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REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)

IN THE AMOUNT OF SDR 11.9 MILLION

(US$15 MILLION EQUIVALENT)

TO

THE FEDERAL REPUBLIC OF YUGOSLAVIA

July 10, 2002

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of July 2, 2002)

Currency Unit	= Yugoslav dinar
YUD 1	= US$0.01618
US$1	= 61.8 YUD

WEIGHTS AND MEASURES

Metric System

ACRONYMS AND ABBREVIATIONS

CBM	Central Bank of Montenegro
DBU	Direct Budget Users
CEED	Center for Entrepreneurship and Economic Development
CFAA	Country Financial Accountability Assessment
DM	German Mark
DPS	Democratic Party of Socialists
DSU	Direct Spending Unit
ECA	Europe and Central Asia
EFF	Extended Fund Facility
EPCG	Electric Power Industry of Montenegro
EC	European Commission
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
GFS	Government Finance Statistics
HV	High Voltage
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion Report
IDA	International Development Association
IFI	International Financial Institution
IMF	International Monetary Fund
KAP	Podgorica Aluminium Plant
LBS	Law on the Budget System
MOF	Ministry of Finance
MVP	Mass Voucher Privatization
NBY	National Bank of Yugoslavia
NMP	Net Material Product
PEIR	Public Expenditure and Institutional Review
PFSAC	Private and Financial Sector Adjustment Credit
PRSP	Poverty Reduction Strategy Paper
SAC	Structural Adjustment Credit
SBA	Stand-by Arrangement
SDR	Special Drawing Right
SFRY	Socialist Federal Republic of Yugoslavia
SIDA	Swedish International Development Agency
SME	Small and Medium Enterprise
TFFRY	Trust Fund for FRY
TSS	Transitional Support Strategy
UCTE	Western European Power Pool
UB	Unemployment Benefits
UNDP	United Nations Development Programme
VAT	Value Added Tax
WTO	World Trade Organization
ZOP	Bureau of Accounts and Payments

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FEDERAL REPUBLIC OF YUGOSLAVIA
STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)
CREDIT AND PROGRAM SUMMARY

Borrower:	Federal Republic of Yugoslavia
Amount:	SDR 11.9 million (US$15 million equivalent)
Terms:	Modified IDA terms with a 20-year maturity, including a 10-year grace period, with no acceleration clause.
Objectives and Description:	The proposed Credit is a Structural Adjustment Credit (SAC) to support the government of the Republic of Montenegro, the smaller constituent republic of the Federal Republic of Yugoslavia (FRY), in the implementation of a structural reform agenda with the main objectives of enhancing medium-term fiscal sustainability and improving the prospects for growth as a basis for sustained poverty reduction. The government's program to be supported by the proposed operation works to achieve these objectives through specific reforms in the five areas of: (i) public expenditure management; (ii) pensions; (iii) the energy sector; (iv) labor markets; and (v) the business environment.
Benefits:	The SAC will work to enhance recent stabilization gains by supporting up front actions to tackle major fiscal imbalances and sectoral reforms to enhance medium-term fiscal sustainability, and by providing financing to close Montenegro's budgetary gap and bolster external reserves. It will also support priority reforms to remove key bottlenecks to restoring economic growth. The elaboration of a sound policy framework and the Bank's assessment of structural reforms in Montenegro will send an important signal to donors wishing to provide budgetary support, as well as to potential private investors and creditors. Given the importance of developments in FRY to the prospects for Southeast Europe, this credit for stabilization and recovery in FRY will also have positive effects on the region as a whole.
Risks:	The need to redefine the constitutional structure of the Federation and relations between the constituent republics is a central political issue. A recent agreement on the proceeding points for a new union between Serbia and Montenegro has been ratified, but the development of precise implementation arrangements will require agreement on critical details, including on the financing the new union structure and on harmonizing external trade policies, which could prove more difficult than originally

envisaged. The challenge of mitigating the short-term social impacts of reforms in the face of public expectations of rising living standards could create pressures to raise government expenditures above budgeted levels. Limited institutional capacity within the Government of Montenegro may limit the pace of reform. Economic recovery could also be affected by delays in the disbursement of pledged donor assistance, and in concluding a concessional debt restructuring arrangement with the London Club.

Schedule of Disbursements:	SDR 5.95 million immediately after Credit Agreement effectiveness (expected in September 2002) and SDR 5.95 million after satisfactory review of Second Tranche conditions.
Poverty Category:	Not applicable.
Project ID Number:	YU-PE-P074746
Map	IBRD No. 31506

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REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION TO THE EXECUTIVE DIRECTORS ON A PROPOSED STRUCTURAL ADJUSTMENT CREDIT TO THE FEDERAL REPUBLIC OF YUGOSLAVIA

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1. I submit for your approval the following Report and Recommendation on a proposed Structural Adjustment Credit (SAC) for the Federal Republic of Yugoslavia (FRY) in the amount of SDR 11.9 million (US$15 million equivalent).[1] The Credit would be on IDA terms with a final maturity of 20 years, a grace period of 10 years, and no acceleration clause.[2] It would be disbursed in two tranches: SDR 5.95 million immediately after Credit Agreement effectiveness (expected about September 2002) and SDR 5.95 million upon satisfaction of second tranche release conditions.

I. INTRODUCTION

2. The governments of FRY, Montenegro and Serbia, have made substantial recent progress on their economic reform agendas. In the late 1990s, even as the Milosevic regime reduced republican prerogatives, FRY retained a very high degree of constitutional republican autonomy.[3] As Montenegro's relations with Belgrade deteriorated, its government worked to achieve further control over economic policy, with support from the international community. Since 1998, it gradually established nearly full macroeconomic autonomy by gaining *de facto* authority over the monetary sphere (in November 2000, the German mark became sole legal tender), trade policy and customs, and by severing almost all fiscal links with the rest of FRY. While significant donor financing helped to address immediate problems, it also supported relatively loose and unsustainable fiscal policies.

3. Federal elections in October 2000, and Serbian parliamentary elections in December 2000, brought reform-oriented governments to office with a mandate to bring greater democracy, modernization and integration with the international economy. Montenegro, which had already elected a more reformist government, was moving to implement market reforms and isolate itself from the economic deterioration in the rest of FRY (see Section II.B.). A recent agreement on a union between Serbia and is likely to reduce near-term uncertainty regarding the broad constitutional structure.[4]

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[1] FRY was formed in 1992 out of the Republics of Serbia and Montenegro as the former Socialist Federal Republic of Yugoslavia (SFRY) was breaking up in civil conflict. Montenegro is by far the smaller of the two republics, with less than 10 percent of FRY's population and a similar share of FRY's GDP.

[2] Exceptionally modified IDA terms for FRY were agreed by the Executive Board in the context of the discussion of FRY's membership and the Bank's Transitional Support Strategy (see para. 5).

[3] The Federal Constitution of 1992 reserved as the main federal functions monetary policy, foreign affairs, trade and defense, while most other functions are the responsibility of the republics. The republics have primary responsibility for economic policy and play the central role in public expenditures and revenue mobilization. Less than one-fifth of consolidated government spending is at the federal level.

[4] On March 14, 2002 an agreement entitled *Proceeding Points for the Restructuring of Relations between Serbia and Montenegro* was signed by representatives of the federal government and the republics of Serbia and

4. In October 2000, FRY asked the Bank to open a dialogue on membership and resolution of its substantial (US$1.7 billion) arrears to the IBRD.[5] As membership in the Bank and arrears resolution was likely to take some time, the Bank's Board of Executive Directors Board approved a transfer of US$30 million from IBRD net income to a Trust Fund for FRY (TFFRY) to finance priority projects prior to membership. These sums are now fully committed.

5. On May 8, 2000, the Board endorsed FRY's succession to membership in the Bank and a Transitional Support Strategy (TSS)[6] outlining a program for FY02. The Board also approved exceptional and temporary IDA eligibility for FRY, with up to US$540 million in IDA resources available over the FY02-FY04 period. Given the key short term objective of macroeconomic stabilization and the need for rapid restructuring of the economy to stimulate private-sector led growth, the TSS outlined adjustment lending as central to the Bank's strategy. Around 80 percent of IDA resources would be employed as structural lending over the three year period, conditioned upon strong policy performance. Overall support to both republics would be provided on an equitable basis.

6. The TSS proposed that US$160 million be used in FY02 to support the adjustment and reform programs in both Serbia and Montenegro. In Serbia, two single tranche adjustment credits have been prepared. The operation under consideration for Montenegro completes the FY02 adjustment program outlined by the TSS. The Bank has also supported a program of targeted investment operations and economic and sector work in FRY aimed to support the economic reform programs and to complement international assistance efforts. In Montenegro, a TFFRY grant is funding a Coastal Environmental Infrastructure project, and an IDA financed Energy Distribution project was negotiated in July 2002. Preparation of two additional IDA funded projects, Export Finance Facilitation and Trade and Transport Facilitation (the latter approved in June 2002) which have components in both republics, was also completed in FY02. In support of the federal and republican governments, the Bank is also completing a Public Expenditure and Institutional Review (PEIR), a Country Procurement Assessment Report, and a Country Financial Accountability Assessment. The Government of FRY has also recently initiated the Poverty Reduction Strategy Paper (PRSP) process, and the Government of Montenegro is working on a PRSP as an integral part of this effort. A Transitional Support Strategy Update, which provides full details on program implementation and policy performance under the TSS at the federal levels and in the republics of Serbia and Montenegro during FY02, has been circulated with this operation.[7]

Montenegro. This agreement sets out a general framework for establishing a union of Serbia and Montenegro which would replace the Federal Republic of Yugoslavia. A Constitutional Commission is currently preparing a Charter which would define operational principles of the union. Under the provisions of the Agreement, Serbia and Montenegro would retain some common institutions, including a Presidency, Parliament, and a Council of Ministers, but would operate as two separate economies (including separate currencies and banking and customs systems), but with free trade between the republics and a phased harmonization of external trade policy.

[5] The former SFRY ceased to be a member of the World Bank Group in February 1993.

[6] Yugoslavia: *Transitional Support Strategy (Final),* May 8, 2001 (R2001-49, 49/1).

[7] Report No. 24476-YU, July 2002. The 2001 TSS outlined a number of performance benchmarks to enable FRY to establish a track record on policy reform. Good progress with respect to the benchmarks in the areas of macroeconomic stability and private sector development would be essential for moving forward with continued exceptional IDA. As reported in the TSS Update, such good progress has been achieved, both in FRY more generally and in Montenegro more specifically.

7. This two-tranche operation builds on the Montenegrin government's recent track record on reforms (Section II.C). The package of measures which it supports aims to achieve two broad objectives – enhancing fiscal sustainability (primarily through reforms in public expenditure management, pensions, the energy sector and labor markets) and removing key bottlenecks to growth (with a focus on the energy sector, labor markets and the business environment). The program, which builds on the agenda outlined in the Bank-EC report *Federal Republic of Yugoslavia – Breaking with the Past* (Report No. 22267-YU, June 2001) and the recent ESW noted above, is described in the attached Letter of Development Policy (Annex 5) and Policy Action Matrix (Annex 7). As a first step, the Montenegrin government has implemented the core measures indicated in the first column of Annex 6.

8. In addressing the economic reform agenda, the Federal and Montenegrin governments face a number of challenges (see section IV.D.). Expectations of the population are high, and limited institutional capacity within the Government of Montenegro may affect the pace of some reforms. Working out the critical details of the new union between Serbia and Montenegro, including the financing of union structures and the harmonization of external trade policies, could prove more difficult than originally expected. Economic recovery may also be affected by global economic fragility. Despite these challenges, the proposed SAC will serve to solidify the important gains made thus far in FRY and Montenegro. The SAC will also send an important signal donors and private investors and creditors, and thereby help stimulate needed capital inflows. Given the importance of FRY to the overall prospects for Southeast Europe, the benefits of the credit to stabilization and recovery in FRY will also have important flow on effects to the region as a whole.

II. INITIAL CONDITIONS, REFORM PROGRESS AND ECONOMIC DEVELOPMENTS

9. In both Montenegro and Serbia, the transition to a market economy is taking place under extremely difficult economic and social conditions. Over the past year, their governments have made good progress in addressing the daunting legacy of the past. These policies have already brought visible improvements in key economic indicators, and laid some of the foundations for a more sustained recovery of output and living standards.

A. The Legacy of the Past

10. The difficult conditions faced by Montenegro and Serbia are the combined legacy of three developments over the past decade:

(i) ***Very poor macroeconomic outcomes,*** including deep declines in GDP and foreign trade and high inflation. In Montenegro as in the rest of FRY, recorded real GDP declined by nearly one-half over the past decade. FRY's chronic high inflation (including severe hyperinflation in 1993) was primarily driven by large fiscal imbalances. However, unlike in Serbia, where recent cash budget deficits have been small (while quasi-fiscal pressures have been severe), Montenegro has recently run

large open fiscal deficits financed by donors. In 2000, Montenegro, which represents less than 10 percent of the FRY economy, accounted for three-quarters of FRY's consolidated cash-based deficit. By the end of 2000, FRY's external debt had reached a very high 141 percent of GDP.

(ii) ***Severe deterioration of the enterprise, financial and infrastructure sectors.*** The past decade saw a lack of deep restructuring and an economy-wide running down of enterprise capital and physical infrastructure, particularly in the energy sector. Foreign direct investment has so far been negligible. As a result, Montenegro's economy remained dominated by large state- and socially-owned enterprises which were inefficiently organized, substantially loss-making and excessively indebted. The private sector composed mainly of small and medium-sized enterprises, while more dynamic, has been severely constrained by energy shortages, repressive regulation (including of labor markets), and an uneven playing field tilted towards the socially-owned companies and enterprises operating in the informal sector.

(iii) ***Worsened social conditions of the population.*** The most recent figures provided in Montenegro's I-PRSP forcefully attest to the increase of poverty during the early 1990s culminating with the 1993 hyperinflation episode. Since then poverty has remained widespread.[8] The rise in poverty, which was driven by poor economic performance and a resulting decrease in real earnings, was accelerated by a deterioration in social protection as available financing fell below levels of existing entitlements. Chronic arrears on some benefit payments were aggravated by arrears in contributions from parts of the consolidated budget.[9] The impending restructuring and privatization of enterprises is likely to increase Montenegro's rates of unemployment and poverty, placing further stress on social services and benefits programs.

11. These negative trends reflected both external and domestic factors. The former included: the impact on established trade links of the breakup of the SFRY and of subsequent conflicts with FRY's neighbors; international isolation and economic sanctions; the Kosovo conflict, which also led to the destruction of productive assets; and the severe drought of 2000, which cut agricultural and hydroelectric output.[10] Even before these events, the SFRY had accumulated a large external debt and its growth rate had begun to decline. In FRY, the last decade brought long delays in economic transition, with sporadic progress giving way to periods of reversal. Decapitalization was the result of deferred maintenance and underinvestment in the face of

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[8] Various surveys conducted in Montenegro during the period 1990-2001 provide incomplete information on household welfare. Rough estimates based on this data put the absolute poverty rate in 2001 at between 15 and 25 percent of the population. These data also suggest a clustering of population just above poverty line, indicating that many families (estimated to be between 20 and 25 percent of Montenegro's population) could fall into absolute poverty as a result of a small shock to their income levels. The Bank is now working with the Montenegrin authorities to prepare an improved household survey for more precise estimation of the level and incidence of poverty in the republic. The initial results of this survey are expected in August 2002.

[9] For example, as of June 2002, unemployment benefits had not been paid since September 2000, and maternity leave since May 2001.

[10] Although Montenegro was less directly affected by sanctions than Serbia, economic activity was still constrained by the disruption of trade with Serbia.

financing constraints. Authoritarian rule, high military spending and general mismanagement further reduced efficiency and eroded fiscal balance. Finally, weaknesses in governance and institutions eroded implementation capacity and created fertile ground for corruption.

12. ***Challenges.*** As outlined in the report *Federal Republic of Yugoslavia – Breaking with the Past,* the federal and republican governments face four key challenges in reversing the negative developments of the last decade:

(i) Restoring macroeconomic stability and external balance;
(ii) Stimulating growth and creating the basis for a sustainable supply response;
(iii) Improving the social well-being of the most vulnerable; and
(iv) Improving governance and building effective institutions.

Since taking office, the respective governments have pursued a two-pronged approach to meeting these challenges, combining stabilization measures with the first steps in an agenda of structural reforms aimed at buttressing these measures and reversing the delayed transition. Stabilization policies and their initial impact are described in Section II.B, while initial progress in structural reforms is outlined in Section II.C.

B. Stabilization Measures and Recent Economic Developments

13. At the time of the political changes at the Federal level and in the Republic of Serbia in late-2000, the Government of Montenegro had already made significant progress in its own stabilization efforts. During 1999 and 2000, international donors (primarily the EU and USAID) supported a macroeconomic program based on two pillars: (i) the gradual introduction of the German Mark (DM) as the sole legal tender (see Box 1); and (ii) substantial foreign grant financing to cover the fiscal deficit. Combined with the severing of almost all fiscal links with the rest of FRY, this left Montenegro with nearly full macroeconomic autonomy.[11]

14. While significant donor financing helped to address immediate problems, it also supported relatively loose and unsustainable fiscal policies, and led to the early symptoms of aid dependence. In 2000, the consolidated republican deficit (on a cash basis) reached 10.4 percent of Montenegro's Net Material Product (NMP).[12,13] By late-2000, the preclusion of monetary financing of the budget due to the adoption of the DM, a decline in foreign financing towards more sustainable levels, and the impact of increased wages and social transfers on public expenditures, forced a renewed focus on fiscal consolidation. The process was first supported by an International Monetary Fund (IMF) Emergency Post-Conflict Facility for FRY approved in December 2000, and then by a June 2001 Stand-by Arrangement (SBA) for FRY of SDR 200

[11] For this reason, the discussion of macroeconomic outcomes below is focused on Montenegro, with cross-references to FRY being made where appropriate.

[12] Excluding extra-budgetary funds, this deficit was 8.3 percent of NMP.

[13] NMP excludes services of the "non-material" sphere, including education, culture, public health, banking, insurance, government services, and defense. GDP is calculated by the Federal Statistical Office, but with a lag of about two years. Based on analyses of earlier series, Montenegrin officials estimate GDP to be about 25 percent greater than NMP. For this reason, the ratios of a given variable to NMP reported below will be higher than those relative to GDP, and comparisons with other economies should be adjusted accordingly.

million (US$249 million equivalent), spanning the period through end-March 2002. The two IMF arrangements were conditional on tight fiscal discipline, including: i) a detailed fiscal framework which envisioned a combination of expenditure and revenue measures to reduce Montenegro's republican fiscal deficit (excluding extra-budgetary funds) to around 5 percent of NMP in 2001; and ii) more realistic budgeting to begin making inroads into the accumulation of arrears. In particular, public sector wages and the minimum wage were frozen in late 2000. Inroads into quasi-fiscal deficits created in the enterprise sector (e.g. through higher energy prices) worked to further enhance fiscal sustainability.

