

**THE GOVERNMENT OF THE REPUBLIC OF SERBIA**

**THE REFORM AGENDA OF THE  
REPUBLIC OF SERBIA**

THE NEEDS FOR INTERNATIONAL FINANCIAL  
ASSISTANCE

**MINISTRY OF INTERNATIONAL ECONOMIC RELATIONS**

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# THE REFORM AGENDA OF THE REPUBLIC OF SERBIA

## THE NEEDS FOR INTERNATIONAL FINANCIAL ASSISTANCE

After assuming power in October 2000, the Government of the SFRY and the Government of the Republic of Serbia adopted a comprehensive reform agenda. After ten years of isolation, armed conflicts and economic degradation, the economy of the FRY was absolutely exhausted, infrastructure destroyed and population impoverished. With rapid transition and the inclusion of the economy in the international community as the basic aims, attempts are made to strengthen the economy and modernize the country. In 2001, emphasis was laid on the country's reintegration and stabilization and assistance to the most needy, while in 2002 it shifted to economic recovery, reconstruction of infrastructure and the revival of institutions. The period up to 2005 will be the period of accelerated reforms and increasing efficiency of the economy and government administration. To accelerate the process of economic recovery and shift to self-sustainable development, to increase output and employment and to achieve convergence in development with other countries in the region, it is necessary to ensure significant foreign direct investment, as well as donors' financial and technical assistance.

## 1. CHALLENGES AT THE BEGINNING OF REFORMS

### 1.1. Priorities and Achievements at the Beginning of Reforms

Reforms in the Republic of Serbia began in an extremely difficult economic situation: in 2000, GDP per capita amounted to about USD 1000, the rate of inflation was 115% per annum, the share of the grey economy in GDP was nearly 50%, the exchange rate on the black market was five times higher than the official one, the country's foreign and internal debt constituted about 185% of GDP, quasi-fiscal deficit exceeded 10% of GDP, not to mention about 800 thousand unemployed and about 700 thousand refugees, one-third of the population living below the poverty line, two-thirds of fixed assets in the economy being either destroyed or written off, etc.

The major challenges in 2001 were as follows:

- Social assistance to the most vulnerable: refugees, children and pensioners;
- Rehabilitation of physical and social infrastructure;
- Stabilization of the economic and political situation;

- Restoring respect for the law and institutions;
- Reintegration into world organizations;
- Mobilization of foreign assistance and attraction of strategic investments.

During the period of two years, a great number of noteworthy results was achieved. Stabilization policy began with monetary reform (characterized by a restrictive monetary policy and an increase in foreign exchange reserves), tight fiscal policy and the reform of public finance, as well as price and trade liberalization. Among the major results, mention should be made of the following:

- ◆ Stable and uniform exchange rate (the black market was eliminated) and the liberalization of foreign exchange transactions;
- ◆ Increased foreign exchange reserves (they cover c. 5-month imports and tend to increase to 6-month imports in 2005);
- ◆ Bringing down inflation (below 41% in 2001, with core inflation of only 11%, while in 2002 inflation amounted to 14.8%, with core inflation of about 7%);
- ◆ Embarking on the restructuring of the banking sector, coupled with the liquidation of insolvent banks;
- ◆ Decrease in and control of the budget deficit (to 1.3% of GDP in 2001, below the planned 6.5%; in 2002, GDP rose to about 3.8%, as a result of the commencement of meeting interest payments on foreign debt /including the Kosovo one/ and increased role of the government in the process of structural adjustment);
- ◆ Tax reform, coupled with the enlargement of the tax bases and decrease in tax rates, as well as increased public revenues (from 35.3% of GDP in 2002, to 37.8% in 2001);
- ◆ The new privatization law was adopted and the process of privatization of large socially-owned enterprises was initiated;
- ◆ Pension reform began (the draft law on old-age pension and disability insurance) was prepared);
- ◆ The first phase of trade liberalization;
- ◆ Tariff system was reformed and the revision of tariff rates in accordance with the WTO requirements is underway;
- ◆ The process of conclusion of free trade agreements with all countries in the region was initiated: the Agreements with Bulgaria, Romania, Albania, Slovenia and Croatia were initialled; it is planned to initial the Agreement with Moldova by the end of February 2003;
- ◆ Contacts with the major foreign donors were established;
- ◆ Preparations for accession to the WTO and association with the EU are underway.

The basic changes in the economic system and institutions were initiated; many new systemic laws were adopted, while existing ones were revised. It is important to note that the new process of privatization was initiated in accordance with the new law (the privatization of several large state-owned enterprises was carried out, including three cement factories, which were privatized in January 2002). The Agencies for Privatization, Small and Medium-Sized Enterprises, and Foreign Investment began to operate. The Anti-Corruption Commission was set up and the new law on the taxation of an extra profit earned during the previous regime came into effect.

**A prerequisite for the sustainability of initiated reforms and economic growth is macroeconomic stability. Economic trends in the first half of 2002 show that by sound public finance and restrictive monetary policy it is possible to maintain the stability of the exchange rate under the managed float regime, coupled with the liberalization of tariff and foreign trade regimes. During 2002, inflation rose to 14.8%, which is much below the projected one of 20% for the same year, despite the removal of price disparities in the electric power industry and some sectors of infrastructure, with the prospects for its reduction to the one-digit level in the coming years – coupled with the filling of the gap of the missing funds. For the smooth implementation of reforms, it is necessary to ensure the inflow of financial resources from abroad.**

## 1.2. Donors' Assistance

Donors' conferences were held in December 2000 and June 2001, after ten years of sanctions and international isolation. They were aimed at providing humanitarian aid and helping the recovery of the Serbian economy. Donors' assistance was provided by 42 countries and 25 international institutions. The use of such funds has so far been successful, displaying satisfactory transparency, functionality and efficiency.

In 2001, the funds earmarked for project financing amounted to about € 1350 million and they should be realized over the next three years. In 2002, the assistance of about € 1300 million was announced. As anticipated, it will be realized until the end of 2004. In 2002, about € 780 million were realized. Those funds were promised at the previous donors' conferences (about € 470 million in 2001 and about € 310 million in 2002). The allocation and purposes of the funds received thus far, by year, are follows:

- In 2000, about € 150 million were received. Assistance was mostly provided for the following: power supply and urgent overhaul of equipment of the power supply and distance heating systems; health care and social assistance to the most vulnerable groups of the population. The bulk of this assistance was used for the import of electric power (about € 66 million), distribution of food, hygienic and other goods to the most needy, as well as for financing various social transfers (about € 50 million).

- In 2001, about € 540 million (about € 255 million from 2000 and about € 285 million from 2001); the bulk of these funds was spent on the import of equipment for the power supply sector and energy products, as well as on the purchase of drugs, social transfers, assistance to pensioners with the lowest incomes, import of fertilizers and diesel fuel for farming, macroeconomic support, as well as credits for structural adjustment.
- In 2002, about € 785 million (about € 5 million from 2000, about € 470 million from 2001 and about € 310 million from 2002); these funds were used mostly for the reconstruction of infrastructure (road network, Bridge of Freedom, Belgrade and Niš airports, Nikola Tesla Thermal Power Plant, Kolubara Coal Mine, Agency for Power Efficiency, private sector development and infrastructural projects at the municipal level).
- It is estimated that in 2003 about € 920 million will be realized (about € 280 from 2001, about € 475 million from 2002 and about € 165 million from 2003); these funds are earmarked for the reconstruction of infrastructure: railway and road networks, air transport and the reconstruction of the power supply sector: transmission network, Tamnava Coal Mine, Nikola Tesla and Kostolac Thermal Power Plants; some of these funds are earmarked for the reconstruction of clinical centres and the improvement of veterinary and sanitary services.

The structure of the funds stemming from donors' assistance was changing. At the beginning of the period, at the end of 2000, humanitarian aid constituted the bulk of it, while since the third quarter of 2002 already, development assistance (credits under favourable terms) has become dominant. This change in the structure of donors' assistance shows that each credit requires funds for regular debt servicing, thus increasing pressure on the balance of payments. A prerequisite for fast economic growth is the rehabilitation and reconstruction of destroyed infrastructure, so that in 2003 and in the coming period the bulk of the funds stemming from donations will be used for these purposes.

**The bulk of development and donors' assistance in 2002 was spent on the rehabilitation of infrastructure: 55% was spent on the reconstruction of infrastructure at the local level, 28% on the urgent rehabilitation and reconstruction of transport and energy supply sectors, while assistance to private sector development amounted to 17% of the funds.**

The results achieved thanks to humanitarian and development assistance during the previous period can be regarded as satisfactory. In using donors' assistance, various government bodies demonstrated a high level of efficiency and coordination and the same applies to control as to whether the funds were used for designated purposes.

## **2. PRIORITIES IN 2003 AND REFORM STRATEGY**

### **2.1 Priorities of the Government of Serbia in 2003**

The basic aim of the Government of Serbia in 2003 is to maintain macroeconomic stability, speed up economic and social reforms and ensure economic growth of 4-5%. In 2002, significant reform projects were carried out:

- Privatization and structural changes in the economy;
- Solving of the redundancy problem in restructured firms;
- Further changes in legislation and its harmonization with EU legislation;
- Establishment of new institutions and strengthening of existing ones;
- Solving of acute social problems, especially the problem of absolute poverty.

In 2001, within its policy of hard budget constraint, the Government of Serbia instituted control over the sources of quasi-fiscal deficit. The cost of electric power rose by 125%, while the costs of distance heating and other public services rose as well. In 2002, further steps were taken toward cutting a deficit: the cost of electric power rose by 50%. The increase in pensions is calculated on a quarterly basis (as the mean value of a rise in salaries and the cost of living); wage-and-salary fund in the public sector was limited and there is strict control over it. Tax laws were simplified; tax administration is undergoing reform. The measures taken with a view to ensuring more efficient tax collection produced good results; the degree of incorporation of the grey economy into the formal market flows was increased; measures against corruption and smuggling were intensified; the degree of tax revenue collection was increased. The fight against corruption continues.

Internal equilibrium, restrictive monetary policy and tight exchange rate policy, coupled with an increase in foreign exchange reserves, brought about the stability of domestic currency and enhanced the credibility of the Government's stabilization programme. In May 2002, a three-year arrangement with the IMF was concluded and the dinar became convertible.

Within the process of privatization, it is anticipated to increase the number of enterprises to be privatized by tender to 200, while nearly 1000 enterprises will be privatized by sale at an auction. In 2002, according to the estimates of the Government of Serbia, about 60 thousand workers lost their jobs. Thus, it prepared the social programme for such workers within its active employment policy.

Underway are the further changes in legislation and strengthening of institutions. The measures were taken so as to remove the obstacles to investing in Serbia, while administrative procedures associated with the issuing of building permits and establishment of enterprises were simplified. Several important laws are under preparation. In addition to a set of tax laws, the following laws were

adopted: the Law on Corporate Income Tax, Draft Law on Amending the Law on Sales Tax and the Law on Tax Procedure and Tax Administration. The Law on Securities and Law on Investment Funds are under preparation. Apart from the adopted Labour Law, additional laws in this area were drafted for the purpose of harmonization with the EU standards. It is expected that in 2003 further progress will be made with respect to foreign investment inflow, thus strengthening the financial sector still more. In order to continue with the reform of government administration and decentralization of government, two new ministries were set up in June 2002: the Ministry of Government Administration and Local Government and the Ministry for the Protection of Natural Resources and Environmental Protection. The Treasury began to operate at the end of 2002.

Insofar as infrastructure and environmental protection are concerned, priority in 2002 was attached to emergency measures aimed at restoring the navigability of the rivers Sava and Danube, reconstruction of the road and railway networks and improvement of transport safety, reconstruction of airports, overhauling work in the power supply sector, removal of all acute ecological trouble spots, municipal and industrial waste water treatment, reconstruction of sewerage and water supply infrastructure for the provision of drinking water.

**The simultaneous changes in the economic, legal and institutional structures, while at the same time maintaining macroeconomic stability, entail transition costs which may call the success of reforms to question. To effect reform-related changes and achieve economic growth at the same time, coupled with the overcoming of the problem of destroyed infrastructure and social problems, further donors' assistance is indispensable to Serbia.**

## 2.2. Reform Strategy

The Government of Serbia is faced with three basic tasks in the process of implementing its reforms:

- Reconstruction of infrastructure and improvement of living conditions;
- Transition (macroeconomic stabilization and economic restructuring);
- Integration (regional and European), coupled with the development of institutions and the rule of law.

The basic aims over a medium term are to increase economic growth and employment, living standards and efficiency. The reform agenda ensures the adjustment of the reform-related tasks with these aims, and its consistency is reflected in achieving sustainable growth within the set time-limit – until 2005. Over a short term, in 2002 and 2003, the basic task of the Government of Serbia is to

maintain macroeconomic stability, while at the same time carrying out reforms and ensuring economic growth.

