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FEDERAL REPUBLIC OF YUGOSLAVIA

TRANSITIONAL SUPPORT STRATEGY UPDATE

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South East Europe Country Unit
ECC04
Europe and Central Asia Region

ABBREVIATIONS AND ACRONYMS

BRA	Banking Rehabilitation Agency
CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
DM	Deutsche Mark
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
ERTP	Economic Recovery and Transition Program
EU	European Union
FIAS	Foreign Investment Advisory Service
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
GEF	Global Environment Facility
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
ICTY	International Criminal Tribunal for Yugoslavia
IDA	International Development Agency
IDF	Institutional Development Fund
IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
I-PRSP	Interim Poverty Reduction Strategy Paper
MIGA	Multilateral Investment Guarantee Agency
NATO	North Atlantic Treaty Organization
NGO	Non-governmental Organization
NMP	Net Material Product
PEIR	Public Expenditure and Institutional Review
PFSAC	Private and Financial Sector Adjustment Credit
PRSP	Poverty Reduction Strategy Paper
SAA	Stabilization and Association Agreement
SAC	Structural Adjustment Credit
SEE	Southeast Europe
SEED	Southeast Europe Enterprise Development Facility
SFRY	Socialist Federal Republic of Yugoslavia
SME	Small- and Medium-Sized Enterprises
SOSAC	Social Sector Adjustment Credit
TFFRY	Trust Fund for the Federal Republic of Yugoslavia
TSS	Transitional Support Strategy
TTFSE	Trade and Transport Facilitation Program for Southeast Europe
UN	United Nations
UNDP	United Nations Development Program
UNEP	United Nations Environment Program
UNICEF	United Nations Children's Fund
UNMIK	United Nations Mission in Kosovo
VAT	Value Added Tax
WBI	World Bank Institute
WTO	World Trade Organization

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Table of Contents

Boxes

Attachments

Annexes

Memorandum of the Executive Directors of IBRD and IDA
Transitional Support Strategy Update for
the Federal Republic of Yugoslavia (FRY)[1]

I. Introduction

FRY succeeded to the membership of the former Socialist Federal Republic of Yugoslavia in the World Bank in May 2001, at which time a Transitional Support Strategy (TSS) was endorsed by the IBRD and IDA Boards of Directors. The TSS outlined a two-phase program of World Bank Group support to FRY – urgent activities in a pre-membership phase funded through a US$30 million Trust Fund for FRY, and a broader program supporting the Economic Reconstruction and Transition Program (ERTP) encompassed under a three year temporary and exceptional IDA envelope. This TSS Update describes recent economic and political developments, updates progress towards the policy objectives outlined in the TSS, underscores the need for continued strong donor support, and provides a strategic framework for continued Bank assistance to FRY during FY03. A full Country Assistance Strategy (CAS) covering FY04-06 is expected to be presented to the Board in the summer of 2003, together with the Government's full PRSP. A full CAS was not considered appropriate for FRY at this time given the need to substantially enhance knowledge of the causes and determinants of poverty through the PRSP process, and the desire to have a core body of sectoral and analytical work in place upon which to build a longer term strategy. Moreover, this timing of the CAS would allow the ongoing process of redefinition of relations between the republics of Serbia and Montenegro under the Belgrade Agreement to be completed.

II. Economic and Political Context

1. ***The Legacy of the Past.*** The renewed transition to a market economy in FRY began under very difficult economic circumstances. These were the combined legacy of a decade of negative external and internal factors. By 2000, recorded per capita GDP had fallen to about one half of its 1989 level. Foreign trade volumes also declined sharply while inflation (including hyperinflation in 1993) was chronic. FRY accumulated large domestic and external debts, with the latter reaching around 141 percent of GDP in 2000[2]. Although cash deficits of the consolidated government were kept low, this was achieved largely through unsustainable expenditure compression, the accumulation of budgetary arrears, non-servicing of public debt, and the toleration of quasi-fiscal deficits in the enterprise and banking sectors. FRY's real sector became largely inefficient due to the lack of market orientated ownership structures, the loss of markets, lack of access to working capital, delayed investment and maintenance, and repressive and complicated taxation and regulation. The banking sector, consisting of around 100 socially owned banks, became loss making, with most major banks insolvent. This pushed a significant portion of the economy into the informal sector, eroding the government's revenue base and leaving many residents with little or no access to social protection. The poor economic performance resulted in a decrease in real earnings, with absolute poverty roughly doubling since 1990. This increase was accelerated by a deterioration in social protection and health services, as available financing fell below existing entitlement levels. The centralization of political power at the federal level during the 1990s weakened economic institutions, degraded public

[1] The Federal Republic of Yugoslavia has two constituent republics, Serbia and Montenegro. This paper is an update of Federal Republic of Yugoslavia: Transitional Support Strategy (report No. 22090-YU, June 26, 2001) which was considered by the Board of Directors at the time of FRY's membership in the Bank on May 8, 2001. As with the May 2001 TSS, this TSS Update does not cover the province of Kosovo which remains under UN administration according to UN Security Council Resolution UNSC-1244.

[2] GDP figures exclude Kosovo.

accountability and led to more government intervention in markets (e.g., with price and exchange controls). The effects of poor economic management were compounded by international sanctions imposed on FRY from 1992 to 1996 and again in 1998-2000 which severely inhibited trade and investment in the country. During 1999 and 2000, international donors supported Montenegro's stabilization and reform program with substantial grant financing to cover the fiscal deficit. While such financing helped address immediate problems, it also supported loose fiscal policies. In 2000, the consolidated republican deficit reached around 10 percent of Montenegro's Net Material Product (NMP).

2. ***Political Developments.*** The main national political debate has recently centered on the redefinition of the constitutional framework of FRY (Box 1). The federal and republican parliaments have ratified the Belgrade Agreement. Constitutional Commission members were appointed in early June, and the process of translating the principles embodied in the Belgrade Agreement into operational arrangements has begun in earnest. During the past year the considerable domestic debate on FRY's cooperation with the International Criminal Tribunal for Yugoslavia (ICTY) has diverted some attention of policymakers, although recent progress on this issue has been made.

Box 1: Belgrade Agreement on a Union of Serbia and Montenegro

On March 14, 2002, an agreement entitled *Proceeding Points for the restructuring of relations between Serbia and Montenegro* (the Agreement), was signed by representatives of the federal government and the republics of Serbia and Montenegro. The Agreement sets out a general framework for a union between Serbia and Montenegro. The new union would replace the Federal Republic of Yugoslavia and would be called the "Union of Serbia and Montenegro " The federal, Serbian and Montenegrin Parliaments completed the ratification process in May. The Agreement provides for the establishment of a Constitutional Commission, comprised of representatives of the three parliaments, to prepare the Constitutional Charter which is to be submitted to the three parliaments

Under the provisions of the Agreement, Serbia and Montenegro would have some common institutions, including a Presidency, Parliament, and a Council of Ministers, but would operate as two separate economies, including separate currencies and customs systems. The Agreement further provides that after three years, either member of the Union may initiate proceedings to withdraw from the Union.

Upon promulgation of a Constitutional Charter, laws on the election of new union-level parliamentary representatives would be adopted by both Serbia and Montenegro. Elections would then take place and a Parliament of the Union of Serbia and Montenegro would be constituted The Parliament would then elect the President of the Union. The Council of Ministers would have five departments foreign affairs; defense; international economic relations; internal economic relations; and protection of human and minority rights. Serbia and Montenegro would jointly finance these common functions.

3. Domestically, the Serbian Government has been faced with demand for further autonomy from the provincial government in the northern province of Vojvodina. Relations with Kosovo continue to evolve and a dialogue between the United Nations Interim Administration in Kosovo (UNMIK) and FRY authorities on a number of topics has been initiated[3]. In Montenegro the situation of the government has been somewhat affected because of differing views within the current coalition on the Belgrade Agreement, although the economic reform program has wide political support. Although these political uncertainties over the past year have occupied the attention of policymakers in both Serbia and Montenegro, they have not derailed the reform effort. The reformist political leaders remain popular, but maintaining this widespread support for continuing reform efforts is likely to be a key challenge throughout the strategy period. Presidential elections in the Serbian Republic are anticipated before the end of 2002, and

[3] A separate Transitional Support Strategy for Kosovo has been prepared (IDA/R2002-0132), and is scheduled to be presented to the Board on July 25, 2002.

parliamentary elections in both republics could also take place before the end of the year, especially in Montenegro. These elections could somewhat circumscribe the ability of the reformers to continue to move ahead at the current rapid pace.

4. Regional stability and cooperation within South Eastern Europe have greatly improved. On-going efforts by the international community to consolidate stability in the region -- especially the establishment of a clear path to European integration through the **EU Stabilization and Association process** -- have provided strong incentives for reform and cooperation. At the same time, the democratic transition in FRY has also greatly contributed to improved relationships within the region; some acceleration in the return of refugees and the on-going process of regional trade liberalization are tangible results. These developments should reduce the risk that FRY's domestic political challenges could lead to backtracking on economic and political liberalization.

5. ***Recent Economic Developments.*** Since late-2000, a renewed focus on adjusting fiscal deficits towards levels financeable from non-inflationary sources has been the key policy instrument for restoration of macroeconomic stability. In Montenegro, this focus was motivated by the very large budget deficit of 2000, the adoption of the German Mark (DM) which precludes monetary financing, and a decline in foreign financing towards more sustainable levels[4]. At the Federal and Serbian levels, it was motivated by the need to confront and manage the hidden fiscal liabilities which grew out of the unsustainable policies of the past.

6. These tighter macroeconomic policies were first supported by an IMF Emergency Post-conflict Facility for FRY approved in December 2000, followed by an IMF Stand By Arrangement for FRY approved in June 2001. The strong implementation of these programs has brought visible progress while laying the foundations for a more sustained recovery and improved living standards. In Serbia, twelve month inflation declined from 115 percent at end 2000 to 39 percent at end 2001,[5] and further to 17 percent in June 2002. The nominal exchange rate of the Yugoslav dinar to the DM/Euro has remained stable and unified since December 2000. Subsequent real appreciation primarily reflects adjustment from an initially undervalued level. Exchange rate unification and liberalization of the foreign exchange market has brought current account convertibility. FRY's official foreign reserves grew to US$1.3 billion (or about three months of goods and service inputs) at end January 2002, easily exceeding targets under the Government's program supported by the IMF. FRY's GDP has rebounded from a steep decline of about 16 percent in 1999 (influenced by the Kosovo conflict), growing by an estimated 5.5 percent in 2001, despite the effects of a transitional recession that contracted recorded industrial sales by around 1 percent of GDP[6]. FRY's 2001 consolidated fiscal deficit (before grants) of 1.3 percent of GDP (Table 1), relative to an expected deficit of 6.3 percent was achieved through revenue over-performance of about 1 percent of GDP accompanied by expenditure compression of almost 4 percent of GDP relative to initially planned levels for

[4] The adoption of the DM in 1999 along with substantial levels of donor support successfully insulated Montenegro from some of the more severe impacts of economic mismanagement after 1998, such as high inflation and growing arrears on pensions and social benefits. The DM was replaced by the Euro as legal tender in Montenegro in 2002.
[5] Underlying inflation, net of the effects of liberalization of administered prices, is believed to be closer to 15% per year.
[6] GDP growth in 2001 was driven by a strong rebound in agriculture, following a severe drought in 2000.

2001[7]. This adjustment reflects a willingness to take necessary steps to align spending with available sources of non-inflationary financing. Reductions in quasi fiscal deficits (e.g. through higher energy prices which helped to contain the losses of state-owned power companies) and a highly concessional November 2001 debt restructuring agreement with the Paris Club further enhance medium term sustainability.

7. In Montenegro, real growth rebounded to low but positive rates of about 4 percent in 2000 and 3.5 percent in 2001. The 2001 upturn was driven by a rebound in tourism, transport (primarily increased transit of goods to and from Kosovo), and construction. In contrast, recorded industrial production contracted by 0.6 percent. Inflation was 25 percent in 2000 and 24 percent in 2001. Montenegro's consolidated *fiscal deficit* declined from 10.4 percent of NMP in 2000 to 6.1 percent in 2001. Foreign grants remained the main source of deficit financing.

III. The Government's Economic and Social Program and Strategic Agenda.

8. The governments of FRY have defined a vision of a society fully re-integrated with the international economy, the Southeast Europe (SEE) region and into Europe, administered by strong and accountable institutions, and in which sustained, broad based increases in living standards are generated by a dynamic private sector. On the basis of this vision, the authorities worked closely with the Bank and the European Commission (EC) to establish a medium-term Economic Recovery and Transition Program (ERTP), which was presented to donors at the June 2001 Donor Conference. The ERTP program lays out near- and medium-term policy reform objectives, and provides a framework for donors to coordinate assistance programs.

