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**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT**

**INTERNATIONAL FINANCE CORPORATION**

**MULTILATERAL INVESTMENT GUARANTEE AGENCY**

# COUNTRY PARTNERSHIP STRATEGY

# FOR

# THE REPUBLIC OF SERBIA

# FOR THE PERIOD FY08-FY11

November 13, 2007

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

Southern Europe and Central Asia
International Finance Corporation, IFC

Multilateral Investment Guarantee Agency, MIGA

**Date of Last Country Assistance Strategy: November 2004**

**CURRENCY EQUIVALENTS**
**(Exchange Rate Effective October X, 2007)**
Currency Unit = Serbian Dinar (RSD)
RSD 1.00 = US$ 0.019
US$ 1 = RSD 53.24

**GOVERNMENT'S FISCAL YEAR**
January 1 – December 31

**ABBREVATIONS AND ACRONYMS**

| | |
|---|---|
| AAA | Analytical and Advisory Activities |
| AERS | Energy Agency of the Republic of Serbia |
| CAD | Current Account Deficit |
| CAS | Country Assistance Strategy |
| CEFTA | Central Europe Free Trade Agreement |
| CPS | Country Partnership Strategy |
| DACU | Donor Assistance Coordination Unit |
| DDO | Deferred Drawdown Operation |
| DIA | Deposit Insurance Agency |
| DPL | Development Policy Loan |
| DS | Democratic Party |
| DSS | Democratic Party of Serbia |
| EAR | European Agency for Reconstruction |
| EBRD | European Bank for Reconstruction and Development |
| EC | European Commission |
| EIB | European Investment Bank |
| EPS | Elektroprivreda Srbije (Serbian Electric Power Company) |
| EU | European Union |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| GEF | Global Environmental Facility |
| GoS | Government of Serbia |
| IBRD | International Bank for Reconstruction and Development |
| ICTY | International Criminal Tribunal for the former Yugoslavia |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |

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|---|---|
| IPA | Instrument for Pre-Accession Assistance |
| ISG | Infrastructure Steering Group |
| MDG | Millennium Development Goals |
| MIGA | Multilateral Investment Guarantee Agency |
| MOP | Materijalno Obezbeđenje Porodice (Family Allowance) |
| MTPL | Motor Third Party Liability |
| NBS | Narodna Banka Srbije (National Bank of Serbia) |
| NIS | Naftna Industrija Srbije (Serbian Petroleum Industries) |
| NIP | National Investment Plan |
| PA | Privatization Agency |
| PPP | Public-Private Partnership |
| PRS | Poverty Reduction Strategy |
| PSC | Public Service Contracts |
| SAA | Stabilization and Association Agreement |
| SAP | Stabilization and Association Process |
| SAI | State Audit Institution |
| SEC | Securities and Exchange Commission |
| SEE | South Eastern Europe |
| SEEA | Agencija za Energetsku Efikasnost (Serbian Energy Efficiency Agency) |
| SFRY | Socialist Federal Republic of Yugoslavia |
| SME | Small and Medium Enterprises |
| UNDP | United Nations Development Programme |
| USAID | United States Agency for International Development |
| VAT | Value Added Tax |
| WBI | World Bank Institute |
| ZS | Zeleznice Srbije (Serbian Railways) |

| | **World Bank** | **IFC** | **MIGA** |
|---|---|---|---|
| Vice President: | Shigeo Katsu | Declan Duff | Yukiko Omura |
| Country Director: | Orsalia Kalantzopoulos | Shahbaz Mavaddat | Frank Lysy |
| Task Team Leaders: | Simon Gray/ Robert Jauncey | George Konda | Mario Marchesini |

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The following World Bank staff contributed to the preparation of the CPS as core team members: Mikko Vayrynen, Mathew Verghis, Lazar Sestovic, Jovana Stojanovic and Jasna Vukoje. The core team is grateful to the following World Bank staff who contributed to the preparation of the CPS: Gavin Adlington, Ivana Aleksic, Tijen Arin, Irina Astrakhan, Varadarajan Atur, Arup Banerji, Marc Blanc, Henk Busz, Emina Djuricic-Cerovac, Gerardo Corrochano, Aleksandar Crnomarkovic, Giovanni Daniele, Ana Djordjevic, Willem van Eeghen, Usaid El-Hanbali, Michael Edwards, Marianne Fay, Charles Feinstein, Miroslav Frick, Bernard Funck, Michele Gragnolati, Anila Graupp, Jasmina Hadzic, Ardo Hansson, Richard Martin Humphreys, Nikola Ille, Zana Ivanovic, Sava Jeremic, Olivera Jordanovic, Plamen Kirov, Indira Konjhodzic, Vesna Kostic, Julian Lampietti, Pradeep Mitra, Aleksandar Nacev, Miroslav Nesic, Alexander Pankov, Snjezana Plevko, Andrej Popovic, Mirjana Popovic, Desanka Stanic, Emma Svec, Hermina Vukovic Tasic, Margo Thomas, Siew Chai Ting, Anders Zeijlon, Sally Zeijlon. The CPS team would particularly like to acknowledge and thank Erika Jorgensen from OPCS and Paul Levy from FINCR for their advice and guidance.

