:</u> To improve payments discipline.

19. The Government is resolved to improve payments discipline in the power sector. To this end, we are pressing ahead with the following measures: (i) maintaining residential collections—defined as cash collected divided by invoices—for the first six months of 2004 at or above the level for the corresponding period in 2003 (thereafter the six month rolling average should be at least as high as the corresponding period in the previous year); (ii) offering at least four of EPS' large electricity debtors for sale and selling at least two of them or viable parts thereof; and (iii) addressing the problem of commercial losses by forming an expert team and identifying areas within the network where commercial losses are high, with a view to achieving a reduction in distribution losses by the end of calendar year 2004. The transmission company will own all assets required both for transmission and system control.

<u>Key objective:</u> To achieve power industry commercialization and restructuring.

20. In line with our efforts to improve the performance and strengthen institutional development in the sector, we are determined to make significant progress in power industry commercialization and restructuring. To this end, we have transferred out of EPS 8 non-core companies and established within EPS from non-core assets 12 new subsidiary companies. Our efforts in this area also included the adoption a Government Decision to separate ownership of power generation/distribution and transmission businesses, which took place in November 2004.

21. Reduction of the labor force in EPS is one of the most important components of the overall restructuring efforts. Although we recognize that radical labor restructuring is likely to be implemented after EPS unbundling—following which management

incentives will be strengthened—the Government will continue its efforts to improve labor productivity through maintenance of a net hiring freeze at EPS during the interim period.

II.3 Strengthening Social Protection

<u>Key objective:</u> **To improve effectiveness of the safety net.**

22. We recognize the need improve effectiveness of the safety net through expanded coverage, greater adequacy of benefits, and improved targeting. Recent amendments to the Social Welfare Law enacted in July 2004 aimed at addressing key problems in benefit design including low coverage and low benefit levels. Due to the delay in passage of the noted amendments, the present allocation for social assistance programs, including Material Support to Families (MoP), in the 2004 budget was based on actual expenditures in 2003. The full implementation of policy changes included in the amendments, which became effective in September 2004, required additional financing. To this end, the Republic of Serbia has allocated funds in its 2004 State Budget, and the Government of the Republic of Serbia has allocated funds in the draft 2005 State Budget submitted to the Republic of Serbia Parliament, adequate to fully implement the Social Welfare Law.

<u>Key objective:</u> **To mitigate the adverse impact of changes in the level and structure of electricity tariffs on the poor.**

23. As part of our efforts to strengthen the safety net, we are determined to address potential affordability impacts of the change in the first block in the block tariff structure from 600 kWh to 350 kWh on poor groups using power. In order to protect these groups in the face of the change in the first block, the Government has introduced a new mitigation scheme to support the poor and vulnerable population, whereby recipients of child benefit, minimum pension and MOP are entitled to a discount of no less than 30 percent of the monthly bill on consumption up to 300 kWh.

<u>Key objective:</u> **To improve coordination between social protection programs and energy related subsidies as well as monitoring of social impact to achieve better targeting and efficiency.**

24. In order to ensure effective implementation of the above noted mitigation scheme, we have established a working group consisting of representatives from Ministry of Mining and Energy, Ministry of Labor and Social Affairs, and EPS with the objective to improve coordination between social protection programs and other energy related subsidies. The Government is determined to take actions to ensure that consumers are aware of available benefits (e.g., a media campaign, a letter to all customers enclosed with the bill).

25. We acknowledge the importance of the use of periodic household surveys carried out by the Republic Statistics Office (RSO) for monitoring reform outcomes and assessing the targeting efficiency of various mitigation schemes. Although the reformed Household Budget Survey (HBS) was revised to address most of the relevant issues in

PRSP monitoring, there is a need to officially entrust the RSO with this work. To this end, we have ensured that production of an updated poverty profile using data collected through HBS, which will be published on a regular basis, is included in the work plan of the RSO.

II.4 Improving Public Administration

<u>Key objective:</u> **To create a Policy Framework for effective reform of the Public Administration.**

26. The Government is aware that essential reforms in the system of Public Administration cannot be achieved without the adoption of a broadly supported reform strategy and action plan. Guided by this principle and following a consultative process including key stakeholders, we have prepared a Strategy and Action Plan on Public Administration Reform in early October, which was endorsed by the Public Administration Reform (PAR) Council and adopted by the Government.