9. The ERTP report highlighted that a return to sustained growth in FRY would require both (i) a sustained program of economic reform on the part of the governments of FRY and, (ii) substantial donor support, including external debt relief. At the June 2001 Donor Conference governments and financial institutions pledged a total of US$1.33 billion toward the ERTP estimated financing requirement of US$1.25 billion in CY2001. Overall needs were estimated at US$3.9 billion over a three to four year program (Box 4). In November 2001, FRY concluded an agreement with Paris Club creditors which details a 51% NPV reduction in outstanding obligations to Paris Club creditors (which stood at around US$4.5 billion) upon approval of a three-year arrangement with the IMF, and a further 15% NPV reduction upon successful completion of this arrangement (expected in March 2005)[8]. Negotiations are continuing with London Club of creditors which is collectively owed US$2.8 billion by FRY.

10. The ERTP, which provides the basis of the overall reform agenda both at the republican and federal levels, identified four closely inter-related strategic objectives:

- Restoring macroeconomic stability and external balance
- Stimulating near-term growth and creating the basis for a sustainable supply response.
- Improving the social well-being of the most vulnerable and building human capacity.
- Improving governance and building effective institutions.

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[7] Figures largely reflect Serbia's progress, as it comprises 94 percent of FRY's total population and contributes about 93 percent of FRY's GDP.

[8] The IMF Executive Board approved a three-year Extended Fund Facility (EFF) for FRY of SDR 650 million (US$829 million equivalent) on May 13, 2002, which made effective the first stage of the Paris Club debt reduction agreement.

Box 2 - Poverty in the Federal Republic of Yugoslavia: A Preliminary Profile.

A long period of instability, international isolation and economic turmoil have adversely affected living standards of a vast majority of population in Yugoslavia. The I-PRSPs from both republics based on the most recent information forcefully attest to the increase of poverty in Yugoslavia during the early 1990's culminating with the 1993 hyperinflation episode; since then poverty held ground, and remains widespread in both republics. Available information on household welfare collected in the various surveys conducted in Serbia and Montenegro during the period 1990-2001 is incomplete, and rough estimates based on this data put the absolute poverty rate by 2001 anywhere between 15 and 25 percent of the population. All available data also suggest clustering of population just above poverty line, indicating that many families in both republics could easily fall into absolute poverty as a result of even a small shock to their income levels.

Groups consistently identified as having higher risk of poverty in most studies in FRY include:

- Unemployed (existing data suggest that more than half of the unemployed are likely to fall well under the poverty line).
- Families with many children and dependents. Families with 3 and more children have as high odds as the unemployed to see their living standards below the poverty line.
- People with low education levels (especially in urban areas), who are restricted to low paying jobs or underemployment. On top of being paid lower wages, they also face a much greater probability of losing their jobs during company restructuring and/or privatization.
- Families of IDPs and refugees, whose living standards depend to a large extent on (shrinking) external humanitarian assistance.
- Disabled and invalids, as minimum disability pensions in both republics have resulted in people to subsist just above the poverty lines.
- Elderly receiving minimum pensions and those not eligible for pensions.

Although existing household surveys do not provide regionally disaggregated data, poverty is likely to go hand in hand with *significant regional differences* in income levels (and therefore is likely to be high in South Serbia and in the north of Montenegro).

Given that unemployment represents a significant poverty risk, policymakers are focusing considerable attention on possible unemployment increase following the restructuring of enterprises. Even though actual unemployment figures (following ILO definitions) may be only half of the officially registered unemployment rates (26.8 % for Serbia and 28.6 % for Montenegro), true unemployment rates in excess of 14 % in both republics already appear high. The timing gap between the immediate social costs associated with hardened budget constraints, and the future benefits in the form of new employment and income opportunities generated by developing private sector, raise the question of social sustainability. The World Bank is assisting the Serbian and Montenegrin Authorities in the development of policies to mitigate the negative effects of reforms (through structural adjustment lending, technical assistance and learning and innovation loans).

The gender dimension of poverty has not yet been well analyzed but gender appears to be a relevant poverty issue. Available data for both republics do not suggest a higher risk of poverty for female headed households. A more general assessment of poverty going beyond income dimensions does however, reveal serious disadvantages facing women. Gender appears to be a relevant poverty issue. Women were more likely to be unemployed or economically inactive than men, and on average earned less than males when employed (i.e. in Montenegro around 20% in the formal sector, but close to 50% in the informal sector). Women from refugee and IDP families do report especially strong biases against them on the labor market. There is an unexplored area for further study regarding gender differences regarding the access to social services, security, protection against violence, participation and empowerment.

Over the coming year the authorities plan to: address identified limitations in the assessment of poverty, produce sufficient data to establish an adequate baseline information on poverty to support the PRSP process (see Box 3), and institutionalize poverty monitoring through the survey process. In addition to making serious efforts toward collecting adequate data on living standards it will also require further analysis to fully understand the causes of poverty, as well as its distribution across regions, gender, professional and ethnic groups.

11. As nearly all economic policy implementation has *de facto* rested with the Republican governments, Serbia and Montenegro have each developed complementary programs of economic stabilization measures and structural reform to address the daunting economic legacy and delayed transition. Policy performance and outcomes have been solid and much has been achieved. GDP and foreign trade volumes have begun to rebound, while fiscal adjustment has supported a reduction of inflation under stable exchange rates. The privatization framework and business environment have been improved, while forceful measures have been taken to restructure the banking sector. Policy reforms and donor assistance have together worked to contain the previously chronic growth of arrears in the social protection system. A detailed summary of reform achievements to date in each republic is presented in Attachment II. A summary of the principal reform achievements against the benchmarks established in the previous TSS is presented in Attachment I.

12. In ***Serbia,*** substantial progress towards *macroeconomic stabilization* has been achieved through initial reforms of public financial management and the tax system, and through progress in containing quasi-fiscal risks in the form of budgetary arrears and losses of key state enterprises and through price liberalization, while maintaining tight monetary policy. Price liberalization and increases in remaining controlled prices (most notably in the energy sector) have been particularly important for enhancing fiscal sustainability. Reform of the financial sector, including the difficult decision to close the four largest banks, the establishment of transparent procedures for the privatization of state- and socially owned enterprises, improvements in the general business environment, and a liberalization of trade policy, have combined to provide a basis for *stimulating near-term growth and creating the basis for a sustainable supply response*. The tax regime has also been simplified, and labor legislation has been reformed to better meet the requirements of a modern market economy. *Protection of the socially most vulnerable and building human capital* has progressed, most notably through reforms to improve the sustainability of the pension system and timeliness of social payments, commencement of decentralization of the education system and of initial steps in restructuring of health financing and delivery. Legal and judicial reform efforts, as well as those in public expenditure management, taxes, and customs are backed by an impressive anti-corruption strategy towards *improving governance and building effective institutions.*

13. The adoption of the German Mark in ***Montenegro*** precluded inflationary domestic financing, and priority efforts towards *macroeconomic stabilization* have concentrated on closing the fiscal gap as sources of donor financing diminish. Energy price rises have been effected to tackle quasi-fiscal liabilities from the energy sector, and to enhance the ability of the electric power industry of Montenegro to address supply shortfalls during the winter. Liberalization of prices and foreign trade have also contributed to stabilization, as well as *stimulating near-term growth.* Montenegro has completed a mass voucher privatization program, and has made progress in improving the overall business environment. Bank restructuring, with a view to privatization, is progressing and the supervisory capacity of the Central Bank of Montenegro is being enhanced. A modern labor law has recently been submitted to parliament, which will improve labor market flexibility and reduce the burden on businesses. The government has extended rights to family material support and improved the targeting of child allowances to better *protect the socially most vulnerable and build human capital.* Recently proposed pension reforms will also be critical to improving the reliability and sustainability of the pension system. Montenegro hasalso established an anti-corruption agency and prepared new anti-corruption legislation, and is working to implement legislated reform of public procurement towards the objective of *improving governance and building effective institutions.* Reform of the judiciary is also

advancing, with the adoption of a new law on the courts and establishment of new judicial bodies.

IV. The Near Term Reform Agenda

14. While impressive progress has clearly been made, the fragility of near-term economic scenarios underlines the need to maintain the pace of reform and deepen efforts across a broad front in both republics. The federal and republican governments have reaffirmed their commitments to moving ahead with the comprehensive multi-year reform agenda presented at the June 2001 Donor Conference (Box 4). Key features of the near-term reform agenda to be implemented over the next twelve months include:

15. ***Restoring macroeconomic stability and external balance.*** A prerequisite for the success of the reform program will be consolidation of the significant gains in achieving macroeconomic stability. The recent PEIR notes that the addition of new sustained budgetary outlays related to restored external debt servicing and the one-off financial and social costs related to enterprise restructuring will put further strain on fiscal performance. As government revenues already represent a high share of FRY's GDP, fiscal adjustment will require reforms to support expenditure containment in other areas where spending is currently high by regional standards and/or inefficient. These areas include the government wage bill, defense, social protection and (in Montenegro) education. Institutional reform priorities for supporting such an adjustment include strengthening the arrangements for budget planning and execution, developing multi-year fiscal planning mechanisms, and improving accountability. Key targets for the next twelve months are:

- Continued improvements in macroeconomic performance within the three-year framework supported by the IMF.
- Satisfactory progress towards the development of a Medium Term Fiscal Framework, further strengthening of the internal audit functions of the Ministries of Finance, and steps towards the establishment of Supreme Audit Institutions in each republic.
- Improvements to tax administration, revisions to excise tax, introduction of synthetic personal income tax and preparations for the introduction of VAT (Serbia). Progress in implementing the new tax action plan (Montenegro).

16. ***Stimulating near-term growth and creating the basis for a sustainable supply response.*** During the past year the FRY governments made significant progress towards modernizing the legal and institutional framework and stabilizing the banking sector. However, over the coming year, FRY will need to intensify efforts towards: (i) developing an environment where the rule of law is respected, property rights and claims are recognized, contracts can be enforced, economic agents can have access to capital, and lenders feel secure; (ii) creating a level playing field between the existing enterprise sector and the new private sector by restructuring loss makers, and thereby avoiding the crowding out of the new private sector; (iii) reaping the benefits of trade by ensuring full free trade within FRY and by expanding the scope for international commerce through further multilateral, European and regional trade liberalization. The Governments plan to act on the following key measures:

- Continued improvements to customs administrations in both republics.

- Amendments to the Companies law, a new Bankruptcy Law, amendment of the Privatization Law to strengthen the government's position as a creditor, progress towards the restructuring of major systems (Serbia). Progress towards successful tender privatizations of SOEs (Montenegro).

- Implementation of a Supervisory Development Plan for Bank Supervision, substantial progress in the liquidation/privatization of directly or indirectly state-owned banks (Serbia). Completion of the resolution process of insolvent banks (Montenegro).

- Continued improvements in the financial situation of the energy utilities, energy sector strategies and new energy laws in both republics.

- Promoting a new labor relations framework that would contribute to greater labor market flexibility and over the medium term, stimulate employment generation (Montenegro).

- Laying the foundation for the development of national strategies for the environment and natural resource management in both republics.

17. ***Improving the social well-being of the most vulnerable and building human capacity.*** The political sustainability of the reform effort will depend to a large extent on the government's success over the next year in shielding the most vulnerable from the negative effects of transition, and building human capital. The beginning of

Box 3. The FRY PRSP Process

The PRSP process was launched in FRY in late April 2002, building on the ERTP framework. Both republican governments prepared interim-PRSPs *Federal Republic of Yugoslavia: Interim Poverty Reduction Strategy and Joint Staff Assessment,* (to be submitted to the Board shortly) over a six week period which present a baseline picture of poverty (Box 2) and define the organizational arrangements for preparing a full participatory poverty reduction strategy by June 2003. Despite the short timing, the interim PRSP has benefited from initial consultations with a varied group of stakeholders in each of the republics. The international community has also signaled its strong support for, and willingness to be part of the process.

Recognizing the multidimensional nature of poverty, the FRY I-PRSP acknowledges the need to address not only income and employment opportunities, but also social inclusion, access to education, health and other public services. The Serbian I-PRSP outlines a three pronged program aimed at (i) promoting growth and enabling private sector employment opportunities with a special focus on small and medium enterprises; (ii) preventative actions aimed at addressing problems of redundant workers and labor redeployment and (iii) improved targeting of social programs especially for vulnerable groups. The Montenegrin I-PRSP focuses on four objectives: (a) maintaining a stable macroeconomic environment; (b) concerted efforts to address problems of the 'gray economy'; (c) strategies to address enterprise restructuring and promote private ownership and (d) improved targeting, especially of vulnerable groups.