The **stabilization programme** includes:

▶ *Monetary reform (restrictive monetary reform and the strengthening of foreign exchange reserves); and banking reform (privatization and liberalization of the financial sector);*

▶ *Restrictive fiscal policy (the budget deficit of the Republic of Serbia was reduced and is now under control and the reform of the system of public finance);*

▶ *Price liberalization (abolition of administrative price control; only the prices of public monopolies and municipal services are still under control);*

▶ *Trade liberalization (aimed at creating the environment that will converge towards the EU and WTO standards; import and export licences for the greatest number of products were abolished; tariff rates were equalized and reduced; import quotas were also abolished, except for the import of steel; the measures against corruption and smuggling were improved).*

The Government of Serbia is firmly committed to **economic restructuring**, which implies:

- *Privatization, through the sale of firms by tender or their previous restructuring and the sale of smaller socially-owned enterprises by auction;*
- *Enhanced competitiveness, by encouraging direct foreign investment, entrepreneurship and the formation of new small and medium-sized enterprises;*
- *Efficiency, by dismissing redundant workers, cost control, improved management and the imposition of hard budget constraint in enterprises.*

To ensure systematic implementation of macroeconomic stabilization and reconstruction process, i.e. the creation of a stable and open market economy and the subsequent, easier integration of the country into the EU, the reform implies: **modernization of legislation** after the model of developed European countries and the establishment of an efficient institutional framework, coupled with the strengthening of market institutions.

**Strengthening of institutions** and development of legislation, rule of law and fight against corruption are vital prerequisites for the success of reforms. Therefore, it was planned, over a medium term, to modernize old institutions and set up some of the missing institutions, thus enabling social infrastructure to follow the plan of a comprehensive structural reform in public finance and the restructuring of enterprises and banks. Functional and efficient administration, coupled with an intensive restructuring of the economy, will enable the advancement of

democracy, human rights and liberties, protection of property, business stability, corruption control, etc.

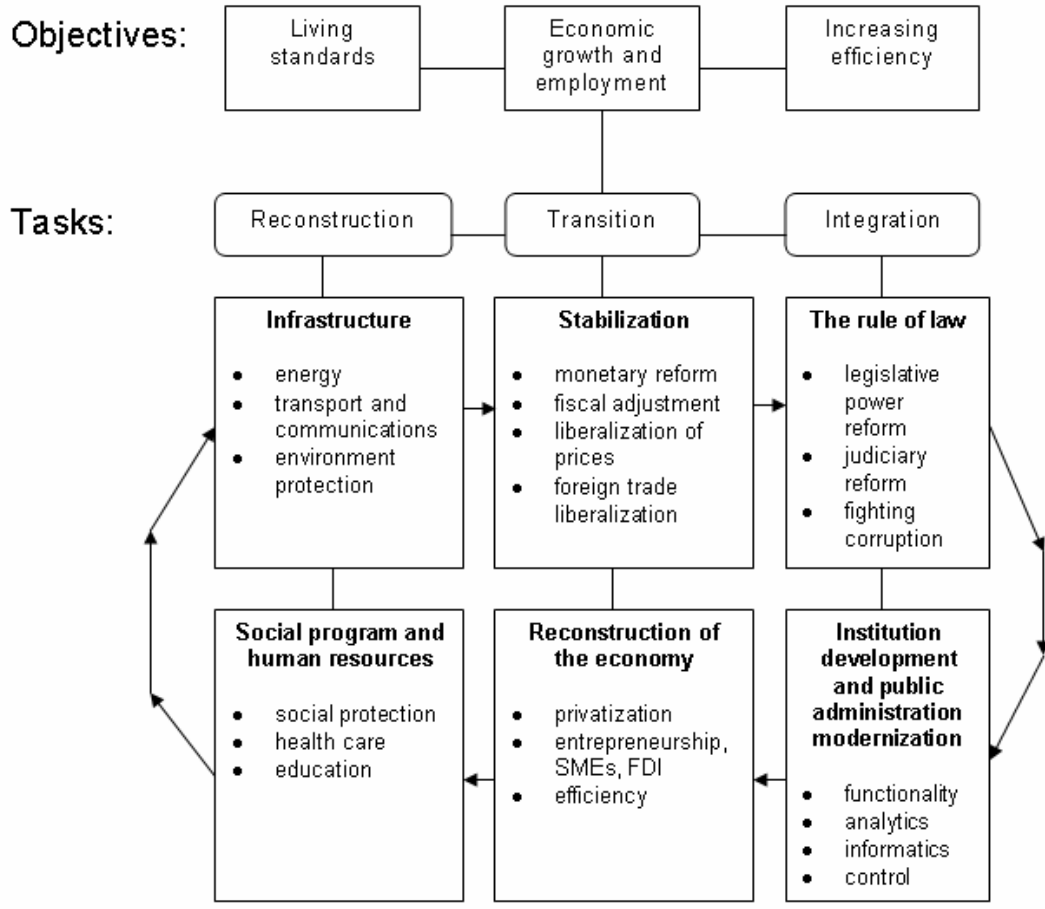
Over a medium term, parallel to radical reforms in the economy, it is necessary to carry out a comprehensive **restructuring of infrastructure**, which anticipates the development of the power supply sector, transport and telecommunications, water supply and sewage disposal systems, in addition to the protection of natural resources and environmental protection.

The factors of **improving the living standards of the population** must be considered from a development viewpoint, through the Government's measures designed to develop the activities improving the living conditions and spurring the development of human resources. They include the active policy of the Government of Serbia, which spurs the development of market relations and business efficiency, new investments and job creation, active employment policy, social program adjusted to the period of economic restructuring, as well as health, educational and social security reforms.

**Foreign financial assistance will be also indispensable in the coming years so as to maintain macroeconomic stability, coupled with liberalization and fiscal adjustment, accelerated economic restructuring, privatization, solving the problem of the unemployed and workers who will lose their jobs in the process of transition, encouraging the formation of new enterprises and new employment, technological adjustment, rehabilitation of infrastructure, as well as the implementation of social programmes with a view to alleviating the consequences of increased poverty. Foreign assistance is necessary in various forms. Apart from financial assistance, technical one is especially necessary for development programmes, programmes of training for new jobs, creation of a market environment, public education on long-term positive effects of transition, development of entrepreneurship, improvement of human rights and the rule of law.**

The Reform Agenda of the Republic of Serbia is presented by the enclosed diagram. Short-term plans and development strategies of specified sectors over a medium term will be presented in the subsequent chapters (the order of presentation in the diagram is shown by an arrow).

## Reform Strategy of Serbia



## 3. STABILIZATION AND LIBERALIZATION

### 3.1. Monetary Reform and Restructuring of the Financial Sector

During the past two years, macroeconomic stabilization was achieved thanks to an adequate macroeconomic policy and policy of structural reforms. A tight monetary and fiscal policy held a central place in this process. Economic stabilization was supported by enterprise and bank restructuring. The rescheduling and write-off of foreign debt ensured the country's more favourable external position.

The economy of the Republic of Serbia has been producing outstanding results since the end of 2000. GDP rose by 5.5% in 2001 and 4% in 2002 in real terms. In 2001, this was achieved primarily by a rise in agricultural output (18%), after the dry year 2000, while in 2002 a rise in the service sector was also pronounced (especially in trade - 15%) and industry (1.7%). During the past two years, exports and imports were increasing at two-digit rates, which was accompanied by an increase in trade deficit.

The inherited national economy was characterized by technological backwardness and disinvestment. Bearing in mind the needs for reconstruction and investment, the projected GDP growth rate for the period 2003-2005 is 5%. Foreign investment, credits and assistance hold the crucial place in these projections, through the provision of balance-of-payments equilibrium and the reconstruction of infrastructure and the economy.

**Monetary stability and restored confidence in the financial sector, which are reflected in the stable exchange rate, increase in foreign exchange reserves and renewal of household savings, have been achieved in two ways:**

- ▶ **by restrictive monetary policy and adequate exchange rate policy, and**
- ▶ **by restructuring the banking sector.**

**Remonetization** is accompanied by a rise in the foreign exchange reserves of the NBY, which had to be increased at the IMF request in order to ensure debt servicing (repayments of principals on IBRD loans will begin in 2003). It can be stated that the previous two-year period was characterized by marked remonetization, based primarily on an increase in net foreign exchange assets and the shift of residents to domestic currency. This tendency is reflected in the threefold increase in the money supply expressed in dollars. In December 2002, the coverage of money supply M1 with foreign exchange reserves amounted to 116.7%. By the end of 2002, total foreign exchange reserves amounted to USD 3.06 billion, whereby the reserves of the Central Bank accounted for USD 2.28 billion. Money issue is carried out only through net foreign exchange transactions, while the permissible government's borrowing from the Central Bank was reduced to 0.5% of GDP in 2002. The nominal exchange rate is stable,

while price increases were slowed down to a significant extent: in 2002, inflation reached the level of 14.8%, of which core inflation accounted for about 7%.

Total savings in commercial banks increased. This was partly a result of the conversion of other currencies into the euro, so that the dinar-denominated savings, expressed in euros amount to less than 10% of total savings. After the expiry of the prescribed period for the conversion of former European currencies into the euro (end-February 2002), foreign exchange savings stagnated (at the level of about € 700 million). At the same time, in the period January-October 2002, dinar-denominated savings were increasing at the average monthly rate of 10.6% (an increase from € 25 to € 62 million). It should be noted that, despite the growth of savings, it is still necessary to increase confidence in the banking sector, which is currently being restructured. In addition, savings do not perform their economic function, since banks have to keep large reserves with the Central Bank, because the system of savings deposit insurance does not exist. Banks increased their supply of consumer credits and began to develop payment card services.

The adoption of the Law on Foreign Exchange Operations created conditions for the liberalization of foreign exchange transactions. It was achieved by introducing managed float (by eliminating multiple rates) and enabling the buy-back of domestic currency abroad. Banks can trade freely in foreign currency so as to maintain their own liquidity. They can also perform foreign exchange operations in their own name and for their own account. To achieve the convertibility of the dinar, current and capital transactions were liberalized in accordance with Article 8 of the IMF Statute (only short-term capital movements were restricted). Numerous restrictions on the inter-bank market were abolished and the documentation required for permissible transactions was significantly reduced.

In order to develop the financial market in Serbia, new legislation provided for trading in the bonds issued in return for old, "frozen" foreign exchange savings, amounting to about € 4.35 billion, whereby the financial market obtained a significant capital base for its development. The Law on Securities (it is in Parliamentary procedure) and the Law on Investment Funds are under preparation.

**The process of bank restructuring** is carried out in several phases:

- ◆ Classification of the credit rating of banks into four categories;
- ◆ Liquidation of insolvent banks (by the end of January 2001, twenty three banks, out of a total of 84, lost their working licenses. At the beginning of 2002, four largest state banks were closed and the process of bank restructuring is continuing; at the same time, the regulations governing the supervision over and control of the credit rating of banks will be adjusted to the international standards);

- ◆ In 2003, it is planned to privatize state capital in 16 banks in which the government has its stake stemming from the conversion of foreign debt into banks' capital;
- ◆ Increasing capital requirements for commercial banks;
- ◆ Measures for encouraging new foreign exchange savings;
- ◆ Privatization of the remaining state banks;
- ◆ In 2002, the transformation of the Bureau for Settlement and Payment Transfers was finished (all conditions for the transfer of payment operations to commercial banks were provided).

At the beginning of reforms, several large European banks began to operate in the Republic of Serbia. In 2001, five large foreign banks obtained working licences and seven others opened their representations. It is expected that, in 2003, further progress will be made in the process of privatization and foreign investment inflow, thus strengthening the financial sector.

**The development plan of the financial sector** in the Republic of Serbia relies on:

- Improved competition of banks, expansion of strong domestic private banks and entry of new foreign banks;
- Privatization of the majority of banks in 2003;
- Agency for credit insurance for the purchase of houses and flats, coupled with the establishment of the guarantee fund;
- Development of the capital market by reviving trade in securities in the privatization process, as well as in old foreign exchange savings bonds;
- Widespread use of payment cards and development of electronic banking;
- Development of deposit insurance.

Efficiency in financial sector development depends, to a great extent, on foreign assistance to supplementary activities relating to the re-training and employment programmes for dismissed employees of the liquidated banks, improvement of legislation and operations of the relevant institutions, as well as on the political and economic situation in the country and its neighbourhood, in general.

### **3.2. Fiscal Adjustment and Price Liberalization**

The critical areas of reforms, both over a short and medium term, are the implementation of a tight fiscal policy and maintenance of public consumption at the anticipated level. In 2002, the deficit of the public sector rose by about 3.7% due to the beginning of debt servicing (including the debt of Kosovo) and increased government's role in the process of structural adjustment and social assistance.