27. The Strategy covers the reform of the central state administration, as well as reforms in the system of local self-government. The intended direction of reform is to move service delivery and regulatory management functions out of the central ministries and vest them in local authorities and public agencies respectively, thus allowing for a more client oriented and efficient form of public service delivery.

28. As a sign of its commitment to administrative reform, the Government has already embarked on the design of a package of key laws, including the Law on Government, the Law on Public Agencies, the Law on State Administration, the Law on Civil Service and the Law on Salaries. The Law on Government and the Law on Public Agencies have already been submitted to the Parliament. The Government thus aims to modernize the legislative framework for the operation of the state administration by March 2005, to form the basis for deep reforms in the administration in the following years.

29. The Implementation of the Strategy and related Action Plan will be monitored by the Public Administration Reform Council. This Council includes all key ministries involved in the design of the reform process. Furthermore, the capacity of the Ministry of Public Administration Reform and Local Self-Government to lead the day to day implementation of the strategy has been enhanced by the appointment of additional staff and the incorporation of the former Agency for Public Administration Development in the structure of the Ministry.

<u>Key objective:</u> **To review and reform of the Salary System for the central Civil Service.**

30. The Government recognizes that the reform of the civil service wage system is an essential part of the reform process. Wage reform has the dual objective of rationalizing a significant element of public expenditure and creating a civil service system that will be

attractive for qualified staff. In this respect, we view successful reform of the civil service wage system as a catalyst for further reforms.

31. Wage reform is a highly complex issue, the design of which needs to be started urgently. To this end, we have completed an in-depth review of the Civil Service pay system. To demonstrate our commitment to reforming the salary system, the Ministry of Finance and Ministry of Public Administration and Local Self Government have issued a joint policy statement, which outlines the direction of reforms consistent with the findings of the recent Review in the following areas (i) reform of the pay and grading system, (ii) development of a performance appraisal system linked to the salary system; (iii) reform of the systematization process; (iv) de-politization; and (v) integrating staff development with careers advancement as set out above. The noted policy statement was subsequently endorsed by the PAR Council in October 2004 with a view to ensure adoption of the action plan by the first quarter of 2005.

32. The Government aims to have in place a new Pay and Grading system for the central state administration with the budget for 2006 and to implement a new performance appraisal system by 2007. The reform of the systematization system will be conducted in conjunction with an overall review of staffing levels across the state administration, which is to be completed by June 2005, followed by detailed reviews of individual institutions. Furthermore the decrees and decisions underlying staff planning methods will be reviewed and amended. De-politization of top level posts in the central state administration will be carried out in the context of the new Laws on State Administration and Civil Service.

33. An inter-ministerial working group, consisting of representatives of the Ministry of Finance, Ministry of Public Administration and Local Self-Government and the Legislative Secretariat has been created to coordinate the implementation of pay system reform.

Key objective: To establish an effective Public Administration Management structures.

34. In moving ahead with Public Administration reform, we recognize the importance of establishing an effective Public Administration management structures. We believe that an effective reform management system requires the creation of a decision-making body at the highest level, which will be chaired by the Prime Minister. Towards this end, we have created a management structure for public administration reform, including a secretariat funded by the state budget in June 2004. We will ensure that Council on Public Administration Reform meets on a regular basis and that its secretariat is fully operational.

35. We recognize that the above noted policy measures in reforming public administration will only set the stage for further reforms in this area. The Government remains resolute to implement a coherent medium-term agenda focusing on de-politicization of the administration, designing and implementing new Civil Service

Legislation as well as Civil Service management mechanisms, and implementation of wage reforms, among other things.

III. Conclusion

36. The Government of Serbia is undertaking major actions to address pending structural problems and improve the business climate. We remain resolute to deepen the reforms in the future, and to complement them with measures aimed at strengthening public finances and improving institutions together with policy actions directed at enhancing the competitiveness of the Serbian economy.

37. The Government undertakes to continue working on these policy issues, for which the support by the World Bank and the rest of the international community will be of vital importance in attaining our objectives of placing the country on a path of sustainable and equitable growth as well as integration into European structures.