## EXECUTIVE SUMMARY

1. **Background**. Serbia has made significant progress on a wide ranging reform program since 2000. Macro-economic stability has been restored, and incomes have risen strongly. GDP per capita, estimated at \$2,200 in 2002, is now approaching \$5,400. Poverty has fallen from 14.6 percent of the population to about 8.8 percent. Growth has been underpinned by structural reforms to improve the business environment and the functioning of the enterprise sector. Public debt has almost halved as a proportion of GDP and reserves stand at over 30 percent of GDP. At the time of Serbia's accession to Bank membership in 2001, analysis was focused on the importance of breaking with the past. Now, however, the theme of this partnership strategy might more appropriately be to build on the success of recent economic gains and seize the future.

2. **Completing the Transition Agenda and Moving Toward Europe**. Due to the turmoil of the 1990s Serbia was one of the last countries in the Western Balkans to embark on the transition agenda. Strong progress has been made, particularly in expanding private sector participation in the financial and real sectors. The reform program has helped to underpin the country's strong economic performance and reductions in poverty. Nevertheless, risks remain. Serbia faces a challenging agenda if it is to fulfill its potential and participate in a wider Europe. Further reforms to spur private sector led growth, while protecting and better managing the environment, will be critical to ensure living standards and quality of life continue to converge with those in Europe. Particular efforts will be required to ensure that all people in Serbia have the opportunity to participate in and benefit from growth. Further strengthening of democratic institutions and overcoming remaining political legacy issues will also be required in the European stabilization and association process. Serbia concluded technical negotiations with the European Union on a *Stabilization and Association Agreement* (SAA) in September 2007. However the political situation and the EU accession process in Serbia remains influenced by recent history.

3. **The World Bank Group has actively supported Serbia's transition since re-engagement in 2001**. The Bank has had a discrete program of lending and analytical work for Serbia. Total IDA credits and grants committed to Serbia since 2001 amount to almost \$740 million, with \$145 million in IBRD commitments. As well as IDA/IBRD support, the Bank Group provided technical assistance from both IFC and MIGA to improve the business environment. IFC has invested over \$325 million in Serbia, and MIGA has provided guarantees of over \$425 million, in both cases predominantly in the financial sector. The objectives of the last CAS's three pillars to: (i) create a smaller, more sustainable, more efficient public sector, (ii) create a larger, more dynamic private sector, and (iii) reduce poverty levels and improve social protection and access to public services, were largely met. The economy has grown at an average of 5.5 percent per annum, driven by the private sector. The proportion of the population living in poverty has fallen by 5 percent, and the Government is already close to meeting their 2010 target of reducing poverty to 6.5 percent. Consistent fiscal deficits in the early part of the decade were reduced as a result of significant consolidation of public expenditures in 2004 and 2005, although spending increased in 2006 as a proportion of GDP in the run-up to the election. Current projections for 2007 suggest that spending has stabilized. This was accompanied by significant structural public sector reform, and the effectiveness of public spending has improved, with the share of public investments rising as a proportion of total government spending. Despite recent progress, there is the need to continue improving the effectiveness of public spending by strengthening the Government's Public Expenditure Management system. The World Bank Group support is widely recognized by the authorities as having strengthened the business environment while maintaining and improving service sustainability and quality in key sectors such as health, transport and energy. The CAS FY05 was noticeable for the country's graduation from IDA to IBRD financing due to Serbia's relatively strong economic performance since 2000.