A Joint IMF-World Bank Staff Assessment of the FRY-I-PRSP notes that the full PRSP will need to: (i) to improve and institutionalize poverty survey instruments and enhance capacity for analysis; (ii) develop an effective system to monitor progress and track improvements; (iii) identify appropriate benchmark indicators and linkages to the Millennium Development Goals; (iv) ensure that resource allocations maintain consistency with the medium term macroeconomic framework supported by the IMF; (v) within the fiscal envelope, identify, prioritize and cost strategic public policies and programs, and (vi) elaborate plans for improving the overall business environment; achieving the un-impeded operation of a common internal market; addressing critical infrastructure and utility investment and maintenance needs; improving public administration, governance, and health and education service delivery.

Together with other donors, notably DFID, the EU, Eurostat TA, the EC Food Security Program and the UNDP, the Bank is helping to improve statistical collection and develop capacity building training programs in Serbia and Montenegro. Building on the substantial body of sectoral and fiduciary work initiated in FY02 (paras. 28 and 36), during FY03 further Bank support to PRSP development will include: poverty profiles including background papers on the labor market, gender the social impact of reform and targeting, and a fiscal sustainability analysis. WBI is sponsoring a number of PRSP seminars and workshops and the IMF is providing technical assistance for improvement in statistical capacity.

efforts to restructure large enterprises will invariably strain social protection mechanisms and require improved efficiency and targeting of resources in order to not jeopardize fiscal sustainability. Improvements in the sustainability of the health system while improving the quality and efficiency of delivery of health services over the short term will also be a key challenge. Priorities over the next year include:

- Developing a full participatory **Poverty Reduction Strategy** and strengthening the foundation for its implementation in both republics (Box 3).
- Improving the targeting of social assistance and child protection benefits based on poverty survey results, further progress on de-linking benefit eligibility from wage levels in both republics. Enactment of a new pension law (Montenegro). Adoption of a new Law on Employment (which governs unemployment programs and active labor market interventions for dismissed workers and existing registered unemployed) and development of a fiscally sustainable program and institutional framework to handle mass redundancies (Serbia).
- Strengthening the Health Insurance Fund and preventing accumulation of new arrears; drafting an interim health services restructuring plan and completion of a health information systems master plan, including the establishment of a data base; improving the efficiency of procurement of pharmaceuticals.
- Monitoring the impact of education spending across municipalities in accordance with the law on local self-government. Improving the definition of the role of municipalities and school boards in managing education (Serbia).

18. ***Improving governance and building effective institutions.*** Political uncertainty, weak state institutions, poor governance, deficient legislation and an inefficient judiciary have been a recognized deterrent to foreign investors, and corruption in state institutions represents a key political liability as well as a fiscal risk. While the restoration of macroeconomic stability dominated early reform efforts, the government has recognized that the building of effective state institutions and implementation of comprehensive legal and judicial reforms is critical to the sustainability of the reform effort and has made this a priority area for action. Among the key elements of the institution building agenda for FY03 are:

- Completion of a constitutional charter and laws defining Federal/Republican jurisdiction. Updating of republican laws in line with charter.
- Development of a Strategy for public administration reform (Serbia). Initial diagnostic on civil service reform (Montenegro).
- Continued progress in establishing republican treasuries and strengthening of other key functions of republican Ministries of Finance (budget inspection and audit, public debt management, budget planning).

V. Medium Term Outlook and External Financing Requirements

19. ***Sustainable growth is achievable under continued decisive reforms and substantial support from donors and creditors.*** In 2002, real GDP is expected to grow by about 4 percent, slightly below the rate of 2001. This modest slowdown primarily reflects the reversion towards more sustainable growth rates in the important agricultural sector, following last year's sharp recovery from the drought of 2000. Growth in the non-agricultural sector is expected to average 5 percent, led by a recovery of power production (including the impact of more secure energy supply to other sectors) and continued growth of the service sectors, including tourism in Montenegro. Growth will also be supported by the coming on stream of non-inflationary donor support of the budget. These projections assume strong macroeconomic management, a continuation of reforms begun in 2001, well-timed and concessional donor support, as well as further concessional debt rescheduling.[9] Under these assumptions, growth could also average about 4 percent during the period 2003-2004 (Table 1).[10] While sound policies and productivity improvements will work promote rapid growth, the daunting legacy of the past (including the need to service inherited

Table 1: Key Economic Indicators

	1997	1998	1999	2000	2001	2002	2003	2004
National Accounts								
GDP (US$ millions) 1/		.	.	8071	10861	12841	13849	14993
Real GDP growth (%)	.	..	-15.7	5.0	5 5	4 0	4.0	4 0
Investment (% of GDP)	.	.	..	14 5	13 5	15.4	16.4	17 2
Gross Domestic Savings (% of GDP)	.		.	-3 6	-8.6	-6 4	-4 0	-2 4
Public Sector Balance								
Expenditures (% of GDP)	.	.		40 2	42 9	48 7	47 8	46 7
o/w public investment				3 3	1 4	3 1	3 7	4 3
Revenue before grants	.	..	..	39.2	41.6	43 0	42 4	41 9
Deficit before grants (% of GDP)	.	.		1 0	1.3	5 7	5 4	4 9
External Accounts								
Exports of goods and services (% change) 2/	19 6	20.9	-45.6	18 6	8.4	14.2	13 1	9 4
Imports of goods and services (% change) 2/	17 9	2 1	-32 8	13.1	28.9	15 3	7 3	7 1
Current account balance	-1561	-660	-764	-339	-596	-1050	-1285	-1292
as % of GDP	.			-4.2	-5.5	-8.2	-9 3	-8 6
Indebtedness								
TDO/XGS 3/	.	.		447 9	432 6	272.6	263 5	259 7
TDO/GDP	.	..		141 3	110 0	67 0	67.9	67 6
TDS/XGS 3/	.	.	..	2 3	3.9	10 9	12 5	12 5
Prices								
Retail price inflation (eop)	..	.	.	113 5	39 0	20 0	10 7	6 4

1/ GDP estimates include Kosovo
2/ Growth rate of dollar values
3/ Exports exclude workers' remittances

[9] For illustrative purposes, projections assume debt relief and rescheduling on highly concessional terms (i.e., 66 percent reduction of the net present value of debt) from official bilateral and commercial creditors in 2001/2002.
[10] Table 1 shows historic data for 1997-2000, and projections from 2001-2004.

domestic and foreign debts and to manage the social impacts of needed reforms in the enterprise and banking sectors) will divert resources from developmental expenditures. Given FRY's starting point, recovery will take time, even under strong reform and concessional assistance. At an average growth rate of 4 percent per year, per capita income would reach about US$2,300-2,400, or about 90 percent of the estimated 1990 level, by the end of the decade.[11]

20. ***Export performance will be essential to growth and macroeconomic sustainability.*** The last TSS noted that exports would recover more slowly than dollar GDP. Following the modest export growth of 2001, a more rapid rebound is expected in 2002. The restoration and creation of new business contacts, combined with some financial re-intermediation and greater access to export credits, should now allow FRY to make better use of the opportunities created by the removal of sanctions in 2000, and the signing of numerous international agreements to liberalize FRY's foreign trade thereafter. Over the medium-term, export growth will be supported by: the modernization of obsolete machinery and equipment and key repairs to public infrastructure; increased foreign direct investment (facilitated by the creation of a single economic space within FRY); greater integration into the regional and EU economy (where the SAA process will be important) and the global economy more broadly (through membership in the WTO). As investment needs and interest payments on foreign debt will initially rise more rapidly than national savings, the current account deficit is projected to rise from close to US$600 million in 2001 to about US$1.3 billion in 2004, with the current account as a share of GDP beginning to decline in 2004.

21. ***Medium-term growth will depend on increased and more effective investments.*** In the early years, donors will represent an important source of investment finance. Following the recent high levels of support for the Serbian energy sector and for various credit lines, donor support is now set to expand to the transport sector. As a result, overall public investment is projected to grow from a very low 1.4 percent of GDP in 2001 to 4.3 percent in 2004. The primary investment needs are in the enterprise sector (including agriculture, finance and tourism in Montenegro), where modestly higher investments should begin to follow from recent reforms to improve the business environment, to establish enterprise privatization on a basis conducive to attracting new investors, and to implement bank restructuring to restore the public confidence needed for its future revival. Assuming strong progress on these fundamental reforms, private investment is expected to rise from 12.1 percent of GDP in 2001 to 13.2 percent in 2004.

22. ***Fiscal deficits are expected to grow in the near term.*** The cash-based consolidated fiscal deficit (before grants) is expected to increase from 1.3 percent of GDP in 2001 to 5.7 percent in 2002. This is because expenditure savings from structural reforms will initially be outweighed by an increase in debt service payments, one-off reform-related expenditures, the containment of arrears through more realistic budgeting, and the inclusion in the budget of some quasi-fiscal activities. As reform-related expenditures diminish while further reforms contain other expenditures, this deficit would then decline to around 5 percent of GDP in 2004. Fiscal deficits would be primarily financed from concessional (including grant) donor financing and privatization revenues. From 2002 to 2004, cash outlays would be reduced by around 1 percentage point GDP per year. As the program would make further inroads into budgetary arrears and other hidden fiscal liabilities, particularly in energy and pensions, it would achieve even greater reductions in expenditure commitments.

[11] A large part of the increase in US dollar growth reflects the impact of real appreciation of the exchange rate from the recent very low levels.

23. ***External financing requirements will remain large in the near term.*** With large physical rehabilitation needs and the rising cost of debt service following the normalization of relations

Box 4. Donor Support to FRY

Currently, over 25 multilateral and bilateral donors are providing, or have expressed interest in providing, developmental assistance. Approximately US$500 million was pledged to meet FRY's urgent needs at an initial Donor Coordination Meeting in December 2000. This amount included humanitarian assistance.

In June 2001 the Economic Recovery and Transition Program (ERTP) report was presented to donors at a conference in Brussels, which estimated external assistance requirements to return FRY to a path of sustainable growth (in addition to commitments at the December 2000 conference). The ERTP report presented financing needs, on a commitments basis, of US$3.9 billion over three to four years. On a ***commitments*** basis, needs for 2001 were estimated at US$1.25 billion, of which US$140 million was needed in quick disbursing budget support. At the conference donors pledged US$1.33 billion towards the 2001 needs as outlined in the ERTP, including US$151 million in budget support. The ERTP recognized that funds committed during 2001 (and in subsequent years) would take time to disburse, depending on the type of assistance.

The Joint EC-World Bank Office in Brussels has recently undertaken a survey of donors to gather data on the status of pledges towards the ERTP as of December 31, 2001. Initial results indicate that of the US$1.33 billion pledged towards the ERTP 2001 needs, 81% (US$1.09 billion) had been firmly committed, US$768 million (56%) had been contracted and US$303 million (23%) had been disbursed by the end of the year. Disbursements picked up in the first quarter of 2002 as some large donor operations were finalized.

During the past year considerable progress has been made toward improving arrangements for aid coordination. Coordination units in each republic have been established with donor technical support, and have provided the focal points for collection and dissemination of data on economic assistance. The World Bank and the Joint Office in Brussels (WB-EC) has worked closely with these units and directly with the donor community. It is envisaged that the next Donor Conference could take place in late 2002 to take stock of progress and secure funding for the next stage of the reconstruction and transition program.

with external creditors, FRY will have substantial financing requirements in the next few years. Assuming strong stabilization and reform performance, and further concessional debt rescheduling, average annual gross external financing needs (excluding for debt rescheduling) for 2002-2003 are estimated at around US$2.1 billion. These resources are needed to finance US$1.25 billion of current account deficits (excluding interest and official transfers), US$0.45 billion in increased international reserves, and the remaining US$0.4 billion to service international debt. These needs are expected to be met from several sources. Foreign direct investment and other private sector finance are expected to grow to around US$0.8 billion per year. The remaining nearly US$1.3 billion of annual financing would come from official, multilateral and bilateral sources, much of which would need to be raised at a second Donor Conference for FRY later in 2002. The proposed Bank program would represent a significant share of this financing, and can thus play a crucial role in ensuring a sustainable recovery in FRY. Overall donor assistance will need to include adequate provision of quick disbursing funds strongly tied to performance. The Bank program, with its large share of adjustment lending, will assist in meeting this crucial need.

24. ***Sensitivity analyses demonstrate the vulnerability of FRY's outlook to slippages in reform effort and insufficient external assistance.*** In the case of a delayed or weaker-than-expected reform effort or an erosion of fiscal control, donor programs (especially those conditional on policy performance) could be expected to be reduced and to have a smaller impact. Real GDP

growth under this scenario is likely to slow to less than 1 percent per year. Private investment would be cut as enterprise restructuring prospects decline, and exports would fall. Debt indicators would worsen and FRY's debt burden could become unsustainable. On the other hand, a low case could also arise from developments exogenous to FRY, such as an economic slow-down affecting key trading partners or a diversion of donor flows to other countries. This would be likely to lead, despite the government's best reform efforts, to reduced demand for FRY's exports and reduced foreign investment. In such a scenario it would be doubly important to ensure donor support is provided. If not, imports would fall, reflecting the smaller amount of external financing. Real GDP growth could be expected to slow to below 1 percent, as under the previous scenario. As donor funding waned, lower capacity to import capital and equipment would cut investment in industry and infrastructure, cutting the increase in employment and creating more persistent poverty. Lower donor spending on social programs would exacerbate this effect. These illustrative scenarios indicate the importance of both a sustained reform effort and strong donor support – and the extent to which the effects of both are inter-linked.