Predrag Ivanović
Minister for International Economic Relations
Serbia and Montenegro

Mladjan Dinkić
Minister of Finance
Republic of Serbia

Serbia: Proposed Structural Adjustment Credit 2: Matrix of Policy Actions[35]

GOVERNMENT'S OBJECTIVES	REFORM BENCHMARKS BY BOARD PRESENTATION	OUTCOME BENCHMARKS
1. MACROECONOMIC STABILITY		
To pursue sound macroeconomic management to promote sustainable growth by providing a more secure environment for private sector investment decisions [LDP paras 5 to 8]	***-Maintain a macroeconomic framework satisfactory to the Bank***	Continue to maintain a sustainable macroeconomic framework
2. IMPROVING THE BUSINESS CLIMATE		
To enable easier entry and improve corporate governance [LDP para 12]	-Undertake a wide public consultation process about the new Enterprise Law including relevant stakeholders. ***- Enact the new Enterprise Law.***	Increase in the number of limited liability companies registered per annum
To improve contract enforcement [LDP paras 13 and 14]	- Undertake a wide public consultation process about the new Law on Execution Procedures including relevant stakeholders. ***- Enact the new Law on Execution Procedures.***	More efficient enforcement of judicial decisions and commercial contracts, as measured by the Enforcing Contracts Indicator[36]
To improve the country's regulatory framework [LDP paras 15 and 16]	-Prepare amendments to the Rules of Operation of the Government necessary for the introduction of Regulatory Impact Analysis and identify an entity (*Regulatory Reform Council*) to carry out this function. ***-Adopt amendments to the Rules of Operation of the Government requiring responsible ministry to prepare a justification statement for a new law, a decree and an order in line with the OECD Regulatory Impact Analysis.***	Steady increase in the use of RIA
3. ENERGY SECTOR: INSTITUTIONAL DEVELOPMENT AND PERFORMANCE IMPROVEMENT		
To adopt an enabling framework for energy sector reform [LDP para 17]	***-Enact an Energy Law that includes the following provisions: establishment of an independent regulator; enabling the restructuring of EPS and the ownership / operation separation of transmission; strengthening the legal framework for enforcement of payments discipline.*** -Adopt Energy Strategy - Appoint key personnel for the new energy regulator.	Full staffing of the Regulator and the adoption of a business plan
To adjust the tariff level and its structure to maintain cost recovery and improve energy efficiency incentives [LDP para 18]	***- Raise power tariffs to yield a revenue increase of the order 10% for EPS from July 1st; the tariff increase should comprise in part a reduction of the first block in the block tariff structure to 350 kWh.***	Ensure ongoing financial viability of EPS defined as positive operating cash flow