Box 1:– The German Mark and Euro in Montenegro

Phased introduction of the German mark (DM). In 1999, eroding confidence in FRY's economic policies and outlook led to a steady depreciation of the Dinar against the DM. As a result, the DM became the dominant means of payment in FRY. In November 1999, Montenegro formalized this situation by declaring the DM an official parallel currency. One year later, in November 2000, the new Central Bank of Montenegro (CBM) declared the DM the sole legal tender in the republic. All deposits were automatically exchanged at 36 Dinars per DM, while citizens and enterprises were given three days to change their cash.

From DM to Euro. The replacement of the DM with the Euro required Montenegro to take part in this conversion. The exchange of deposits and cash was managed by the CBM. From November, 2001, both prices and bills required double denomination. On January 1, 2002, the Euro was introduced as Montenegro's official currency. Existing deposits were automatically converted free of charge. Cash in amounts up to 10,000 DM was exchanged, while higher amounts had to be deposited to be converted. Both the DM and Euro were legal means of payment until March 31, 2002. The use of the Euro reinforces non-monetary adjustments (i.e. fiscal policy) as the key macroeconomic policy instrument.

15. On May 13, 2002, the IMF Executive Board approved a three-year arrangement for FRY under the Extended Fund Facility (EFF) of SDR 650 million (US$829 million equivalent) spanning the period through end-March 2005. Such an extended arrangement is a prerequisite for implementing the 66 percent debt reduction negotiated with the Paris Club in November 2001, which cuts FRY's debt by 51 percent upon approval of the EFF, and by a further 15 percent upon its successful completion in 2005. EA macroeconomic objectives include: (a) achieving GDP growth of 5 percent in 2003-05; (b) reducing Montenegro's inflation from 24 percent in 2001 to 4 percent in 2005; and (c) reducing FRY's current account deficit (before grants) from 10.9 percent of GDP in 2001 to 8.8 percent in 2005. In Montenegro, key structural reforms supported by the EFF include: (a) completing the tax reform through introduction of a VAT; (b) further progress in privatization; and (c) completing restructuring of the banking sector and strengthening its supervision.

16. ***Recent economic developments.*** As in the rest of FRY, Montenegro's real output rebounded from the 9 percent contraction of 1999 (which reflected the impact of the Kosovo conflict) to recorded low but positive **growth** rates of about 4 percent in 2000 and 3.5 percent in 2001. The 2001 upturn was driven by a sharp rebound in three sectors; (a) tourism (where revenues increased by around 30 percent); b) transport (where the real value of services increased by around 9 percent, primarily due to increased transit of goods to and from Kosovo); and (c) construction, with real growth of about 9 percent. In contrast, recorded industrial production contracted by 0.6 percent, with electricity production falling by 6.2 percent. Factors

working to reduce output and demand include a transitional recession resulting from shifts in relative prices and a sharp decline in real wages.[14]

17. As in the rest of FRY, the most visible recent changes were exchange rate stability and substantially reduced inflation. **Exchange rates** versus the DM/Euro have been maintained at a fixed level in Serbia, and are stable by definition in Montenegro, where the stabilization policies described above brought 2000 **inflation** to 25 percent, well below the 115 percent recorded in Serbia. In 2001, Montenegro's inflation rate remained roughly constant at 24 percent (compared to 40 percent in Serbia), the combined result of sharp increases in administered prices and an annual core inflation rate closer to 10 percent.

18. FRY's consolidated **fiscal deficit** before grants (on a cash basis) grew modestly from 1 percent of GDP in 2000 to 1.3 percent of GDP in 2001, well below the original target of 6.2 percent.[15] This reflected revenue overperformance of 1.3 percent of GDP (driven by tax reform and improved tax collection) and a compression of spending equal to 3.5 percent of GDP, relative to original targets for 2001. The latter primarily reflected delayed donor-financed public investments and a deferral of some initially anticipated debt service payments to 2002. Consolidated general government revenues (excluding grants) amounted to 41.6 percent of GDP, and expenditures to 43 percent of GDP. In Montenegro, the cash-based consolidated deficit before grants declined from 10.4 percent of NMP in 2000 to 6.1 percent in 2001. General government revenues (excluding grants) amounted to an estimated 46.8 percent of NMP, and expenditures to 52.9 percent of NMP. Revenue performance was buoyed by a good tourism season, higher transit fees, and improved collection of excises and customs duties. Nonetheless, expenditures also exceeded planned levels because of high transfers and subsidies, and higher spending ahead of the April 2001 republican elections. Driven by the large wage increases and associated increases in social transfer payments of late-2000, the public payroll (including government support of the wage bill in some large enterprises) increased to account for 29 percent of total expenditures, or about 15 percent of Montenegro's NMP. Off-budget expenditures on pensions reached almost 13 percent of NMP. While foreign grants remained the main source of deficit financing, their lower than anticipated level left a financing gap which was filled in large part by borrowing from the domestic payments and clearing system.

19. In FRY,[16] **foreign trade** volumes have increased. Following an 18.6 percent rebound in 2000 from the lows of the Kosovo conflict, exports of goods and services (in US dollars) rose by a further 8.4 percent in 2001, but remained almost 20 percent below their real 1998 level. More rapid growth has so far been precluded by capacity and liquidity constraints and a less favorable external environment. In 2001, the recorded dollar value of imports of goods and services grew by a much larger 29 percent, primarily reflecting greater donor financing, including for energy imports. While imports grew much more rapidly than exports, the high grant-financed component of additional imports meant that the current account deficit increased slightly from

[14] During 2001, nominal wages increased by around 10 percent while the consumer price index increased by 24 percent.

[15] Given its much larger size, these outcomes primarily reflect developments in the Republic of Serbia.

[16] External variables are discussed only for FRY as a whole. This is for three reasons. First, the SAC provides balance of payments financing to FRY. Second, Montenegro's nascent own balance of payments data remain highly unreliable. Third, as the responsibility for servicing FRY's external debt has yet to be fully apportioned, detailed estimates of debt service and key capital account variables remain premature.

4.2 percent of GDP in 2000 to 5.5 percent in 2001. These relatively constrained levels obscure a much more negative resource balance (18 percent of GDP in 2000 and 22 percent in 2001), which has historically been financed by large private transfers from the Yugoslav diaspora, and to a lesser extent by targeted donor and humanitarian support.

C. Recent Progress in Structural Reforms

20. In Montenegro, structural reforms began somewhat earlier than in the rest of FRY, with the support of international donors. While particularly good progress was made in adopting reform legislation, Montenegro's reforms remain incomplete, and must now be planned in a more integrated fashion with a greater focus on establishing implementation capacity. Beginning in 1998, the Government of Montenegro targeted reform efforts at the following six areas:

- ***Tax reform.*** An estimated 30–50 percent of the Montenegrin economy lies outside the formal sector. In response, the Government has recently begun to take measures to simplify the tax system and fight the gray economy. A Tax Action Plan approved in 2001 delineates measures for the planning and implementation of a comprehensive tax code, with a view to broadening the effective tax base and improving tax collection and A number of new laws were passed in December 2001, including on tax administration, personal and corporate income taxes, property taxes and excises.

- ***Price liberalization.*** The macroeconomic stabilization efforts commenced in 1998 have been supported by phased removal of price controls. Following the August 2001 liberalization of the prices of bread and milk, Montenegro now has a set of remaining controlled prices similar to that in other market economies. In addition, the Government has made progress in raising the remaining controlled prices towards levels which cover the costs of production.

- ***Foreign trade reform.*** Although foreign trade policy and customs are constitutionally federal areas of competence, Montenegro gradually obtained *de facto* autonomy over these areas. It has used this autonomy to establish a liberal trade policy regime. In July 2000, the Government adopted a Temporary Act on Customs Tariffs. Almost 92 per cent of all products are imported at rates of 5 percent or less, and the average tariff rate is just below 3 percent. Montenegro has also established its own customs administration.

- ***Privatization.*** The extension of the privatization program begun in 1991 has been one of the main expressions of the Government's commitment to market-oriented reforms. In 1999, the Montenegrin parliament passed a new law establishing the Privatization Council, which has been responsible for all activities in this area. Montenegro is relying on a mass voucher privatization (MVP) program for small stakes in selected enterprises as well as tenders and auctions for majority stakes with a view to attracting strategic investors. The MVP program was completed in late 2001 when vouchers were distributed to all citizens and widespread share ownership was established. So far only a few tenders and auctions have been completed.

- ***Financial Sector.*** Montenegro has obtained *de facto* autonomy in this nominally federal area of competence. In November 2000, its parliament adopted new laws on the Central Bank of Montenegro (CBM) and on the banking system promoting bank restructuring and strengthening the supervision capacity of the CBM. A law on the bankruptcy and liquidation of banks was adopted in September 2001. Diagnostic reports of all 11 banks in Montenegro have been completed. The main commercial bank has been placed under temporary administration, and its restructuring is under way. Five of the remaining banks have been re-licensed.

- ***Reform of social assistance.*** To address hardship among a wider group of the population, the Government of Montenegro has extended the right to *family material support* (the main program of cash social assistance) from to those who were unable to work, to those who are capable of work and responsible for the maintenance of children. At the same time, it has targeted *child allowances,* which were formerly given to the first three children in all families irrespective of need, only to children in families which receive material support and to children with disabilities. The savings from targeting child allowances will help in part to meet the costs of expanded material support. While there is need for careful monitoring and assessment, these changes represent important steps in improving the coverage and adequacy of benefits of the social safety net.

III. THE GOVERNMENT'S STRUCTURAL ADJUSTMENT PROGRAM

21. After taking the early actions and achieving the initial outcomes described in Sections II.B and II.C., the Government of Montenegro has now developed a more comprehensive adjustment and reform program. The Federal and Montenegrin governments have requested the Association's support for key elements of the program focused on the enhancement of macroeconomic sustainability and the promotion of growth. Given the absence of monetary and exchange rate policy, the large recent fiscal deficits, the pending resumption of foreign debt service, and the likely increase in claims on the social safety net, restoring macroeconomic stability will require addressing immediate pressures through short-term fiscal policy adjustments supported by the IMF EFF, structural reforms to enhance fiscal sustainability, and adequate support from the Bank and other donors. Reversing the sharp decline in output and living standards of the past decade will require creating strong foundations for growth and employment creation through structural reforms to promote private sector development, a well-functioning labor market, and a reliable supply of energy. Enhancing transparency will be critical in addressing both of these challenges.

22. The reform program of the Government of Montenegro to be supported by the SAC begins to tackle many of the gaps identified above through discrete policy reforms and steps in what will be a longer-term process of expenditure containment, sectoral reform, and legal and institutional development. The program focuses on five areas (see Table 1):

- *Reforming and enhancing the transparency of public expenditure management.* Gaps in the associated procedures and institutions have contributed to the loss of fiscal control. Reforms are needed to prepare and execute budgets in ways which better align

commitments with available resources and ensure a more transparent and efficient use of public and donor resources. To this end, the Government of Montenegro plans to establish a more consolidated medium-term framework for budget preparation, to continue implementation of the recently established Treasury system, and to reinvigorate inspection and auditing procedures.

- *Reform of the pension system.* Pension expenditures account for a very large one-third of consolidated public spending. As revenues from contributions cover less than 60 percent of pension expenditures, the system has been balanced through *ad hoc* budgetary transfers and donor support. This has swelled Montenegro's consolidated fiscal deficit and diverted resources from economic development and social programs. Delays in pension payments have had a negative effect on the most vulnerable. The program of the Government of Montenegro to tackle these structural sources of fiscal deficits includes concrete adjustments to rebalance and improve the implementation of the existing pension system, as crucial first steps in a longer process of change.

- *Reforms of the energy sector.* This sector is the source of two significant problems: quasi-fiscal liabilities in the form of chronic losses of key utilities; and the inability of electricity supply to meet demand, particularly during the winter. The program of the Government of Montenegro to address these problems includes a phased set of revenue adjustments to return the Montenegrin electricity utility to financial self-sufficiency, and the formulation by the power utility of a strategy to mitigate the supply shortfall problem. It also includes the first steps in developing a legal and institutional framework to consolidate the sector's medium-term financial sustainability and ensure that it contributes to Montenegro's growth potential.

- *Reform of labor markets.* As summarized in new laws on labor and employment, these reforms will provide an impetus to growth of employment and output by increasing labor market flexibility, supporting enterprise restructuring, and integrating the gray economy into the official economy. They will also enhance fiscal sustainability by bringing existing entitlements (which are bound to increase further with enterprise restructuring) in line with available resources, and by eliminating a key bottleneck to cutting overstaffing in enterprises and state institutions. Reforms to entitlements will contain the arrears which now prevent these programs from acting as an effective social safety net.

- *Improvement of the business environment* are required to raise efficiency and facilitate the emergence of a vibrant enterprise sector which can create new and more formalized employment opportunities for workers released from inefficient state- and socially-owned enterprises facing privatization and restructuring. The program will focus on removing constraints to the entry and growth of new enterprises, on facilitating the exit of inefficient enterprises, and on completing the system of secured financing to improve enterprise access to capital.

23. Together with the maintenance of a sustainable macroeconomic framework consistent with the IMF EFF, these inter-related and mutually reinforcing reforms are designed to address both immediate and medium-term causes of fiscal imbalances, and to remove key bottlenecks to

restored growth and employment creation. They are also designed to set Montenegro on a path for deeper structural reforms to be completed beyond the horizon of the SAC.

A. Improving the Transparency and Management of Public Expenditures

24. Past fiscal imbalances partly reflected weaknesses in public financial management. The absence of a comprehensive, medium-term macroeconomic framework hampered budget formulation. Limits on the government's ability to align commitments with available resources worked to increase unplanned outlays and/or budgetary arrears. Transparency was reduced by the fragmentation of general government operations, and by the limited capacity and institutions for *ex post* audit.

25. In late 2000, and supported by ample technical assistance, the Montenegrin government embarked on a program of public finance reforms aimed at increasing fiscal transparency and improving budgetary procedures, revenue collection and expenditure control. 2001 was a landmark year in this respect, when a Law on the Budget System (LBS) and Law on Public Procurement were passed, and a republican Treasury was established. Other bold steps to improve the transparency of public finances included full integration of the Ministry of Interior into the general public expenditure system, including incorporation of Ministry's own revenues into the single treasury account.

26. The preparation of a 2002 Budget based on new IMF GFS methodology was generally successful. In September 2001, the Ministry of Finance (MOF) issued a new Budget Preparation Instruction to the line ministries. It provided ample training to the line ministries and other direct budget users (DBUs) on the procedures established by the LBS. The launch of the Republican Treasury began with appointment of the Treasurer and key staff, and issuance of a Treasury operations manual. By spring 2002, the Treasury was already processing all public service payroll. However, due to capacity limitations in the MOF, progress in *ex post* control was restricted to the contracting of an *ad hoc* audit of the 2000 budget to a major auditing firm.

27. This experience revealed some remaining bottlenecks, particularly in defining sustainable macro/fiscal and sectoral policies and realistic sectoral budget requests. Uniform and effective application of the LBS remains hampered by an absence of a range of secondary legislation, policies, instructions, and operating procedures. Budget consolidation is needed to control the shifting of fiscal pressure from the republican budget to social funds via the accumulation of budgetary arrears. The existing organizational structure of the MOF is not yet supportive of its new roles under the LBS. Institutional capacity for fiscal analysis and policy formulation remains weak, both in the MOF and in the line ministries. There is no medium-term fiscal framework, no mechanism to cut back program and policy over-commitments, and no analysis of strategic allocation of funds across various budget areas. Further progress is also needed to increase the transparency of the budget process, develop aid monitoring and coordination, and improve public understanding of government finances.

28. **Reform Objectives and SAC Measures.** While the passage of legislation and establishment of a Treasury were major milestones, the challenge now is to implement the changes introduced by the LBS before starting new reforms. The Government of Montenegro's reform program aims to deliver greater macro-fiscal control and accountability of the public

finance management system. Further improvements in the monitoring and management of public expenditures can work to limit unplanned expenditures and better align commitments with available resources. High standards of transparency in the use of public funds are essential for efficiency, and for achieving adequate level of social and donor support for the Government's programs. Strengthening institutions for the management of Montenegro's share of FRY's external debt service will also be crucial for fiscal sustainability.[17] To assist the Government of Montenegro in achieving these objectives, the SAC will support near-term reforms in the three areas of budget formulation, execution, and audit and control.

Table 1:- Montenegro's Reform Program Supported by the SAC

Objectives	*Reform Areas*	*Priorities*
Achieving a sustainable medium-term macroeconomic framework	Fiscal policy	Correcting imbalances which emerged after a decade of economic decline and recent large inflows of donor support.
Improving the transparency and management of public expenditures	Budget preparation	A more comprehensive, medium-term macro/fiscal framework for budget planning.
	Budget execution	Continued implementation of the new Treasury and the Law on the Budget System.
	Audit and control	A new Internal Audit Department in the MOF. Initial steps to create an external audit function.
Achieving a more fiscally sustainable pension system	Balance of commitments and resources in the state pension system	Reforms of the existing pension system.
	Transparency of implementation arrangements	Improving the timeliness of the government's own payroll tax contributions.
Reducing the fiscal impact of the energy sector and improving the balance between energy supply and demand.	Financial position of the power utility	Enhancing revenues through price increases, improved collections and reduced barter.
	Sector strategy and legal framework	A new Law on Energy.
Creating a labor market more conducive to job creation, and improving the effectiveness and fiscal sustainability of employment benefits and programs.	Labor market flexibility	A new Law on Labor with provisions for severance and other benefits which are conducive to job creation and are more affordable.
	Unemployment benefits (UB) and employment services	A new Law on Employment which improves the functioning of UB by aligning benefits with available resources and improves incentives.
Improving the business environment as a basis for more rapid growth and employment creation.	Framework for the entry and operation of businesses	Adoption and implementation of a new Enterprise Law.
	Framework for the redeployment of assets to more productive uses	Adoption and implementation of a new Law on Business Organization Insolvency.
	The system for secured financing	Adoption and implementation of a new Law on Secured Transactions.

[17] In the medium-term, the main objectives are to gradually replace input-based budgeting with budgeting practices geared to measurable outcomes; and to further strengthen the transparency of the public spending system by extending fiscal reporting, inspection and audit functions beyond the republican budget to general government as a whole.