VI. World Bank Group Assistance

Pre-membership Assistance

25. During the first stage of World Bank assistance to FRY, in view of its urgent needs and concurrent with the arrears clearance process, the Bank established a Trust Fund for FRY (TFFRY) using US$30 million of IBRD surplus net income to provide grant financing for selected priority activities. The TFFRY was approved by the Board of Directors on March 13, 2001. Five grants totaling US$30 million have been approved under the TFFRY and are currently under implementation, laying a foundation for a broader first year IDA-financed program:

- ***a private sector technical assistance grant*** (US$6 million) designed to provide urgent assistance to the Serbia Agency for Privatization to support up to 28 "early win" enterprise sales to strategic investors, strengthen institutional capacity in the Agencies for Privatization, Foreign Investment and SME Development, and support measures to improve the investment climate;

- ***a financial sector technical assistance grant*** (US$6 million) intended to strengthen FRY's Bank Rehabilitation Agency and to support the rehabilitation and rapid privatization of some large state banks and support the liquidation and restructuring of insolvent banks not selected for privatization.

- ***a social protection grant*** (US$10 million) for Serbia aiming to improve the equity of the existing safety net while developing a more sustainable framework, support policy development for reform of the social insurance system, and promote a more market-oriented labor relations framework to facilitate initial restructuring.

- ***an electric power emergency reconstruction grant*** (US$6 million) for Serbia complements an EC-funded program, designed to help restore reliable electricity supply through urgent facility repair. It also supports improvements in the financial management of the electric power company and legal and policy advisory services.

- ***an environmental infrastructure grant*** (US$2 million) in Montenegro focusing on improving solid waste disposal in the coastal area of Montenegro and improving the quality of the water supply in the republic's Zeta Valley.

26. ***FY02-04 Transitional Support Strategy***. On May 8, 2001, FRY succeeded to membership in the World Bank, and the Bank's Board of Directors endorsed a first Transitional Support Strategy (TSS) for the Federal Republic of Yugoslavia[12]. It contained a three-year IDA envelope of up to US$540 million for FRY on a temporary and exceptional basis, with actual lending to depend upon performance against agreed performance benchmarks. It was envisaged that up to eighty percent of the program could support policy based lending. The TSS laid out a program of lending, analytical work and advisory services for FY02.

FY02 TSS Program Implementation

27. ***Lending.*** In line with the core TSS objectives, at end-June 2002, 4 projects totaling US$171.76 had been approved. Consistent with the agreed strategy, the program focused on providing quick disbursing funds to support the initiation of the reform program with selective investments in key sectors aimed at macroeconomic stabilization, stimulating private sector-led growth, protecting the vulnerable and developing human capital, and developing institutional capacity and strengthening institutions in both republics. Core fiduciary work has been completed, and urgently needed TA and advisory services in such areas as financial and private sector development, energy, and poverty monitoring has been provided. The FY02 lending program comprised:

- ***Serbia Structural Adjustment Credit (SAC I)***, (US$70 million-approved January 2002-fully disbursed), designed to strengthen public expenditure management; and initiate reforms in energy, social protection, health, and labor markets.
- ***Serbia Private and Financial Sector Structural Adjustment Credit*** *(PFSAC)* (US$85 million – approved May 2002) designed to assist the Government in: (i) strengthening the financial system through an improved policy and regulatory environment and liquidation of troubled banks; (ii) privatizing and restructuring socially owned enterprises that crowd out private sector growth, hamper banking sector activity and are a source of quasi-fiscal risk; and (iii) improving the investment climate and business environment.
- ***Serbia Education Improvement Project*** (US$10 million –approved May 2002) aims to (i) build institutional capacity in the Ministry of Education, (ii) provide systematic information to policymakers to promote reform and improve teaching and learning, and (iii) empower local communities to take responsibilities for the schools.
- ***FRY Trade and Transport Facility Southeast Europe (TTFSE)*** (US$6.76 million – approved June 2002). The TTFSE is part of a regional program in Southeast Europe. It seeks to reduce non tariff costs to trade and transport and to reduce smuggling and

[12]A plan to clear FRY's arrears to the World Bank was approved with the membership package that provided for the exceptional consolidation of FRY's arrears and principal not yet due into a new package of IBRD loans. These Consolidation Loans were approved by the Board on December 13, 2001, and became effective in early-January 2002.

corruption at border crossings through providing support for customs modernization, improved information systems, enhanced information dissemination among the trading community and border control agencies, equipment for enforcement and pilot initiatives.

28. ***Analytical and Advisory Assistance.*** The Bank has completed a set of core fiduciary economic work for FRY. A **Public Expenditure and Institutional Review** (PEIR) covering both Serbia and Montenegro provides an institutional analysis of public expenditure management, evaluating the efficiency of decision-making and implementation processes in public spending. The findings and recommendations of the PEIR will inform the PRSP process and are expected to underpin further adjustment lending. A **Country Financial Accountability Assessment** assessed the strengths and weaknesses of FRY's financial management capacity, offered best practice advice and indicated the level of financial accountability risk. A **Country Procurement Assessment Report** for FRY was also completed. In addition, a **Private and Financial Sector Review** (Serbia) is being completed focusing on linkages between enterprise restructuring and financial sector reform. This review benefits from experiences in other transition economies. A **Diagnostic Study of the Legal, Judicial and Institutional Framework** (FRY) was undertaken to identify the principal problems and needs, and the nature and extent of reforms that might be required to modernize the Yugoslav system of justice. It could serve as a basis for both interim reform measures and the development of a longer-term legal reform program.

29. **Three Post-Conflict Fund grants** for Serbia are currently under implementation: (i) the Southern Serbia Municipal Infrastructure Recovery Project, implemented by UNDP, aims to reduce social tensions through municipal infrastructure rehabilitation; (ii) a grant to the International Committee for the Red Cross is supporting a pilot health care financing initiative; and (iii) a grant to the Center for Liberal Democratic Studies seeks to build consensus on the reform program through a series of workshops and study papers. In FY02 an **IDF grant** was also extended to the Serbian Ministry of International Economic Relations to support efforts to improve public communications on the government's reform program.

30. Considerable **technical assistance** has also been provided to both republics through trust funding, IDA credits and the Bank's policy dialogue. The Bank is supporting the development of a **sustainable poverty monitoring system**, starting with data collection improvements under the Household Poverty Survey which will underpin the PRSP process. The **financial and enterprise sectors** have received significant assistance through TFFRY grants and **energy and social sector reform** efforts have also benefited.

FY03 Program

31. The Bank's lending program in FY03 will continue to be guided by the principles articulated in the May 2001 TSS. Specifically, the focus will remain on adjustment lending, with up to 80 percent of the Bank's resources supporting policy reform in support of the four key objectives outlined in the TSS. A strong program of complementary analytical work and technical and advisory services has also been developed to provide input to the policy agenda for the next phase of structural reforms as well as the preparation of the Government's Poverty Reduction Strategy. The IFC and MIGA programs complement and support the realization of these overarching program goals.

32. The program envisages policy-based adjustment operations supporting reforms in public expenditure management, and in the financial, private, energy and social sectors. As many donors are providing support to the infrastructure sector, the Bank's role will be primarily in terms of policy advice and support for public-private partnerships in which IFC is expected to play a key role. The full CAS will elaborate plans for a gradual shift in balance toward investment lending and further analytical work. Three projects -- the FRY Export Credit Facility, the Montenegro Energy LIL and the Montenegro SAC -- were originally planned for the FY02 program. All have been negotiated and will be presented to the Board for approval in the first quarter of FY03. Attachment III provides detailed descriptions of the planned FY03 lending and analytical and advisory program at the federal and republican levels.

33. ***Adjustment Lending.*** As envisaged in the May 2001 TSS, a program of sequenced adjustment lending has been initiated. In both Serbia and Montenegro adjustment lending will consolidate and build on the reform effort to improve fiscal sustainability and transparency initiated in FY02 operations and address emerging near-term issues. Following the first Structural Adjustment Credit for Serbia which focused on fiscal sustainability and the Serbian Private and Financial Sector Adjustment Credit (PFSAC) which laid the groundwork for an improved policy and regulatory environment, a proposed **Social Sector Adjustment Credit** (SOSAC) for Serbia would support systemic reform of the pension system, improved targeting, equity and efficiency in the operation of social assistance and child protection programs, reforms in active and passive programs for the unemployed, as well as key reforms in the health sector, including health financing and service delivery. Work on a second **Private and Financial Sector Adjustment Credit** (PFSAC II) for Serbia would build on and deepen the reforms implemented under the first PFSAC by supporting the process of enterprise restructuring and privatization in close coordination with the restructuring and liquidation of banks through the Bank Rehabilitation Agency. The credit would also support the establishment of sound prudential oversight capacity for banking in FRY, and the development of sound regulatory environment for the non-bank financial sector. In Montenegro a **first Structural Adjustment operation (SAC I)** would assist the republic in the implementation of a structural reform agenda in (i) public expenditure management; (ii) pensions; (iii) energy sector; (iv) labor markets; and (v) the business environment. During FY03, work on a **second SAC for Montenegro** would begin, deepening the reforms initiated under SAC I and extending the program to financial and private sector reforms.

Table 2 – Strategic Objectives and the Bank Group Program

Strategic Objective	World Bank Group Program (Program benchmarks for FY03 are outlined in Attachment I and detailed descriptions are provided in Attachment II)
Restoring macro-economic stability and external balance	***FY02*** Lending: SAC I (Serbia) AAA: Public Expenditure Review; Country Procurement Assessment Report; Country Financial Accountability Assessment **FY03** Lending: SOSAC; Montenegro SAC I; Public Finance Capacity Building; (possible Debt and Debt Service Reduction) AAA Fiscal Sustainability Analysis
Stimulating near-term growth and creating the basis for a sustainable supply response	***FY02*** Lending: PFSAC; PSD TA grant; Banking TA grant; Electric Power Emergency Reconstruction grant; Montenegro Coastal Environmental Infrastructure grant; Social Protection grant; Trade and Transport Facilitation in Southeast Europe project AAA:, FIAS barriers to entry study IFC, MIGA, FIAS programs; Southeast Europe Enterprise Development (SEED) **FY03** Lending: PFSAC II; Enterprise Restructuring and Financial Sector TA project; Montenegro Energy LIL; Labor LIL; Montenegro Environment project; FRY Export Credit Facility; GEF Lake Skadar (Montenegro); GEF on Nutrient Pollution (Serbia) AAA: PS/FSD linkage paper; Energy Sector Study; Agriculture Sector Study; Environment Sector Review; Transport Sector Strategy (Serbia) Environment–Poverty Workshop IFC and MIGA Programs, Public-Private Infrastructure Initiative (IFC) SEED Program
Improving social well-being of the most vulnerable and building human capacity	***FY02*** Lending: Education Improvement Project; Social Protection grant; post-conflict grants; Montenegro Coastal Environmental Infrastructure grant AAA: Poverty household surveys; Public Expenditure Review **FY03** Lending: Montenegro SAC I; SOSAC; Health Sector Investment; Montenegro Environment Project; Labor LIL AAA: Health Sector Human Resources Strategy; Poverty Profile/Poverty Assessment and background papers; PRSP related assistance WBI – programs in poverty alleviation, community empowerment, health sector reform
Improving governance and building effective institutions	**FY02** Lending: Serbia SAC I; Education Improvement Project; post conflict grants; AAA: Legal and Judicial Diagnostic **FY03** Lending: Public Finance Capacity Building; Health Sector Investment AAA: Fiscal Sustainability Analysis (FRY); Transport Sector Strategy (Serbia) Anti-Corruption TA/advisory services (Serbia) IDF grant on court administration reform (Serbia) WBI – corporate governance and business ethics

34. ***Investment lending.*** In both republics, planned IDA investment lending in FY03 has been carefully selected to tackle critical impediments to effective public sector management and private sector development and underpin reforms initiated under the Bank-supported adjustment program. An **Export Credit Facility** for both republics will support sustainable economic growth by catalyzing and facilitating trade transactions through the creation of the Serbia and Montenegro Export Credit Agency (SMECA) to support both import and export activities through a variety of facilities. In Serbia an **Enterprise Restructuring and Financial Sector Technical Assistance** credit will support the implementation of measures initiated under PFSAC I and to be continued under the proposed PFSAC II. It would finance necessary advisory services, as well as complement the activities of the IFC and MIGA in private sector development. A **Labor Learning and Innovation Loan (LIL)** for Serbia will build capacity in the public sector to promote more cost effective labor redeployment programs, pilot innovative services for the unemployed, and promote a balance between social mitigation, fiscal sustainability and facilitating re-entry to the labor market. It would also support efforts to monitor and evaluate the employment and other social impacts of different interventions. A **Public Finance Capacity Building** credit for Serbia will strengthen the capacity of the Ministry of Finance and other spending units to plan, program and manage the use of public finances. A **Health Sector Investment Project** for Serbia will complement the policy reforms planned under the SOSAC through reorganization and modernization of the health financing system, implementing a master plan to restructure the health delivery system, and strengthening the capacity of the Government to introduce sound public policy[13]. A GEF grant for Serbia on **nutrient pollution prevention** will also be pursued.