35 The "core" conditions are italicized and bolded.
36 The World Bank "Doing Business in 2004: Understanding Regulation"

GOVERNMENT'S OBJECTIVES	REFORM BENCHMARKS BY BOARD PRESENTATION	OUTCOME BENCHMARKS
To improve payments discipline [LDP para 19]	-Keep residential collections—defined as cash collected divided by invoices—for the first six months of 2004 at or above the level for the corresponding period in 2003. Thereafter the six-month rolling average should be at least as high as the corresponding period in the previous year. -Form teams in distribution companies and EPS headquarters, and identify areas where commercial losses are a problem. ***- Offer at least four of EPS' large electricity debtors for sale and sell at least two of them or viable parts thereof— all in a manner and on terms and conditions satisfactory to the Bank***	Maintain residential collections ratio in the rage of 92-95 percent
To achieve power industry commercialization and restructuring [LDP paras 20 and 21]	-Transfer out of EPS 8 non-core companies[37] and establish within EPS from non-core assets 12 new subsidiary companies.[38] -Adopt a Government Decision to separate ownership of power generation/distribution and transmission businesses. -EPS to maintain net hiring freeze.	
4. STRENGTHENING SOCIAL PROTECTION		
To improve effectiveness of the safety net [LDP para 22]	***-Ensure adequate funds within the 2004 State Budget and the draft 2005 State Budget submitted to the Parliament for full implementation of the Social Welfare Law upon its effectiveness.***	13,000 new beneficiaries covered by MOP
To mitigate the adverse impact of changes in the level and structure of electricity tariffs on the poor [LDP para 23]	***-Introduce a new mitigation scheme to support the poor and vulnerable population, whereby recipients of child benefit, minimum pension and MOP are entitled to a discount of no less than 30% of the monthly bill on consumption up to 300 kWh.***	A minimum of 50,000 new beneficiaries to be protected by the energy sector social safety net
To improve coordination between social protection programs and energy related subsidies as well as monitoring of social impact to achieve better targeting and efficiency [LDP paras 24 and 25]	-Establish a working group consisting of representatives from MoME, MoSA, and EPS to coordinate and oversee the implementation of energy mitigation schemes. -Prepare a report on poverty in 2004 based on household survey to monitor the social impact of reform and revise the program of publication by RSO to include the production of poverty data on a regular basis.	
5. IMPROVING PUBLIC ADMINISTRATION		
To create a Policy Framework for effective reform of the Public Administration [LDP paras 26 to 29]	-Complete the preparation of a Strategy and Action Plan on Public Administration Reform, satisfactory to the Association, satisfactory to the Association. ***-Adopt the Public Administration Reform Strategy and related Action Plan, satisfactory to the Association***	Adoption of basic laws[39] on PA based on the principles and objectives set out in the strategy providing the foundation for the creation of a modern and competitive civil service

[37] These companies are (1) Kolubara Ugostiteljstvo, Vreoci; (2) Standard, Kostolac; (3) Sava Tent, Obrenovac; (4) 24 September, Užice; (5) Elektroizgradnja, B. Bašta, (6) Betonjerka, Aleksinac; (7) Energosoft, Novi Sad; (8) Djerdap usluge, Kladovo.

[38] The 12 companies taken from the following list: (1) Univerzal, Veliki Crljani, founder JP RB Kolubara; (2) Gradjevinar, Lazarevac, founder JP RB Kolibara; (3) Usluge, Lazarevac, founder JP RB Kolubara; (4) Kolubara Metal, Vreoci; (5) TENT Usluge, Obrenovac, founder JP TENT; (6) Vodovod Tara, Perućac, founder JP Drinske; (7) Hotel Jezero, Perućac, founder JP Drinske; (8) Ishrana, Leskovac, founder JP ED Leskovac (9) Elektroinžinjering, Leskovac, founder JP ED Leskovac; (10) Elektromontaža, Kraljevo, founder JP ED Kraljevo; (11) Betonjerka, Sombor, founder JP ED Elektrovojvodina; (12) Održavanje i usluge, Novi Sad, founder JP ED Elektrovojvodina; (13) Georad, Kostolac, founder JP PK Kostolac; (14) Autotransport, Kostolac, founder JP PK Kostolac; (15) PRIM, Kostolac, founder JP PK Kostolac and JP TE Kostolac; (16) Gumiko, Kostolac, founder JP PK Kostolac; (17) RIO, Kostolac, founder JP PK Kostolac and JP TE Kostolac; (18) Obezbedjenje Kostolac, founder JP PK Kostolac: (19) Javna rasveta, founder JP ED Beograd; (20) Projektni tim rudnika Kovin; (21) Južna Bačka.

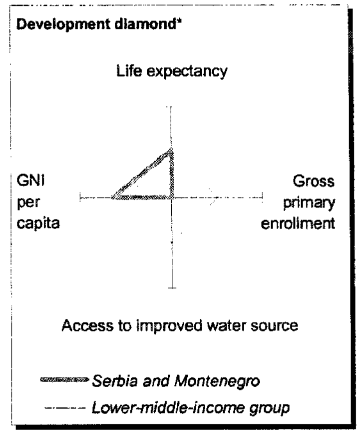
[39] The package of key laws include the Law on Government, Law on Civil Service, Law on Public Agencies, Law on State Administration and the Law on Salaries.