Tax reform was successfully carried out in 2001 and 2002. Tax reforms were conducted in two phases. In the first phase, the tax system was made simpler, more transparent and more equitable. In essence, the reform consisted in the abolition of numerous taxes; easing of tax burden on salaries, shift to indirect taxes and elimination of tax exemptions, thus enlarging the tax base and introducing uniform excise tax rates. The Republic's budgetary revenues rose considerably thanks to the efforts at curbing the grey economy.

The second wave of tax reforms began in September 2002. It anticipates a number of measures, including the provision of incentives for employment and investment, decrease in the rates of corporate income tax and personal income tax (which are the lowest in Europe, 14% and 10% respectively), abolition of taxes on specified products and the promotion of privatization. The adopted systemic laws provide a basis for modern tax administration and adjust the tax procedure with the European standards. In 2003, tax reforms will be continued so as to increase the competitiveness of the economy by enlarging the tax base, which is also a prerequisite for the further decrease in tax rates.

In 2002, the system was adjusted so as to eliminate distortions. It is also necessary to introduce the following institutions and mechanisms:

- ◆ Treasury (set up in 2002), the further implementation of the system is planned for 2003;
- ◆ Value-added tax (VAT), its introduction is set for the beginning of 2004 (due to the need for developing information infrastructure);
- ◆ Synthetic tax, replacing the current personal income tax, by the end of 2003;
- ◆ Reform of corporate income tax;
- ◆ Fiscal policy should support investment in infrastructure, enterprise restructuring and social costs of transition.

**Public consumption in the Republic of Serbia until 2005 should solve the following problems:**

- ◆ **Relative public debt reduction in relation to GDP (including old foreign exchange savings), from 127% in 2001 to 64% in 2005;**
- ◆ **Meeting interest payments on the new and rescheduled guaranteed foreign debt;**
- ◆ **Increasing the share of investments in GDP;**
- ◆ **Social policy within the framework of structural adjustment and activation of the labour market.**

The servicing of the new and rescheduled, guaranteed foreign debt began in 2002. Serbia's budgetary expenditures for interest payments and repayments of old foreign exchange savings account for about 2.5% of GDP. They will increase to 5.2% of GDP in 2005 and to 7.3% in 2009; the budget plan also anticipates the expenditures for restructuring, social security, transfers to the funds (health, pensions, etc.), subsidies, etc.

Therefore, it is estimated that the consolidated public expenditures in Serbia in 2003 will be reduced to 45.8% of GDP of the FRY (from 46.8% in 2002), whereby the consolidated deficit will amount to 3.5% of GDP. The major sources of financing this deficit are provided from direct assistance to the budget out of grants, revenues from privatization and earmarked credits from abroad. In step with this is an increase in the current account deficit, which is expected to amount in 2003 (before donations) to about € 1.9 billion (or about 12% of GDP).

<b>Consolidated revenues, expenditures and deficit of the Republic of Serbia, in % GDP</b>				
	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>Consolidated revenues</b>	<b>43,1</b>	<b>42,3</b>	<b>41,5</b>	<b>40,7</b>
<b>Consolidated expenditures</b>	<b>46,8</b>	<b>45,8</b>	<b>44,8</b>	<b>43,8</b>
<b>Consolidated deficit</b>	<b>3,7</b>	<b>3,5</b>	<b>3,3</b>	<b>3,1</b>

In the coming years, apart from the anticipated flow into the capital account, it is planned – under the three-year arrangement with the IMF - to increase exports of goods and services from 25.4% of GDP in 2001 to 28.5% in 2005, while at the same time reducing imports from 47.5% of GDP in 2001 to 46.4% of GDP in 2005. So, parallel to an increase in GDP, it is planned to decrease the current account deficit to 8.5% of GDP in 2005 and then to continue with this trend. At the same time, the share of consolidated public expenditures in GDP should also be successively reduced. So, in 2005, it should amount to about 43% (the budget deficit would then amount to 3.4% of GDP).

The major challenge to public finance will be posed by the servicing and rescheduling of foreign debt. After the successful negotiations with the Paris Creditors' Club, the country's foreign debt was significantly decreased. However, our country has retained the status of a heavily indebted country, with the 76% share of foreign debt in GDP. The scenario, developed in cooperation with the IMF and assuming write-off and rescheduling under favourable terms, anticipates an increase in debt servicing obligations from 2.5% of GDP at present to 5.2% in 2005 and to 7.3% in 2009. Insofar as exports of goods and services are concerned, the servicing of (guaranteed) foreign debt will range from 11.5% in 2002 (only 6.2% was paid) to 16.7% in 2005. However, as a result of repayment of principal to the Paris Creditors' Club in the period 2006-2010, it will rise to even 25% of exports of goods and services (if the estimated commercial debt is also included).

**Simultaneous liberalization and deregulation, coupled with a restricted increase in pensions and salaries, affects adversely the standard of living of the population, especially vulnerable groups. Therefore, it is necessary to provide additional budgetary resources for regular social transfers to the most needy. This is the source of a considerable part of the financial gap, which prevents the budgetary financing of other needs. The inflow of foreign resources will enable the implementation of reforms and the reconstruction of infrastructure without any delay.**

### **3.3. Trade Liberalization**

The strategic aim of the Government of the Republic of Serbia is the creation of a free trade area in the Balkans, in 2003, thus fulfilling the obligations from the Memorandum of Understanding on Trade Liberalization and Facilitation, concluded by the foreign affairs ministers of the Balkan countries in Brussels, in June 2001. The process of creating a free trade area, to which the FR of Yugoslavia made a noteworthy contribution in 2002, will provide a strong impetus to the conclusion of the Agreement on Association and Stabilization of the FR of Yugoslavia with the EU, as well as to the process of the country's accession to the WTO. Thanks to its successful policy of trade liberalization, the FRY was given grade 4 by the IMF in 2001 (the previous grade was 8), thus being ranked among the countries with moderate restrictions.

In May 2001, the Federal Government brought a number of decisions relating to trade liberalization:

Licences for imports and exports of goods were abolished, except for imports of oil and oil products;

Quantitative import and export restrictions were abolished, except for exports of some agricultural products and raw hide;

The new Customs Tariff was adopted, tariff rates were reduced to 9.5% on the average and the dispersion of rates was reduced from 36 to 6;

All administrative procedures were simplified, while reporting foreign trade transactions and compulsory sale of a part of foreign exchange earnings to the National Bank of Yugoslavia were abolished.

Thanks to the activities of the competent institutions relating to the creation of conditions for trade liberalization in the Balkans, significant results were achieved in 2002:

- Free Trade Agreements with Bosnia and Herzegovina and Hungary were concluded and became effective;
- Free Trade Agreements with Croatia, Slovenia, Romania, Bulgaria and Albania were initialled;

- It is expected that the Free Trade Agreement with Moldova will be initialled by the end of February 2003.

In 2002, the Federal Government abolished the remaining quantitative restrictions on exports of major agricultural products and raw hide, thus carrying out trade liberalization almost in full. Quantitative restrictions were retained only on imports of ferrous metallurgy products.

The Draft Customs Law, adjusted to the EU rules and standards, was prepared and so is the Law on Customs Tariff, which changes the customs nomenclature and harmonizes it with the combined customs nomenclature of the EU. These two legislative projects are undergoing the reviewing and adoption procedure in the Federal Parliament, but it is uncertain when they will be adopted due to the difficulties associated with the constitution of the new state union of Serbia and Montenegro, and the division of competences between the republics and the state union.

According to the level of its trade liberalization, as well as the average level of its tariff rates of 9.5%, which is lower than in the neighbouring countries, the FR Yugoslavia ranks among the Balkan countries which made the greatest progress in the process of trade liberalization.

Trade liberalization exerted influence on the improvement of competition on the domestic market that generated favourable effects, in general. In the past period, however, market liberalization was accompanied by the removal of internal price disparities, which generated adverse effects: operating costs increased, losses in the economy increased as well (especially in some sectors), while trade deficit rose by almost 50%. In 2001, exports were lower by USD 2 billion, while imports amounted to USD 4.8 billion. Trade deficit amounted to nearly USD 3 billion and was higher than the previous year's one by 47.6%. The coverage of imports with exports fell from 46.6% to 39.3%. The share of exports in GDP is low and so is the rate of domestic plant utilization.

In 2002, the negative trends in foreign trade continued. In 2002, exports amounted to about USD 2.2 billion, thus increasing by 18.3% as compared to the same period in 2001. During the same period, imports amounted to USD 5,558 billion, thus increasing by 25%. The deficit exceeds the amount of USD 4 billion, while the coverage of imports with exports declined to 36.70%. In 2002, the FRY exports to and imports from the developed countries rose by 10.4% and 31.8% respectively. The FRY exports to the developed countries accounted for 49.70% of total exports. At the same time, the FRY imports accounted for 51.69% of total imports.

It should be noted that the deficit rose despite asymmetric trade preferences granted by the EU after the political changes in the country in October 2000. The influence of the EU preferences in 2001:

- Total exports rose by 10.5% and exports to the EU market by 24.8%;
- Imports from the EU area rose by 31% and total imports by 30.3%;
- FRY exports to the EU accounted for 43% of total exports.
- FRY imports from the EU accounted for 41% of total imports.

In 2002, the impact of these preferences declined due to the disruption of the integrity of the Yugoslav market. Some problems, which are encountered in practice, also aggravate the use of preferences (because the exporters of some products, e.g. meat, did not obtain accreditation certificates due to a slow adjustment to the EU standards).

**Donors' assistance is necessary for the implementation of the projects contributing to:**

- ◆ **Overcoming non-trade barriers to foreign trade;**
- ◆ **Equipping and improving the operation of the customs administration;**
- ◆ **Prevention of illegal trade channels, i.e. «grey» economy;**
- ◆ **Preparation of a free trade area with the neighbouring countries;**
- ◆ **Monitoring the implementation of the bilateral free trade agreements that have been included.**

As for the future trends in foreign trade, one can expect further trade liberalization and harmonization of the overall foreign trade system with the WTO rules, especially in the service sector. This will expand the market, enhance competition and strengthen economic relations, thus contributing to the stability of the whole region and the inflow of foreign direct investments, which is one of the basic aims of the Government of the Republic of Serbia.

## **4. INSTITUTIONAL REFORMS**

### **4.1. The Rule of Law and the Reform of Government Administration**

Successful transition anticipates the introduction of the **rule of law**, democracy and market institutions.

**The reform of government administration** is one of the vital prerequisites for the development of a market economy, stable democratic system and inclusion in modern European integrations. The Government of the Republic of Serbia set up the Council for Government Administration, as its major consulting and strategic body, whose basic tasks are to monitor and analyze the development of government administration; to propose the measures relating to the development and improvement of government administration to the Government of the Republic of Serbia; to coordinate the work of the ministries and special organizations on the development of government administration,

which comes within the competence of the Government, as well as to consider the proposals relating to the development of government administration which are submitted to the ministries and special organizations and to give its opinion on them to the Government. In order to carry out successfully the reform of public administration, including the decentralization of government, the Ministry of Government Administration and Local Government was set up. It began its activities in May 2002.

**The situation faced by the Government of Serbia upon assuming power was as follows: obsolete practice and equipment, low skill and productivity, coupled with the low salaries of those employed in the government administration. In this regard, the greatest problem is posed by the lack of professionalism and an adequate information system. For the reform of government administration, it is not only necessary to have a successful strategy, but also appropriate donors' technical and financial assistance. The Government demonstrated its firm commitment to carry out the reorganization of government administration, modernization of equipment, skill improvement through personnel training and increased work efficiency, coupled with the introduction of new values into government administration, such as: transparency and responsibility, respect for clients and high-quality services.**

The reforms relating to the legislative, executive and judicial branches of government require substantial resources because, apart from routine daily activities, they anticipate significant measures **over a medium term** in the following areas:

- Organizational (introduction of modern methods of management, work and spending of funds);
- Personnel (training, change in the employee composition, improved skills) and
- Information (improvement of equipment and the quality of data and their use).

The aims of government administration reforms can be successfully achieved only through the coordinated work of all institutions. It is necessary to define the functions and organizational structure of administrative institutions); to implement the new management principles; to simplify procedures; to decentralize tasks; to seek assistance from foreign experts and organizations, as well as to have our institutions participate in regional and international development initiatives.

**Over a short term**, there is an urgent need for setting up the **Centre for Public Administration** which would, apart from consultations and research, organize personnel training through seminars and courses for middle and higher management staff, including specifically the training of the officials who will be in charge of the reconstruction of infrastructure.