29. ***Budget formulation.*** The SAC will support the continuation and implementation of reforms to strengthen and increase the transparency of budget preparation procedures. To simultaneously address the need for a more comprehensive budget and a medium-term perspective in fiscal policy, it will support the development of a three-year fiscal framework comprising the central budget, social funds and local governments, and fully reflecting all major policy commitments, such as the resumption of external debt servicing, bank and enterprise restructuring, and the reform of the social welfare system. These changes now under preparation will be introduced with the 2003 budget cycle. The transparency of the budget preparation process will be further increased by the drafting of a Citizen's Guide to the Budget. To *strengthen aid coordination,* the MOF has presented to the Government a draft Interim Policy on Donor Funding. Moving forward, it is committed to prepare, and the Government to approve, a larger policy paper on the use of donor funds, including clear procedures for incorporating into the budget in-year receipt and use of donor funding. In addition, MOF has begun its own *institutional* reform, which it is committed to complete by second tranche release. As part of this process, it has defined the functions and staffing of the Budget Department comprising a budget formulation unit and a macro/fiscal analysis unit. The macro/fiscal analysis unit has been established and staffed, with training being provided.

30. ***Budget execution.*** The SAC will support key measures to complete implementation of the Treasury within the MOF. To strengthen commitment controls, the MOF has successfully transferred two pilot DSUs and the payroll of all DSUs into the Treasury. By second tranche, it will have transferred accounts of all ministries and agencies financed from the Government of Montenegro budget into the single treasury account, and have adopted a time-bound plan for extending Treasury services to the operations of all social funds. In addition, the MOF will introduce pilot commitment control procedures on major risk categories of budget spending, on the basis of which it will propose new controls as appropriate. Furthermore, the Government has outlined the functions and staffing of a Debt Management Department in the Treasury, which it is committed to establish, and begin staffing and training. Finally, transparency has been enhanced through generation by the Treasury of monthly budget execution reports which are being provided to the MOF management team. Once the Treasury is operating at a level which makes these reports reliable and comprehensive, MOF will provide monthly summaries of budget execution to the Cabinet and the general public.

31. ***Audit and Control.*** To enhance the accountability of public spending, the SAC will support reinvigoration of the essential functions of budget inspection and audit. Continuing the good practice established in the previous year, the Government has contracted an audit of the final accounts for the 2001 budget from a major auditing firm and disclosed its results to the Montenegrin Parliament. Going forward, the MOF will establish and staff an Internal Audit Department, outline its functions, and adopt both its procedures and an annual audit plan for 2003. Montenegro will also initiate a study on the suitability of different models of external audit, as a basis for choosing the most suitable external audit model.

B. Pension Reform

32. Any program to improve fiscal sustainability in Montenegro must address the fiscal pressures coming from its over-scaled public pension system. In 2000, this system consumed

one of the highest shares of GDP in the ECA region (around 15 percent on an accruals basis), while generating a deficit of over 6 percent of GDP.[18] While economic decline has played a role, the current situation largely reflects a sharp increase in the number of beneficiaries and a decline in the contributor-beneficiary ratio, which currently stands at 1.4:1. Other specific factors include overly generous and essentially unaffordable benefit provisions,[19] and a history of accommodating structural deficits through budgetary transfers and donor assistance. In spite of the latter support, the system has sustained arrears on benefit payments (leaving an average payment lag of about 2 months), as well as the accumulation of arrears between the pension, health and employment funds, and from the republican budget to these funds.

33. **Reform Objectives and SAC Measures.** Until recently, progress in pension reform was limited. In mid-2001, the Government of Montenegro appointed two working groups, one to determine pension policy and the other to develop the technical details of pension reform options. After this hiatus in pension reform activity, the Government of Montenegro is again developing measures to improve the fiscal sustainability and implementation of the existing pension system. Its main near-term objectives are achieving immediate fiscal savings, becoming current on its own contributions to the Pension Fund, and creating the basis for further future savings. In the medium-term, it aims to bring pension entitlements fully in line with available resources through demonstrable reductions in pension spending as a share of GDP, to further improve the efficiency of the existing system, and to begin laying the groundwork for more fundamental reforms.

34. To achieve these objectives, the SAC will support: a) reforms to the existing pension system; and b) initial improvements in implementation arrangements. While the changes will bring some hardship to pensioners and some individuals near retirement, they will also allow for improvements in the pension system and the overall economy. Lowering the deficit in the pension system is likely to improve the timeliness of pension payments and release budgetary resources for other priority areas. The changes will also support growth by creating the possibility of a future phased reduction in payroll taxes, which would improve the incentives for employment-creating growth and for drawing the informal economy back into the formal sector.

35. ***Reforms to the existing pension system.*** The SAC supports preparation and enactment of a new law on pension and disability insurance which will make the pension system more sustainable and reduce the overall fiscal burden through a better alignment of benefits with available resources. To this end, the Government of Montenegro has accepted and submitted for public discussion a draft law that *inter alia*: (i) raises and equalizes the retirement age for men and women from 60 years for men and 55 years for women to 65 years for both; (ii) raises the age of availing of early retirement (with pension reductions) to 60 years; (iii) changes indexation from wage indexation to indexation that is no more than the arithmetic average of wages and the cost of living; (iv) lengthens the work history included in the pension base calculation; (v) abolishes privileged work histories; and (vi) abolishes Category III invalidity pensions (based on remaining work ability). These reforms (most notably changes to indexation) are estimated to

[18] The deficit is measured as the difference between all pension fund expenditures (except for support for pensioners associations and investment activities) and payroll contributions.

[19] Average replacement rates (ratio of pensions to net wages) are in the 80-90 percent range. For old-age pensions, replacement rates are even higher.

yield fiscal savings of at least one-third of a percentage point of GDP in 2003, rising to at least 1.1 percentage points by 2005. If indexation is changed to price growth alone, the latter figure would rise to around 2 percentage points. Following the public discussion of this draft law, the Government of Montenegro is committed to submit a satisfactory draft law to Parliament in the autumn of 2002, for enactment starting January 2003.

36. ***Improvements in implementation arrangements.*** In recent months, the Government has improved its performance in making contributions for its own employees to the Pension Fund. Starting July 1, 2002, it is committed to becoming fully current on these payments. This will improve the stability of system revenues and strengthen overall contribution compliance. To achieve greater clarity of purpose and operations in the Pension Fund, the Government will propose the elimination of specified non-pension benefits from the Pension Fund in its draft 2003 budget. Finally, the Government has begun to prepare a more comprehensive reform of the existing pension system to follow up on the initial reforms supported by the SAC.

C. The Energy Sector

37. During the 1990s, prices for energy in Montenegro (particularly for electricity) were chronically set by the state at levels well below operating costs. The resulting poor financial state of the state power company, the Electric Power Industry of Montenegro (EPCG), led to its considerable de-capitalization through underinvestment and deferred maintenance. The industrial sector represents 45 percent of total electricity demand, nearly 90 percent of which is accounted for by the Podgorica Aluminum Plant (usually referred to by its local acronym KAP) (see Box 2). Although industrial consumption declined by 17 percent during the 1990s, household energy consumption more than doubled, as the under-pricing of electricity led to the widespread use of electric space heating. The resulting growth of demand and decline in production has left Montenegro importing roughly one-third of its electricity. Despite international donor funding for electricity imports, EPCG was unable to cope with peak demand in the winter of 2001/2002, when regular 4-hour rolling blackouts became the norm during colder periods.

Box 2:– The Podgorica Aluminum Plant (KAP)

The decision to build KAP in 1971 was based on using low-cost domestic hydro resources and indigenous bauxite. As is the case for aluminum smelters worldwide, the investment decision was based on the long-term availability of low-cost electricity in the form of an implied long-term contract. In fact, the current electricity price charged to KAP of $20/MWh, while below the cost of imported power or the cost of production at the existing coal-fired plant, is similar to prices experienced by the aluminum industry globally. However, KAP suffered considerably during the 1990s with low production during the sanctions period leaving limited funds for maintenance and upgrading. This left the plant with low efficiency and an unsustainable debt burden. The plant has come to an agreement with creditors regarding the existing debt. Foreign advisors have helped KAP to reduce the cost of production considerably through low cost interventions, resulting in record high production and operating profits for 2001, with further improvements expected in the next few years. Investments are expected to reduce the cost of production by at least 10 percent, and lead to reductions in electricity consumption by about the same order. Some of this funding will come from the divestiture of the downstream industries to private investors. The Government of Montenegro and KAP management are currently considering the next step: continued investments to further modernize the plant before privatization or moving directly to privatization. The Government is studying these options and will discuss a strategy with the Bank in the autumn of 2002.

38. As demand increased, the electricity sector became a hidden drain on fiscal resources in the form of losses by EPCG which have been covered by transfers from the state or through arrears financing. In 2001, even after a bold decision to postpone a traditional reversion to lower summer tariffs in April 2001 (which kept average tariffs at US$25/MHW, or 50 percent above originally scheduled levels), prices of electricity remained well below the average operating cost of EPCG. EPCG's poor finances reflect not only low prices, but also a poor collections record and high network losses of around 20 percent (with theft presumed to be about one-half of the total). While the ratio of collections to billings has increased from 55 percent in 1999 to 76 percent in 2001, further progress is needed. Similarly, while the share of barter payment for electricity has been reduced from 55 percent of total transactions in 1999 to around 30 percent in 2001, the latter level remains unacceptably high.

39. **Reform Objectives and SAC Measures.** The SAC supports the efforts of the Government of Montenegro to tackle the sources the fiscal pressures associated with the electric power system by allowing the system to self-finance (including covering deferred maintenance and new investment) in as short a time as possible, while maintaining adequate protection for the poor. The sector will also take steps to improve the reliability of supply, first to reduce load shedding, and then to achieve quality improvements required to support downstream industry and the coastal tourism sector. Without such investments, customers would resort to higher cost options, and diminished output capacity would cut growth potential. The SAC supports reforms in two broad areas: a) a staged program of revenue enhancement measures to return EPCG to financial self-sufficiency; and b) the development of a sector strategy and legal framework.

40. ***Returning EPCG to financial self-sufficiency.*** To this end, the Government has developed and begun to implement a program of price adjustments, improved operating practices and investments. Under the part of the program supported by the SAC, EPCG has finalized a time-bound action plan for reducing electricity blackouts and achieved demonstrated progress in its implementation.[20] This comprehensive program addresses all aspects of the power supply industry. However, EPCG will need to continue to import electricity for the near- to medium-term, as no quick solutions are available to address the shortage of generating capacity.[21]

41. The Government is continuing electricity price reforms to enable prices to cover operating and debt service costs by 2003. In November 2001, it established an average winter tariff for electric power (excluding KAP, which is buying electricity under a separate power purchase agreement valid until the end of 2002) of 37 EUR/MWh (about US$36/MWh). This represents an increase of 50 percent from the winter of 2000/2001. To further strengthen EPCG's finances, the Government also cancelled a traditional shift to lower summer tariffs which would have returned the average summer price of electricity (excluding KAP) to 25 EUR/MWh (about US$24/MWh). To cushion the social impact of this reform, it also introduced

[20] In parallel to changes supported by the SAC, the Government is working with the Bank and other donors to implement investments and programs to: (a) decrease system losses and theft; (b) introduce energy efficiency measures in industry (particularly KAP) and households; (c) improve power plant reliability; and (d) arrange for long-term supply of electricity imports on a competitive basis.

[21] The ability to import electricity, however, is limited due to a lack of interconnection with the Western European Power Pool (UCTE) and the poor financial condition of EPCG.

a lower 'lifeline' tariff (covering the first 500 kWh of monthly consumption) for those families eligible for the main targeted social assistance program, the so-called Material Assistance to Families. The combined effect of these recent policy changes was to reduce the losses of EPCG, and hence its hidden impact on the budget, by around US$20 million per year, or by about 2.5 percent of Montenegro's NMP. By second tranche release, the Government will establish and have maintained an average winter price of electricity for 2002/2003 which is satisfactory to the Bank. To reduce the negative impact of KAP on the finances of EPCG, and more generally to place its operations on an economically sound basis, the Government will prepare a strategy for KAP, including a time bound action program that addresses ownership and operating issues for the supply of bauxite and electricity.

42. To improve collections, harden budget constraints, and reduce the risk that higher prices will spill over into higher budgetary and inter-enterprise arrears, EPCG has announced a program for disconnecting non-payers, based on clear procedures and including specific performance benchmarks.[22] Good early progress in implementation has already decreased losses and increased revenues. In November 2001 alone, six HV customers, 55 10 kV customers and 9,200 low voltage customers were disconnected from a total customer base of 269,000. By second tranche release, EPCG is committed to further increase the ratio of collections to billings, such that its Accounts Receivable have not increased by more than 15 percent of its total revenues over the previous 12 month period. EPCG has also fully eliminated third party barter, with only direct barter of goods and services needed by EPCG remaining for now. By second tranche release, it is committed to have further reduced the share of barter in total collections to a maximum of 10 percent.

43. ***Sector strategy and legal framework.*** With the support of foreign advisors, the Ministry of Economy has begun preparation of an energy strategy as a basis for developing a draft energy law. By second tranche release, the Government of Montenegro will submit a bill on such a law, satisfactory to the Bank, to the Parliament of the Republic of Montenegro. The law will require the accounts of EPCG to be audited in accordance with International Accounting Standards, and envision the establishment of an independent regulator responsible for setting energy prices based on clearly established criteria. The law will aim to create an enabling environment for private participation in the sector and to allow competition where feasible.[23] This will enhance prospects for efficiency gains and for the medium-term elimination of budgetary support for the energy sector.

44. Recent progress notwithstanding, the power sector remains a key risk to fiscal balance and macroeconomic stability. The system is still operationally fragile and stretched to the limit

[22] This program will allow all industries and budget entities to be disconnected after a suitable warning period. When public health is a concern, adequate budget resources will be allocated to enable energy payments to be made in a timely manner.

[23] All aspects of electricity supply (generation, transmission and distribution) will be regulated initially due to the monopoly nature of networks and the constraints on competition created by the small market and network constraints. However, the separation of generation, transmission and distribution accounts will enable the regulator to establish network service charges to facilitate Third Party Access. Initially, some large Qualified Customers will be allowed to enter into bilateral contracts for electricity supply from local or foreign generators. Once transmission networks are upgraded in neighboring countries, enabling a synchronous connection with the UCTE, the role of competition may be reconsidered.

by years of deferred maintenance. Possible major breakdowns, coal supply problems or an exceptionally cold winter could further increase the need for imports and/or emergency maintenance, which would eventually need to be financed from the budget. In addition, as price increases will have a negative impact on the household income of the poorest (through their heating bills), there will be a need for careful monitoring of the ability of targeted lifeline tariffs and the social safety net to provide adequate mitigation of price increases, and possibly for adjustment of current support mechanisms.

D. Reform of Labor Markets

45. As was the case in Serbia, where these issues were tackled with the support of a World Bank Social Protection Grant and a SAC, the current legal framework for the labor market in Montenegro is one of the most rigid and protective of all transition economies. Overly generous entitlements, such as severance pay of 24 months of salary, maternity leave of up to two years, and rigid preconditions for valid dismissals, deter employers from hiring additional workers and hinder enterprise restructuring and civil service reform. The high costs imposed on enterprises by the law discourage official employment and push economic activity into the informal sector.[24] This impedes efforts to raise public revenues and leaves many workers with no legal protections. Current maternity leave provisions are a particular deterrent to female employment. Entitlements well in excess of available revenues are also a hidden drain on fiscal resources.

46. Expenditures on unemployment benefits (UB) have been limited primarily by the confinement of benefits to those workers with some contribution history, a class of workers which has so far experienced little open employment. In addition, the prevalence of long-term unemployment means that many job seekers have exhausted their eligibility to benefits. In fact, out of 80,000 registered unemployed, only 2200 individuals are entitled to a benefit amounting to 60 percent of the minimum wage. However, since no budgetary transfers have been made to the Employment Fund, the benefit has not been paid since September 2000. In the absence of reforms to make the system more affordable and incentive compatible, the projected increase in the number of claimants as restructuring takes hold would further strain UB programs and limit their effectiveness. In addition, existing labor market programs are costly to administer and are given almost reverse emphasis to what international experience suggests is most cost-effective.

47. **Reform Objectives and SAC Measures.** Rapid action to reform the labor relations framework is a crucial element in the transition of Montenegro to a market economy. A more flexible labor market is a prerequisite for successful privatization, for the development of a dynamic small and medium enterprise base, for drawing enterprises back into the formal economy, and for attracting new foreign investments. With the use of the Euro precluding exchange rate changes, it is also a crucial channel through which the Montenegrin economy can adjust to changing circumstances. Reforms of entitlements are important for fiscal sustainability, and for eliminating the chronic payment arrears which contribute to vulnerability of those citizens most dependent on such benefits. To support reforms aimed at creating a more flexible

[24] Around 30 percent of employed people are believed to work without contract. The results of a recent household survey, in which 28 percent of respondents confirmed that their salaries are not registered at the ZOP (Bureau for Accounts and Payments), also confirm high informal employment.

labor market and a more affordable and efficient system of severance, maternity and unemployment benefits, the SAC would focus on two broad areas of reform:

48. ***A new law on labor.*** This is the single most important reform for enhancing labor market flexibility and bringing entitlements in line with available resources and to levels characteristic of other market economies. With the support the Bank, the Government of Montenegro has developed and submitted to the Montenegrin Parliament a draft law on labor, which would, *inter alia*: a) differentiate the level of severance pay between 0 and 6 months for individual dismissals, according to seniority, and not more than 6 monthly wages for mass lay-offs; (ii) remove restrictions on circumstances for concluding fixed term, temporary and part time contracts; (iii) abolish or reduce special leave entitlements and replace them with a leave without pay option; (iv) include alternative mechanisms for settlement of individual labor disputes and a mechanism for resolution of collective labor disputes; (v) ease preconditions for valid dismissal; and (vi) limit the level of maternity leave relative to current entitlements to 12 months. The Republic of Montenegro is committed to enact such a law by second tranche release.

49. ***Reform of unemployment benefits and employment services.*** The reform program aims to ensure the financial sustainability of these programs, to improve incentives for labor supply and job search, and to ensure that these services are structured to meet the needs of an economy facing significant restructuring. This program has two elements. First, the Government has prepared, and the Montenegrin parliament has approved, a new Law on Employment establishing a flat rate unemployment benefit which lowers the average replacement rate and maximum duration for receipt of benefits to levels in line with regional comparators and with fiscal possibilities. Second, the Government will conduct an assessment of the existing labor market programs and propose a rebalancing from predominantly micro credits and some training towards more cost effective options such as providing information on vacancies, counseling and job search assistance.

E. Improving the Business Environment

50. The return to growth of the Montenegrin economy - and its ability to absorb labor released through the restructuring of existing enterprises - requires a business environment conducive to private sector development. Burdened by a myriad of regulations, many businesses have resorted to operating in the gray economy, or with a foot in both the formal and the gray economy. A recent analysis of barriers to doing business performed by the Center for Entrepreneurship and Economic Development (CEED) in Montenegro shows that the largest obstacles to doing business are (i) administrative burdens, e.g. registration and licensing requirements, (ii) lack of access to financing, (iii) unfair competition, (iv) frequent changes in the legal and regulatory environment, and (v) high taxes and levies.