GOVERNMENT'S OBJECTIVES	REFORM BENCHMARKS BY BOARD PRESENTATION	OUTCOME BENCHMARKS
To review and reform of the Salary System for the central Civil Service [LDP paras 30 and 33]	***-Finalize an in-depth review of the Civil Service pay system and identify two alternative options for reform that will be fully explored and costed.***	system The Law on Salaries sets compression ratio in civil service pay at minimum 1:6.
To establish an effective Public Administration Management structures [LDP para 34 and 35]	-Create a management structure for public administration reform and ensure that it has adequate staffing and is fully operational.	Initial steps in public administration reform are effectively implemented according to set deadlines

Serbia and Montenegro at a glance

11/11/04

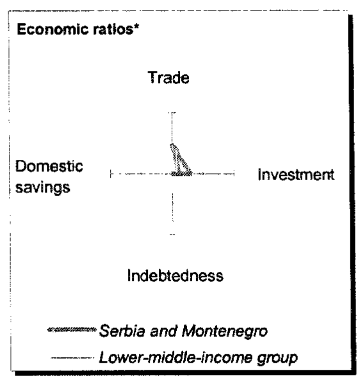
POVERTY and SOCIAL	Serbia and Montenegro	Europe & Central Asia	Lower-middle-income
2003			
Population, mid-year *(millions)*	8.3	473	2,655
GNI per capita *(Atlas method, US$)*	1,900	2,570	1,480
GNI *(Atlas method, US$ billions)*	15.8	1,217	3,934
Average annual growth, 1997-03			
Population *(%)*	..	0.0	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

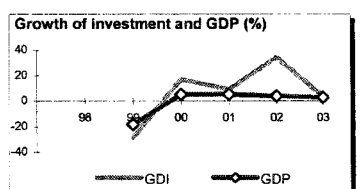
	1983	1993	2002	2003
GDP *(US$ billions)*	..	..	15.5	20.5
Gross domestic investment/GDP	..	..	16.2	15.9
Exports of goods and services/GDP	..	..	20.9	19.9
Gross domestic savings/GDP	..	..	-7.2	-6.6
Gross national savings/GDP	..	..	7.2	6.3
Current account balance/GDP	..	..	-8.9	-9.6
Interest payments/GDP	..	..	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

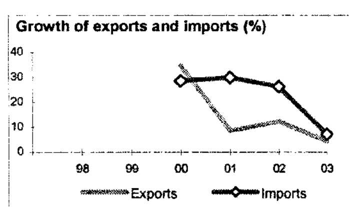


STRUCTURE of the ECONOMY

	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



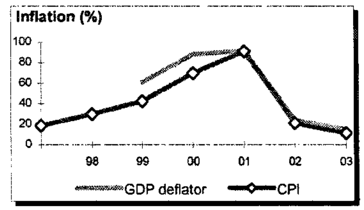
Note: 2003 data are preliminary estimates.

* 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

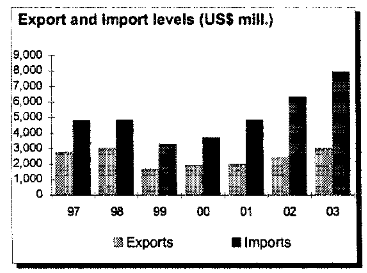
PRICES and GOVERNMENT FINANCE

	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



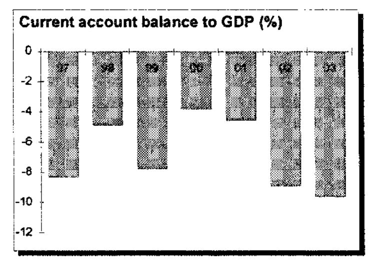
TRADE

	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)*	..	..	..	..



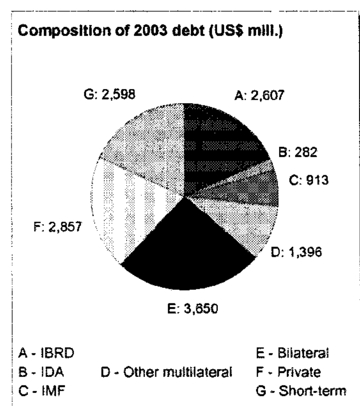
BALANCE of PAYMENTS

	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



Annex : Fund Relations Note

The Executive Board of the International Monetary Fund (IMF) completed the third review of Serbia and Montenegro's economic performance under the Extended Arrangement on June 7, 2004. The decision enabled the release of an amount equivalent to SDR 100 million (about US$147 million), bringing total disbursements under its current Extended Arrangement to SDR 300 million (about US$440 million). The three-year Extended Arrangement was approved on May 12, 2002 for a total of SDR 650 million (about US$953 million). The financial position of Serbia and Montenegro in the Fund is presented in Table 1.