35. In Montenegro, an **Energy Sector Learning and Innovation Loan** will assess consumer response to the introduction of remote electricity metering and introduce automated billing and demand side management; (ii) facilitate the eventual privatization of distribution services; and (iii) lay the basis for comprehensive institutional strengthening in the energy sector. An **environment operation** will build on the coastal environment and water supply project, possibly including water supply and sanitation and waste management in the coastal zone and energy-environment issues. A **GEF grant for Lake Skadar** will be developed to assist Montenegro and Albania in the areas of biodiversity conservation and pollution prevention of Lake Skadar, creating a basis for joint management of the lake ecosystem.

36. ***Analytical work and technical assistance.*** Over the next twelve months, the Bank will continue work on the following studies: An **environmental sector review** (covering both republics) will assess policy reforms, identify priority actions, and highlight linkages between economic reconstruction, social policy and environmental protection. It will also serve as a basis for helping the Governments to develop a comprehensive National Environmental Action Plan. A **national workshop on environment-poverty linkages** will be conducted and the outcomes will be inputs to the PRSP process. **Poverty profiles** for both republics and supporting background papers on labor market, gender, social impact of reforms and targeting of social transfers will be undertaken. A subsequent participatory **Poverty Assessment** - feeding into the

[13] In the event that FRY is able to conclude a concessional debt restructuring agreement with London Club creditors, the Bank would consider a request from the government to re-align the program to include a Debt and Debt Service Reduction Credit in FY03, within the available resource envelope. Such a credit could be up to US$15million covering both Serbia and Montenegro.

PRSP process - will take place on the foundation of the local capacity created at the first stage. An **agricultural sector study** covering both republics will: (i) identify the major constraints inhibiting productivity and sectoral growth; and (ii) develop the main priorities for short and medium-term action consistent with a coherent long-term strategy for broad based agriculture and rural development. A national workshop is planned to disseminate the results of the study and to bring best practices from several countries in the region. An **energy sector study** will analyze ways to move the sector toward commercialization and prepare for private sector participation. The study would address the needs of the poor, both in terms of supply needs and the impact of price increases likely to result from privatization on household income

37. In Serbia the Bank will assist the Government in preparing a **health sector human resources strategy** by undertaking a situation analysis of the health sector human resource problems (HRPs) in the republic. Particular focus will be placed on imbalances in skills mix, issues around low salaries and informal payments, and public/private sector mix. A **transport sector strategy** for Serbia will provide proposals regarding: (i) priorities for State and donor funding within and across transport modes; (ii) improvements in governance and the regulatory framework; promote the private sector, and control environmental externalities; and (v) increased cost recovery and sound subsidy systems to protect the poor.

38. The Bank has initiated some limited **anti-corruption advisory services in Serbia** in (i) conflict of interest management and (ii) institutional development of regional anticorruption bodies. A proposal for an **IDF Grant to assist Serbia in reforming its court administration system** is under development. The proposed Grant would assist the Ministry of Justice and the judiciary to intensify knowledge of the problems, build capacity and skills and prepare short-term measures as well as a medium-to-long-term master plan for modernizing the court administration system.

39. ***Regional Initiatives.*** The FRY program will continue to benefit from regional initiatives in support of economic development and cooperation in South Eastern Europe. These include on-going analytical and advisory activities on trade and investment policy, which directly aim at supporting the integration of FRY and the other countries of the region in the world economy, and with Europe in particular. The Trade and Transport Facilitation Program for South Eastern Europe has recently been extended to include FRY; its overall objectives are to reduce non-tariff costs to trade and transport, to reduce smuggling and corruption at border crossings, and to strengthen customs and border control agencies in the region. The Social Development Initiative for South Eastern Europe aims at promoting social cohesion and reducing inter-ethnic tensions through capacity building and community development. The development of a South Eastern Europe Regional Energy Strategy would be initiated in FY03. Finally, the Bank continues to support selected regional initiatives under the **Stability Pact**, most notably the Investment Compact and the Anti-Corruption Initiative, in collaboration with the OECD and other partners.

40. ***Partnerships.*** The FY03 Program would continue to benefit from consultations and partnerships with the donor community and civil society, which will be enhanced within the PRSP framework. Over 25 multilateral and bilateral donors are providing support for FRY's transition and reform program. **The European Commission** is a key partner, sharing the mandate with the World Bank, to coordinate donor assistance to FRY and the other countries of the region. In addition, the **Stability Pact for South Eastern Europe** remains an important vehicle for cooperation with the donor community. The Bank is also working closely with the

IMF, particularly supporting the Government in the PRSP process. On May 13 the IMF Board of Directors completed a third and final review of FRY's economic program supported under the June 2001 Standby Arrangement. An Extended Fund Facility of SDR 650 million (about US$829 million) to support FRY's 2002-2005 program was approved concurrently.

41. ***Program Performance and Monitoring.*** As outlined in the May 2001 TSS, roughly 80 percent of Bank lending over FY02-04 is expected to be policy based. Policy performance against the FY02 benchmarks was strong and, in a number of instances, exceeded expectations. These achievements are detailed in Attachment I, where specific benchmarks for the planned FY03 program are also elaborated. Bank Group support in FY03 would continue to be provided on a performance-linked basis. The FY03 Bank lending program remains heavily weighted toward policy-based lending, under a satisfactory macroeconomic framework. The front-loaded adjustment program is thus largely self-regulating. Compliance with up-front conditionality 'triggers' allows the program to proceed, whereas failure to meet the front loaded conditionality (or significant slippages in policy performance) would preclude subsequent policy lending. The full CAS, anticipated in summer 2003 upon completion of the full PRSP, will provide a more complete framework of performance indicators and monitoring and evaluation.

42. ***Fiduciary Issues.*** The Country Financial Accountability Assessment (CFAA) conducted in FY02 identified a number of risks concerning the management of public funds, including: weak capacity, especially in auditing; the central banking structure; and lack of recent experience in implementing Bank-financed projects. To address *fiduciary issues related to Bank funding*, a number of mitigation measures have been agreed and put in place, including: (i) the use of a small number of pre-screened banks and auditors; (ii) the establishment of appropriate institutional and implementation arrangements for financial management, disbursement and procurement in Bank-assisted projects; (iii) the provision of training on financial management, disbursement and procurement to FRY project staff; (iv) special ring-fencing of deposit account and the correspondent bank account for adjustment operations; and (v) audit provisions for adjustment lending. In addition, the Bank will place an accredited financial management specialist in the Country Office and remain in continuous dialogue with the three levels of government as the new constitutional arrangements take shape. The CFAA will be updated in about 18 months.

43. *A first Joint Bank-Government Country Portfolio Performance Review* will be conducted during FY03 to take stock of compliance with policy benchmarks and fiduciary measures and to assess overall implementation experience of the FRY portfolio.

44. ***Field Presence.*** Since the 2001 TSS the Bank's Belgrade 'mission support office' has been converted to a full Country Office. This Office is contributing significantly to policy dialogue as well as providing on the ground services in key areas. Staffing has been augmented. Bank Group program effectiveness has also been enhanced with the opening of an IFC Office and the IFC-administered Southeast Europe Enterprise Development (SEED) Office in Belgrade. The Loan Department has conducted training workshops and seminars for the central banks and ministries of finance staffs. A program for hands-on procurement advice and training will be initiated together with the discussions on the Country Procurement Assessment Report.

45. ***World Bank Institute (WBI).*** WBI, through policy formulation and training services, aims to build national capacity in FRY in four areas: (i) poverty alleviation; (ii) community empowerment; (iii) health sector reform; and (iv) corporate governance and business ethics.

While part of the training activities will be offered at the sub-regional level, bringing participants from the neighboring countries of South East Europe, selected FRY-specific activities and policy workshops are also planned. Additional areas for cooperation wil be explored during development of the CAS. .

46. To support the PRSP process, within the ***Attacking Poverty Program***, WBI will offer three type of activities: (i) Development Debate (DD); (ii) the Balkan Poverty Forum; and (iii) Capacity Building in Poverty Measurement and Diagnostics. The objective of the DD series is to add value to national policies and strategies to effectively attack poverty. A Poverty Forum for three PRSP countries in the Balkans is planned for the Fall of 2002. The third type of activity will provide skills training in poverty measurement, poverty monitoring and poverty impact evaluation.

47. WBI's ***Community Empowerment Program*** is designed to gradually increase civic participation and citizen involvement in decision making and policy making processes at the local level through partnerships with local government and civil society. Specific activities will include training and sensitizing focus groups in administrative, legal and institutional frameworks under which public servants operate. In addition, WBI intends to offer its core courses on Health Sector Reform, Corporate Governance and Trade and Globalization.

International Finance Corporation (IFC)

48. FRY became a member of IFC in May 2001, and an IFC office was opened in Belgrade in September 2001. Since then, 4 projects have been approved, two in financial markets and two in manufacturing, for about US$30 million. In addition, IFC has a robust pipeline in both the financial and manufacturing sectors pursuing an aggressive program of support to private sector development and the facilitation of direct foreign investment in FRY. Its strategic country objectives are to: (i) focus on the financial sector (banks) and develop other financial intermediaries (leasing, funds); (ii) support privatization and the restructuring process; (iii) invest in commercially viable companies, both private and partially private/to be privatized, and provide flexible solutions for their modernization investments and working capital needs; (iv) promote the growth of local entrepreneurship and SMEs; and, (v) provide technical assistance to support capacity building (market focus, business plans, accounting discipline).

49. The financial sector is a focal point of IFC's program in FRY. IFC's strategy in the financial markets is to catalyze strong foreign strategic investors to establish viable financial institutions in the country, assist in bank and insurance privatization, plus very selectively, assist private banks to attract strategic partners. IFC is also looking for opportunities to develop and support the non-bank financial sector, via both investment and technical assistance in leasing and securities market development. Mobilization of financial resources to local intermediaries for on-lending to SMEs remains one of IFC's priorities. IFC is in discussions with two equity fund managers, one for investments in SMEs, and the other for larger equity investments particularly in privatizations.

50. In addition, new project development is under way in garment-textiles, agribusiness mechanical industry, pharmaceuticals, retail distribution, and tourism. IFC is building a broad pipeline of investment opportunities in order to diversify risks and over the past year has intensified its cooperation with the Privatization Agency to help increase results on the ground.

IFC, in cooperation with IDA, is also exploring with the Government possibilities for public-private sector financing partnerships to support the significant infrastructure needs in FRY.

51. ***Foreign Investment Advisory Service (FIAS)*** At the Government's request, FIAS prepared a report on barriers to entry which has fed into the Government's Business Environment reform agenda.

52. ***The Southeast Europe Enterprise Development (SEED)*** is a multi-donor initiative managed by the IFC. SEED supports SME development and strives to improve overall environment for SME growth and competitiveness in the region in three target areas: (i) enterprise-level investment services; (ii) capacity building; and (iii) improvement of the enabling environment. SEED has a Belgrade Office and anticipates the opening of an office in Montenegro soon.

The Multilateral Investment Guarantee Agency (MIGA)

53. On April 9th, 2002 the Federal Republic of Yugoslavia succeeded to the membership of the Socialist Federal Republic of Yugoslavia in MIGA. Programs have begun in two areas:

- ***Guarantees.*** MIGA is currently accepting applications for projects in FRY. Demand for MIGA coverage is currently in the area of US$200-US$300 million, representing projects in manufacturing, finance and infrastructure sectors. There is one active pipeline project in the finance sector at this time.
- ***Investment Marketing Services.*** MIGA undertook a detailed assessment of the technical assistance needs of the Serbian Investment and Export Promotion Agency (SIEPA), and proposed a program of assistance to support the start-up phase. MIGA has prepared a development plan for the agency to make it effective and professional. SIEPA is now initiating procurement under an allocation of US$285,000 of the TFFRY PSD Technical Assistance grant , including hiring a long-term adviser to provide assistance on strategic and operational issues.