51. With donor-funded technical assistance, the Government of Montenegro has taken a number of positive steps to construct the framework of laws, rules, and institutions for a market economy. In addition to the tax reform, foreign trade reform, price liberalization measures described in Section II.C., the Montenegrin parliament has recently adopted a new Law on Accounting and Auditing. This law, designed to improve the transparency of business operations, will lead to a two-stage conversion to International Accounting Standards to be finalized in 2003. The new Institute of Accountants and Auditors of Montenegro is the main

institution for implementing the law, and for providing training to accountants, auditors, tax authorities and enterprises. In addition, the business-government dialogue has recently intensified, mainly in the framework of public debate over the drafted package of commercial laws. The government is working to formalize such a dialogue for proposed laws or regulations which have a major impact on business.

52. **Reform Objectives and SAC Measures.** Despite this initial progress in improving Montenegro's business environment, a challenging reform agenda remains. This agenda is focused on further upgrading the legal foundations and institutional capacity for a sound business environment. The main objectives of these reforms are: acceleration of economic growth and job creation, with a particular focus on SME development; promotion of foreign and domestic investment; and reduction in the size and scope of the gray economy by reducing disincentives for businesses to enter the formal economy. To this end, the SAC will support priority reforms to: (i) remove administrative and legislative barriers to entry and efficient operations of business; (ii) reduce barriers to the efficient exit and redeployment of nonproductive assets; and (iii) establish a system of secured financing to improve enterprise access to capital.

53. ***Reducing barriers to entry and efficient operation of businesses.*** The Montenegrin government's efforts in this area have been focused on a new Business Organization Law (Enterprise Law), which has recently been adopted by Parliament. The new registration procedures are designed to provide practical, commercially reasonable mechanisms to record necessary information on a company and to provide access to legitimate users of this information. The law significantly streamlines the registration process, shifting the principal approach from approval to notification. It also narrows the functions of the Commercial Courts, shifting the handling of registration to a Central Registry which comes under the overall administration of these courts, but has an appropriate degree of independence. The new law also eliminates the obligatory minimal capital deposit for the limited liability companies and increases penalties on companies for provision of false information. To facilitate implementation of the new law, the Government has developed and begun to implement a time-bound action plan for introduction of the new registration procedures, including for IT infrastructure modernization, updating the existing database, staff training of the Central Registry, and a public information campaign. It has already secured premises and hardware for the new business registry, and drafted necessary instructions. The Government is committed to adopt and begin to implement the registration procedures developed in accordance with the new Law on Business Organizations by second tranche release.

54. ***Reducing barriers to restructuring and exit.*** To enable the efficient redeployment of physical and financial assets to more productive uses, the Government of Montenegro prepared a new Law on Business Organization Insolvency (Bankruptcy Law), which has now been adopted by the Montenegrin Parliament. This law establishes rules for the resolution of business failure in a clear, predictable and fair manner. It provides a mechanism for businesses to reorganize where possible, and an orderly means of exit when they cannot. It also provides for the orderly collection of assets, clear and timely claim submission and resolution procedures, and rules governing the distribution of proceeds to claimants. It contains transparent procedures and outcomes, as well as definite deadlines and incentives for movement toward case resolution. The

law also provides the enabling framework for out-of-court settlement of disputes, and for dealing with bankruptcy matters spanning beyond Montenegro.

55. The Government recognizes that a new law is a necessary but insufficient condition for an effective bankruptcy system. As shown by experiences elsewhere in the ECA region, this also requires building capacity in the courts and the trustee community. To meet this challenge, the Government, with technical assistance from USAID, has developed and agreed on a time-bound action plan for the application of this law. The first steps in its implementation have included drafting the required forms and training materials, and beginning to train commercial judges. During the rest of 2002, the major efforts will be focused on expanding training to other key functionaries in the insolvency system, including government officials, bankruptcy administrators, attorneys, and accountants.

56. ***Developing a functioning system of secured financing*** is important for improving the access of enterprises to capital. Collateral legislation in Montenegro is not yet fully developed. The limited real estate financing goes under the Law on Fiduciary Transfer of Property introduced in 1996. A Mortgage Law is under preparation. The State Agency of Real Property efficiently performs the functions of the immovable pledge registry. Leasing operations can be conducted under the Federal Law on Torts and Obligations. To improve the access of enterprises to capital, the Government of Montenegro has now turned its focus to completing the system of secured financing. After extensive public discussion, it has approved a draft law on secured transactions, which has been submitted the Montenegrin Parliament. The new law will equip Montenegro with a modern legal framework for secured transactions, as well as with implementing institutions to support sophisticated credit transactions involving movable property (inventory, equipment, accounts and consumer goods) as collateral. The Government has developed and agreed on a time-bound action plan for implementation of the new law. It is committed to successfully implementing this plan, most importantly by establishing and staffing the centralized Pledge Registry by second tranche release.

F. Medium-Term Prospects and Financing Requirements

57. ***Growth prospects.*** In Montenegro as in FRY as a whole, positive growth in 2000 and 2001 was primarily driven by one-off rebounds from earlier exogenous shocks. From 2002 to 2004, real output is expected to grow at an annual rate of around 4 percent in both FRY as a whole and in Montenegro. These projections assume strong macroeconomic management, a sustained reform effort, adequate donor financing, and further concessional debt rescheduling, and are thus associated with some downside risk. Near-term growth is expected to be driven by exports, a more vibrant SME sector better integrated into the official economy, improved balance in the energy sector, and greater donor financing of investments. These factors are expected to outweigh the contractionary near-term impact of further fiscal adjustment and the remaining transitional recession. Medium-term growth will also be driven by greater productivity and enhanced financial intermediation (including as a result of accelerated privatization, improvements in the business environment, and banking reforms), the entry of new foreign and domestic firms (facilitated by the creation of a single economic space within FRY), infrastructure rehabilitation and investments in new productive capacity. A restructured tourism sector will

work to promote growth in Montenegro, while gradual reintegration of the shadow economy will work to increase recorded growth rates.

58. ***Fiscal prospects in Montenegro.*** The limited domestic sources of budget financing[25] and the reduction in external financing to more sustainable levels will require a phased reduction in fiscal deficits. This will be particularly challenging in the near-term, as the resumption of debt service payments, the more realistic budgeting of commitments (to cut growth of budgetary arrears), and the bringing on budget of some quasi-fiscal activities, will create additional cash outlays, while the expenditure savings from the structural reform program will only come over time. In such a setting, counterpart funding from the SAC will work to ensure that the overall fiscal adjustment is not excessively abrupt. The cash-based consolidated fiscal deficit (excluding official grants) will slightly increase from 6.1 percent of NMP in 2001 to 6.3 percent in 2002, driven by a much larger increase in public debt service payments, and then begin to decline to around 4 percent in 2004. Reductions in the outer years will be supported by deeper expenditure reductions as SAC reforms take hold, and by improvements in tax administration. In parallel, structural reforms to improve the financial position of energy utilities, other enterprises and banks, will make inroads into hidden quasi-fiscal deficits. While cash outlays will decline by around 2.3 percentage points of NMP from 2002 to 2004, the program also achieves additional cuts in expenditure commitments and hidden quasi-fiscal deficits, with the biggest direct impacts coming from the energy and pension reforms. More sustainable fiscal policies are expected to support a reduction of *inflation* from 24 percent in 2001 to about 12 percent in 2002, and then to around 5 percent in 2004.

59. ***External balances of FRY.*** The growth of exports of goods and services (in US dollars) is expected to rise from 8.4 percent in 2001 to around 14.2 percent in 2002, before returning to more sustainable but still high rates in the outer years. The initial rise of export growth will primarily reflect the phased restoration of business contacts. In the later years, export recovery could be supported by a rebound in the economies of key partners, deepened trade integration (including through the EU Stabilization and Association and WTO accession processes), the rehabilitation of infrastructure networks, productivity improvements, and higher FDI (supported by external trade liberalization and a single economic space within FRY).

60. FRY's current account deficit (including grants) is expected to rise from 5.5 percent of GDP in 2001 to 9.3 percent in 2003, driven by the increase in debt servicing costs and investment. It will then begin to gradually decline, reaching around 8.6 percent in 2004. These levels reflect a fundamental structural imbalance between a low savings rate (growing out of a deep decline in living standards, the erosion of enterprise profitability, and low budgetary savings), and the increased investment needs following a decade of severe decapitalization. Gross domestic fixed investment as a share of GDP is expected to rise from a low 13.5 percent in 2001 to 15.4 percent in 2002 and 17.2 percent in 2004. In parallel, and supported by public sector saving, a strengthened banking system, and an increase in enterprise profitability, gross domestic savings will increase from –8.6 percent of GDP in 2001 to –2.4 percent in 2004. In the early years, donor grant funding will play a significant role in closing the gap between national savings and investment needs.

[25] A nascent treasury bill market does not represent a major source of net financing, as new issues primarily go to redeeming bills coming due. However, the acceleration of privatization will represent a larger source of financing.

Table 2:- Federal Republic of Yugoslavia - Medium-Term Macroeconomic Prospects

	2000	2001	2002	2003	2004
National Accounts					
GDP (US$ millions) 1/	8071	10861	12841	13849	14993
Real GDP growth (%)	5.0	5.5	4.0	4.0	4.0
			(% of GDP)		
Investment	14.5	13.5	15.4	16.4	17.2
Gross Domestic Savings	-3.6	-8.6	-6.4	-4.0	-2.4
Public Sector Balance 2/					
Total Revenues (including grants)	40.0	42.3	44.0	43.5	42.8
Revenues (excluding grants)	39.2	41.6	43.0	42.4	41.9
Expenditures 3/	40.1	43.0	48.7	47.8	46.7
Balance (deficit)	-0.2	-0.6	-4.7	-4.3	-4.0
Before grants	-1.0	-1.3	-5.7	-5.4	-4.9
External Accounts					
Exports of goods and services (% change)	18.6	8.4	14.2	13.1	9.4
Imports of goods and services (% change)	13.1	28.9	15.3	7.3	7.1
Current account balance	-339	-596	-1050	-1285	-1292
Before grants	-610	-1187	-1646	-1685	-1741
as % of GDP	-4.2	-5.5	-8.2	-9.3	-8.6
Before grants	-7.6	-10.9	-12.8	-12.2	-11.6
Indebtedness 3/					
TDO/XGS	447.9	432.6	272.6	263.5	259.7
TDO/GDP	141.3	110.0	67.0	67.9	67.6
TDS/XGS	2.3	3.9	10.9	12.5	12.5
Inflation					
Retail price index (e.o.p. - % change)	113.5	39.0	20.0	10.7	6.4

1/ GDP estimates exclude Kosovo. The economy of Kosovo is estimated to be about 6% of the total FRY economy.
2/ Excludes Kosovo.
3/ Stock of debt includes short-term obligations.

61. ***Financing needs.*** To achieve this macroeconomic scenario and finance the transition to a market economy under high physical rehabilitation needs and resumed debt service, FRY and Montenegro will require substantial capital inflows. Even following a sharp increase in dollar GDP in 2001 (largely driven by real appreciation), FRY's external debt remained a very high 110 percent of GDP at end-2001. Between 2002 and 2004, gross external financing requirements are estimated at about US$11.0 billion. These resources are needed to finance US$4.4 billion of debt restructuring, US$3.7 billion of current account deficits (excluding interest and official transfers), US$1.4 billion in increased international reserves (to raise these to a level of 4 months of imports), and the remainder of US$1.5 billion to fulfill net income obligations. During this period, as the fiscal deficit is increasingly brought under control, these needs will shift from the budgetary sector to the private sector.

62. ***Financing sources.*** These needs are projected to be met from several sources. Multilateral, bilateral and commercial creditors are assumed to finance US$4.4 billion of these financing needs through agreements to restructure and reduce outstanding debt and arrears. With good progress on reforms, including those supported by the proposed SAC and other adjustment operations, foreign direct investment and other private sector finance will grow to total around US$2.8 billion during this three year period. The remaining US$3.8 billion of financing during this three year period will come from official bilateral and multilateral sources. The Bank program generally, and the proposed adjustment operations more specifically, would represent a significant share of this financing, and can thus play a crucial role in helping to ensure adequate financing for the reform programs in FRY and Montenegro.

Table 3:- Republic of Montenegro - Medium-Term Macroeconomic Prospects

	2000	2001	2002	2003	2004
National Accounts					
NMP (millions DM)	1300	1570	1817	2003	2187
Real NMP growth (%)	4.0	3.5	4.0	4.0	4.0
			(% of NMP)[1/]		
Consolidated Fiscal Accounts (cash accounts)					
Revenues (excluding grants)	45.8	46.8	46.6	46.5	46.4
Total Revenues (including grants)	56.5	50.8	49.7	49.0	48.3
Expenditures	56.3	52.9	52.9	52.0	50.4
Balance (deficit)	0.2	-2.1	-3.2	-3.0	-2.1
before grants	-10.4	-6.1	-6.3	-5.5	-4.0
Inflation					
Retail price inflation (e.o.p.)	...	24.0	12.0	6.0	5.0

1/ As noted previously (footnote 13), NMP is generally estimated to be about 80 percent of GDP. Under this assumption, ratios of a given variable to GDP would be about 80 percent of the ratios to NMP expressed here.

63. In the event of a London Club agreement on similar terms to the Paris Club agreement, debt service indicators would decline significantly to still high levels. FRY's total external debt would be expected to fall from 110 percent of GDP in 2001 to 68 percent in 2004, driven primarily by deep debt relief, but also by some further real appreciation. This ratio would then decline further to around 50 percent in 2010. FRY's ability to maintain a relatively stable ratio of debt to GDP despite relatively large current account deficits, will initially be facilitated by the high degree of average concessionality of official external financing, and later by increasing inflows of private capital. The ratio of total debt service to exports would fluctuate in the range of 11-17.4 percent in the period 2002-2004, and reach a level of around 20 percent in the medium-term.

IV. THE PROPOSED CREDIT

64. This section provides a summary of the proposed Credit including: (a) details on the Credit and its implementation; (b) coordination with the IMF and other donors; (c) poverty implications; and (d) benefits and risks. The broad rationale and objectives of the Credit, and its links to the Bank's TSS, are discussed in Section I.

A. Project Implementation

65. *Credit Amount, Borrower, Terms, Tranching.* The proposed Structural Adjustment Credit (SDR 11.9 million) will be made to the Federal Republic of Yugoslavia, represented by the Federal Ministry of Finance. The Credit will be on modified IDA terms, with a maturity of 20 years including a grace period of 10 years, and no acceleration clause. It will be released in two equal tranches, the first upon Credit Agreement effectiveness, and the second upon fulfillment of the tranche release conditions. We consider the full completion of the core measures in the first column of Annex 6, in addition to significant progress already made (see Sections II.B and III), sufficient to justify the release of the first tranche.

66. *Implementation, Monitoring and Supervision.* During SAC preparation, the Association has assisted the Government of Montenegro in defining processes to facilitate timely implementation of the agreed reforms. Through regular reviews, the Association will monitor the general progress of Montenegro's reform program, and more specifically the implementation of agreed benchmarks described in the Development Credit Agreement and Letter of Development Policy. This will require regular supervision conducted jointly by staff of the Bank Office in Belgrade and headquarters-based staff.

67. *Loan management.* The Federal Ministry of Finance will open and maintain a Deposit Account in the National Bank of Yugoslavia (NBY), on terms and conditions satisfactory to the Association.[26] Loan administration will be the responsibility of a loan manager employed by the Federal Ministry of Finance, who will be responsible for preparing the withdrawal applications, maintaining the Deposit Account, arranging for its timely audit (if requested by the Association). The loan manager will also be responsible for coordinating the preparation of contributions of the Federal and Montenegrin Governments to the Implementation Completion Report and for writing those sections related to loan administration. The Credit Agreement will be subject to ratification by the Federal Assembly before it becomes effective.

68. *Disbursements.* Upon Credit Agreement effectiveness, and with the submission by the Borrower of a withdrawal application, the proceeds of the Credit will be deposited by the Association into a Euro Deposit Account of the Borrower. Based on the enactment of a Federal law containing the provisions for onlending the SAC proceeds to the Republic of Montenegro, and the enactment by the Republic of Montenegro of a counter guarantee law (both Conditions of Effectiveness), the Borrower will transfer to a deposit account of the Republic of Montenegro (represented by the Central Bank of Montenegro (CBM)) the Euro equivalent of the proceeds of the Credit under terms and conditions satisfactory to the Association. The CBM, through its role as the fiscal agent of the Government of Montenegro, will in turn open a deposit account for the Ministry of Finance of the Republic of Montenegro. If, after deposit in the Deposit Account, the proceeds of the Credit are used for ineligible purposes (i.e. to finance items imported from non-member countries, or goods and services from the Association's standard negative list), the

[26] The recent FRY CFAA analyzed the flow of funds for structural adjustment operations with the National Bank of Yugoslavia (NBY) and did not find difficulties in transferring and tracking credits from the Association to the NBY and then to government accounts.

Association will require the Borrower to either: (i) return the amount to the account for use for eligible purposes; or (ii) refund the amount directly to the Association.

69. *Reporting, Accounting and Auditing.* The Federal Ministry of Finance, with the assistance of the National Bank of Yugoslavia, the Central Bank of Montenegro, and the Montenegrin MoF, would maintain records of all transactions under the Credit in accordance with sound accounting practices. Although routine audits of the deposit accounts will not be required, the Association reserves the right to require audits at any time. In such cases, the Borrower should furnish and audit report not later than four months after the date of the Association's request for such an audit.

70. *Closing Date.* The closing date of the Credit will be September 30, 2003.

71. *Environmental Impact.* The proposed SAC is not expected to result in any negative impact on the environment. In line with Operational Directive 8.60, it has been placed in Category U, which does not require an environmental assessment.

B. Coordination with the IMF and Donors

72. The achievement of SAC objectives will be supported by the Bank's close collaboration with the IMF and donors. The Montenegrin Government's overall reform program has been designed within a macroeconomic framework consistent with FRY's EFF with the **IMF** (see Section II.B). The EA and the SAC were prepared in close cooperation between the Bank and the Fund, and complement each other. The IMF has provided technical assistance in areas covered by the proposed operation, including public expenditure management, while Bank input was important in developing the structural elements of the SBA and EA.