On June 7, 2004, the IMF Executive Board also completed the financing assurances review and granted the authorities' request to waive the nonobservance of an end-December 2003 performance criterion on net bank credit to government.

Following the Executive Board discussion, Anne Krueger, First Deputy Managing Director and Acting Chair, said:

"Serbia and Montenegro has made good progress in lowering inflation, attracting foreign direct investment, and strengthening foreign reserves, while macroeconomic policies are broadly on track. To strengthen growth and improve the external position, which continues to be vulnerable to adverse shocks, macroeconomic policies should be geared toward restraining demand, and structural reforms expedited to enhance the economy's supply response.

Against this background, the authorities' macroeconomic policies and structural reform agenda contained in the 2004 economic program appropriately focus on reducing the current account deficit, enhancing growth prospects, and correcting the existing fiscal and external imbalances. The authorities intend to broaden the political support to accelerate the pace of structural reforms.

The authorities will tighten fiscal policy in 2004 and shift spending from current to investment uses. However, the fiscal tightening in Serbia relies entirely on revenue increases, leaving the expenditures at a high level in relation to GDP. Placing the fiscal accounts on a sustainable path will require streamlining of spending, particularly cuts in subsidies, and containment of growth in wages and social transfers.

The monetary authorities intend to maintain tight credit conditions with a view to achieving the inflation objective and safeguarding official foreign reserves. Wage restraint will be key to improving external competitiveness, while containing inflationary pressures. With continued high, albeit slower, credit growth, bank supervision should be vigilant, with strict enforcement of prudential regulations to ensure that new lending is sound.

Structural reforms need to pick up pace. In the banking sector, privatization of the nationalized banks is critical to building a healthy system. Privatization and restructuring of nonperforming state enterprises are also a priority. In addition, rapid progress is needed on the much-delayed legislative agenda, to ensure successful implementation of the VAT in 2005, set the basis for a functioning bankruptcy process, facilitate a restructuring of the energy monopolies, and establish a proper regulatory framework for that sector. These key structural reforms, as well as additional measures to improve governance and strengthen public institutions, should help promote private sector development.

It is important that the authorities continue to negotiate in good faith with London Club and other creditors to restructure their debt on terms comparable to those granted by the Paris Club. The success will depend crucially on the authorities' credibility in forcefully implementing the policy framework," Ms. Krueger said.

Table 1. Serbia and Montenegro
(Updated as of September 30, 2004)

I. **Membership Status:** Joined December 14, 1992; adopted Article VIII on May 13, 2002.

II. **General Resources Account**	SDR Million	%Quota
Quota	467.70	100.00
Fund Holdings of Currency	1,078.29	230.55

III. **SDR Department**	SDR Million	%Allocation
Net cumulative allocation	56.66	100.00
Holdings	19.81	34.95

IV. **Outstanding Purchases and Loans**	SDR Million	%Quota
Extended arrangement	400.00	85.52
Stand-by arrangements	210.58	45.02

V. **Financial Arrangements**

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
EFF	5/14/02	5/13/05	SDR 650.0 million	SDR 400.0 million
Stand-by	6/11/01	5/31/02	SDR 200.0 million	SDR 200.0 million
Emergency Post-Conflict Assistance	12/20/00		SDR 116.9 million	SDR 116.9 million

VI. **Projected Obligations to Fund Under the Repurchase Expectations Assumptions**[40] (In millions of SDR)

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	52.12	139.71	27.08	50.00	116.67
Charges/Interest	5.13	17.22	13.82	12.91	10.51
Total	57.25	156.93	40.91	62.91	127.17

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Mr. Andreas Westphal (awestphal@imf.org, 623 7389)

[40] This schedule presents all currently scheduled payments to the IMF, including repayment expectations where applicable and repayment obligations otherwise. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk.

MAP SECTION