Risks

54. The program faces risks at three levels: external, political, and policy implementation:

- Various ***external shocks*** could strain FRY's ability to maintain a sustainable macroeconomic framework and return to growth. Even with continued strong performance toward stabilization and reform, a marked slowdown in the economy of key trading partners or a renewal of regional conflict could reduce the growth of exports and/or private capital inflows. 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. These risks underscore the importance of IDA financing. 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.

- There are several sources of ***political risk,*** most importantly, the possible erosion of support for the economic reform program. 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 transition-related expenditures above the level of available fiscal resources, as well as hamper needed further inroads into hidden quasi-fiscal deficits. Implementation arrangements under the Union Agreement will require agreement on critical but as yet undefined details, including on crucial issues such as the financing of the new union structure and the precise modalities for harmonizing external trade policies and ensuring free inter-republican trade, which could prove more difficult than envisaged. Reform implementation could slow down in the run-up to the anticipated fall republican elections. In addition, although both republics have highlighted the need for improved governance and designed anti-corruption strategies, implementation will require considerable support and close monitoring. Finally, although the regional outlook is more encouraging than in prior years, a deterioration in relations with Kosovo or in southern Serbia could affect program implementation. The Bank is working to mitigate these risks through continued policy dialogue, increased outreach to the public and civil society, and IDF and post-conflict grants to support communication of reform strategies and public dialogue on key policy issues. The PRSP process is also expected to be a unifying force in facilitating a dialogue on priorities within each republic. The establishment of a clear path to European integration through the EU Stabilization and Association process will also buttress the economic reform program. The sequencing of adjustment operations offers the opportunity to both reinforce reforms and to mitigate possible policy slippage.

- The program will face ***implementation and capacity issues*** which have proved difficult in other economies in transition. Although the federal and republican governments have moved quickly to meet agreed targets and deadlines, existing implementation capacity has been operating at about full capacity and the implementation of follow-up measures may test its limits. To some extent, the coming on stream of the substantial technical assistance available to FRY will mitigate this. Fiduciary risks at both the country and Bank program level are present. Although measures have been identified and put in place to mitigate, this will bear close monitoring.

55. On balance, the risks are outweighed by the potential benefits to be derived by improving the economic environment 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 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.

James D. Wolfensohn
President

By Shengman Zhang

July 18, 2002
Washington, D.C

Federal Republic of Yugoslavia
Transitional Support Strategy Update (FY03)
Matrix of Development Objectives, Bank Program and Performance Benchmarks

Objective	Bank Program	FY02 TSS Performance Benchmarks	Reform progress against Performance Benchmarks to date	FY03 TSS Performance Benchmarks (to be completed by end FY03)
Restoring macro-economic stability and external balance	***FY02*** Lending: SAC I (Serbia) AAA: Public Expenditure Review; Country Procurement Assessment Report; Country Financial Accountability Assessment ***FY03*** Lending: SOSAC Montenegro SAC I; Public Finance Capacity Building; (possible Debt and Debt Service Reduction) AAA *Fiscal Sustainability Analysis*	• Macro. [FRY] Government's macroeconomic program, supported by IMF, on track • Public expenditure management. [FRY and republics] Unified, agreed budgets; and improved budget execution monitoring systems; [Serbia] Substantially increased power tariffs; preparation of medium-term expenditure management strategy • Tax reform. [Serbia] Tax (sales tax, excise) unification and simplification, elimination of exemptions; [Montenegro] Tax Action Plan, comprehensive tax code • External debt. [FRY] Concessional rescheduling of official (2001) and commercial (2002) • External financing. [FRY] Mobilization of sufficient foreign assistance for ERTP (annually)	• Macro. IMF SBA successfully completed. 3 year IMF EFF approved. • Public expenditure management. Good progress in both republics on budget formulation. Introduction of full GFS for 2002 budget. Initial progress towards Medium Term Fiscal Framework, more advanced in Serbia. Power tariff rises effected. • Tax reform. New simplifying tax code implemented, tax base expanded, exemptions reduced [Serbia] Approved Tax Action Plan [Montenegro] • External debt. Paris Club concessional rescheduling deal completed and effective. Negotiations with London Club continuing. • External financing. US$1.34 m in pledges raised towards ERTP program for CY01. Preparations ongoing for pledging conference tentatively planned for late 2002.	• Macro. [FRY] Government's macroeconomic program, supported by IMF EFF, on track • Public Expenditure Management. [Republics]: Satisfactory progress towards development of a Medium Term Fiscal Framework. Full setting up of Treasuries in republican MOFs. Full disclosure of audits of 2001 budget execution. • Tax Reform: Improvements to tax administration, further revisions of excise tax, introduction of synthetic-personal income tax, adequate progress towards implementation of tax action plan. [Montenegro]

Attachment I

Stimulating near-term growth and creating the basis for a sustainable supply response	***FY02*** Lending: PFSAC; PSD TA grant; Banking TA grant; Electric Power Emergency Reconstruction grant; Montenegro Coastal Environmental Infrastructure grant; Social Protection grant; Trade and Transport Facilitation in Southeast Europe project AAA:, FIAS barriers to entry study IFC, MIGA, FIAS programs; Southeast Europe Enterprise Development (SEED) ***FY03*** Lending: PFSAC II; Enterprise Restructuring and Financial Sector TA project; Montenegro Energy LIL; Labor LIL; Montenegro Environment project; FRY Export Credit Facility; GEF Lake Skadar (Montenegro); GEF on Nutrient Pollution (Serbia) AAA: PS/FSD linkage paper; Energy Sector Study; Agriculture Sector Study; Environment Sector Review; Transport Sector Strategy (Serbia) Environment–Poverty Workshop IFC and MIGA Programs, Public-Private Infrastructure Initiative (IFC) SEED Program	• Trade. [FRY] Revised trade legislation; government-approved customs reform plan • Private sector development. [Serbia] New foreign investment law; revised privatization legislation; establishment of privatization agency; 1 large and 1 pool of 6 medium firms offered for sale; 3 large and 4 pools offered for sale (Jul 2002); [Montenegro] New company law, bankruptcy law • Banking. [Serbia] Preparation of strategy for intervention in insolvent banks; intervention in large insolvent banks; new prudential legislation and enforcement manual • Utilities. [Serbia] New energy policy, new electricity and regulatory laws • Labor: [Serbia] Revised law on labor relations	• Trade. Significant improvements to legislation, simplified tariff regime, greatly reduced licenses and quotas. Prepatory work towards WTO and SAA. Initial steps to combat corruption and smuggling. • Private sector development. Privatization Agency established, new privatization law, foreign investment law, 28 companies contracted to investment banks for sale by tender. In addition, new bankruptcy law drafted, draft strategy paper for restructuring of 44 'systems' submitted to govt. [Serbia] • Banking: Implementation of a strategy for intervention in insolvent banks, including closure of largest four . Completion of audit of most banks. Improvements to prudential regulation and enforcement [Serbia] Diagnostic reports of all banks completed [Montenegro] • Utilities. Ongoing work towards Energy Law [both Republics] Implementation of phased program of price rises and costs containment, measures to increase efficiency, reduce demand, decrease in barter payments [Serbia] Strategy to mitigate power shortfalls, initial work to develop legal/regulatory framework [Montenegro] • Labor: New labor law, draft employment law [Serbia], draft labor law submitted to parliament, [Montenegro]	• Trade: Continued improvements to customs administration. • Private Sector Development: Amendments to Companies Law, new Bankruptcy Law, amendment to Privatization Law to strengthen government position as creditor, begin process of enterprise restructuring, strengthening and capacity building in Privatization agency to manage restructuring agents. [Serbia] • Banking: Preparation of a Supervisory Development Plan for Bank Supervision. • Utilities: Continued improvement of financial position of EPS, Energy sector strategy [Serbia], new Energy Law, price increases, increase in collection ratio [Montenegro] • Labor: New law on employment, new fiscally sustainable institutional framework for mass redundancies [Serbia]. Assessment of effectiveness of existing labor market programs [Montenegro]

Improving social wellbeing of the most vulnerable and building human capacity	***FY02*** Lending: Education Improvement Project; Social Protection grant; post-conflict grants; Montenegro Coastal Environmental Infrastructure grant AAA: Poverty household surveys; Public Expenditure Review ***FY03*** Lending: Montenegro SAC I; SOSAC; Health Sector Investment; Montenegro Environment Project; Labor LIL AAA: Health Sector Human Resources Strategy; Poverty Profile/Poverty Assessment and background papers; PRSP related assistance WBI – programs in poverty alleviation, community empowerment, health sector reform	• Social protection. [Serbia] Draft social protection strategy; new social welfare legislation revised pension law • Education. [Serbia] Draft decentralization strategy; increased share of spending on education • Health: Health reform strategy and financing plan (new health insurance law, co-payments system) • Poverty: [FRY] Preparation of Interim Poverty Reduction Strategy	• Social protection. Substantial improvements through revised pension legislation, introduction of uniform republican thresholds for social benefits, data base on social welfare institutions[Serbia] New draft pension law [Montenegro] • Education. Education decentralization strategy completed, spending on education increased [Serbia] • Health: National Health policy prepared, improvements to drug procurement, audit of HIF completed, pilot co-payments introduced, [Serbia], • Poverty: FRY I-PRSP completed. Improved Poverty Surveys in both republics.	• Social Protection: Passage of new pensions law which introduces systemic reform, including disability and farmers' pensions; New law on employment. [Serbia] Adoption of new pension law;, steps to eliminate non-pension benefits from pension fund [Montenegro] • Health: Complete new Health Insurance Law, new pharmaceutical law, Interim Health Services Restructuring Plan completed, Health Information Systems master plan completed and database established. • Poverty: complete analysis of poverty survey results. Complete poverty assessment; finalize PRSP.
Improving governance and building effective institutions	***FY02*** Lending: Serbia SAC I; Education Improvement Project; post conflict grants; AAA: Legal and Judicial Diagnostic ***FY03*** Lending: Public Finance Capacity Building; Health Sector Investment AAA: Fiscal Sustainability Analysis (FRY); Transport Sector Strategy (Serbia) Anti-Corruption TA/advisory services (Serbia) IDF grant on court administration reform (Serbia) WBI – corporate governance and business ethics	• Civil service reform. [Serbia] New law on government; public administration reform strategy • Judiciary. [Serbia] New law on independent judiciary.	• Civil service reform. New laws on the Budget System, Public Procurement [Republics], new constitutional structure is being defined [Federal and Republics], • Judiciary. Adoption of new judicial legislation and establishment of new judicial bodies [both republics] progress towards development of a judicial reform strategy;	• Civil service reform: Complete constitutional charter and laws defining federal/republican jurisdiction. Strategy paper on public admin. Reform [Serbia] Initial diagnostic for civil service reform [Montenegro]

Federal Republic of Yugoslavia - Republic of Montenegro
Recent Structural Reform Progress

Structural reforms in Montenegro began in 1998 with substantial donor support, and have thus progressed to a different stage than those in Serbia. In Montenegro, the key challenge is now building the capacity and institutions to implement legislated reforms effectively. Recent progress has included:

(i) ***Price liberalization.*** Montenegro's macroeconomic stabilization efforts 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. Progress has also been made in raising the remaining controlled prices towards levels which cover the costs of production.

(ii) ***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.

(iii) ***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 delineates measures for the planning and implementation of a comprehensive tax code, with a view to improving tax collection and broadening the effective tax base. A number of new laws were passed in late-2001, including on personal income taxes, property taxes and excises.

(iv) ***Public expenditure management.*** Gaps in procedures and institutions have contributed to the loss of fiscal control in Montenegro. In response, the Government has undertaken reforms 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. This has been achieved through the development of a consolidated medium-term framework for budget preparation, improved budget execution through implementation of the recently established Treasury system, and reforms to reinvigorate inspection and auditing procedures. In August 2001 the Montenegrin Parliament passed in a new Law on Public Procurement, which moves towards the EU Procurement Directives.

(v) ***Energy.*** 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. A phased set of revenue adjustments to return the Montenegrin electricity utility to financial self-sufficiency has been introduced, and the power utility has formulated a strategy to mitigate the supply shortfall problem. The first steps have been taken towards developing a legal and institutional framework for the sector.

(vi) ***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 early 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.

(vii) ***Improvement of the business environment.*** The business environment program focuses 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. A new Enterprise Law was enacted that significantly streamlines the company registration process. Montenegro also has adopted a new Enterprise Insolvency Law, which establishes clearer rules and procedures for enterprise resolution and protection of creditor rights, and is working with USAID to implement the new law. Montenegro has recently adopted a new Law on Secured Transactions and an action plan to implement the new law, including the creation of a centralized computerized pledge registry.

(viii) ***Financial Sector.*** Montenegro has *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. Diagnostic reports of all 11 banks in Montenegro have been completed. The largest bank in Montenegro, Montenegrobanka, is under administration and is expected to be privatized within 12 months.