73. At a Donor Conference for FRY held on June 29, 2001, multilateral and bilateral **donors** pledged a substantial initial package of financial and technical assistance totaling around US$1.3 billion, including sums pledged specifically for Montenegro. The SAC builds on the financial and technical assistance efforts of two large donors in Montenegro. The European Commission (EC) is supporting FRY and its two republics through macro-financial support and a large assistance program (EUR 230 million). Its program in Montenegro makes important contributions in the areas of public expenditure management, social protection and energy. The longstanding USAID program provides important support in a wide range of areas, including public expenditure management, energy, business environment, and pensions. Other agencies (e.g. Germany's GTZ and KfW, US Treasury) are also providing more targeted assistance in the public expenditure management and energy areas. During SAC preparation, the Bank has liaised closely with key donors to ensure broad agreement in overall reform priorities and specific policies, particularly to ensure that the reform benchmarks of the SAC are harmonized with conditionality under other assistance programs.

C. Poverty Implications

74. The proposed SAC and the Government program which it supports will have important impacts on poverty. Some reforms, such as higher energy prices and the reduction of statutory

entitlements to severance pay, could have negative initial impacts. These will be addressed through two channels. First, reforms to enhance the transparency of public finances should help to enhance the potential for donor support for payment of social benefits. Second, the Government of Montenegro has demonstrated a clear concern for managing any negative social impacts of reforms. It has implemented recent reforms (see Section II.C) to improve the targeting of social assistance, and its 2002 budget includes a real increase in resources for social welfare programs. The authorities are also working with the Bank and other donors to develop the data and analytical capacity required to ground future adjustment operations in a deeper understanding of the impact of various policies on the living standards of the poor.

75. The SAC will have other positive effects on poverty. By supporting the formulation of more realistic budgets, improved budget execution and reform of entitlements programs, it will limit the accumulation of arrears on social transfers, thus enhancing the predictability of incomes of those dependent on such transfers. It will reduce hidden enterprise subsidies which have delayed restructuring and led to the *ad hoc* crowding out pro-poor expenditures when the emergence of hidden liabilities forced sudden adjustments in other expenditures. A more stable macroeconomy, together with better functioning labor markets, a more secure supply of energy, and additional fiscal space for development expenditures, will also create the basis for investments needed for medium-term growth and employment creation, and thus for more sustained poverty reduction.

D. Benefits and Risks

76. The proposed SAC will provide a range of potential *benefits,* in addition to the positive impacts on poverty described above. First, it will work to enhance stabilization gains made so far by supporting up front actions to tackle major fiscal imbalances and sectoral reforms to enhance medium-term fiscal sustainability, and by providing financing to close Montenegro's budgetary gaps and bolster external reserves. In the absence of such financing, Montenegro and FRY could be forced onto a financially and politically less sustainable adjustment path. Second, it will provide a framework for planning an inter-related set of structural reforms designed to remove key bottlenecks to growth. Third, the elaboration of a sound policy framework and the Bank's assessment of structural reforms will send a positive signal to donors wishing to provide budgetary support, as well as to potential private investors and creditors. Finally, by working for a more stable and prosperous FRY, it will indirectly promote economic recovery in the wider South East European region.

77. The proposed SAC also entails external, political and implementation risks. Various *external shocks* could strain Montenegro's ability to maintain a sustainable macroeconomic framework and to return to growth. Donor flows below pledged levels, and/or inability to secure appropriately concessional debt restructuring from remaining creditors would also exacerbate macroeconomic fragility. Even debt relief on the most favorable terms will lead to a sharp jump in debt service payments, further stretching fiscal and external balances. A marked slowdown in the economy of key trading partners could reduce the growth of exports, foreign direct investment and other private capital inflows. The resulting downward pressure on the money supply would have a deflationary impact. While most external shocks cannot be mitigated, the

Bank and EC are together monitoring aid flows and working to ensure more timely conversion of pledges into disbursements.

78. There are several sources of *political* risk. Implementation arrangements under the new union accord will require agreement on critical but as yet undefined details, including on crucial issues such as the financing of the union structure and the precise modalities for harmonizing external trade policies and ensuring free inter-republican trade, which could prove more difficult than envisioned. Second, while the current Montenegrin government has demonstrated ownership of the program, and while first tranche measures have been satisfactorally completed, differences in views within Montenegro's governing coalition on the way to resolve the constitutional issues could complicate implementation of second tranche measures. Finally, a public expecting rapid improvements in living standards could eventually tire of the required sacrifices, eroding support for the program. The Government of Montenegro is working to broaden public understanding and effect timely implementation. The Bank is working to mitigate these risks through continued policy dialogue. The establishment of a clear path to European integration through the EU Stabilization and Association process, and the strengthening of policy conditionality by other donors relative to the recent past, has also increased the prospects for sustained reform in the face of such pressures.

79. The proposed SAC addresses difficult reform challenges in a setting of uneven *implementation capacity*, part of which reflects Montenegro's small size. The SAC begins to tackle reforms (e.g. in pensions and labor markets) which have been postponed in the past. There now appears to be a greater understanding for the need for such reforms and commitment for their implementation. In addition, major ongoing technical assistance efforts are increasingly shifting their focus from formal adoption of reforms to a deepening of implementation capacity.

80. On balance, the risks are outweighed by the potential benefits to be derived by improving the political economy at a difficult and critical juncture of the reform process, by providing much needed budgetary support, and by creating a more secure and consistent foundation for other donors to provide similar support. Recovery will remain difficult and will not be possible without adequate and timely support from the Bank and other donors. These benefits will be felt not only in Montenegro and FRY, but also in the wider South East European region, as FRY's more rapid and sustainable recovery allows it to become a stabilizing force in the region.

V. RECOMMENDATION

81. I am satisfied that the proposed Credit complies with the Articles of Agreement of the Association and I recommend that the Executive Directors approve the Credit.

James D. Wolfensohn
President

By Shengman Zhang

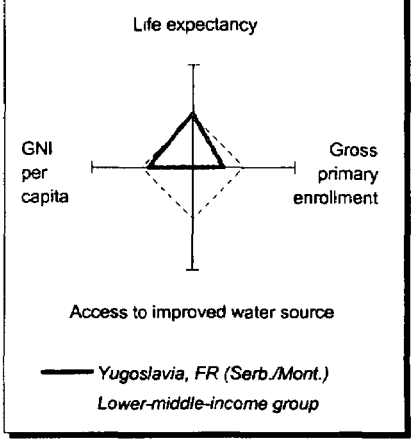
Washington, D.C.
July 10, 2002

Yugoslavia, FR (Serb./Mont.) at a glance

7/16/02

POVERTY and SOCIAL	Yugoslavia, Fed. Rep.	Europe & Central Asia	Lower-middle-income
2001			
Population, mid-year *(millions)*	10.6	475	2,046
GNP per capita *(Atlas method, US$)* 1/	990	2,010	1,140
GNP *(Atlas method, US$ billions)* 1/	10.5	956	2,327
Average annual growth, 1995-01			
Population *(%)*	0.1	0.1	1.0
Labor force *(%)*	0.5	0.6	1.3
Most recent estimate (latest year available, 1995-01)			
Poverty *(% of population below national poverty line)* 2/	15 - 25	.	..
Urban population *(% of total population)*	52	67	42
Life expectancy at birth *(years)*	72	69	69
Infant mortality *(per 1,000 live births)*	13	21	32
Child malnutrition *(% of children under 5)*	2	..	11
Access to an improved water source *(% of population)*	..	90	80
Illiteracy *(% of population age 15+)*	..	3	15
Gross primary enrollment *(% of school-age population)*	69	100	114
Male	69	101	116
Female	70	99	114

Development diamond*

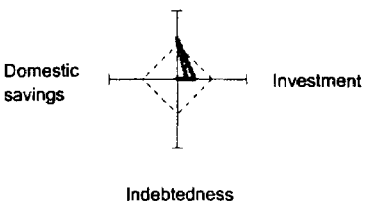


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1981	1991	2000	2001
GDP *(US$ billions)*	.	..	8.1	10 9
Gross domestic investment/GDP	..		14 5	13.5
Exports of goods and services/GDP	..	..	31 6	25.4
Gross domestic savings/GDP	..	.	-3.5	-8.6
Gross national savings/GDP	..	.	10.3	8.0
Current account balance/GDP	.	.	-4.2	-5.5
Interest payments/GDP 3/	..	..	0.6	0.7
Total debt/GDP	.	.	141.3	110.0
Total debt service/exports 3/	..	.	2.3	3.9
Present value of debt/GDP	..	..	..	
Present value of debt/exports	..	.	..	..

	1981-91	1991-01	2000	2001	2001-05
(average annual growth)					
GDP	..	.	5.0	5.5	4 3
GDP per capita	.	..	4.9	5.0	3.8
Exports of goods and services	.	..	34.8	9.4	10 7

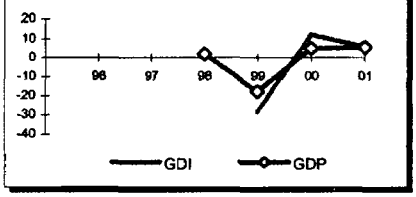
Economic ratios*



STRUCTURE of the ECONOMY

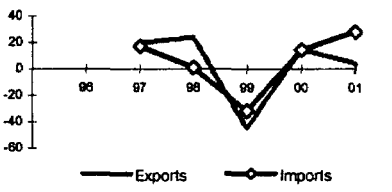
	1981	1989	2000	2001
(% of GDP)				
Agriculture	..	10.1	17.6	.
Industry	..	43.1	37.6	..
Manufacturing	..	..	..	..
Services	..	46.8	44.8	..
Private consumption	..	..	85 0	90.2
General government consumption	.	..	18.5	18.4
Imports of goods and services	..	..	49.6	47.5

Growth of investment and GDP (%)



	1981-91	1991-01	2000	2001
(average annual growth)				
Agriculture	..	..	-20.0	25.0
Industry	..	..	10.9	0.0
Manufacturing	.	..	..	..
Services	..	..	..	..
Private consumption	..	..	20.0	14.8
General government consumption	..	..	-24.5	5.2
Gross domestic investment	..	..	17 5	5.8
Imports of goods and services	..	..	28.6	30.0

Growth of exports and imports (%)



Note: 2001 data are preliminary estimates.

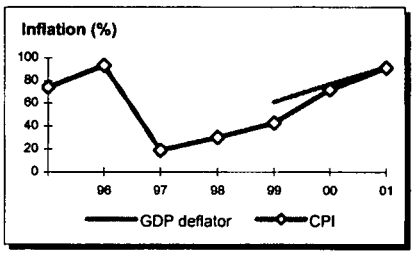
* The diamonds show four key indicators in the country (in bold) compared with its income-group average If data are missing, the diamond will be incomplete

1/ Estimate for 2000; excludes Kosovo and is calculated using the market exchange rate 2/ Estimated range 3/ On a cash basis.

Yugoslavia, FR (Serb./Mont.)

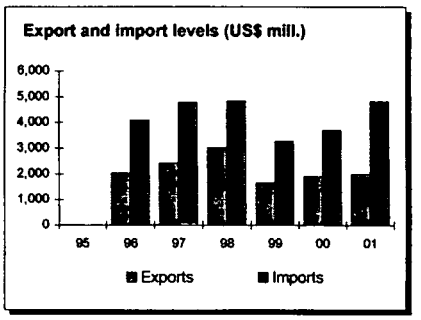
PRICES and GOVERNMENT FINANCE

	1981	1991	2000	2001
Domestic prices				
(% change)				
Consumer prices	.	.	71.8	91.1
Implicit GDP deflator	.	..	76 8	91.7
Government finance				
(% of GDP, includes current grants)				
Current revenue 4/	..	.	40.0	42.3
Current budget balance	..	..	3.2	0.7
Overall surplus/deficit		..	-0.2	-0 6



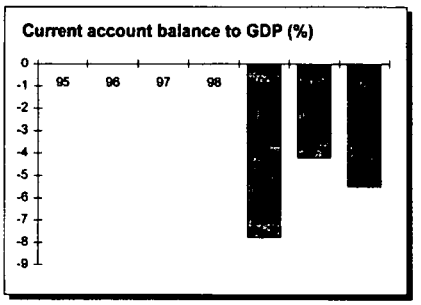
TRADE

	1981	1991	2000	2001
(US$ millions)				
Total exports (fob)	..	..	1,923	2,003
Food	..	..	.	297
Other fuel	..	..		50
Manufactures	..	..	.	694
Total imports (fob) 5/	..	..	3,711	4,838
Food	..	..	.	552
Fuel and energy	.	..	..	1,032
Capital goods	..		..	1,012
Export price index *(1995=100)*		..	.	
Import price index *(1995=100)*	..	.	..	..
Terms of trade *(1995=100)*	..	.	..	



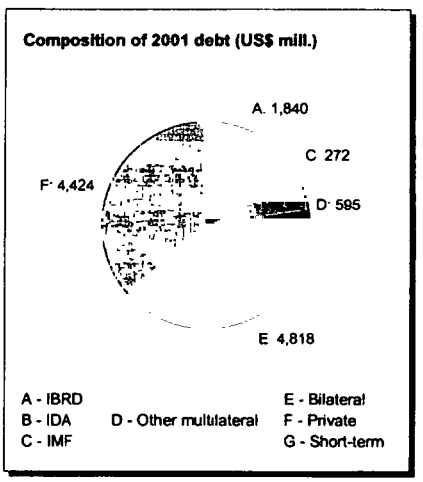
BALANCE of PAYMENTS

	1981	1991	2000	2001
(US$ millions)				
Exports of goods and services	..	.	2,547	2,762
Imports of goods and services	..	..	4,004	5,160
Resource balance	..	..	-1,457	-2,398
Net income	.	.	-1	-26
Net current transfers	.	..	1,119	1,828
Current account balance	..	..	-339	-596
Financing items (net)	..	.	585	1,120
Changes in net reserves 6/	.	.	-246	-524
Memo:				
Reserves including gold *(US$ millions)*	.		516	1,169
Conversion rate *(DEC, local/US$)*	..	.	44.4	66.7



EXTERNAL DEBT and RESOURCE FLOWS

	1981	1991	2000	2001
(US$ millions)				
Total debt outstanding and disbursed	..	..	11,407	11,949
IBRD 7/	..	..	1,812	1,840
IDA	.	..	0	0
Total debt service	..		56	107
IBRD	0	0	0	0
IDA	0	0	0	0
Composition of net resource flows				
Official grants	..	..	271	591
Official creditors	..	.	377	333
Private creditors	0	0	49	202
Foreign direct investment	..	..	25	165
Portfolio equity	..	..	0	0
World Bank program				
Commitments	0	0	0	0
Disbursements	0	0	0	0
Principal repayments	0	0	0	0
Net flows	0	0	0	0
Interest payments	0	0	0	0
Net transfers	0	0	0	0



4/ Includes current grants. 5/ Breakdown is preliminary WB staff estimate. 6/ On a gross basis. 7/ Includes interest arrears and penalty interest.

Yugoslavia, FR (Serb./Mont.) - Key Economic Indicators

Indicator	1997	1998	1999	Estimate 2000	2001	Projected 2002	2003	2004
National accounts (as % of GDP)								
Total Consumption	..	..	..	104	109	106	104	102
Gross domestic investment	..	..	..	15	13	15	16	17
Government investment	..	..	..	3	1	3	4	4
Private investment	..	..	..	11	12	12	13	13
Exports (GNFS)[a]	..	..	..	32	25	25	26	26
Imports (GNFS)	..	..	..	50	48	46	46	46
Gross domestic savings	..	..	..	-4	-9	-6	-4	-2
Gross national savings	..	..	..	10	8	7	7	9
Memorandum items								
Gross domestic product (US$ million at current prices)	..	..	10281	8071	10861	12841	13849	14993
Real annual growth rates (%, calculated from 2000 prices)								
Gross domestic product at market prices	..	..	-15.7	5.0	5.5	4.0	4.0	4.0
Real annual per capita growth rates (%, calculated from 2000 prices)								
Gross domestic product at market prices	..	..	..	..	5.0	3.5	3.7	3.8
Total consumption	..	..	..	..	20.7	7.3	1.5	2.8
Private consumption	..	..	..	..	15.7	8.2	3.2	3.1
Balance of Payments (US$ millions)								
Exports (GNFS)[a]	3265	3947	2148	2547	2762	3154	3566	3900
Merchandise FOB	2447	3033	1677	1923	2003	2250	2616	2900
Imports (GNFS)[a]	5161	5270	3539	4004	5160	5949	6385	6838
Merchandise FOB	4799	4849	3296	3711	4838	5567	5985	6424
Resource balance	-1896	-1323	-1391	-1457	-2398	-2795	-2819	-2938
Net current transfers	310	655	668	1119	1828	2046	1875	2022
Current account balance	-1561	-660	-764	-339	-596	-1050	-1285	-1292
Net private foreign direct investment	740	113	112	25	165	400	450	500
Long-term loans (net)	54	25	12	213	502	950	926	813
Official[b]	54	25	12	213	333	787	747	634
Private	0	0	0	0	169	163	179	179
Other capital (net, incl. errors & ommissions)	749	407	529	347	453	162	327	464
Change in reserves[c]	18	115	111	-246	-524	-462	-418	-485
Memorandum items								
Resource balance (% of GDP)	..	..	-13.5	-18.1	-22.1	-21.8	-20.4	-19.6
Annual dollar-value growth rates								
Merchandise exports (FOB)	19.8	23.9	-44.7	14.7	4.2	12.3	16.3	10.9
Merchandise imports (CIF)	17.0	1.0	-32.0	12.6	30.4	15.1	7.5	7.3

(Continued)

Yugoslavia, FR (Serb./Mont.) - Key Economic Indicators (Continued)

Indicator	1997	1998	1999	Estimate 2000	2001	Projected 2002	2003	2004
Public finance (as % of GDP at market prices)[d]								
Current revenues and grants	..	..	..	40.0	42.3	44.0	43.5	42.8
Current expenditures	..	..	..	36.8	41.6	45.6	44.1	42.4
Current account surplus (+) or deficit (-)	..	..	..	3.2	0.7	-1.6	-0.6	0.4
Capital expenditure	..	..	..	3.3	1.4	3.1	3.7	4.3
Overall balance				-0.2	-0.6	-4.7	-4.3	-4.0
Monetary indicators								
M2/GDP[e]	..	..	..	9.1	8.5	8.9	11.0	14.0
Price indices(2000 =100)								
Real exchange rate (US$/LCU)[f]	..	..	..	100.0	134.0	146.3	145.3	147.0
Retail price index (% change)	..	..	49.9	113.5	39.0	20.0	10.7	6.4

a. "GNFS" denotes "goods and nonfactor services."
b. Includes use of IMF resources.
c. On a gross basis.
d. Consolidated general government.
e. Comprises Serbian money supply only.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

Yugoslavia, FR (Serb./Mont.) - Key Exposure Indicators

Indicator	1997	1998	1999	Estimate 2000	2001	Projected 2002	2003	2004
Total debt outstanding and disbursed (TDO) (US$m)[a]	..	..	..	11407	11949	8598	9397	10130
Net disbursements (US$m)[a]	0	0	0	229	502	950	899	991
Total debt service (TDS) (US$m)[b]	0	0	0	56	107	343	444	487
Debt and debt service indicators (%)								
TDO/XGS[c]	..	..	..	447.9	432.6	272.6	263.5	259.7
TDO/GDP	..	..	..	141.3	110.0	67.0	67.9	67.6
TDS/XGS	..	..	..	2.3	3.9	10.9	12.5	12.5
IBRD exposure indicators (%)								
IBRD DS/public DS	0.0	0.0	0.0	0.0	0.0	34.9	29.3	24.7
Preferred creditor DS/public DS (%)[d]	0.0	0.0	0.0	0.0	51.1	50.9	45.5	53.0
IBRD DS/XGS	0.0	0.0	0.0	0.0	0.0	4.8	4.3	4.1
IBRD TDO (US$m)[e]	1144	1128	1148	1119	1012	1834	1834	1919
IDA TDO (US$m)[e]	0	0	0	0	0	290	450	535

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.
b. Reflects debt service relief.
c. "XGS" denotes exports of goods and services.
d. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.
e. Excludes interest arrears and penalty interest through 2001.