The needs for financing the reform of public administration	
PROJECT	OBJECTIVE
Reconstruction of administrative institutions	Improvement of the role and functioning of government administration; adjustment of the structure to new functions; improvement of efficiency, skill, responsibility
Reorganization of the federal state	New competences of the republican administration and related changes, as stipulated by the agreement of 14 March
New business practice	Management performance; ethics and fight against corruption; quality of services
User participation programme	Transparency and openness of public administration, user participation in decision-making; establishment of the institution of ombudsman
Training funds	Technical improvement; managerial ability; professionalism of public servants
Development of the system of human resources management	Choice and selection of personnel; introduction of the new role of public servant; creation of conditions for career development

## 4.2. Development of Market Relations Based on Changes in Legislation

Changes in the legal system in Serbia imply the modernization of legislation by the establishment of an efficient legal framework that will ensure structural changes in the economy and be suitable for the strengthening of market institutions and harmonization with the EU regulations.

**Administrative law reform** is carried out in two waves. The first wave refers to the adopted laws and decrees on public administration, public servants, ministries, local government, tax administration, etc. The second wave includes the adoption of the law on general administrative procedure, administrative lawsuits and other systemic laws. The preparation of laws and other general enactments is accompanied by the observance of the legal standards, values and criteria of European law, as well as by the introduction of new methods of analyzing the impact of adopted regulations, especially in the economic sector (Regulatory Impact Analysis).

Changes in legal regulations that should create the **market system** and an environment that will accelerate economic growth and development, consists in the following:

- Reform of business legislation;
- Removal of obstacles to investment;
- Incentive measures to induce investment.

**The reform of business legislation** began with the adoption of the following systemic laws: the package of laws and related regulations governing privatization, package of tax laws, Public Procurement Law, Enterprise Law, Foreign Investment Law, Labour Law and the Law on the System of Environmental Protection. A certain number of laws was submitted to the National Assembly for adoption, i.e. the: Law on Concessions, Law on Lien on Movable Property Entered in the Register, Law on the Guarantee Fund. The following draft laws were also prepared: Bankruptcy Law, Law on Leasing, Law on Investment Incentives, Law on International Commercial Arbitration, Law on Securities and the Law on Investment Funds, as well as the Anti-Monopoly Law, for the purpose of its harmonization with the EU and WTO principles. The study of the possibilities for legal regulation of leasing was also made; underway is the preparation of the draft law on foreign trade.

The study entitled "Removal of Obstacles to Investing in Serbia" was finished early in 2002. It identified the major obstacles to the entry of investors and to doing business on the domestic market. For each identified obstacle a solution was proposed, in addition to institutions for dealing with such problems and tentative implementation schedule. Nine months after the completion of this study, it can be stated that, in the meantime, certain obstacles were removed. Underway is the removal of the remaining ones. In the coming period it will be necessary to improve the institutions in charge of the implementation of new regulations.

The strategy of determining investment incentives anticipates the defining of the general aim of encouraging investments, adoption of a special law on investment incentives and introduction of additional incentives both for foreign and domestic investors, i.e. equal treatment of all investments (both in new and existing enterprises).

**It is necessary to carry out intensive work on the adoption of new laws and regulations, upgrading of institutions in charge of their implementation, monitoring of the results of their implementation and elaboration of the proposals for the further improvement of legislation, for which donors' financial and technical assistance is necessary.**

### **4.3. Fight against Corruption and Increased Credibility of Government Institutions**

The Government of the Republic of Serbia adopted the fight against corruption as one of its high priorities, coupled with the reduction of poverty and improvement of the living standards of the population. In this regard, it implemented a number of anti-corruption measures. The Law Amending the Criminal Code of the Republic of Serbia introduced the new chapter devoted to corruption as a criminal act. It anticipates more severe penalties for criminal acts with the elements of corruption. Under the Law on the Organization and Competence of Government Bodies in Combatting Organized Crime, provision is made for a more efficient detection and prosecution of the perpetrators of criminal acts, such as giving and taking bribe with the elements of organized crime. On the other hand, by amending the Criminal Code, provision was made for the use of special investigating techniques in detecting and proving such criminal acts. The Law on the Budget System, Privatization Law, Public Procurement Law and the Law on the Prevention of Money Laundering were adopted. A comprehensive reform of tax legislation was carried out and numerous discretionary powers (such as quotas, licences, etc.) were abolished. The Tobacco Law, Law on the Games of Chance, Law on Donations, Law on Associations and Law on the Ombudsman were submitted to the National Assembly for adoption. The following was also prepared: National Anti-Corruption Strategy, Code of Conduct of Civil Servants and the drafts of the Law on Preventing the Conflict of Public and Private Interests, Law on the Anti-Corruption Agency, Law on Free Access to Information, Law on the Financing of Political Organizations and Anti-Monopoly Law.

In December 2001, Serbia joined the Stability Pact Anti-Corruption Initiative (SPAI). In January 2002, the Anti-Corruption Council, as an advisory body of the Government, was set up with a view to launching anti-corruption initiatives and raising the awareness of citizens about the harmful effects of corruption. The Ministry of Finance and Economy set up a special department for the coordination of anti-corruption activities which, among other things, provides logistic support to the Council.

In January 2002, on the initiative of the Prime Minister, anti-corruption teams were set up in 26 towns in Serbia. They are comprised of representatives of the criminal police and prosecutor's office. Within the scope of their activities, 24-hour contact telephones were introduced, so that the citizens can report any criminal act of corruption. After receiving information about criminal acts with the elements of corruption, the task of anti-corruption teams is to analyze the data so obtained and take the prescribed measures and actions so as to gather evidence. In addition, the Government of the Republic of Serbia and the Serbian Judges' Society set up the Judicial Centre for Training and Professional Improvement of Judges.

The budgetary inspection of the Ministry of Finance and Economy performed a comprehensive control over the spending of budgetary funds during the past ten years, which resulted in bringing more than a hundred criminal charges

against responsible persons in the ministries and other institutions. The department of the Ministry of Finance and Economy, which coordinates the fight against corruption, has taken a number of steps with a view to coordinating anti-corruption activities, drafting the relevant regulations, improving transparency in the public sector and raising public awareness of the problem of corruption through education and prevention. In January 2002, the implementation of the project of local anti-corruption networks also began. It is aimed at ensuring better coordination among the institutions being responsible for the prevention and control of corruption at the local level, coupled with the mobilization and channelling of civil society activities. The Department reviews and submits citizens' complaints about corruptive practices to the competent bodies; keeps records of the measures taken; follows the criminal proceedings initiated on the basis of the Budgetary Inspection's reports; updates the data on the presence of members of the Government and persons appointed to the ministries and special organizations in the managing boards of enterprises, institutions and organizations, where such a body exists, and performs other tasks of significance for anti-corruption activities.

**In the fight against corruption it is necessary to provide financial resources, so that institutions can begin to function more efficiently. It is necessary to continue with the institutional reform of all actors in the chain of anti-corruption fight (police, prosecutors, judiciary), especially after the adoption of the regulations enabling the formation of specialist bodies for the struggle against organized crime and corruption, and the use of special investigating techniques in detecting and proving these criminal acts. It is necessary to ensure the coordination of the mentioned institutions, improve the regular and specialist training of prosecutors, policemen and judges relating to the fight against corruption and money laundering. After the change of regulations within substantive and procedural criminal legislation, it is also necessary to analyze and adjust all regulations, especially due to the transfer of all competences in this area from the federal level to the republican one. In that sense, it is necessary to ensure that the application of the Criminal Code relating to corruption should be adjusted, bearing in mind the differences between the newly introduced criminal acts of corruption, specific for certain sectors, and general criminal acts of corruption, as well as to consider the need to incriminate bribe by legal entities. It is also necessary to continue with the introduction of more transparent administrative procedures and simpler legal and institutional environment for business operations.**

It is necessary to provide for sanctions for the violation of accounting regulations and improve accounting and auditing laws and regulations still further so as to reduce the proportions of the grey economy and enable enterprises to keep appropriate records that will be available to inspection and investigating bodies. It is also necessary to continue with the inclusion of private sector representatives in the preparation of the laws and regulations governing the economic sector.

It is important to continue the work on the prevention, raising of public awareness and promotion of changes in behaviour regarding corruption. It is necessary to improve the quality of the reports on the results achieved in the fight against corruption and to continue giving publicity to anti-corruption activities, especially by providing the examples of specific measures that produced good results. It is also necessary to continue cooperation with non-governmental organizations, by organizing and participating in the forums and campaigns aimed at disseminating information about the dangers of corruption, as well as to ensure skill improvement relating to the implementation of the structures acting within the anti-corruption campaign. It is necessary to promote the formation of anti-corruption coalitions between civil society and business associations on the central and local level. It is also necessary to ensure skill improvement of journalists in the field of investigative journalism and encourage professional, investigative journalism regarding corruption. It is also necessary to continue the work on the improvement of the capabilities of the Government and government bodies to inform, educate, consult and involve civil society in the fight against corruption.

After the adoption of the relevant laws (the Law on Preventing the Conflict of Public and Private Interests, Law on the Financing of Political Organizations, Law on the Anti-Corruption Agency, Law on Free Access to Information, Law on the Ombudsman, etc), it will be necessary to provide substantial human and material resources for their implementation, especially with respect to institutions which should be responsible for control over the implementation of these regulations.

## **5. ECONOMIC RESTRUCTURING**

### **5.1. Privatization**

The process of privatization is based on a combined strategy: the sale of large enterprises to strategic partners by tender (in certain cases, restructuring precedes privatization) and sale of small and medium firms by auction, or liquidation. Multiple favourable effects can be expected over a long term, i.e. improved corporate governance, increased efficiency and profitability of output and exports, improved competitiveness and general business climate.

The following results have so far been achieved:

- *Creation of a legal framework in July 2001: the Privatization Law, Law on the Privatization Agency, Law on the Share Fund; as well as a number of decrees on: the sale of capital by auction, amendments to the Decree on the Sale of Capital by Public Auction, by Tender, on Restructuring, etc.;*

- *At the end of 2002, it was undertaken to amend the Privatization Law, Law on the Privatization Agency and the Law on the Share Fund, as well as a number of related decrees;*
- *Institutional changes, which implied the setting up of*
- *Privatization Agency, within which the Provisional Share and Shareholders' Register was established, including the hitherto updated data in about 1000 enterprises; offices were opened in Novi Sad and Kraljevo; underway is the opening of the office in Niš and the opening of an office in Kragujevac is also planned;*
- *Share Fund, to which the minority blocks of shares from previous privatizations will be transferred and which are traded on the Belgrade Stock Exchange;*
- *Educational and promotional campaigns (a broad-based advertising campaign for the promotion of privatization: visits were paid to the regions where the response of enterprises to join the privatization programme was poor. The Agency used marketing mix, which contributed to an increased interest of investors to participate in privatization);*
- *The sale of enterprises by tender and by auction. At the beginning of 2002, three cement factories were privatized:*
- *Beočin Cement Factory, which was bought by the French company Lafarge for € 50.8 million;*
- *The Greek company Titan bought 70% of the socially owned capital of Kosjerić Cement Factory for € 35.5 million;*
- *The new owner of Novi Popovac Cement Factory is the Swiss company Holcim; 70% of socially-owned capital of this enterprise was sold for € 52.5 million.*

In May and June 2002, more than 20 public calls were made for the first five groups of enterprises (engaged in the pharmaceutical, chemical and manufacturing industries, production of car spares and agriculture). At the end of September, the contract on the sale of Merima was concluded with Henkel, which paid € 14.4 million for 70% of socially-owned capital. Early in October 2002, the sales contract was signed with Impol, which thus became the new owner of Sevojno Aluminium Rolling Mill.

In September and October, the Privatization Agency published twenty or so new public calls for construction, agricultural and textile enterprises. In October, another four contracts for the privatization of sugar factories were concluded, i.e. Jugozapadna Bačka, Jedinstvo, Donji Srem and Žabalj. In November the contract on the sale of Zorka-farma was concluded.

At the end of December the contracts on the sale of PKS Lateks and Zdravlje were signed.

The Privatization Agency organized the first auctions early in April 2002. At the beginning, auctions were held once a month, but at the end of the year they

became more frequent. In 2002, 33 public calls were published and 221 enterprises were privatized. In 2002, the total proceeds from the sale by auction amounted to € 65 million. The success of privatization by auction in 2002 was 84%.

To accelerate the process of auction privatization, the Privatization Agency started to recruit financial consultants for the elaboration of enterprise privatization and valuation programmes. So far, financial consultants for 21 groups of enterprises have been engaged. In 2003, it is planned to engage consultants for a minimum of 60 enterprises.

In 2003, the Privatization Agency plans to invite twenty or so tenders. The necessary documents are prepared in cooperation with financial consultants and the enterprises from this group are, among others, Beopetrol, Vranje Tobacco Factory and Niš Tobacco Factory.