(ix) ***Social protection and labor markets.*** To address hardship among a wider group of the population, the Government has extended the right to *family material support* (the main program of cash social assistance) to include 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, to children in families that receive material support and to children with disabilities. 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.

(x) ***Pensions.*** The government has designed a new law on pension and disability insurance which modifies key parameters of the current system to contain fiscal costs, while at the same time planning for a more comprehensive future reform of the pension system including funded elements.

(xi) ***Legal and Judicial Reform.*** Montenegro has established an Anti-Corruption Agency and has prepared special anti-corruption legislation and also participates in the Stability Pact Anti-Corruption Initiative. The Criminal Code was amended to introduce a number of new criminal offences, particularly in the area of corruption, organized crime, money laundering, computer crimes, human trafficking and domestic violence. Montenegro has also moved ahead with the adoption of a new law on courts, established a new Court of Appeal and a new Administrative Court and a High Judicial Council.

Federal Republic of Yugoslavia - Republic of Serbia
Recent Structural Reform Progress

The transition to a market economy in FRY and Serbia began with the fall of the previous federal Government in October of 2000, followed by the election of a new government in Serbia in January of 2001. The overall agenda was elaborated in the 'Structural Reform in Serbia' presented to the June 2001 donor's conference in Brussels, and the World Bank/EC ERTP. Significant progress has been achieved, including:

(i) ***Price liberalization.*** By early autumn of 2000, the fixing of key prices at well below market clearing levels had led to chronic shortages, particularly of food, fuels and medicines. As one of its last decisions, the outgoing Serbian government freed most of these prices, leaving a small set of controls, similar to that in most ECA countries. The resulting (often several fold) price increases quickly restored balance to product markets and worked to improve incentives, at the cost of further straining the living standards of the most needy. Remaining controlled prices have been raised closer to cost-recovery levels, including more than doubling of power prices during 2001, higher natural gas and district heating prices, and higher pharmaceuticals prices.

(ii) ***Foreign trade reform.*** The new Federal Government inherited a highly distorted foreign trade regime, which hampered revenue collection and created fertile ground for corruption. In December 2000, the Federal Government moved to suppress the most egregious administrative controls, and (with input from the Bank) to prepare a more fundamental reform of trade policy. This reform, approved in May 2001, drastically simplified the tariff regime (reducing the number of tariff rates from 37 to 6), removed almost all foreign trade licenses, and limited the use of quotas. The Federal Government also began the longer-term process of accession to the WTO and the negotiation of a EU Stabilization and Association Agreement. In addition, it has launched measures to reform the customs system and limit corruption and smuggling.

(iii) ***Tax reform.*** The new Serbian government inherited a highly complex tax regime, with around 250 different taxes and levies. In spring 2001, it successfully implemented tax reform which sharply cut the number of taxes and levies and widened the tax base. In April 2001, the previously multiple (often earmarked) turnover taxes were unified, while most exemptions were eliminated. Excise taxes were similarly streamlined. In June 2001, expansion of the base for the personal income tax (by bringing in previously non-taxed benefits) allowed a significant cut in the payroll tax rate. All of these measures will work to improve incentives, enhance revenue collections and reduce possibilities for arbitrary application and corruption.

(iv) ***Public expenditure management.*** Reform efforts have focused on budget preparation and execution, aligning commitments with available resources, and ensuring more transparent and efficient use of public and donor resources. To this end, the Government has passed a new Law on the Budget System, which lays the basis for establishing a more consolidated and comprehensive medium-term framework for budget preparation, to improve budget execution through the introduction of a Treasury system, and to improve the transparency of the budget through enhanced inspection, auditing and procurement procedures.

(v) ***Energy.*** The Serbian Government has begun a phased program of revenue and cost containment measures to return the Serbian electricity utility EPS to financial self-sufficiency. This program included a more than doubling of power prices and a containment of initially high real wages in EPS. It has also commenced other reforms to reduce energy demand, reduce costs by increasing productivity, and improve the efficiency of energy use.

(vi) ***Privatization.*** The Serbian Government moved quickly to halt privatization under the flawed existing framework, which involved opaque procedures and favored insiders. In parallel, and building on the experiences of other transition economies, it quickly developed a new framework allowing 70 percent of enterprise equity to be offered to strategic investors in a transparent fashion, with a view to establishing clearly defined and dominant owners. The new Privatization Law, adopted in June 2001, has been followed by the creation of a privatization agency, the adoption of secondary legal acts, and the beginning of the process of selling about 60 "early win" firms with the assistance of international investment banks. The government has also initiated a process for auction privatization of selected enterprises, through which 60 enterprises are expected to be offered by the end 2002, with several hundred more expected to be in the pipeline for 2003.

(vii) ***Banking reform.*** Reforms are under way to promote the entry of new banks and improve prudential regulations and their enforcement[14]. In tandem, substantial progress has been made towards implementing a strategy to restructure insolvent banks in Serbia (the four largest state owned banks representing 60 percent of the system have been liquidated) and to strengthen the Federal Bank Rehabilitation Agency (BRA) to manage the resolution and liquidation process (again with extensive technical assistance from the Bank).

(viii) ***Business Environment.*** Considerable work has been initiated on commercial law reform including laws on securities, competition, insurance, company bankruptcy, secured transactions etc. A revised federal Law on Foreign Investment[15] was enacted. Legal and judicial reforms and anti-corruption initiatives complement the effort.

(ix) ***Legal and judicial reform.*** The Serbian authorities have initiated efforts to make the law-making process more transparent and inclusive. Achievements include (i) Amendments to the federal Criminal Procedure Code in line with European and international standards and to the Serbian Criminal Code to introduce new crimes, especially pertaining to corruption; (ii) Initial steps to implement a comprehensive judicial reform including adoption of five new organic laws on the organization of courts, the status of judges and the prosecutors office, and the establishment of a judicial training center.

(x) ***Anti-corruption.*** The Serbian government is implementing a multi-pronged strategy in this area. In addition to measures described above (public expenditure reform, legal reforms, simpler and more transparent trade and tax regimes, customs reform, and a more transparent process of privatization), there has been a clampdown on illegal trade in tobacco and liquid fuels. Both republican and local level bodies are preparing anti-

[14] Four foreign commercial banks have already commenced operations in Serbia.

[15] Drafted with the assistance of FIAS and enacted in January 2002, the law is de facto applied on the level of the FRY and in Serbia. Montenegro has passed its own law.

corruption strategies and legislation. Serbia participates in the Stability Pact Anti-corruption Initiative.

(xi) ***Social protection and labor markets.*** Pensions have been a particularly large source of budgetary outlays and arrears, and delays in social assistance payments have had a negative effect on the most vulnerable. The government has implemented parametric reforms and improved the administration of the existing pension system as crucial first steps. As a result, the timeliness of pension payments has improved. Reforms to social assistance have been implemented to better cushion the impact of adjustment on the poorest members of society and to place these benefits on a more sustainable financial footing. Reform of labor markets has begun through the passage of a new labor law and the drafting of a new law on employment, which will remove structural impediments to cost containment in the enterprise sector, remove a key bottleneck to reducing overstaffing in, and provide an impetus to growth in employment by increasing flexibility in the labor market.

(xii) ***Reform of the health care system.*** This sector was also identified as a major source of government expenditures and arrears. Reforms to begin restoring financial balance are also a prerequisite for improving its functioning and its ability to provide basic health care services to all citizens. Initial steps have been taken to reform the system of health care financing (including the introduction of co-payments and the adoption of a more limited essential drugs list).

(xiii) ***Education.*** The Serbian Ministry of Education and Sports has presented its decentralization strategy to donors, and received World Bank and other donor investment funding to help implement this strategy. In parallel, the share of government resources allocated to education at the Republic level has increased, mostly through higher teacher salaries, while revenue assigned to municipalities has increased to help fund the decentralization effort. Recently adopted amendments to the education laws for primary and secondary education support decentralization efforts by shifting more responsibilities to school boards.

FY03 IDA Program
Federal Republic of Yugoslavia

FRY Export Credit Facility (US$11.5 million) This project aims to support sustainable economic growth by catalyzing and facilitating trade transactions through the creation of the Serbia and Montenegro Export Credit Agency (SMECA). SMECA will support both import and export activities through the following facilities: export credit insurance; working capital loans and guarantees; exporter performance insurance; medium term import insurance/guarantee; and technical assistance to exporting enterprises on marketing/match-making. Imports will be facilitated through political risk insurance; and limited comprehensive import credit insurance.

In the event that FRY is able to conclude a concessional debt restructuring agreement with London Club creditors, the Bank would consider a request from the government to realign the program to allow for a ***Debt and Debt Service Reduction Credit*** in FY03. Such a credit could be up to US$15million covering both Serbia and Montenegro

Planned analytical work and technical assistance:

- an ***environmental sector review*** (both republics) commenced in FY02 is designed to assess policy reforms, identify priority actions, and highlight linkages between economic reconstruction, social policy and environmental protection. The ESR will serve as a pilot for testing the concept of Country Environmental Analysis--analyzing environmental problems from first principles based on economic costs as well as developing the Bank's strategy for the environment sector in FRY. It will also serve as a basis for helping the Governments to develop a comprehensive National Environmental Action Plan.
- A ***national workshop on environment-poverty linkages*** will be conducted and the outcomes will provide inputs to the PRSP process, emphasizing the following issues : (a) poverty and quality of environment linkages, (b) poverty and sustainability of natural resource management; (c) poverty and vulnerability to natural disasters; and (d) poverty and vulnerable social groups (notably IDP, refugee and Roma communities).
- ***poverty profiles*** for both republics and supporting background papers on labor market, gender, social impact of reforms and targeting of social transfers will be completed. At the second stage, during 2002-2003 a participatory Poverty Assessment (linked to the PRSP process) will take place facilitated by the local capacity created at the first stage.
- an ***agricultural sector study*** covering both republics will (i) identify the major constraints inhibiting productivity and growth and (ii) develop the main priorities for short and medium-term action consistent with a coherent long-term strategy for broad based agriculture and rural development.
- a broad based ***energy sector study*** covering both republics will analyze ways to: (i) move the sector to commercialization in preparation for adoption of EU principles and Directives; (ii) prepare the sector for private sector participation (privatization, concessions, leasing, management contracts); (iii) address the over-staffing problem in the sector and the need to close down or dispose of uneconomic assets; and (iv) address the needs of the poor, both in terms of supply needs and the impact of price increases likely to result from privatization on household income.

FY03 IDA Program
Republic of Montenegro

Adjustment Lending:

- ***Montenegro SAC*** (US$15 million - *Negotiated*). The operation is designed to assist the republic in the implementation of a structural reform agenda in (i) public expenditure management; (ii) pensions; (iii) energy sector; (iv) labor markets; and (v) the business environment.

- Work on a ***second SAC*** for Montenegro would begin in FY03, building on the reforms initiated in SAC I and expanding the agenda to focus intensively on private and financial sector reforms.

Investment Lending:

- ***Montenegro Energy Sector Learning and Innovation Loan*** *(LIL)* (US$5 million-*Negotiated*) The LIL is intended to (i) assess consumer response to the introduction of remote electricity metering and introduce automated billing and demand side management; (ii) facilitate the eventual privatization of distribution services; and (iii) lay the basis for comprehensive institutional strengthening in the energy sector

- An ***environmental operation*** (US$5 million)would build on the coastal environment and water supply project, possibly including: (a) water supply & sanitation and waste management in the coastal zone; (b) forestry; and (c) energy-environment issues.

- A ***GEF grant for Lake Skadar*** would be developed to assist Montenegro and Albania in the areas of biodiversity conservation and pollution prevention of Lake Skadar by implementing changes in sectoral policies (agriculture, industry, forestry, and others), promoting sustainable fisheries, and ecological tourism and by creating a basis for joint management of the lake ecosystem.

FY03 IDA Program
Republic of Serbia

Adjustment Lending:

- As envisaged in the TSS, the proposed S***ocial Sector Adjustment Credit*** (SOSAC) (US$61 million) would be the third in a series of adjustment credits. This Credit would support systemic reform of the pension system, improved targeting, equity and efficiency in the operation of social assistance and child protection programs, reforms in active and passive programs for the unemployed, as well as key reforms in the health sector, including health financing and service.

- A second ***Private and Financial Sector Adjustment Credit*** (PFSAC II) (US$60 million) to Serbia would build on and deepen the reforms under the first PFSAC by supporting the process of enterprise restructuring and privatization in close coordination with the process of restructuring and liquidation of banks through the Bank Rehabilitation Agency. The credit would also support the establishment of sound prudential oversight capacity for banking in FRY, and the development of sound regulatory environment for the non-bank financial sector. PFSAC would be included in the FY04 program.

Investment Lending:

- An ***Enterprise Restructuring Technical Assistance*** credit (US$11.0 million) would support the implementation of measures initiated under PFSAC I and to be undertaken under the proposed PFSAC II. It would finance necessary advisory services, as well as complementing the activities of the IFC and MIGA in private sector development.