Yugoslavia, Federal Republic of - Status of Bank Group Operations
Operations Portfolio (IBRD/IDA and Grants)
As of 07/05/2002

Active Projects		Last PSR Supervision Rating			Original Amount in US$ Millions					Difference Between Expected and Actual Disbursements a/	
Project ID	Project Name	Development Objectives	Implementation Progress	Fiscal Year	IBRD	IDA	GRANT	Cancel.	Undisb.	Orig.	Frm Rev'd
P074127	FIN SEC DEVT TA GRANT	S	S	2001			6.00		4.02	1.80	
P074145	PRIV SECT DEVT TA GRANT	S	S	2001			6.00		4.50	2 50	
P074618	MONT. ENV. INFRASTRUCTURE GRANT	S	S	2002			2.00		2 00	-	
P074124	SOCIAL ASST GRANT	S	S	2002			10.00		0.60	0 60	
P074136	EMG ELEC POWER RECN GRANT	S	S	2002			6.00		4 07	3.10	
P074586	SERBIA SAC	S	S	2002		70.00			-	-	
P074090	TRADE & TRANSPORT FACILITATION IN SE	S	S	2002		6.76			6.76	-	
P074486	PFSAC	S	S	2002		85.00			85.00	-	
P075189	SERBIA EDUCATION IMPROVEMENT	S	S	2002		10 00			10.00	-	

Yugoslavia, Federal Republic of - Statement of IFC's
Held and Disbursed Portfolio
As of May 2002
(In US Dollars Millions)

		Held				Disbursed			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
2002	Fresh&Co	7.17	0.00	0.00	0.00	4.78	0.00	0.00	0.00
1982/87	Igalo	8.06	0.00	0.00	0.00	8.06	0.00	0.00	0.00
1985	Jugobanka	4.06	0.00	0.00	0.87	4.06	0.00	0.00	0.87
1980	Monte Hotels	2.00	0.00	0.00	0.00	2.00	0.00	0.00	0.00
1980	Radoje	1.17	0.00	0.00	0.00	1.17	0.00	0.00	0.00
2002	Raiffeisen Yug	0.00	2.33	0.00	0.00	0.00	0.94	0.00	0.00
1980	SMSIE Yugo	1.08	0.00	0.00	0.00	1.08	0.00	0.00	0.00
2002	Tigar Tyre	14.89	0.00	3.72	0.00	5.59	0.00	0.00	0.00
1987/89	Vojvodjanska	38.09	0.00	0.00	18.94	38.09	0.00	0.00	18.94
Total Portfolio:		**76.52**	**2.33**	**3.72**	**19.81**	**64.83**	**0.94**	**0.00**	**19.81**

Approvals Pending Commitment

		Loan	Equity	Quasi	Partic
2002	MFB Yugoslavia	4.00	1.00	0.00	0.00
Total Pending:		**4.00**	**1.00**	**0.00**	**0.00**

Timetable of Key Processing Events

Federal Republic of Yugoslavia
Proposed Structural Adjustment Credit (Republic of Montenegro)

Time taken to prepare:	11 months
Identification Mission:	September 2001
ICM Review:	November 19, 2001
Preparation Missions:	December 2001, February 2002, April 2002
ROS Review:	April 18, 2002
Appraisal departure:	May 6, 2002
Negotiations:	May 29-31, 2002
Board presentation:	August 8, 2002

FEDERAL REPUBLIC OF YUGOSLAVIA
FEDERAL GOVERNMENT
Office of Deputy Prime Minister
Miroljub Labus

July 3rd, 2002

Your Excellency,

Please find enclosed a Letter of Development Policy for Structural Adjustment Credit - Republic of Montenegro, signed by Mr. Miroljub Labus, Deputy Prime Minister of the Federal Republic of Yugoslavia, and Mr. Miroslav Ivanišević, Minister of Finance of Republic of Montenegro, written to Mr. James D. Wolfensohn, President of The World Bank.

Also, please find enclosed a letter Mr. Miroljub Labus addressed to Mr. Christiaan Poortman, Country Director for FR Yugoslavia at the World Bank, regarding the Transitional Support Strategy for FRY.

Sincerely,

CHIEF OF THE OFFICE
Ana Firtel

Mr. Rory O'Sullivan
Chief of Mission
World Bank Country Office
Belgrade

Federal Republic of Yugoslavia (FRY)
Structural Adjustment Credit – Republic of Montenegro

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

Dear Mr. Wolfensohn,

I. Introduction

Having succeeded to membership in the World Bank on May 8th, 2001, the Federal Republic of Yugoslavia (FRY) is requesting support from the World Bank for a comprehensive economic reform program. The government believes that it is best to present the reform efforts of the two republics of Serbia and Montenegro separately for consideration for support from the World Bank, as each republic is at a different stage in its process of transition, and is facing specific challenges and priorities. This Letter of Development Policy describes the core elements of the economic reform program of the Republic of Montenegro to be supported by a Structural Adjustment Credit (SAC) provided by the International Development Association (IDA). This program of reforms seeks to overcome the legacy of many decades of macroeconomic instability and economic decline.

We are committed to pursuing a rapid and comprehensive transformation to a market economy in order to achieve sustained and rapid growth. As restoring growth will require a sustainable macroeconomic framework, and as past macroeconomic instability has been primarily driven by fiscal imbalances, one of our immediate priorities is undertaking measures to achieve sustainable fiscal outcomes. In parallel, as growth and employment creation will require a strong supply response, our other immediate priority is removing key impediments to the activities of the utilities, industrial enterprises, and smaller businesses which must create such a supply response. The policy reforms outlined in this letter are focused on five areas which we believe are the most critical for achieving these two objectives in Montenegro – public expenditure management, pensions, energy, labor markets, and the business environment. Our reform program is being implemented in the context of a macroeconomic framework supported by an arrangement under the Extended Fund Facility of the International Monetary Fund (IMF) that was approved on May 13, 2002.

The constitutional arrangements related to the relationship between FRY and its constituent republics are now being revised. On March 14th, 2002, representatives of FRY, the Republic of Serbia and the Republic of Montenegro signed an agreement for the future establishment of a union of Serbia and Montenegro. On April 9, 2002, this agreement was ratified by the parliaments of the Republic of Montenegro and the

Republic of Serbia. In the event that it is ratified by the Federal Assembly, subsequent steps required for the new constitutional arrangements will be pursued. In parallel, we would begin to work out a range of detailed arrangements to ensure the practical implementation of this new constitutional arrangements.. Irrespective of the forthcoming constitutional changes, both the Government of FRY and the Government of the Republic of Montenegro (GOM) are committed to the full implementation of the program.

II. Macroeconomic Framework

As you are aware, Montenegro and Serbia are currently dealing with the dire consequences of several decades of economic mismanagement under a flawed economic system, exacerbated by a decade of regional conflicts and sanctions. Despite modest growth in 2000 and 2001, GDP still stands at around one-half of its 1989 level. In 2001, FRY exports were down about 50 percent and imports about 25 percent from 1989 levels. Inflation, while now much reduced, remains a source of concern. At the end of 2001, prices in Montenegro were 23 percent above the level of the previous year. Living standards have fallen in tandem with the decline in economic indicators. As a result of a decline in real wages over the past decade, average net wages in Montenegro now stand at around US$130 per month. A UNDP study in the year 2000 indicated that about one-quarter of Montenegro's population is living on a monthly per capita income of less than 100 Deutschemarks (US$50) in 2000. Unemployment is high, with the unemployed appearing to have the greatest risk of poverty. Female and youth unemployment are areas of particular concern.

The key elements of the IMF-backed macroeconomic stabilization program are reducing macroeconomic imbalances, continuing economic restructuring and protecting the most vulnerable. Fiscal policies of the Federal, Montenegrin and Serbian governments should set the stage for further reductions in inflation, while social policy will aim to protect the vulnerable. The target consolidated budget deficit (excluding grants) for 2002 is 5.7 percent of GDP for FRY as a whole, and 6.3 percent of GDP for Montenegro specifically. No increases in this deficit will be allowed unless concrete external financing sources are identified. We are strongly committed to continued adherence to a sustainable macroeconomic framework.

Although Montenegro has already made substantial progress in economic reform, the complete transition to a market economy will require further rapid and simultaneous progress in many sectors, as well as a commitment to often difficult future reforms. Over the past years a phased program of price liberalization, including the August 2001 removal of controls on prices of basic foodstuffs, has left us with a set of price controls similar to that in most market economies. Also, the recent passage of a set of new tax laws, and the ongoing implementation of a Tax Action Plan, will work to broaden the effective tax base and improve tax collection. The liberalization of our trade and foreign exchange regimes has created a more favorable basis for export-led growth and increased the transparency of our foreign trade system. A fifteen-month wage freeze in the face of ongoing inflation, reforms to allow greater control and transparency of budget processes,

the completion of a mass privatization scheme (which placed most formerly socially-owned enterprises in private hands), and substantial initial progress in restructuring the financial sector, have all contributed to the stabilization of the economy and, we believe, the beginning of economic recovery. Our recent reforms of social assistance, which we discuss in greater detail below, were important steps in creating a more effective and affordable social safety net. We anticipate working closely with the World Bank and the IMF over the coming years to build on this progress.

In addition to the broad reform agenda we have begun, as described above, we are committed to pursue a set of structural reforms aimed at improving Montenegro's macro-financial sustainability, and at removing in the shortest possible time key bottlenecks to the growth of output and employment in Montenegro. The SAC will support immediate reforms in the five priority areas noted above, with a view to achieving rapid gains as well as to creating a basis upon which subsequent structural adjustment operations could support required follow-up reforms. Details of the policy reforms to be undertaken in the above sectors are outlined below, along with an indication of the elements of a medium-term policy agenda.

III. Public Expenditure Management Reform

Context. The unsustainable fiscal outcomes of the past were the result not only of sectoral policies which placed direct or hidden pressures on our budget (some of these policies are discussed later in this letter), but also of gaps in our processes of public expenditure management. The absence of a comprehensive, medium-term macroeconomic framework hampered budget formulation. Weaknesses in our ability to identify expenditure overruns have hampered our capacity to align commitments with available resources and has threatened either to create unplanned outlays, or to translate any revenue shortfall into arrears and/or an undue disruption in government services. Transparency was hampered by the fragmentation of general government operations, and by a very limited evaluation and auditing of budget outcomes.

From late 2000, we have already made substantial progress in adjusting sectoral policies, particularly through measures to raise controlled prices – and thereby remove hidden subsidies - and to bring existing subsidies onto the budget. At the same time, we embarked on a donor-supported program of public finance reforms aimed at increasing fiscal transparency and improving budget planning, revenue collection and expenditure control. In 2001, the Parliament of the Republic of Montenegro adopted important Laws on the Budget System (LBS) and Public Procurement, and established a Republican Treasury. These reforms allowed us to prepare a 2002 Republican budget based on new IMF Government Financial Statistics (GFS) methodology. In August 2001, the Ministry of Finance (MOF) of the Republic of Montenegro issued a new Budget Preparation Instruction to the line ministries. It worked intensively with the line ministries and other direct spending units (DSUs), and extended training to DSUs on the procedures established by the LBS. The launch of the Treasury began with the appointment of the Treasurer and key staff, and the issuance of a Treasury operations manual. Since 1999,

we also contracted annual audits of the budget to an auditing firm, and in 2001, we began to implement and enforce the Law on Procurement.

While these initial changes were generally successful, we know that further reforms and institutional strengthening are needed to consolidate and deepen this progress. To complete the implementation of the LBS, we need to adopt further supporting or secondary legislation, and to conduct an institutional reform of the MOF. To efficiently determine and rationally implement needed reductions in public spending, we need to strengthen the capacity for fiscal analysis and policy formulation, both in the MOF and in the line ministries. The formal mechanisms to cut back program and policy over-commitments, now consist solely of disciplined budget formulation and budget amendment requests where appropriations limits would be breached without them. We are committed to continue to increase our capacity to analyze the strategic allocation of funds across various budget areas. Further progress is also needed to increase the comprehensiveness of the budget process, develop aid monitoring and coordination, harmonize the budget management processes of social funds with central budget practices, and improve public understanding of public finances. We have already established parliamentary control over spending below the aggregate level, and will begin to establish parliamentary control over external audit functions.

Reforms supported by the SAC. The GOM has now developed and begun to implement a reform program which aims to deliver greater macro-fiscal control and accountability of the public finance management system. The former will require limiting unplanned expenditures and better aligning commitments with available resources. In addition, the major fiscal adjustment which we have commenced, and which we must sustain for many years, will only be supported by our citizens and by the donor community, if we are able to show that scarce public funds and donor support are being spent efficiently and on legislated goals. While the passage of the LBS and establishment of the Treasury were major milestones, we still face an extensive agenda of changes to achieve their full implementation. Rather than starting many new reforms, we will focus our immediate efforts on this agenda.

Our program to achieve these objectives addresses key gaps in the three areas of budget formulation, execution, and audit procedures and institutions. The efforts of the GOM in the area of ***budget formulation*** are focused on implementing the reforms to strengthen and increase the transparency of budget preparation procedures which it initiated in 2001. In particular, to get a more complete picture of state finances, and to prevent the shifting of fiscal pressure from the republican budget to social funds through the accumulation of arrears, we wish to introduce a more comprehensive and more medium-term perspective for fiscal policy. To this end, we are developing a three-year macro-fiscal framework which includes the central budget, social funds and local governments, and fully reflects major policy commitments, such as the resumption of external debt servicing, bank and enterprise restructuring, and reform of the social welfare system. These changes now under preparation will be introduced with the 2003 budget cycle, beginning with the preparation of a 'Budget in Brief' which explains the macroeconomic framework and the proposed level and broad composition of

consolidated expenditures. We will further increase the transparency of the budget preparation process drafting a Citizen's Guide to the Budget. To strengthen aid coordination, the MOF has presented to the GOM a proposed interim policy on donor funding, which will serve as the basis for a more comprehensive policy including clear procedures for incorporating into the budget in-year receipt and use of donor funding. In addition, MOF has begun its own institutional reform, which it is committed to complete by the end of 2002. As part of this reform, it has defined the functions and staffing of the Budget Department comprising a budget formulation unit and a macro/fiscal analysis unit, and established, staffed and begun to train the latter.

In the area of ***budget execution,*** the GOM is focused on completing implementation of the Treasury within the MOF. In addition, the MOF has required all budget users financed from the republican budget to use the standard budget classification provided by the new LBS. It is committed to introduce pilot commitment control procedures on major risk categories of budget spending. The MOF has transferred most DSUs and the payroll of all DSUs to the Treasury. By the end of 2002, we are committed to implement a modern Single Treasury Account as defined by the OECD-Sigma standards. We will also develop a schedule for extending the Treasury system to all social funds. After evaluating the effectiveness of these procedures the MOF will propose new controls as appropriate. Furthermore, the MOF has established and begun to develop the Debt Management Department in the Treasury, and is committed to establish this department, and begin hiring and training its staff. Transparency in budget execution has also been enhanced through the generation by the Treasury of monthly execution reports, which are being provided to the MOF management team. The MOF is committed to making monthly summaries of budget execution available to the Cabinet and the general public.

Finally, to further enhance the accountability of public spending, we have begun to upgrade and implement the internal and external ***audit procedures and institutions*** of the MOF and the line ministries. Continuing the practice established in 1999, the GOM has externally contracted an audit of the final accounts for the Budget 2001, and publicly disclosed its results to the Montenegrin parliament. It is committed to also disclose these results to the public and Montenegro will soon initiate a study on different models of external audit, as a basis for choosing the most suitable model for our circumstances. In parallel, the MOF is committed to establish an Internal Audit Department, outline its functions, provide adequate staffing, and adopt its procedures and the annual audit plan for 2003.

In the medium-term, the main objectives in public expenditure management reform are to gradually replace input-based budgeting with budgeting practices geared to measurable outcomes, and to further strengthen the transparency of the public spending system by extending fiscal reporting, inspection and audit functions beyond the republican budget to the general government as a whole.

IV. Pension Reform

Context. The system of social protection in Montenegro consists of both social assistance and social insurance (in the form of pensions), and has come under pressure owing to the economic decline of the last decade, high entitlements and the limited resources of the state. In 2001, the GOM took important steps to reform Montenegro's system of social assistance. To address hardship amongst the poor, we extended the right to *family material support* (the main program of cash social assistance) from those who were unable to work, to also cover those who are capable of work but responsible for the maintenance of children. At the same time, we improved the targeting of *child allowances,* which were formerly given to the first three children in all families irrespective of need, by limiting benefits to those families with children receiving material support and families with disabled children. We expect that the savings from targeting child allowances will help to meet in part the costs of expanded material support. These changes represent important steps in improving the coverage and adequacy of benefits in the social safety net. We are critically aware of the need for continued careful monitoring and assessment of social protection programs, and for protecting the standard of living of the most vulnerable members of society in a fiscally sustainable way.

The GOM is now ready to tackle a similar reform of our Republican pension system. We recognize that current entitlements to pensions in Montenegro are high, and that our pension spending as a share of GDP is well-above regional levels. In addition to contributing to a burdensome level of labor taxes, this pension system is a significant source of fiscal pressure. During 2001, revenues from contributions covered less than 60 percent of pension expenditures, with the remaining gap (over 6 percent of Montenegro's GDP) being covered through budgetary transfers and other arrangements, including donor assistance. Yet, in spite of such support, the system has tended to run arrears on benefit payments, between the social funds, and from the republican budget to these funds. These imbalances have resulted from economic decline, unaffordable benefit provisions, and a sharp increase in the number of beneficiaries and a decline in the contributor-beneficiary ratio during the 1990s.