The Privatization Agency/Share Fund began to trade in the first blocks of shares of the enterprises privatized under the earlier laws at the end of April 2002. In 2002, 48 blocks of shares were sold on the Belgrade Stock Exchange and total revenue was € 83.8 million. In 2003, the Privatization Agency will be involved in the project of initial public offers and will organize a pilot project that will include 5-8 enterprises.

So far, 50 large systems that should be identified for restructuring before privatization have been identified. Of this number, 32 enterprises are already undergoing the first phase of restructuring or, in other words, an analysis of their condition is being prepared in cooperation with financial consultants. The first auctions of newly established enterprises are planned for the beginning of 2003.

**Over a short term**, the privatization of 55 enterprises by tender is anticipated, while about 1000 enterprises will be privatized by auction. It is expected that in the next two years the restructuring and privatization of all large systems that have been identified for restructuring will be completed.

**Over a medium term** it is expected that, by the end of the privatization process, there will be 3000 privatized enterprises, of which about 200 enterprises will be sold by tender (this number also includes enterprises which were formed by restructuring large systems and public enterprises). The Share Fund will sell most of the shares from its portfolio on the Belgrade Stock Exchange. After five years, the capital registered in the Privatization Register will be distributed.

In 2003, the Central Register will be set up and it is also planned to develop the facilities that should enable the registration of shares/shareholders, balancing/clearing, integration with the Stock Exchange information system, as well as links with broker/dealer organizations.

Necessary assistance in the privatization process during the period up to 2005	
PURPOSE	USER
Development of bankruptcy legislation and related infrastructure	Bankruptcy courts, Association of trustees in bankruptcy, Agency for conducting bankruptcy proceedings against state-owned enterprises
Development of legislation and the new register of enterprises and entrepreneurs	Register – a new independent institution
Development of infrastructure	Linking of the Stock Exchange, Central Register and Securities Commission; network of local centres of the Privatization Agency, regional enterprises and entrepreneurship
Promotion	New advertising campaign. Promotion of IPO and PR campaign in support of privatization by tender and by auction; education of journalists
Consulting services	Financial and legal consultants in restructuring, tender and auction sale, as well as sale by using the technique of initial public offering. Consultants for assessing the impact on the environment. Assistance in monitoring the performance of contractual obligations of buyers

## 5.2. Small and Medium-Sized Enterprises and Changes in Laws and Regulations

In the first year of its reforms already, the Government of the Republic of Serbia, in cooperation with the World Bank, undertook to formulate the strategy for the development of small and medium-sized enterprises (SMEs) and set up the **Agency for Small and Medium-Sized Enterprises** that will play the leading and coordinating role in the system of related institutions. The hitherto activities carried out in support to the development of entrepreneurship and SMEs can be presented as follows:

► *Establishment of a legal framework (adoption of the Law on the Agency for SMEs; preparations for the simplification of legal procedures for the establishment of shops and enterprises, issuing of building permits; initiatives for a more efficient organization of work and inspection services);*

► *Institutional changes (the Agency for SMEs began to operate; in cooperation with the European Agency for Reconstruction, implementation of the projects on non-financial assistance to SME development, i.e. on the establishment of a network of regional agencies and centres; establishment of the Entrepreneurial Council of private entrepreneurs; setting up of an inter-ministerial team that should*

*prepare recommendations for the simplification of conditions and procedures for SME development).*

**Over a short term**, it is planned to adopt the strategy of SME development and entrepreneurship, as well as the national framework for organizing support to SMEs. The initiative for making urgent amendments to the laws and regulations posing the greatest obstacle to the faster development of SMEs was realized (i.e. the Law on Private Entrepreneurs in the Republic of Serbia, and the federal Enterprise Law); the adoption of the Law on the Credit Guarantee Fund is expected, in addition to related regulations; thereafter, the Credit Guarantee Fund will be set up, thus creating conditions for financial support to the projects of small and medium-sized enterprises.

**Over a medium term**, within the next few years, the following activities will be carried out with a view to accelerating the development and operations of SMEs and private enterprises:

- Development and organization of institutional facilities for carrying out a comprehensive regulatory reform at the fastest possible pace;
- Development of a network of regional centres of the Agency for SMEs throughout the territory of the Republic of Serbia (it is planned to open 15 regional agencies/centres; in the current year four regional offices were opened);
- Computerized linkages of all institutions being of significance for SME development, including equal access to relevant information, as well as the permanent media promotion of the idea of entrepreneurship and specific measures of support to SME development.

<b>Necessary assistance in the development of small and medium-sized enterprises</b>	
<b>USER</b>	<b>PURPOSE</b>
<b>Agency for Small and Medium-Sized Enterprises</b>	<b>Consulting</b>
<b>Network of regional centres</b>	<b>Development of facilities</b>
<b>Ministry of Privatization</b>	<b>Promotion of entrepreneurship</b>
<b>Credit Guarantee Fund</b>	<b>Guarantee potential</b>

### **5.3. Promotion of Foreign Direct Investment**

Foreign direct investment (FDI) is indispensable for Serbia's fast economic growth not only because of the scarcity of domestic capital and high unemployment, but also because of the improvement of corporate governance and transfer of new technology.

In the balance-of-payments projections for the period 2002-2005, under a three-year arrangement with the IMF, the inflow of FDI of USD 2 billion is planned. This is a relatively modest amount as compared to GDP (3.4% per annum on the average) and is absolutely low considering the development needs of the Republic of Serbia. Also, considering the low capital-earning capacity of the national economy, the annual share of FDI in total non-government investments would amount to 24.3%. In 2001, the inflow of FDI amounted to USD 165 million, which was much higher than in 2000 (USD 25 million), while in 2002 it amounted to about USD 550 million (including privatization). However, this value of FDI inflow is still extremely low in relation to our developmental needs and its structure is unfavourable. An insignificant part of FDI inflow accounts for export-oriented programmes as the consequence of the period of sanctions against Serbia and political and economic instability. The projected FDI inflow in the coming years (USD 400-600 million a year) should not only be increased in accordance with the development needs, but should also be efficiently invested in order to promote exports. Therefore, the priority of our development policy is to create an attractive environment for foreign and joint investments, especially for export-oriented ones, in addition to improving the approach and enabling successful integration through the consolidation of regional markets.

The Government of Serbia achieved a satisfactory macroeconomic stability, convertibility of national currency, as well as a favourable privatization strategy, but it is also necessary to reduce inflation and interest rates still further, and to lessen political risks for investment. The current laws and regulations are sufficiently liberal for foreign investors, although some administrative obstacles must be removed through legal and institutional changes (i.e. it is necessary to simplify the procedures for issuing building permits and enterprise registration). The task of the newly formed **Foreign Investment Agency** is to promote the advantages offered by our country for the purchase of socially-owned enterprises and for new investments.

**In conceiving and implementing the policy of encouraging foreign direct investment, donors' assistance is necessary in the form of financial and technical assistance to the institution responsible for FDI promotion. Assistance to credit institutions for covering the risks and costs of investing in Serbia would have direct effects, while donors' assistance to other sectors of the economy and society would have indirect effects. Additional assistance should also be channelled into the projects within the scope of the Turn-Around Management in Business Advisory Services.**

**Donors' assistance to the on-going reforms would exert influence on the greater inflow of FDI than the projected one, with the expected positive results: development of civil society, coupled with stable democratic government, international co-existence and cooperation, rule of law, protection of private property and safety of citizens.**

## 5.4. Unemployment and Labour Market Reform

The coming years will be critical for the Government of Serbia, because the population is faced with the problems arising from inequality in the distribution of gains and losses caused by transition, i.e. a rise in unemployment and discontent about the loss of income and job, which is inevitable in the process of economic restructuring.

During the years of enterprise privatization and restructuring, the distribution of gains and losses is asymmetric in time. Whereas the losses are instantaneous (the loss of job and fall in real income due to the closing of enterprises), the gains, as the result of such measures, are distributed over time. Economic growth, job creation, re-training and adjustment to new motives require a specified period of time. Therefore, despite predicting the further growth of GDP in real terms, the balance between winners and losers, both in numerical and value terms, is at the losers' expense almost throughout the transition period.

For many of them the loss of job will be the third big fall in their income in the decade. The first occurred when the SFRY collapsed and UN sanctions were imposed, and the second was caused by NATO bombing. Therefore, it can be expected that many people, probably the majority, will resist reforms. The experience of other countries in transition shows that short-term costs are not evenly distributed on the population, so that the poorest population groups are frequently most adversely affected. For example, price liberalization affects to a greater extent those people whose share of food in expenses is high, while in the process of enterprise restructuring the first to lose jobs are workers with lower qualifications, etc.

**The unemployment rate in the FRY is about 28.5% (more than 900 thousand unemployed persons). This rate already is too high, but all estimates show that the number of fictitiously employed (i.e. the workers having their work posts, but actually having no work) ranges from 500 to 600 thousand which, altogether, constitutes about 45% of the total labour force.**

The feeling of uncertainty among the employed socially-owned enterprises which are to be closed is as great a problem as low salaries, if not greater. The recent public surveys have shown that a high proportion of the population considers the economic problems to be the most significant, i.e. unemployment and low real incomes.

The solving of the unemployment problem in Serbia is one of the priorities of the reform agenda. **The on-going labour market reform** includes the following activities:

- Reform and strengthening of the system for an analysis of the actual situation on the labour market (labour supply and demand);
- Reform of the systems determining the needs on the labour market by skill, age, gender and working abilities (youth, women, disabled);
- Reform of the system for the analysis of labour supply and demand on the labour market so as to enable the orientation of future personnel;
- Establishment and development of institutions: tripartite Socio-Economic Councils at the national and regional levels, consisting of representatives of the government, trade unions and employers, for carrying on a social dialogue;
- Functional strengthening of the Ministry of Labour and Employment and reorganization of employment offices;
- Legal reform relating to labour and employment (the new Labour Law was adopted in 2001), with the solutions harmonized with the EU and ILO standards; adoption of the Law on Occupational Safety and Health, Law on Peaceful Settlement of Collective and Individual Disputes, Trade Union Law, as well as the Strike Law that will be adopted in 2003;
- Reform of the system of unemployment benefits, implying a reduction in their amount and the shortening of the period during which such benefits are received;
- Active employment programmes aimed at providing assistance in finding a job;
- Programmes for redundancies in the process of restructuring and privatization;
- Support to the employment of people with impaired abilities.

The priorities of **employment policy** in the coming years are as follows:

- Adoption of the national employment, which should be in harmony with the EU employment strategy and should rest on four pillars (employability, promotion of entrepreneurship, adaptability and equal employment opportunities/elimination of discrimination);
- Support to the implementation of the new Employment Law which will be submitted to the National Assembly for adoption at the beginning of 2003; the Law promotes active employment measures and new approaches to problem groups for employment;
- Adoption of the Law on the Employment of Disabled Persons;
- Assistance in self-employment through:
- Measures for encouraging new employment;
- Employment of hardly employable groups of the unemployed (i.e. persons looking for a job the first time, those waiting for a job for a longer period or are older than 50);

- Employment of members of ethnic minorities;
- Employment and occupational rehabilitation of disabled persons;
- Professional mobility;
- Recruitment for public works;
- Setting up small funds for the promotion of self-employment at the local level;
- Social dialogue in the process of reforms;
- Development and implementation of active programmes of employment policy and special programmes for redundancies in privatized enterprises;
- Development of the facilities of the Ministry of Labour and Employment and a network of local centres of the National Employment Services;
- Regular payments of unemployment benefits in employment offices;
- Greater control by the labour inspectorate and the implementation of the appropriate measures.

**Over a medium term**, the employment policy should influence a rise in the mobility of labour and flexibility of the labour market, encourage job creation, self-employment and active job seeking, as well as the development of measures and services for the improvement of human resources: vocational training, re-training so as to reduce a disproportion in the occupational structure between supply and demand on the labour market so as to adjust it to the needs of new technologies on the market, while at the same time promoting entrepreneurship through incubator centres and other local programmes, supporting professional rehabilitation of persons with special needs, etc.

## **6. SOCIAL PROGRAMMES AND THE IMPROVEMENT OF HUMAN RESOURCES**

### **6.1. The Incidence of Poverty and Social Security**

Insofar as social security is concerned, it should be noted that, in 2001 and 2002, the Government of Serbia settled the outstanding debts arising from various social transfers, whose payment was delayed between 26 and 32 months; the condition and quality of working conditions in the majority of social security institutions were improved. The Government also initiated a better labour market policy, including training, re-training, etc.

Despite the progress made so far, ten years of lagging cannot be made up for within such a short period. Poverty in Serbia is still widespread and, like in most countries in transition, it has become mostly a rural phenomenon.