- A ***Labor Learning and Innovation Loan (LIL)*** (US$3.5 million)would build capacity in the public sector to promote more cost effective labor redeployment programs in partnership with a range of actors, piloting innovations in services for the unemployed and promoting an effective balance in privatization and restructuring programs between social mitigation, fiscal sustainability and facilitating re-entry to the labor market. It would also support efforts to monitor and evaluate the employment and other social impacts of different interventions.

- A ***Public Finance Capacity Building*** credit (US$8 million)would seek to facilitate the implementation of the recommendations of the PEIR and develop to capacity of the Ministry of Finance and other spending units to manage the use of public finances.

- A ***Health Sector Investment*** project (US$15 million) would complement the policy reforms planned under the SOSAC by ensuring the availability of accurate and timely data for health policy making and developing the capacity of the health system to use these data effectively; reorganizing and modernizing the health financing system; improving the quality and access of health services by implementing a master plan to clinically and physically restructure the delivery system, and strengthening the public health system and the capacity of the Government to introduce sound public policy.

- A GEF grant for Serbia on ***nutrient pollution prevention*** may be developed focusing on: (a) the introduction of better manure management and disposal practices to large pig farms; (b) implementing regulatory and incentive based reforms to popularize non-phosphate based detergents; (c) industrial nutrient pollution reduction ; (d) non-point sources nutrient pollution reduction through implementing best agricultural practices

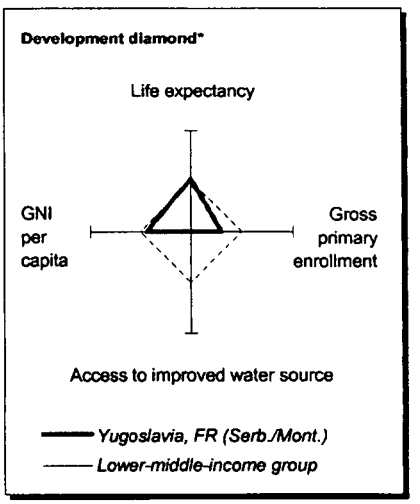
Planned analytical work and technical assistance:

- The Bank will assist the Government of Serbia in preparing a ***health sector human resources study*** by (i) undertaking a situation analysis of the health sector human resource problems (HRPs) in the republic; (ii) identifying the causes of the HRPs; (iii) prioritizing the HRPs Serbia currently faces, (iv) identifying strategic options for the next 2-3 years, including resources required; and finally, (v) identifying a preferred HR strategy, and explain why it was chosen. Main problems that have been identified include imbalances in skills mix, issues around low salaries and informal payments, and public/private sector mix.
- A ***transport sector study*** for Serbia will provide proposals regarding: (i) priorities for State and donor funding within and across transport modes; (ii) improvements in governance and the regulatory framework in the sector in order to better use State funds, promote the private sector, and control environmental externalities; and (v) increased cost recovery and sound subsidy systems to protect the poor.
- The Bank is providing ***anti-corruption advisory services in Serbia*** in (i) conflict of interest management and (ii) institutional development of regional anticorruption bodies. A report will be prepared describing options and recommendations for the Government of Serbia. In addition, the Bank will provide advice through videoconferencing and email on comparative practice in conflict of interest management. A conference on this topic is also planned. The Bank is also exploring options to provide the Government with a technical advisor on conflict of interest management and anticorruption on a more extended (3 - 6 month) basis, to support their efforts in implementation.
- A proposal for an ***IDF Grant to assist Serbia in reforming its court administration system has*** been developed. The proposed Grant would assist the MOJ and the judiciary to intensify their knowledge of the problems and needs of the court administration system in Serbia and of existing models in other countries, build capacity and skills for court administration through provision of equipment and training, and prepare short-term measures as well as a medium-to-long-term master plan for modernizing the court administration system.

Federal Republic of Yugoslavia at a glance

7/16/02

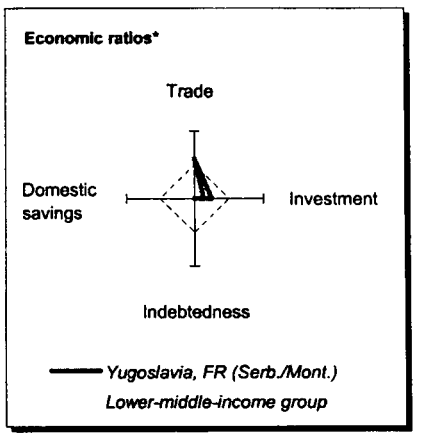
POVERTY and SOCIAL	Yugoslavia, Fed. Rep.	Europe & Central Asia	Lower-middle-income
2001			
Population, mid-year *(millions)*	10.6	475	2,046
GNP per capita *(Atlas method, US$)* 1/	990	2,010	1,140
GNP *(Atlas method, US$ billions)* 1/	10.5	956	2,327
Average annual growth, 1995-01			
Population *(%)*	0.1	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



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

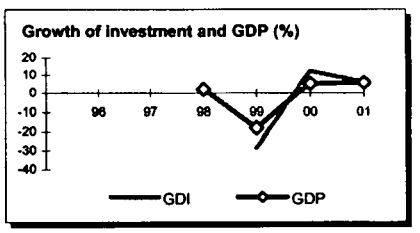
	1981	1991	2000	2001
GDP *(US$ billions)*	..	..	8.1	10 9
Gross domestic investment/GDP	..	..	14.5	13.5
Exports of goods and services/GDP	..	..	31.6	25.4
Gross domestic savings/GDP	..	..	-3.5	-8.6
Gross national savings/GDP	..	..	10.3	8.0
Current account balance/GDP	..	..	-4.2	-5 5
Interest payments/GDP 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

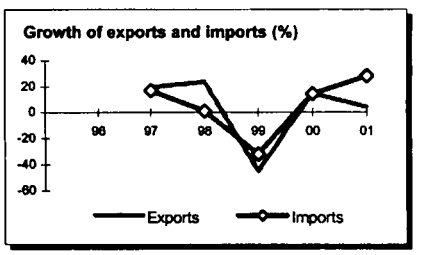


STRUCTURE of the ECONOMY

	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



	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



Note: 2001 data are preliminary estimates.

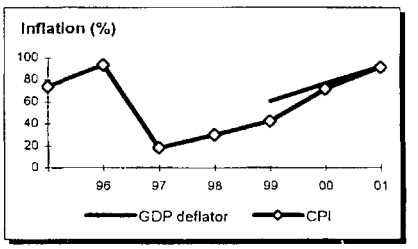
* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

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.)

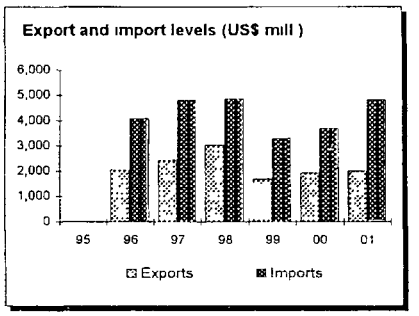
PRICES and GOVERNMENT FINANCE

	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



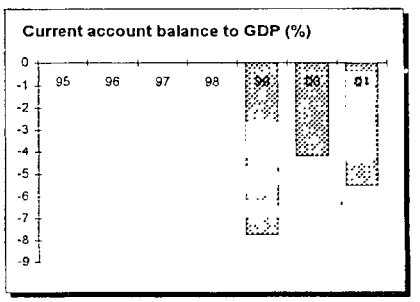
TRADE

	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)*	..	..		..



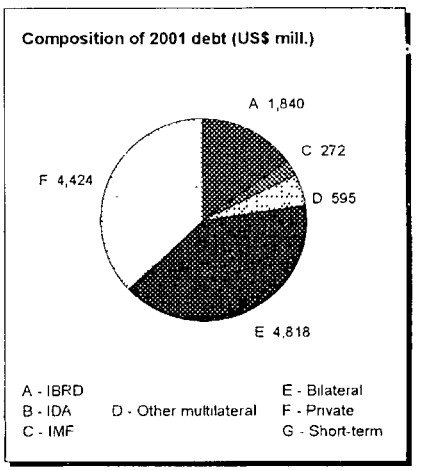
BALANCE of PAYMENTS

	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.

Federal Republic of Yugoslavia - Key Iconomic 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)	.	.		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)	..	..	..	-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)

Federal Republic of Yugoslavia - Key Iconomic Indicators

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.

Federal Republic of Yugoslavia - Key Exposure Indicators

Annex 3

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.

Federal Republic of Yugoslavia
IBRD/IDA Program Summary
As of 7/05/02

Annex 4

Proposed IBRD/IDA Base-Case Lending Program [a]

Fiscal year	*Proj ID*	*US$(M)*	*Strategic Rewards b (H/M/L)*	*Implementation b Risks (H/M/L)*
2003	EXP FIN FAC	11.5	M	M
	HEALTH	15 0	H	H
	LABOR LIL	3 5	M	M
	MONTENEGRO EMG POWER LIL	5.0	M	M
	PFSAC 2	60 0	H	H
	PRIV & RESTR OF BANKS & ENTERPRISES TA	11 0	H	H
	SAC (MONTENEGRO)	15.0	H	H
	PUBLIC FIN. CAP BUILDING	8 0	H	M
	MONTENEGRO ENVIRONMENT	5 0	H	M
	SOSAC	61.0	H	H
	Result	**195.0**		

Federal Republic of Yugoslavia
IFC and MIGA Program, FY 2000-2003
As of 07/15/02

IFC approvals (US$m)	32.12
Sector (%)	
FINANCE & INSURANCE	25
FOOD & BEVERAGES	21
PLASTICS & RUBBER	54
Total	100
Investment instrument(%)	
Loans	75
Equity	14
Quasi-Equity	11
Other	
Total	25
MIGA guarantees (US$m)	0.00

Federal Republic of Yugoslavia
Summary of Non-lending Services
As of 7/05/02*

Product		*Completion FY*	*Completion Cost*	*Audience*[a]	*Objective*[b]
Recent completions					
Country Procurement Assessement		FY02	80	G, D, B, PD	KG, PS
Country Fin. Accountability Assessment		FY02	109	G, D, B, PD	KG, PS
Legal and Judicial Diagnostic		FY02	65	G, D, B, PD	PS, KG
Barriers to Entry (FIAS)	*Completed*	*FY02*		*G*	*PS, KG*
Underway					
Public Expenditure and Institutional Review		FY03	368	G, D, B, PD	KG, PS
Agriculture Sector Study		FY03	229	G, D, B, PD	KG, PS, PD
Environmental Sector Review		FY03	159		
Poverty Assessment		FY03	155		
Poverty Household Survey		FY03	203		
Private Sector/Financial Sector Linkages		FY03	94		
Anti-Corruption Advisory Service		FY03	25	G	PS, KG
Health Sector Human Res Strategy		FY03	77	G, D, B, PD	KG, PS, PD
Planned					
Fiscal Sustainability		FY03	75	G, D, B, PD	KG, PS
Energy Sector Study		FY03	80	G, D, B, PD	KG, PS, PD
Transport Sector Review		FY03	80	G, D, B, PD	KG, PS, PD

a Government, donor, Bank, public dissemination.
b. Knowledge generation, public debate, problem-solving.

* *Estimated*

Federal Republic of Yugoslavia
Operations Portfolio
(IBRD/IDA and Grants)
As of 7/05/2002

Closed Projects 1

IBRD/IDA *

Total Disbursed (Active)	84.81
of which has been repaid	0.00
Total Disbursed (Closed)	0.00
of which has been repaid	0.00
Total Disbursed (Active + Closed)	84.81
of which has been repaid	0.00
Total Undisbursed (Active)	116.95
Total Undisbursed (Closed)	0.00
Total Undisbursed (Active + Closed)	116.95

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 GI	S	S	2001			6.00		4.02	1.80	
P074145	PRIV SECT DEVT TA	S	S	2001			6.00		4.50	2.50	
P074618	MONT. ENV. INFRAS	S	S	2002			2.00		2.00	-	
P074124	SOC ASST GRANT	S	S	2002			10.00		0.60	0.60	
P074136	EMG ELEC POWER F	S	S	2002			6.00		4.07	3.10	
P074586	SERBIA SAC	S	S	2002		70.00			-	-	
P074090	TRADE & TRANSPOI	S	S	2002		6.76			6.76	-	
P074486	PFSAC	S	S	2002		85.00			85.00	-	
P075189	EDUC IMPRVMT	S	S	2002		10.00			10.00	-	
Overall result				Result		171.76	30.00		116.95	8.00	

Federal Republic of Yugoslavia
Statements of IFC's
Held and Disbursed Portfolio
As of 7/05/2002
(In US Dollars Millions)

		Held				Disbursed			
FY Apprc	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**

IMAGING

Report No.: 24476 YU
Type: CAS