Reforms supported by the SAC. We believe that addressing the fiscal pressures from the public pension system is a necessary component of any program to improve macroeconomic sustainability in FRY and Montenegro. For this reason, the GOM is committed to achieve both immediate and medium-term fiscal savings through reforms which better align pension entitlements with available resources, and which improve the implementation of the pension system. The centerpiece of our program to reach these objectives, and to make the system more consistent with those in the rest of Europe, is a reform of the existing pension system. To this end, the GOM has accepted and presented for public discussion a draft Law on Pensions and Disability Insurance which *inter alia*: (i) raises and equalizes the retirement age for men and women from 60 years for men and 55 years for women to 65 years for both; (ii) raises the age at which early retirement (with pension reductions) can be availed to 60 years; (iii) changes indexation from wage indexation to indexation which is no more than the arithmetic average of wages and the cost of living; (iv) lengthens the work history included in the pension base calculation; (v) abolishes beneficial work histories; and (vi) abolishes Category III invalidity pensions

(based on remaining work ability). The GOM is committed to full enactment of these changes to pension entitlements by no later than January 1, 2003.

The GOM is also committed to implementing more comprehensive reforms of the pension system, including the introduction of mandatory funded and voluntary funded pensions. Work on these reforms, aided by international technical assistance, is to continue. The future introduction of a mandatory funded pillar (with significant investment of pension savings outside Montenegro) will occur at a time when it is fully consistent with the macroeconomic, fiscal and balance of payments position of the Republic. Close attention will also be paid to the technical and institutional requirements for implementing funded pensions. As an important step in the process of legislating the introduction of funded pensions, a concept paper will be developed outlining the options for a second pillar and an implementation strategy.

In addition, the GOM will take steps to improve the implementation of the current pension system. We recognize that past delays in transferring payroll tax contributions for the GOM's own employees have exacerbated financial imbalances in the Pension Fund. For this reason, and to improve stability of system revenues and strengthen overall contribution compliance, we intend to take steps to make the GOM current on its own payroll tax contributions. We are committed to sustain this progress in the future. Furthermore, to achieve greater clarity of purpose and operations in the Pension Fund, the GOM will propose the elimination of specified non-pension benefits from the Pension Fund in its draft 2003 budget.

These are but the first steps in multi-year process of creating a pension system which is consistent with our overall objectives of restoring macroeconomic stability and growth while reducing poverty. We realize that achieving these objectives will require further difficult measures to structure a pension system in a way that its commitments represent a lower share of Montenegro's GDP and are fully in line with available resources. While these changes will bring some hardship to pensioners and some individuals near retirement, lowering the deficit in the pension system is likely to improve the timeliness of pension payments and release budgetary resources for other priority areas. The changes will also support growth by creating the possibility of a future phased reduction in payroll taxes, which would improve the incentives for employment-creating growth and for drawing the informal economy back into the formal sector.

V. Energy Sector Reform

Context. The Montenegrin energy sector has been characterized by the setting by the state of prices, particularly of electricity, at levels which are well below the cost of production. As a result, the 1990s saw considerable de-capitalization of the sector due to lack of investment and deferred maintenance. Montenegro's industrial sector accounts for around 45 percent of its total electricity demand, nearly 90 percent of which is accounted for by the Podgorica Aluminium Kombinat (KAP). While industrial consumption declined by 17 percent during the 1990s, household energy consumption more than doubled as low power prices led to the widespread use of electric space heating. The

growth of demand and decline in production has left Montenegro importing roughly one-third of its electricity. High demand, low prices, a poor record of collections, and high network losses combined to produce significant losses for the Electric Power Industry of Montenegro (EPCG). As a result, EPCG became a major direct and hidden drain on our fiscal accounts. Even with donor funding for electricity imports, we found it difficult to match peak demand in the winter of 2001/02. This forced us to impose regular 4-hour rolling blackouts during many colder periods.

To begin tackling the structural sources of these financial losses and power shortages, and to reduce and eventually eliminate our reliance on donor-supported electricity imports, we have developed and begun to implement a phased program of price adjustments, improved operating practices and focused investments and maintenance to enable supply improvements to the system. One part of this program involves working with the World Bank and other donors to implement investments and programs to: (a) decrease system losses and theft; (b) introduce energy efficiency measures in industry and households; (c) improve power plant reliability; and (d) arrange for long-term supply of electricity imports on a competitive basis.

Reforms supported by the SAC. The part of this program for which we are seeking support from a SAC focuses on: a) phased reforms to enhance the revenues of EPCG so that it will be able to self-finance in about 2-3 years; and b) the first steps in the process of establishing the legal and regulatory framework for the energy sector. Under this program, EPCG has finalized a comprehensive time-bound Action Plan for reducing electricity blackouts, and has already achieved progress in its implementation. However, as no quick solutions are available to help address the shortage of generating capacity, EPCG will need to continue importing electricity for the near- to medium-term.

Revenue enhancement measures are centered on a staged program of power price increases. In November 2001, the GOM established an average winter tariff for electric power (excluding KAP, which is buying electricity under a separate power purchase agreement valid until the end of 2002) of 37 EUR/MWh. This represents an increase of 50 percent from the winter of 2000/2001. In April 2002, to further strengthen the finances of EPCG, the GOM also cancelled a traditional shift to lower summer tariffs which would have cut the average summer price of electricity (excluding KAP) to 25 EUR/MWh. To cushion the impact of higher prices on our poorest citizens, we introduced a lower 'lifeline' tariff (covering the first 500 kWh of monthly consumption) for those families eligible for our main means-tested social assistance program, the so-called Material Assistance for Families. By no later than November 1, 2002, the GOM is committed to establish an average winter price of electricity (excluding KAP) for 2002/03 which achieves satisfactory further progress in meeting the aims of restoring financial balance to EPCG and addressing the balance between the supply and demand for electricity in Montenegro. Assuming that average collections reach around 85 percent of new billings, these price increases should enable the operating costs of EPCG (net of donor support) to be fully funded from internally generated cash. To reduce the negative impact of KAP on the finances of EPCG, and more generally to place the operations of KAP on an economically sound basis, the GOM will prepare a strategy for KAP,

including a time bound Action Program that addresses ownership and operating issues for the supply of bauxite and electricity. The draft program will be shared with the Bank so that its comments can be taken into account before implementation starts January 1, 2003. As we move forward, we will continue to monitor the impact of energy prices on the welfare of our poorest citizens, and stand ready to consider further mitigation measures which might be required.

While EPCG has already increased the ratio of collections to billings from 55 percent in 1999 to 76 percent in 2001, further progress will be needed to truly harden budget constraints, reduce the risk of higher prices spilling over into higher budgetary and inter-enterprise arrears, and avoid the development of a culture of non-payment. To support the improvement of collections, EPCG has announced a program for disconnecting non-payers, based on clear procedures and including specific performance benchmarks. This program will allow all industries and budget entities to be disconnected after a suitable warning period. When public health is a concern, the GOM will allocate adequate budget resources to enable energy payments to be made in a timely manner. The progress we have already made in implementing this program has brought some decreased losses and increased revenues. By the end of 2002, EPCG is committed to make satisfactory further progress, as evidenced by its Accounts Receivable increasing by no more than 15 percent of total revenues during the previous 12 month period.

Similarly, while EPCG had already reduced the share of barter payment for electricity from 55 percent of total transactions in 1999 to 30 percent in 2001, we see a need for further progress. EPCG has now eliminated all barter except for some direct barter of goods and services which it needs for its own use. By the end of 2002, it is committed to have further reduced the share of barter in total collections to a maximum of 10 percent, and plans to fully eliminate barter during 2003.

In parallel, we have commenced the process of longer term energy sector reform. Over time, we hope to shift from meeting urgent needs to becoming competitive in an open market and adopting the principles of the European Union. As a basis for establishing the medium-term legal and regulatory framework for the energy sector, the Ministry of Economy of the Republic of Montenegro is working with international advisors to prepare an energy strategy, which the GOM will adopt during 2002. By no later than the end of 2002, we are committed to submit a draft Law on Energy, satisfactory to the Bank, to the Montenegrin Parliament. This law will aim to create an enabling environment for private participation in the sector and to allow competition where feasible. It will require the accounts of EPCG to be audited in accordance with International Accounting Standards, and will envision the establishment of an independent regulator of energy prices. All aspects of electricity supply will initially be regulated due to the monopoly nature of networks and the limitations on competition created by the small market and network constraints. However, the separation of generation, transmission and distribution accounts will enable the regulator to establish network service charges to facilitate Third Party Access. Initially, some large Qualified Customers will be allowed to enter into bilateral contracts for electricity supply from local or foreign generators. Once transmission networks are upgraded in neighboring

countries, enabling a synchronous connection with the Western European Power Pool, the role of competition may be reconsidered.

In the medium-term, we are committed to further address the losses of the energy sector through additional measures to increase the level of cost recovery. Our aim is for EPCG to cover operating and debt service costs by [2003], and then to move to a pricing regime implemented through an independent regulator which would attract private sector investments.

VI. Labor Market Reform

Context. Labor legislation in the Republic of Montenegro has been amongst the most rigid of all transition economies, and has represented a serious obstacle to flexible labor markets. Our current legislation prescribes very generous worker entitlements, such as severance pay of 24 months of salary, maternity leave of up to two years, and rigid preconditions for valid dismissals. We are concerned that these provisions have deterred employers from hiring additional workers (particularly women) and hindered enterprise restructuring and civil service reform. The high costs which they impose on enterprises discourage official employment, and push economic activity into the informal sector. This has impeded our efforts to raise public revenues and to reduce the gray economy, and has left many workers with no legal protections. As current labor legislation creates entitlements well in excess of available revenues, we are also concerned that it is a hidden drain on our fiscal resources. As the system is generating arrears (for example, we have been unable to pay maternity benefits since May 2001), these imbalances are impeding the functioning of our social safety net.

Similarly, our expenditures on unemployment benefits have so far been limited by provisions which restrict the eligibility for benefits to classes of workers which have up to now experienced little open employment, or who have already exhausted their eligibility for benefits. Since we have recently been unable to make budgetary transfers to the Employment Fund, this benefit has not been paid since September 2000. We are concerned that in the absence of reforms to make the system more affordable, the projected increase in claimants as restructuring takes hold would further strain these programs and limit their effectiveness. In addition, we wish to improve the administration of our existing labor market programs and begin to shift the emphasis given to specific elements towards that which international experience shows to be most cost-effective.

Reforms supported by the SAC. Reform of labor legislation is the central element of a range of policy measures by which the GOM aims to improve the capacity of the Montenegrin economy to adjust to changing circumstances. We believe that labor market flexibility is a prerequisite for success of our privatization program, for the development of a dynamic small and medium enterprise base, for drawing enterprises back into the formal economy, and for attracting new foreign investments. Reforms of entitlements are also important for fiscal sustainability, and for eliminating the arrears on benefit payments, which contribute to the vulnerability of citizens dependent on such benefits.

Our reforms aimed at creating a more flexible labor market and a more affordable and efficient system of severance, maternity and unemployment benefits (with levels characteristic of other market economies) are focused on two important legislative acts. First, with the support of the World Bank, the GOM has developed and submitted to the Montenegrin Parliament a draft Labor Law which *inter alia*: a) differentiates the level of severance pay between 0 and 6 months for individual dismissals, according to seniority, and not more than 6 monthly wages for mass lay-offs; (ii) removes restrictions on circumstances for concluding fixed term, temporary and part time contracts; (iii) abolishes or reduces special leave entitlements and replace them with a leave without pay option; (iv) includes alternative mechanisms for settlement of individual labor disputes and a mechanism for resolution of collective labor disputes; (v) eases preconditions for valid dismissal; and (vi) reduces the level of maternity leave to a maximum of 12 months. We are committed to enacting this law by no later than the end of 2002.

Second, to improve incentives for labor supply and job search, and to ensure that these services are structured to meet our fiscal constraints and the needs of an economy facing significant restructuring, the Republic of Montenegro has adopted a new Law on Employment. This law reforms the system of unemployment benefits by introducing a flat rate unemployment benefit which lowers the average replacement rate and maximum duration for receipt of benefits to levels in line with regional comparators and with fiscal possibilities. Moving forward, the GOM is also committed to conduct an assessment of the existing active labor market programs and to propose a refinement of the current scheme – predominantly micro credits – towards potentially more cost effective options such as counseling and job search assistance.

In the medium term, we will define a more comprehensive strategy to address the implications of enterprise and public sector reform. An integral element of this strategy will involve the development of a labor redeployment program to address expected widespread redundancies, including pre-layoff and post-layoff services, and a strengthening of labor market institutions responsible for offering these services.

VI. Business Environment

Context. The return to growth of the Montenegrin economy - and its ability to absorb labor released through the restructuring of existing enterprises – will require a business environment conducive to private sector development. We recognize that past over-regulation has led many businesses to resort to operating in the gray economy, and may have discouraged some economic activity altogether. We have already taken important steps to construct the framework of rules, legal systems, and institutions needed for a market economy. In addition to the tax and foreign trade reform, price liberalization, privatization and financial sector reform measures described in Section II above, the Republic of Montenegro has recently adopted a new Law on Accounting and Auditing, which leads to a phased conversion to International Accounting Standards to be completed in 2003. In addition, we have recently intensified the business-government dialogue, and are working to formalize and regularize such dialogue for proposed laws or regulations which have a major impact on business.

Reforms supported by the SAC. Despite this initial progress, we believe that further measures are needed to upgrade the legal foundations and institutional capacity for a sound business environment. Their main objectives are: acceleration of economic growth and job creation, with a particular focus on SME development; promotion of foreign and domestic investment; and reduction in the size and scope of the gray economy by reducing disincentives for businesses to enter the formal economy. To this end, we are focusing our efforts on the three areas of: (i) removing administrative and legislative barriers to the entry and efficient operations of business; (ii) enabling the efficient redeployment of financial and physical assets to more productive uses; and (iii) completing our system of secured financing to facilitate enterprise access to capital.

The centerpiece of our efforts to ***reduce barriers to entry and efficient operation of businesses*** is a new Business Organization Law, which has recently been adopted by the Republic of Montenegro. The new registration procedures are designed to provide practical, commercially reasonable mechanisms for the GOM to record necessary information on a company and to provide access to legitimate users of this information. The Law significantly streamlines the registration process (shifting the principal approach from approval to notification), eliminates the obligatory minimal capital deposit for the limited liability companies, and increases penalties on companies for provision of false information. To facilitate implementation of the new Law, the GOM has developed and begun to implement a time-bound action plan for introduction of the new registration procedures. It has already secured needed premises and hardware for the new business registry, and drafted necessary instructions. Going forward, the GOM is committed to successfully implement this plan, and to have begun implementing the registration procedures for new enterprises established by the new Law. The GOM will also seek feedback from enterprises on the functioning of the new registration procedures as a basis for their further improvement.

The focus of our reforms to enable the ***efficient redeployment of physical and financial assets*** is a new Law on Business Organization Insolvency, which was recently adopted by the Republic of Montenegro. This Law is designed to establish clear and predictable rules for the resolution of business failure. It provides a mechanism for businesses to reorganize where possible, and a means of exit when they cannot. It also provides for the orderly collection of assets, clear and timely claim submission and resolution procedures, and rules governing the distribution of proceeds to claimants. It ensures the protection of creditors' rights, and in reorganization cases, provides an equitable allocation of risk. The law also contains transparent and predictable procedures and outcomes, and definite deadlines and incentives for movement toward case resolution. Finally, it provides the framework for out-of-court settlement of disputes, and for dealing with bankruptcy matters spanning beyond Montenegro. The GOM recognizes that an effective bankruptcy system also requires building capacity in the courts and the trustee community. To meet this challenge, the GOM, with technical assistance from USAID, has developed and agreed on a time-bound action plan for the application of this law. The first steps in its implementation have included drafting the required forms and training materials, and beginning to train commercial judges. During the rest of 2002, our

efforts in this area will be focused on expanding training to other key functionaries in the insolvency system, including government officials, bankruptcy administrators, attorneys, and accountants.

Developing ***a functioning system of secured (collateral) financing*** is important for enhancing the access of our enterprises to capital. We have already established part of the legislative and institutional framework for such a system. Some real estate financing is possible under the existing Fiduciary Transfers Law, with the State Agency of Real Property performing the functions of an immovable pledge registry. A Mortgage Law is under preparation. Leasing operations can be conducted under the Federal Law on Torts and Obligations. The centerpiece of our current efforts to improve this system is a Law on Secured Transactions, which was recently approved by the GOM and submitted to the Montenegrin parliament after extensive public discussion. The draft Law equips Montenegro with a modern legal framework for secured transactions, and the institutions to support credit transactions involving movable property as collateral. We have developed a time-bound action plan for implementation of the new Law. We are committed to successfully implementing this plan, and to establish and staff the centralized Pledge Registry envisioned by the new Law by no later than end-2002. We are also working to ensure delivery of training to improve judicial understanding of the new legal provisions and their means of enforcement, and the dissemination of information to parties likely to use or benefit from the new system.

The reforms described above are important steps in a long term program aimed at creating a modern business environment framework in Montenegro which would be conducive to private sector led growth. We are committed to ensuring their fair and even implementation.

VII. Conclusion

The last several decades have left FRY and the Republic of Montenegro facing considerable economic challenges. We believe that the measures outlined above demonstrate our strong commitment to confronting the structural obstacles to macroeconomic stability, growth and poverty reduction. Although we have already made important progress in managing our resources more effectively, much more remains to be done and we cannot afford to slacken the pace of reform. Given the burden that gaps in the areas of public expenditure management, pensions, energy, and labor markets currently place on our fiscal balance, we expect this package of reforms to bring us much nearer to our goal of macroeconomic sustainability. In addition, the removal of key bottlenecks in the energy sector, labor markets, and the general business environment will be crucial for enhancing the potential for growth and employment creation in Montenegro. Looking to the medium term, our reforms will be directed at the full elimination of quasi-fiscal deficits in the form of losses by EPCG and other large enterprises and of budgetary arrears and other hidden fiscal liabilities. In the longer term, we understand that significant reductions in overall expenditure commitments as a share of GDP, including in the areas of pensions and labor markets will be critical for fiscal

sustainability, especially in the context of increased debt service payments and the bringing on budget of past hidden fiscal liabilities.

We are also intent on taking further steps towards the establishment of institutions and systems that will allow us to manage public resources efficiently and transparently, and to enable the private sector recovery we need to return to sustainable growth. At the same time we need to ensure that the poorest segments of the population are adequately protected form the short term hardships of transition. The continued support of the World Bank and the international community will be essential to us if we are to achieve these ambitious goals.