**According to the Survey of the Standard of Living, which was conducted in 2002 and covered 6386 households in the Republic of Serbia, 10.6% of the population lives below the poverty line, with the monthly income of 4489 dinars per member of the household. The poverty line is defined as the sum of the minimum consumer basket and other basic expenses per unit of equal consumption. The concentration of the poor around the poverty line is very high, since a small upward movement of the poverty line increases the share of poor people to a significant extent. This means that should the poverty line be increased by about 20%, the share of the poor would increase to 20%. It should be noted that these data on poverty do not include refugees and internally displaced persons whose number in the Republic of Serbia is about 700,000.**

The rural population is dominant among the poor. The hardest hit are the persons aged over 65, children aged 7-14 and unemployed persons. Most of such households have five or more members.

For the improvement of the standard of living, so that the consumption of all people is above the poverty line, it is necessary to provide 8.9 billion dinars. This means that the **poverty gap** amounts to about 1% of GDP which is estimated for 2002, assuming the perfect targetting of assistance to the poor. The more realistic amount needed for the eradication of poverty is 11.6-12.5 billion dinars provided that the targetting of social assistance is 70% and 60%.

The strategy of social security reform covers three important areas: reduction of poverty, assistance to families and care for children, elderly and disabled persons, in addition to the reform of the system of old-age pension and disability insurance. In order to evaluate the current status and define the process of reforms and necessary changes in social policy, the mechanisms for dealing with poverty, social assistance to the affected groups of population and old-age pension and disability insurance, have been established.

The strategy of social security reform also includes the transformation of the social security system. **Short-term reforms** include raising the quality of the life of beneficiaries in social security institutions and gradual transformation of existing institutions; introduction of the plurality of services and the establishment of a legal framework for the new system and standards of professional work, as well as raising the level of social welfare centres. **Medium-term reforms** include the provision of stable financing through fiscal stability, as well as through a more precise targetting of beneficiaries, improvement of the quality, efficiency and accessibility of services, establishment of the market of social services, adoption of comprehensive legislation, which will be harmonized with EU legislation.

At the same time, the reforms of the system of **old-age pension and disability insurance** will be continued. The last year's changes were just the first steps, i.e. the pensionable age was extended by 3 years (58 for women and 63 for men),

pension indexation was changed (a combination of the cost of living and salaries), the contribution rate was decreased, while the tax and contribution base was enlarged. For the first time after ten years, pensions are paid on a regular basis, delay in the payment of farmers' pensions was reduced (by 12 months) and the payment of the old debt to pensioners began. The fight against corruption in the system also began.

**The anticipated changes at the beginning of 2003 will additionally contribute to the financial stabilization of the system of old-age pension and disability insurance, by establishing a stronger relationship between the paid-in contributions and the amount of pension. The anticipated changes in legislation include a change in the method of calculating pensions, change in the procedures and tightening of the criteria in old-age pension and disability insurance with a view to paving the way for further reforms, especially those creating creating conditions for the introduction of voluntary insurance.**

## **6.2. Short-Term Effects of Restructuring and Strategies of the Government of Serbia**

Economic restructuring and privatization in Serbia are carried out under conditions of widespread poverty, high unemployment and high redundancies, showing the tendency of the further losses of employment and income for many people.

According to the data of the Government of Serbia, there are about 60 thousand workers who lost their jobs in the process of restructuring socially-owned enterprises in 2002, thus increasing the unemployment rate by about 8%. This also means that about 200 thousand people, or almost 3% of the population in Serbia, can be directly affected by this measure. Even if some of them had a second job in the informal sector, the income of their families in 2002 was reduced and became more uncertain. Launching the programme for decreasing grey economy and encouraging formal employment entails additional costs.

The Government of the Republic of Serbia estimates that the number of employed who will lose their jobs in 2003 amounts to over 100 thousand, so that the number of unemployed, due to enterprise restructuring and preparations for privatization, will increase by 11%. Therefore, the aim of the Government of Serbia is to minimize short-term adverse effects of transition by anticipating a dual approach to the solving of the unemployment problem, i.e.:

- Proactive measures,
- Defensive activities.

An active approach includes such measures as re-training, severance pay, facilities for the formation of small and medium-sized private enterprises, removal of legal obstacles to their formation and development and, naturally, the improvement of conditions for encouraging domestic investment and attracting foreign direct investment. Proactive measures are very important because, without them, severance pay to workers will lose their sense (as shown by the experience of several other countries in transition). The Government of Serbia is aware of the need to spur the development of new private enterprises, thus providing a basis for renewed growth in transition.

Some of active employment measures entail high costs: the re-training of workers is very expensive, while severance pay implies the one-time payment of relatively high amounts of money (as shown by the experience with the Zastava workers). Therefore, donors' assistance, in combination with intensive measures for the improvement of operating conditions, is of great significance for the implementation of active employment measures.

The other part of the Government's approach is "defensive" in character. It consists of planning the security system that would retain the motivation for employment and prevent the most severe forms of poverty, on one side, and retaining the compatibility with the country's low income, on the other. This system must not result in the creation of a climate in which employment is avoided and unemployment benefits are regarded as a better option.

**In the reform agenda of the Government of Serbia, the eradication of poverty is one of the priorities in the current year, as well as in the subsequent years, but not in the form of transfers of large amounts of money from one group of citizens to the other. The eradication of poverty is based on an active policy of ensuring economic growth and sustainable development, together with the measures of encouraging employment and improving economic conditions and market-oriented operations. The Government of Serbia committed itself to work out the Anti-Poverty Strategy until the middle of 2003.**

On the other side, social security is necessary not only to eliminate the most severe forms of poverty (which can be defended from an ethical viewpoint). Namely, it also has an economic function. Without the programme of social security, human capital degrades very fast. For example, during the years of extreme poverty, as shown by the experiences of some countries in transition, the rate of children's enrolment in school is declining. Poverty also aggravates the state of health of the population to a significant extent, not to mention the increasing tendency towards criminal activities. This also aggravates the conditions for a rise in domestic and foreign investments. The more these phenomena are present, the greater are the obstacles to the country's successful transition and integration into the global economy.

The protection of a minimum standard of living during the difficult period of economic restructuring helps that the family preserves its human capital and makes better use of economic opportunities in the future. Thus, the social strategy of the Government is planned to be a social safety net in the current

period and, in combination with the activities aimed at strengthening the market and economic growth, provides good prospects for a fast recovery in the future.

### 6.3. Improvement of Health Care

**After more than one decade of being neglected, the health system found itself in a serious crisis. The revenues of the Republican Office for Health Insurance are still decreasing, since they stem mostly from contributions assessed on salaries, which are slowly increasing or are stagnant, while the number of employed is decreasing. In the 1990s, the share of the resources earmarked for health care in gross national income was about 10%, while in 2000 it fell to 7%. Accordingly, the deficit in the fund of the Republican Office for Health Insurance in 2002 accounted for 2% of gross national income.**

**The salaries of health workers are low, while medical equipment and building facilities are in a very bad condition.**

**It is necessary to carry out a comprehensive health reform, whose basic aims should be as follows:**

- **Better organization and more efficient use of existing infrastructure and**
- **Introduction of the new forms of organization and method of financing health care.**

The management and financing of health care is based on the existing facilities and not on the operating results. A bad pricing policy resulted in the low quality of health services, while the use of health service at different levels of health care is not adjusted to the criteria of efficiency and cost reduction.

According to the documents relating to the health policy and vision of the future health system by the Ministry of Health of the Republic of Serbia, the basic tasks over a **short term** are aimed at improving as follows:

- Efficiency in the utilization of health facilities (e.g. reduced average lengths of hospitalization, rationalization of the network of health institutions);
- Planning, contracting and financing of health service;
- Method of monitoring financial flows, which should enable accurate cost estimates and rationalization of the structure of health costs, and which is a vital prerequisite for the introduction of the national health account;
- Information system that will provide information on the performance of the health service and financial costs;
- Efficient allocation of available financial resources;
- Relationship and communications between those who pay for health services and those who use them (80% of the revenues of the health insurance fund stems from contributions assessed on the salaries of the employed who constitute less than 30% of the population).

- Health reform must fulfil three basic tasks:
- Increasing the fiscal stability of health insurance funds, coupled with the protection of the poorest groups;
- Reforming the health system, thus improving the quality, efficiency and accessibility of health care, which includes the provision of financial and technical assistance for the reconstruction of the hospital system, system of primary health care and improvement of human resources, as well as donors' capital investments in specified sectors (emergency medicine, child health care, anti-cancer health care);
- Development of the facilities for the management and efficient implementation of health policy, including personnel training programmes in the field of management, and the introduction of new management and communications strategies into health care.

**Donors' assistance is necessary over a short term for the reform of primary health care, restructuring of the health system, development of the health information system/information network and improvement of health management.**

## 6.4. Educational Reforms

Education is one of the priorities of the reforms of the Republic of Serbia due to its greater importance for economic recovery, democratic transformation of the society and integration into Europe. This sector covers pre-school, elementary school, secondary school and higher education and directly includes 20% of the population. In the past period, education suffered great damage, whose consequences should be carefully eliminated through a comprehensive reform. The reasons why additional financing is indispensable for the improvement of education lies in the following:

- Real expenditures for education were declining parallel to real GDP, expenditures for secondary school education declined even by 57% in the period 1990-1999. This generated adverse effects on the working conditions and quality of education of children, size of the class, equipment in educational institutions (schools), salaries and motivation of teaching staff at all educational levels.

**More than 50% of schools has no adequate water supply, more than 25% has no adequate sewerage, 56% has no telephone line, while nearly 25% has the heating problem.**

**In the institutions of higher learning there is a great shortage of laboratory equipment, libraries and computers.**

- International sanctions generated more adverse effects on the educational system than on other sectors, because communications with the rest of the world are indispensable for progress in education, especially at the time of fast development of information technology. The equipping of schools and faculties with teaching aids and modern technology, coupled with systematic work on skill improvement of teaching staff by applying modern teaching and learning methods, as well as regular contacts with the experiences of developed countries in the sphere of education are indispensable both for the quality of teaching and for restoring enthusiasm, professionalization and reputation to this profession.
- The high centralization of education during the 1990s, in terms of financing and curricula, poses an obstacle to the advancement of education, its autonomy and adjustment to local needs. Therefore, the Ministry of Education and Sport initiated the programmes of its new organization and development at local and regional levels through decentralization and democratization of the educational system.
- A general decline in the living standards decreased the significance of education and made the acquisition of higher qualifications unattractive. Thus, parallel to a decline on the demand side (students' interest), the supply side, i.e. the quality of education, was also declining due to inadequate curricula, staff de-professionalization and the lack of institutional support. The educational reform initiated by the Ministry of Education and Sport requires important changes in legislation, the development of institutions, improvement of skills and facilities for high quality provision and valuation of education, as well as the dissemination of information about reform through the media, brochures on the development of facilities and handbooks.

**The modernization of equipment, curricula, textbooks, system for skill improvement of teaching staff, and evaluation of the results of education, as well as the formation of new institutions are of utmost significance to educational reform. In that sense, contacts and cooperation with the appropriate institutions outside the country and additional financial resources are crucial.**

**Also, the motivation of teachers to improve the quality of teaching and work on their own professional improvement is affected by their low salaries and the poor equipment level of schools and faculties, which poses the greatest threat to the success of educational reform.**

The Government of Serbia has taken measures so as to implement the educational reform and modernize and decentralize the educational system in terms of financing and programmes. Under preparation is a new package of laws on higher education, pre-school education, and elementary and secondary school education, while the new University Law has already been adopted. The aim of this reform is to ensure the quality of curricula, textbooks, grading and evaluation system, as well as the training and education of teaching staff. However, the most urgent need in the educational sector is still the financial one.

<b>Major tasks of education – projects not covered by donations</b>	
<b>PROJECT</b>	<b>OBJECTIVE</b>
<b>Rehabilitation of school buildings and equipment in elementary school, secondary school and higher education</b>	<b>Provision of conditions for education, modernization of equipment</b>
<b>Continuation of the reform of elementary school, secondary school and higher education</b>	<b>Quality of the curricula and changes in legislation in accordance with the EU</b>
<b>Decentralization and democratization</b>	<b>New competences of directors and teachers; new subjects, new method of educational management and the organization of education at the local and regional levels</b>
<b>Grading and evaluation</b>	<b>New grading methods, encouraging and developing the culture of self-evaluation</b>
<b>Teachers' training and professional development</b>	<b>Professionalization of the teaching profession (interactive methods, informatics, foreign languages), centers for teachers' skill improvement</b>
<b>Pre-school and adult education</b>	<b>Reform of pre-school education and increased coverage of children, reform of adult education</b>
<b>Minorities and children with special needs</b>	<b>Elimination of the marginalization of pupils with special needs, and national programmes</b>

## **7. RECONSTRUCTION OF INFRASTRUCTURE AND ENVIRONMENTAL PROTECTION**

### **7.1. Energy Supply Sector**

Political changes at the end of 2000 found the energy supply sector on the brink of collapse, totally unregulated oil sector from a fiscal and market viewpoint and almost exhausted mining industry. After two years of intensive work on the rehabilitation of the system and radical and socially burdensome rise in the prices of energy products, especially electric power, the supply of energy products was stabilized. If the international community continues to support the hitherto investments at the same pace, the return to the equipment level of the early 1990s can be expected in 3-4 years. In the meantime, the Government's efforts are being increasingly directed to institutional and regulatory reform so as to establish a framework that will ensure the sustainability and efficiency of operations both in the energy supply and mining sectors. This framework should arouse interest in the participation of private

investors and much higher energy efficiency of households and the economy, coupled with a relative decrease in power consumption and greater respect for the environmental impact of energy supply system development.

During the past ten-year period, the electric power sector served as the source of capital out of which, through the low prices of electric power, social tranquility was paid. Due to many years of non-investment, the system found itself on the brink of collapse at the end of 2002. During the winter season 2000/2001, the international community provided about USD 100 million for: imports of electric power, energy products for municipal heating stations, as well as for the acquisition of spare parts for coal mines, thus easing pressure on the energy supply system. Today, power supply has been normalized to a significant extent, the level of consumption has been stabilized, imports have been reduced by almost half a billion KWh, while the pattern of consumption, after the threefold price increase, has been returning to a more normal level. Considering the relatively low costs of domestic output, **the aim of the medium-term development** of the system is to completely eliminate imports by 2006.

For the more lasting rehabilitation of the energy supply system, it is necessary to cut the consumption for heating by providing alternative energy products; to carry out the plan of thermal and gas power supply of urban settlements; to reduce losses in the distribution network; to increase output still further, as well as to erect new facilities. It is of utmost importance to reconnect the energy supply system of the Republic of Serbia to the West European network UCTE, which will require investments in the adjustment of the system for operation under the strict rules of this interconnection. For a more reliable supply of end consumers, it is necessary to reinforce the distribution network that has not been planned for such high consumption. Underway is the establishment of a regulatory framework for encouraging private initiative and foreign capital. Underway is also the preparation of the Energy Strategy of the country, which will provide investors with a clear vision. The draft Law on Energy Supply has been completed. It will enable the market game of both the private and state sectors under equal conditions. After the adoption of the Law, it will be necessary to elaborate sub-legal enactments, as well as to set up the Regulatory Agency. The project of its organization has already been finished, but the recruitment of professional personnel, as well as its preparation for work will pose a serious short-term challenge. The elaboration of the Mining Law is in its final phase.

The liberalization of the oil product market is of equal importance, but it can be achieved only over a medium term after the strengthening of the administrative-management function of the government so as not to endanger the fiscal inflow from this market. In the meantime, underway is the liberalization of the Decree on the Import of Crude Oil, which will create as competitive relations on the internal oil product market as possible.

In the field of energy supply, the further rise in the price will be ensured. It will be gradual, bearing in mind the limits of social and economic acceptability, in addition to the simultaneous improvement of system efficiency. It is necessary

to continue the work on the programmes of social assistance to the part of the population that cannot pay the economic price. The Agency for Energy Efficiency has been set up and the basic funds for its two-year operation have been provided, but the programmes relating to the promotion of energy efficiency will require a more comprehensive and longer-term support so as to achieve a radical change in the structure of power consumption. The activities relating to industrial and municipal power supply, alternative (renewable) sources of energy and the combined generation of electric power and heat (co-generation) have been intensified. The work on the problems of environmental protection has also been intensified.

In 2003, the restructuring of the Electric Power Industry of Serbia (EPS) and Oil Industry of Serbia (NIS) will begin: the Ministry of Mining and Energy needs financial assistance for institutional and staff improvement.

**Short-term** priority activities in the energy supply sectors of the Republic of Serbia include:

- ▶ Further rehabilitation of the sector and the beginning of its reconstruction;
- ▶ Establishment of a framework for energy supply strategy;
- ▶ Adoption of the Law on Energy Supply and related regulations in accordance with the requirements of the European Declaration;
- ▶ Adoption of the Mining Law; setting up of the Regulatory Agency and other institutions stipulated by law;
- ▶ Restructuring of public enterprises EPS and NIS;
- ▶ Preparations for participation on the liberalized market;
- ▶ Improvement of economic and technical efficiency in the whole sector;
- ▶ Improvement of managerial abilities of management staff;
- ▶ Privatization of certain enterprises.

Under the programme of the energy supply sector, **medium-term activities** should provide for the inclusion in the energy supply market of South Eastern Europe, privatization of the oil and gas industries, completion of the reconstruction of existing energy supply and distribution facilities and the construction of new ones.

<b>Short-term priorities and assistance required by the sector of mining and energy supply</b>		
<b>SECTOR</b>	<b>USER</b>	<b>PURPOSE</b>
<b>Rehabilitation and reconstruction</b>		
<b>Coal mining and processing</b>	<b>Mines: Kolubara – Tamnava, Polja D, Kostolac – Drmno</b>	<b>Increasing overburden; increasing output and the reliability of coal supply supply</b>
<b>Electric power generation, transmission and distribution</b>	<b>Power stations, transmission network and distribution</b>	<b>Improvement of operation readiness and reliability; rehabilitation of transmission and distribution networks</b>
<b>Industrial power stations, heating stations and co-generating facilities</b>	<b>Self-government industry</b>	<b>Use of new technologies; increase in energy efficiency; promotion of profitable and market-oriented operations; adjustment to international standards, decreasing environmental pollution</b>
<b>Institutional development</b>		
<b>Energy Supply Law</b>	<b>Ministry of Mining and Energy</b>	<b>Preparation of sub-legal enactments; personnel development</b>
<b>Regulatory Agency</b>	<b>Ministry of Mining and Energy</b>	<b>Preparation of sub-legal enactments; personnel development</b>
<b>Restructuring of public enterprises</b>	<b>Ministry of Mining and Energy; EPS; NIS</b>	<b>Assistance of export teams in restructuring; technical assistance, programmes of alternative employment in EPS; preparation of enterprises within NIS for privatization</b>

## **7.2. Transport and Telecommunications**

The transport network of Serbia suffered has great damage, so that there are great needs for foreign assistance in the reconstruction of transport infrastructure. The road network is especially ruined due to disinvestment over 15 years, not to mention the bombing when many bridges were destroyed. Only about 30% of roads is in a satisfactory condition. The rehabilitation of infrastructure requires not only investment in its reconstruction but also:

- Maintaining the basic level of safety and quality of transport services;
- Harmonization of regulations;
- Environmental protection;
- Improvement of management.

In 2001 and 2002, there was some progress: several contracts on the reconstruction of transport infrastructure were concluded, several arrangements with the EIB and EBRD were concluded for financing the

reconstruction of the railway and road networks, laying special emphasis on Corridor X, the Law Amending the Law on Road Transport was adopted; the Law on Telecommunications and the Law on Railways are in parliamentary procedure. Underway is the preparation of the following draft laws: the Law on Roads, Law on Passenger Transport by Road, Law on Cargo Transport by Road and the Law on Postal Services. In addition, USD 70 million were invested in the reconstruction and maintenance of the road network. In 2002, the project of cleaning the river Danube commenced and, within it, the reconstruction of the Bridge of Freedom, which is supported by the European Union, commenced as well. The Law on Roads has been prepared and underway is the elaboration of the new Law on the Transport of Hazardous Materials, as well as the elaboration of the new Law on Road Transport Safety in cooperation with the Ministry of Internal Affairs.

**Over a short term**, in 2003, the highest priorities are:

- Rehabilitation of railway and road infrastructure;
- Further emergency measures aimed at recovering the navigability of the rivers Sava and Danube and lifting the sunken bridges around Novi Sad and Belgrade;
- Increased safety of road transport;
- Adoption and implementation of the Telecommunications Law and the Law on Postal Services;
- Modern management and the introduction of international regulations and standards. The sector for the adjustment of the policy and regulations to those of the EU requires an organized training system for those who will work on harmonization with the EU regulations and laws.

**Over a medium term**, the priorities are investments in the international corridors VII and X. Investment projects also anticipate the construction of the new road network, particularly the road connection from the Yugoslav-Hungarian border with the state borders with Bulgaria and Macedonia (about 300 km), reconstruction of the Belgrade-Bar road (Ibar highway: 570 km), extension of the roads to Croatia and Romania (140 km). For the implementation of these projects it is necessary to provide financial and technical assistance. The priorities over a medium term also include the activities on the renewal of the motor pool in the Republic of Serbia, whereby special emphasis is laid on the feet of buses and possibilities for the involvement of domestic manufacturers.

**Basic tasks in the reconstruction of transport infrastructure by sector**

<b>TRANSPORT</b>	<b>SHORT TERM</b>	<b>MEDIUM TERM</b>	<b>PRIORITIES IN 2003</b>
<b>Rail</b>	Rehabilitation, reform of management and rates	Investment in transport means and related rail infrastructure	Corridor X and Belgrade-Bar railway
<b>Road</b>	Emergency repairs, higher level of safety	New road networks	Reconstruction of bridges, Ibar highway
<b>River</b>	Removal of sunken structures from the navigable route of the river Danube, under Djerdap 2 Hydroelectric Power Plant; rehabilitation and improvement of the navigability of the Danube-Tisa-Danube Canal; improvement of the navigability of the river Tisa; rehabilitation and improvement of the navigable route of the river Sava; marking of the bridges on the rivers Danube, Tisa and Sava;	Purchase of plant for waste collection from ships; bringing Corridor VII to the classification level in accordance with the requirements of the Danube Commission; maintaining the navigability of the Danube, Sava and Tisa	Navigability of the Danube
<b>Air</b>	Reconstruction of Belgrade and Niš Airports	Investment and modernization	Reconstruction of Belgrade Airport
<b>Telecom.</b>	Reconstruction and modernization of infrastructure	Development of fixed telephony; EU standards	
<b>Postal</b>	Increase in efficiency	Profitability and independence	
<b>Adjustment of the policy and regulations to the EU</b>	Organized training system for the employees responsible for harmonization with the EU regulations and laws		

### 7.3. Environmental Protection

During the 1990s, Serbia went through the period of enormous aggravation of its ecological conditions. The indicators of environmental pollution and degradation are evident. This became especially so after the bombing in 1999, with the increasing risk of further negative consequences. Therefore, an active environmental protection policy has become an integral part of the country's reforms and support to its economic development. As part of its ecological reform strategy, the Government of Serbia formed the new Ministry for the Protection of Natural Resources and Environmental Protection in May 2002.

A vital prerequisite for Serbia's sustainable economic development is the careful use of natural resources, renewable sources of energy, technologies and production processes which do not affect the environment. The Government's firm commitment to an active environmental protection and the prevention of lasting environmental pollution as its priority are becoming an integral part of the policy of all business activities. So far, Yugoslavia has ratified more than 50 international agreements on environmental protection, but the shortage of funds and poor organizations have restricted their implementation. The new reform strategy emphasizes the following **short-term priorities**:

- Removal and remediation of ecological hotbeds and prevention of the destruction of natural resources;
- Development and strengthening of the institutions and services concerned with environmental protection (Ministry for the Protection of Natural Resources and Environmental Protection, Agency for the System of Environmental Protection);
- Establishment of a regulatory framework for the system of environmental protection, harmonization with international regulations.

Serbia's reform agenda includes the implementation of the programme of solving the problem of inherited cases of pollution, programme of ecological support to poverty control measures, through the programmes of sustainable consumption, provision of ecological conditions for specific infrastructural projects, as well as the full implementation of international conventions and standards in the relevant sectors. **Over a medium term**, the following will be undertaken:

- ◆ Further development and strengthening of the institutions and services dealing with the system of environmental protection, improvement of inspection service, including education and the provision of technical facilities;
- ◆ Modernization of water supply infrastructure and sewage disposal systems;
- ◆ Monitoring and control of the quality of water, air and other environmental factors;

- ◆ Development of an integrated information system relating to environmental protection and sustainable use of resources;
- ◆ Development of a strategy for sustainable use of natural resources and the national action plan for environmental protection, with the following priorities: waste management, protection of water quality in the Danube river basin, sustainable fishery and improved management of geological investigations;
- ◆ Further work on solving the problems relating to municipal, hazardous, medical and other waste and transport of hazardous materials;
- ◆ Creation of and programmes relating to protected natural environments.

In addition, bearing in mind the competences of the newly established ministry relating to forestry and hunting, the following priorities are emphasized:

- Programme of afforestation and
- Fire protection of forests and related preventive measures.

The short-term activities in 2003, as well as in the next few years, require foreign assistance so as to organize training, ecology studies and plans, technical assistance, development and strengthening of institutions, mobile units for field work, removal of acute hotbeds and hazardous wastes, as well as the inspection, control and management system.