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Key Structural Policies and Reforms

By Board presentation	By second tranche (expected November 2002)
Public expenditure management Two pilot direct spending units (DSUs) and the payroll of all DSUs have been successfully transferred to the Treasury. All budget users financed from the republican budget are using a standard budget classification as provided by the new Law on the Budget System (LBS).	**Public expenditure management** The Ministry of Finance (MOF) has developed a comprehensive medium-term macro/fiscal framework including major policy commitments, and used this framework in the process of formulating the 2003 budget. The Government of Montenegro has designed and implemented a satisfactory Treasury system and has transferred accounts of Government of the Republic of Montenegro budget-financed ministries and agencies into a single treasury account. The MOF has established and staffed the Internal Audit Department, outlined its functions, and adopted its procedures and the annual audit plan for 2003.
Pension reform The Government has accepted and submitted for public discussion a draft law on pension and disability insurance, satisfactory to the Bank.	**Pension reform** The Republic of Montenegro has enacted a law on pension and disability insurance, satisfactory to the Bank.
The energy sector The Government has established an average 2001/2002 winter tariff for electricity (excluding KAP) of 37 EUR/MWh (representing a 50 percent increase from the winter of 2000/2001) and cancelled the traditional reversion to lower summer tariffs for 2002. EPCG has announced a program including specific performance benchmarks for disconnecting non-payers, with demonstrated early progress in implementation.	**The energy sector** The Government has submitted to the Parliament of the Republic of Montenegro a bill on a law on energy, satisfactory to the Bank. The Government of Montenegro has established and maintained a satisfactory to the Bank average level of electricity tariffs during 2002/2003 winter.
The labor market The Government has submitted a draft law on labor, satisfactory to the Bank, to the Montenegrin Parliament. The Montenegrin Parliament has adopted an Employment Law, satisfactory to the Bank.	**The labor market** The Republic of Montenegro has enaced a law on labor, which includes provisions on severance pay, maternity leave and special leave entitlements, and which is satisfactory to the Bank.
Business environment The Montenegrin Parliament has adopted a Law on Business Organizations (Enterprise Law) satisfactory to the Bank.. The Montenegrin Parliament has adopted a Law on Business Organization Insolvency (Bankruptcy Law), satisfactory to the Bank. The Government has submitted a draft Law on Secured Transactions, satisfactory to the Bank, to the Montenegrin Parliament.	**Business environment** The Government of Montenegro has adopted and begun to implement registration procedures for new enterprises, developed in accordance with the Law on Business Organizations. The Republic of Montenegro Pledge Registry has been established and staffed.

FEDERAL REPUBLIC OF YUGOSLAVIA
PROPOSED STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)
POLICY ACTION MATRIX

Area/Sector and Key Challenges	Actions recently taken to achieve desired outcomes	Actions to be taken by Board Presentation	Actions to be taken by second tranche release
MACROECONOMIC FRAMEWORK		**Maintenance of an appropriate medium-term macroeconomic framework**	**Maintenance of an appropriate medium-term macroeconomic framework**
OVERALL PROGRAM		**Satisfactory progress in carrying out the Program**	**Satisfactory progress in carrying out the Program**
PUBLIC EXPENDITURE MANAGEMENT			
Legal framework	In August 2001, Republican Parliament enacted a new Law on the Budget System (LBS), reflecting international good practice	The Ministry of Finance of the Republic of Montenegro (MOF) has prepared a list of secondary legislation, policies, instructions, and operating procedures required for uniform and effective application of the new rules for public expenditure management, along with a timetable for their preparation and adoption.	MOF has made satisfactory progress in the preparation and adoption of the secondary legislation, policies, instructions, and operating procedures required for uniform and effective application of the new rules for public expenditure management.
Budget formulation			
Comprehensive budget framework and accountability	No such medium-term framework exists	MoF has begun developing a comprehensive three-year macro/fiscal framework as basis for public expenditure planning, comprising the central budget, social funds and local governments.	**The MOF has developed a comprehensive medium-term macro/fiscal framework including major policy commitments, and used this framework in the process of formulating the 2003 budget.** MOF has prepared a Citizen's Guide to the Budget.
Prudent treatment of donor funds	Donor funds (of significant but uncertain volume and timing) not fully incorporated into budget accounts.	MOF has presented to the Government a proposed Interim Policy on Donor Funding, which at a minimum defines: (a) authorization to accept donor funds; (b) intra-year fund planning; (c) budget execution commitment control; (d) monitoring; and (e) auditing.	MOF has prepared and the Government has approved a larger policy paper on the use of donor funds, including clearly established procedure for incorporating into the budget in-year receipt and use of donor funding.
Institutional development	Budget management functions in the MOF are not separated, staff is inadequate, insufficiently trained.	MOF has defined the functions and staffing of the Budget Department comprising a budget formulation unit and a macro/fiscal analysis unit. The macro/fiscal analysis unit has been established and staffed, with training being provided.	

Actions in **bold** are "core" benchmarks for Board Presentation or second tranche release.

FEDERAL REPUBLIC OF YUGOSLAVIA
PROPOSED STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)
POLICY ACTION MATRIX

Area/Sector and Key Challenges	Actions recently taken to achieve desired outcomes	Actions to be taken by Board Presentation	Actions to be taken by second tranche release
Budget execution			
Development of a single treasury function	Treasury established in November 2001. Transparency improved with Government issuance of GFS-compliant budget classification in September 2001.	**Two pilot direct spending units (DSUs) and the payroll of all DSUs have been successfully transferred to the Treasury.** **All budget users financed from the republican budget are using a standard budget classification as provided by the new LBS.**	**The Government of Montenegro has designed and implemented a satisfactory Treasury system and has transferred accounts of Government of the Republic of Montenegro budget-financed ministries and agencies into a single treasury account.** MOF has adopted a time-bound plan for extending Treasury services to the operation of all social funds.
Commitment control	The new LBS introduces the concept of commitment accounting.		Pilot commitment control procedures have been introduced on major risk categories of budget spending.
Public debt management	Very limited capacity to manage public debt.	MOF has outlined functions and staffing of the Debt Management Department in the Treasury	Debt management department in the Treasury has been established, with staff being hired and training being organized.
Fiscal reporting	The Treasury system being established under the LBS provides for regular fiscal reporting.	New Treasury is generating monthly budget execution reports and providing these to the MOF management team.	MOF is providing monthly summaries of budget execution to the Cabinet and the public.
Budget Inspection and Audit			
Institutional capacity	Very limited capacity for Budget inspection/Audit in the MOF and DSUs.		**MOF has established and staffed the Internal Audit Department, outlined its functions, and adopted its procedures and the annual audit plan for 2003.**
External audit	No external audit function.	An externally contracted audit of the final accounts for the Budget 2001 has been conducted and the results have been presented to the Montenegrin Parliament.	A study on the suitability of different models for external audit for Montenegro has been initiated as a basis for future choice of an external audit model.

Actions in **bold** are "core" benchmarks for Board Presentation or second tranche release.

FEDERAL REPUBLIC OF YUGOSLAVIA
PROPOSED STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)
POLICY ACTION MATRIX

Area/Sector and Key Challenges	Actions recently taken to achieve desired outcomes	Actions to be taken by Board Presentation	Actions to be taken by second tranche release
PENSIONS			
Parametric reforms to make the existing pension system more sustainable and reduce the overall fiscal burden of pensions. Both revenue measures and changes to entitlements.	Two Working Groups appointed to oversee the development of policy and modeling of reform options.	**The Government has accepted and submitted for public discussion a draft law on pension and disability insurance that, *inter alia*: (i) raises and equalizes the retirement age for men and women from 60 years for men and 55 years for women to 65 years for both; (ii) raises the age of availing of early retirement (with pension reductions) to 60 years; (iii) changes indexation from wage indexation to indexation that is no more than the arithmetic average of wages and cost of living; (iv) lengthens the work history included in the pension base calculation; (v) abolishes privileged work histories; and (vi) abolishes Category III invalidity pensions (based on remaining work ability).**	**The Republic of Montenegro has enacted a law on pensions and disability insurance, satisfactory to the Bank.**
			The revenues of the Pension Fund have been improved by the Government becoming current on its contributions to the Pension Fund starting July 1, 2002.
	Budget for 2002 proposes a reduction in specified non-pension–entitlements by 50 percent.		Draft budget for 2003 proposes elimination of specified non-pension social benefits from the PF.
Preparation of a further reforms of the pension system.		The Ministry of Labor and Social Affairs has begun to develop a concept for more comprehensive reform.	The Ministry of Labor and Social Affairs has further developed its concept for more comprehensive reform.

Actions in **bold** are "core" benchmarks for Board Presentation or second tranche release.

FEDERAL REPUBLIC OF YUGOSLAVIA
PROPOSED STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)
POLICY ACTION MATRIX

Area/Sector and Key Challenges	Actions recently taken to achieve desired outcomes	Actions to be taken by Board Presentation	Actions to be taken by second tranche release
ENERGY			
The economy is suffering from four hours per day of electricity blackouts.	Over the short-term, shortfalls are being met by a combination of imports and rolling blackouts. The government is developing a strategy to deal with this problem over the medium-term, including a combination of supply and demand-side measures.	The Government has finalized a time-bound Action Plan for reducing electricity blackouts and have achieved demonstrated progress in its implementation.	Actions have been taken to reduce the electricity supply problem prior to the next heating season.
The Government will develop a medium term sector strategy to address this problem.		The Ministry of Economy has begun preparation of an energy strategy as a basis for developing a draft Energy Law designed to provide the legal and regulatory framework to support the sectoral reform program.	**The Government has submitted to the Parliament of the Republic of Montenegro a bill on a law on energy, satisfactory to the Bank.**
Reduce the quasi-fiscal deficit coming from the energy sector through measures which enable the Electric Power Industry of Montenegro (EPCG) to cover operating costs as a first step to full cost recovery.	The Government increased average power prices (excluding KAP) by 50% in April 2001.	**The Government has established an average 2001/2002 winter tariff for electricity (excluding KAP) of 37 EUR/MWh (representing a 50 percent increase from the winter of 2000/2001) and cancelled the traditional reversion to lower summer tariffs for 2002.**	**The Government has established and maintained a satisfactory to the Bank average level of electricity tariffs during 2002/2003 winter.** The Government has prepared a strategy for KAP, including an time bound Action Program that addresses ownership and operating issues for the supply of bauxite and electricity. The draft program has been shared with the Bank so that its comments can be taken into account before implementation starts January 1, 2003.
Design and start implementation of a satisfactory strategy for improving collections.	The ratio of collections to billings has increased from 55% in 1999 to 76% in 2001.	**EPCG has announced a program including specific performance benchmarks for disconnecting non-payers, with demonstrated early progress in implementation.**	EPCG has further increased the ratio of collections to billings, such that its Accounts Receivable do not increase by more than 15 percent of total revenues during the previous 12 months.
Reduce the role of barter	EPCG has reduced the share of barter in total collections from 50% in 1999 to 30% in 2001.	EPCG has fully eliminated third party barter, with only direct barter of goods and services.	EPCG has reduced the share of barter in total collections to a maximum of 10 percent.

Actions in **bold** are "core" benchmarks for Board Presentation or second tranche release.

FEDERAL REPUBLIC OF YUGOSLAVIA
PROPOSED STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)
POLICY ACTION MATRIX

Area/Sector and Key Challenges	Actions recently taken to achieve desired outcomes	Actions to be taken by Board Presentation	Actions to be taken by second tranche release
LABOR MARKET			
Create a more flexible labor market	A draft Labor Law has been prepared.	**The Government has submitted a draft law on labor, satisfactory to the Bank, to the Montenegrin Parliament which *inter alia*: a) differentiates the level of severance pay between 0 and 6 months for individual dismissals, according to seniority, and not more than 6 monthly wages for mass lay-offs; (ii) removes restrictions on circumstances for concluding fixed term, temporary and part time contracts; (iii) abolishes or reduces special leave entitlements, and replaces them with a leave without pay option; (iv) includes framework provisions on alternative mechanisms for settlement of individual labor disputes, and introduces a mechanism for resolution of collective labor disputes; (v) eases preconditions for valid dismissal; and (vi) limits the level of maternity leave to 12 months.**	**The Republic of Montenegro has enacted a law on labor, which includes provisions on severance pay, maternity leave and special leave entitlements, and which is satisfactory to the Bank.**
Make the system of unemployment insurance more incentive compatible and fiscally sustainable and encourage more effective active labor market programs.	Draft Employment Law has been approved by the Government.	**The Montenegrin Parliament has adopted an Employment Law, satisfactory to the Bank, which *inter alia*: (i) establishes a flat rate unemployment benefit; (ii) differentiates the duration of benefit payment between 3 and 12 months, depending on contribution period.**	The Ministry of Labor and Social Affairs has assessed the existing active labor market programs and is refining the scheme from predominantly micro credits towards more cost effective alternative options such as counseling and job search assistance

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FEDERAL REPUBLIC OF YUGOSLAVIA
PROPOSED STRUCTURAL ADJUSTMENT CREDIT (REPUBLIC OF MONTENEGRO)
POLICY ACTION MATRIX

Area/Sector and Key Challenges	Actions recently taken to achieve desired outcomes	Actions to be taken by Board Presentation	Actions to be taken by second tranche release
BUSINESS ENVIRONMENT			
Reduce barriers to entry and efficient operations of business by simplifying and streamlining business registration procedures	An analysis of registration procedures was performed by the Center for Entrepreneurship and Economic Development (CEED), and major findings and recommendations were reflected in the new draft of the Enterprise Law.	**The Montenegrin Parliament has adopted a Law on Business Organizations (Enterprise Law) satisfactory to the Bank.** The Government has developed and agreed on a time-bound action plan, satisfactory to the Bank, for the introduction of new registration procedures, and made satisfactory initial progress in its implementation.	**The Government of Montenegro has adopted and begun to implement registration procedures for new enterprises, developed in accordance with the Law on Business Organizations.**
Increase efficiency of bankruptcy system to allow efficient exit of nonproductive assets.	The Law on Business Organization Insolvency has been drafted and discussed by the Government and submitted to the Parliament.	**The Montenegrin Parliament has adopted a Law on Business Organization Insolvency (Bankruptcy Law), satisfactory to the Bank.** The Government has developed and agreed on a time-bound action plan, satisfactory to the Bank, for introduction of Law on Business Organization Insolvency, and made satisfactory initial progress in its implementation.	Satisfactory progress has been made in implementing the action plan for the introduction of the Law on Business Organization Insolvency, including through the training of a core group of commercial judges, bankruptcy administrators, attorneys and accountants.
Support creation of the system of secured financing to improve enterprise access to capital.	The law on Secured Transactions has been drafted and publicly discussed. The final amendments have been introduced by the expert working group.	**The Government has submitted a draft Law on Secured Transactions, satisfactory to the Bank, to the Montenegrin Parliament.** The Government has developed and agreed on a time-bound action plan, satisfactory to the Bank, for the introduction of the new system of secured transactions.	**The Republic of Montenegro Pledge Registry has been established and staffed.**

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MAP SECTION

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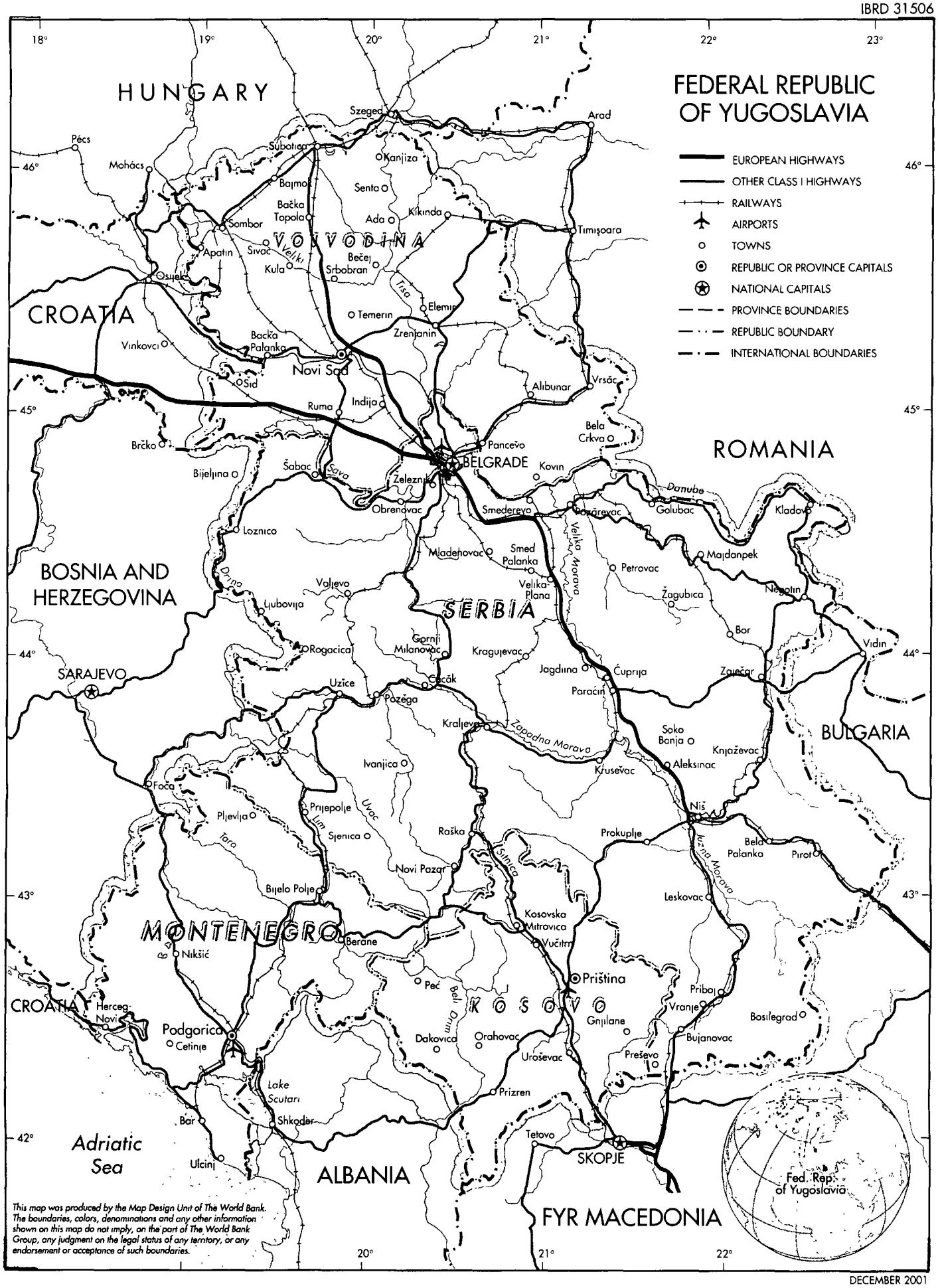

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IMAGING

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