<b>The needs for foreign assistance in environmental protection over a short term</b>	
<b>USER</b>	<b>PURPOSE</b>
<b>National environmental protection plan</b>	<b>Planning the strategy for environmental rehabilitation and protection</b>
<b>Ministry for the Protection of Natural Resources and Environmental Protection</b>	<b>Management of natural resources based on the ecological principles; planning the management of hazardous wastes</b>
<b>Ministry for the Protection of Natural Resources and Environmental protection</b>	<b>Process of harmonization with EU legislation, improvement of inspection service, implementation of international agreements</b>
<b>Mobile units for quality control and emergency cases</b>	<b>Better response in the case of ecological disasters, education and improvement of technical facilities</b>
<b>Local ecological trouble spots: Pančevo, Bor, Kragujevac, etc.</b>	<b>Prevention of further degradation of the local environment, lessening of the risk to human health</b>

## **8. FINANCIAL GAP IN PURCHASING THE AIMS OF TRANSITION**

### **8.1. Financial Gap and Needs for Additional Financing in the Coming Period**

The two basic structural indicators of the sustainability of macroeconomic stability in the Republic of Serbia over a medium term are the balance-of-payments deficit and fiscal deficit.

A comparison with the group of transition economies shows that our current deficit is extremely high. In its analyses and evaluations of transition economies, the European Bank for Reconstruction and Development sets the limit of 7% for the share of deficit in GDP, above which this deficit becomes critical for maintaining macroeconomic stability over a medium term. This reiterates the decisive role of direct foreign investment and foreign assistance in the coming years.

The projected fiscal deficit, as the second structural indicator of sustainable macroeconomic stability, ranks Serbia's economy much better in relation to the current deficit. The projected fiscal deficit is approaching those Poland and Hungary, the countries that have been successfully maintaining their economic stability for years already. As for the fiscal deficit, the European Bank for Reconstruction and Development sets the limit of 5% share in GDP, above which it becomes dangerous for sustainable macroeconomic stability. Although the projected fiscal deficit is below 5%, it must be kept strictly at the anticipated level, because it could easily enter the high deficit zone and endanger economic stability over a medium term. Here it is necessary to make a methodological remark. Namely, the International Monetary Fund (IMF) shows a somewhat higher deficit in our country by including capital investments earmarked for public enterprises in expenditures for which credits have already been provided, and treating them as deficit financing. Nevertheless, the figure is still around 5%, thus showing that there is no room for any increase.

In the coming period, the economy of Yugoslavia and Serbia will be recording a high balance-of-payments deficit, which will range from 11.1% to 8.5% of GDP (Table 1). In essence, it is the result of a wide discrepancy between the level of domestic savings and necessary investments. Therefore, foreign exchange savings in the form of foreign direct investment, credits and assistance, should play a decisive role in making up this deficit.

**Table 1 Movements in current account deficit during the period 2002-2005  
in % GDP**

	2002	2003	2004	2005
<b>Current account deficit</b>	-11,1	-10,9	-9,4	-8,5
<b>Deficit financing of the current account and foreign exchange reserves 11</b>	11,1	10,9	9,4	8,5
<b>Donations</b>	3,2	3,1	2,7	2,2
<b>Foreign credits</b>	3,8	3,4	2,3	2,2
<b>FDI and portfolio investments</b>	3,1	3,4	3,6	3,8
<b>Domestic savings and exchange transactions</b>	7,2	1,0	0,8	0,3

As can be seen, the share of foreign direct investment does not exceed 4% of GDP. It is anticipated that, during the observed period, the share of donations and foreign credits will be declining as the process of transition progresses. The effect of exchange transactions in deficit financing was a non-recurring one, resulting from the conversion into the euro, while foreign credits will be limited by the possibilities of debt sustainability, which cannot be seen in this model. Most credit arrangements will be in the form of "non-market"-concessional loans, with a long grace period and the interest rates ranging from 0.75% to 3%.

The terms, credits, donations and investments (expressed in absolute terms), which have not been contracted, but are needed for debt servicing and development, are shown in Table 2.

**Table 2 Credits and donations, as the missing funds for debt servicing and development (this is contained in the arrangement concluded with the IMF: expected financing-below the line) in USD mil.**

	2003	2004	2005
<b>Missing funds</b>	920	860	760

These resources will enable the economy to span the period during which, as already mentioned, domestic savings will not be able to service foreign liabilities and increase the share of investments<sup>1</sup> in GDP. The attainment of these aims would ensure, over a medium term, the transformation of the economy and a rise in output up to the development level of the Central European countries, with the ultimate aim being to accede to the European Union.

<sup>1</sup> It is estimated that this year's share of investment in GDP amounted to 15%. It can be seen from the Transition Report that even in underdeveloped economies (Romania, Bulgaria, ...), this ratio reaches 20%.

### Projection of gross domestic product (GDP) – FR Yugoslavia

	2001	2002	2003	2004	2005
<b>GDP, current prices, in billion of dinars</b>	771,8	1.006,9	1.225,9	1.401,8	1.564,6
<b>GDP, in USD millions</b>	10.861	15.563	18.407	19.550	20.778
<b>GDP per capita, in USD</b>	1.278	1.831	2.166	2.300	2.444
<b>GDP, real growth rates</b>	5,5	4,0	5,0	5,0	5,0

The crucial part of the transition of the macroeconomic and financial systems (and their infrastructure) to a market-based model of the economy has been defined, with programmed time sequences, within the three-year extended arrangement with the IMF, which was approved in 13 May, 2002.

The conditions for association with the EU will be provided through the further economic development and surmounting of great social problems arising from the inherited low level of GDP per capita and high unemployment.

**In 1989, Serbia's GDP per capita amounted to half of that (48%) in Slovenia. Today, Serbia's GDP per capita amounts to 13% of that in Slovenia. In other words, it is only one-fourth of GDP which Serbia would have had, parallel to Slovenia, had it continued the transition process initiated in 1989. Such a fall in GDP is without precedent for the East European countries in transition. As for unemployment, including those being fictitiously unemployed, whose workplaces will have to be closed within structural changes, its rate is about 45%. This poses a great social problem, which is also without precedent for the countries in transition.**

The possibility of achieving the targetted rate of economic growth may turn out to be the critical area of transition. It has been estimated that Serbia will avoid transition recession in large measure, because most of its productive enterprises have already reduced or halted their production. However, the possibility of achieving the desired growth, especially in the first years, until significant investments are made in the economy, is still called to question. With about USD 1300 GDP per capita in 2001 (in present dollars, at the mean rate of € 1 = \$ 0.88), the FRY is lagging very much behind the countries being the candidates for membership in the EU in the first round (in 2000, Hungary had GDP per capita amounting to USD 4.6 thousand, Czech Republic and Estonia USD 5 thousand each, Poland USD 4.1 thousand and Slovenia USD 9.1 thousand). It should be noted that, during the 1990s, the ratio of investment to depreciation in Serbia was only 43.2%, while this ratio in industry was only 29.1%. Therefore, foreign capital inflow is regarded as a prerequisite for the successful implementation of reforms and economic integration.

In order to satisfy the needs of anticipated growth, i.e. the anticipated development financing, support to the budget, debt servicing and an increase in the foreign exchange reserves up to the level ensuring external liquidity:

- It is necessary to ensure the inflow of foreign investment, credits and donations to the amount of least USD 3 billion during the period of three years (2003-2005);
- More than half of the necessary amount still has to be contracted or approved.

Only if the missing amount of USD 6 billion dollars, in the form of foreign investments, credits and donations, is provided, it will be possible to achieve the projected development up to 2005, coupled with a major change in the pattern of domestic demand. It has been planned that fixed investments should increase their ratio to GDP from 13.2% in 2001 to 20.3% in 2005, while at the same time reducing the share of consumption.

Attracting financial resources in the form of foreign direct investment represents a strategic issue. Large investments should ensure the accelerated rate of economic growth in the second five-year period. The experience of advanced countries in transition shows that the share of fixed investment in GDP amounts to 24-29%, while the share of foreign direct investment, in the years of maximum growth, was reaching 9-10% of GDP, thus covering more than 50% of the current account deficit. In our case, the share of foreign direct investment projected for 2005 amounts to only 4.1% of GDP and 22% of the projected current account deficit in foreign trade operations. The projections with a more active approach to investment and attraction of foreign investment – up to 8% of GDP in 2006 – could be a prerequisite for:

- Sustainable, faster development after 2005 (6-8% a year, coupled with the fast establishment of new small and medium-sized enterprises in that context);
- Decrease in the unemployment rate, up to 2010, to the level that is comparable with advanced countries in transition;
- Overall economic performance, which could actually make our country a candidate for EU membership.

## **8.2. Needs for Donors' Assistance in 2003 and in the Coming Years**

There are two basic reasons why donors' assistance – in the form of grants and credits under special terms (low interest rates and the grace period until 2009) - is absolutely necessary to the Republic of Serbia so as to implement its reform agenda.

► Serbia is the potentially largest market in the Balkans and the important factor of peace and stability in the region due to its geopolitical position. On the other hand, the great delay in the implementation of its reforms, as

compared to other countries in transition, is the result of specific circumstances: the non-democratic regime in the country, long years of economic sanctions and isolation of the country, NATO bombing and, finally, the destroyed economy. To achieve the level of economic development of the countries in the region, i.e. convergence in development as a prerequisite for the economic integration of the whole region into Europe, Serbia must make a much faster progress.

► Considering the earlier experience, customs and standards of consumers, human capital, market orientation and tradition of foreign business relations, Serbia has the potentials for fast economic integration. On the other hand, the past decade was marked by the great devastation of infrastructure and impoverishment of the population. To spur economic development and carry out reforms parallel to a rise in the living standards of the population, without a threat to reforms, it is necessary to ensure the inflow of foreign capital.

The new democratic government of Serbia has a well-developed programme of fast reforms and efficient use of these resources for a successful transition to an open market economy. The financial gap, which was assessed for the economic growth conducive to the successful development convergence and desired integration of the country, is approximately equal to the amount of the resources required for the implementation of the anticipated reforms in specified sectors. The enclosed table shows the designated purposes of those resources.

<b>Transition programme of Serbia – Needs for foreign donations (in USD mil.)</b>				
	<b>2002</b>	<b>2003-2005</b>	<b>Total</b>	<b>%</b>
<b>Macroeconomic management and spurring of growth</b>	<b>290</b>	<b>1456</b>	<b>1746</b>	<b>29.7%</b>
<b>Financial sector development:</b> Agency for Bank Rehabilitation, Credit Guarantee Fund	46	128	174	2.9%
<b>Labour market reform:</b> modernization of the Agency, severance pay to dismissed workers	162	1100	1262	21.5%
<b>Private sector development,</b> SMEs, FDI promotion; support to agencies	82	228	310	5.2%
<b>Infrastructure</b>	<b>740</b>	<b>2082</b>	<b>2822</b>	<b>48.1%</b>
<b>Energy supply:</b> rehabilitation and modernization, land restitution, institutional development	497	988	1485	25.3%
<b>Transport:</b> bridges, roads, railways, telecommunications	185	862	1047	17.8%
<b>Environmental protection:</b> institutions, equipment, personnel training	58	232	290	4.9%
<b>Social development</b>	<b>304</b>	<b>993</b>	<b>1297</b>	<b>22.1%</b>
<b>Social security,</b> fight against poverty	165	495	660	11.2%
<b>Health:</b> equipment, drugs, education	84	286	370	6.3%
<b>Education:</b> institutions, equipment, education	55	212	267	4.5%
<b>Total</b>	<b>1334</b>	<b>4531</b>	<b>5865</b>	<b>100%</b>

It is expected that donors' assistance from abroad will last five years, parallel to the inflow of credits, whose amount is restricted by the debt crisis. In the first year of reforms, in 2001, the funds were used mostly for the urgent needs of the population, i.e. for the provision of food, drugs, fuel, electric power, urgent repairs and indispensable investments in the rehabilitation of infrastructure. Intensive reform-oriented activities began in 2002, including privatization, solving of the redundancy problem, radical change in legislation, formation of new institutions and strengthening of existing ones, solving of acute social problems, primarily the problem of absolute poverty. However, a precondition for fast economic growth is the rehabilitation and reconstruction of destroyed infrastructure, so that in 2002 and in the coming years about half of the funds stemming from donations will be spent for these purposes.

The provision of an inflow of the anticipated financial assistance would bring about - parallel to dynamic economic growth - a change in the structure of the economy, while the simultaneous change in legislation and institutions would create a basis for sustainable growth. Therefore, it is rightfully expected that, by 2005, Serbia can overcome the crisis of economic underdevelopment and structural change, and embark on the road of self-sustainable economic development. At the same time, the planned donations would also represent investment in the peace and prosperity of the whole region, since they would enable the stabilization of the largest West Balkan country.