4. **The new Country Partnership Strategy (CPS).** This CPS reflects the coordinated support able to be provided to Serbia from all parts of the Bank Group. Interventions from IBRD, IFC, MIGA, and WBI, will

be coordinated closely and are expected to have strong synergies. Over time, all parts of the Bank Group, including IFC, MIGA, and WBI are likely to play an increasingly central role in the Bank Group's program. Given Serbia's relatively strong economic progress to date and the country's graduation to IBRD this CPS envisages the Bank working even more closely with the Authorities to ensure that the Bank program is demand driven and focused on supporting the Government's own reform program. The four year CPS is designed to ensure that the World Bank programming cycle is consistent with the anticipated political cycle in Serbia. Following Parliamentary elections in January 2007, the normal Parliamentary term in Serbia would run until the end of 2010. The CPS consequently coincides with the current Parliamentary mandate. Within the overarching framework of European integration and poverty reduction, the CPS supports three Government identified priorities.

i. encouraging dynamic private sector led growth to ensure incomes continue to converge with European levels;

ii. providing opportunities and broadening participation in growth; and

iii. managing emerging environmental and disaster risks.

5. **A focused program of investment operations, support for reform efforts, deployment of a range of financial instruments beyond traditional lending and technical assistance is planned.** The CPS envisages an indicative base-case lending envelope of $600 million over four years. Within the strategic framework outlined in the CPS, mechanisms have been introduced to ensure that support is able to be tailored and adjusted to meet emerging needs and the rapidly changing circumstances of a middle-income country situated in a region still on the road to political stability. This CPS outlines a set of agreed investments and analytical support for FY08 and FY09. Indicative areas for potential engagement in the second half of the CPS period are also set out. Nevertheless, decisions on interventions in the latter half of the CPS period will be made as part of a mid-term review process anticipated for late calendar 2009. Scope is also available to calibrate lending to reflect changes in Serbia's overall creditworthiness compared to current projections, and lending volumes will be considered again in the mid-term review. The Government recognizes the value added and comparative advantages that can be brought by the Bank Group. The Bank will, however, need to continue to adjust its business model to remain responsive to Serbian requirements and a rapidly changing environment. This is likely to require the deployment of a range of financial instruments beyond traditional lending, including possibly deferred drawdown financing and catastrophic risk insurance. Greater involvement by all parts of the Bank Group to work with the Authorities to encourage public-private partnerships, including at the sub-national level, offers particular scope to encourage further investment in the delivery of important infrastructure and social services.

6. **Partnerships.** The Bank Group will work in partnership with the authorities and other members of the international community. Given the over-arching role of the EU, Bank interventions will be aligned with EU programs to help Serbia reach European standards. Specific rural and regional development investments will also be undertaken in close coordination with the EC. The Bank continues to work closely with the IMF, although Serbia does not currently have a program. The Bank will cooperate closely with the range of multilateral and bilateral partners active in Serbia. In light of Serbia's prevailing strong resource position the Bank will increasingly seek to leverage local resources in support of investment activities.

7. **Risks.** Risks remain, particularly given the increasingly uncertain situation in the region arising from unresolved Kosovo status issues. Serbia also remains vulnerable to exogenous shocks. Managing risks will require that the Bank Group work cooperatively with the Serbian Authorities in a highly flexible manner in order to encourage Serbia's continued international engagement and integration at a particularly sensitive time. At the same time, Bank Group support is necessarily dependent on Serbia meeting international responsibilities. The Bank will need to be agile in responding to changing circumstance and the demands of a sophisticated middle income client with a range of options for both financial products and advisory services.

# THE REPUBLIC OF SERBIA

# COUNTRY PARTNERSHIP STRATEGY

## I. INTRODUCTION

1. **Serbia has made significant progress since beginning a wide ranging program of democratic and economic reforms in 2001.** Macro-economic stability has been restored, and incomes have risen strongly. GDP per capita, estimated at $2,200 in 2002, is now approaching $5,400. Poverty has fallen from 14.6 percent of the population to about 8.8 percent. Serbia is now well placed to move forward toward integration with Europe, having completed technical discussions on a *Stabilization and Association Agreement*. At the time of Serbia's accession to Bank membership in 2001, analysis was focused on the importance of breaking with the past. Now, however, the theme of this partnership strategy might more appropriately be seizing the future.

2. **A challenging reform agenda remains if Serbia is to fulfill its potential**. Increasing competitiveness and attracting further investment is key to creating more jobs while maintaining strong growth. Serbia was one of the last countries in the Western Balkans to embark on the transition agenda. Progress has been significant, as evidenced in the major improvements in the business environment that saw Serbia ranked as the top reformer globally in *Doing Business 2006,* for reforms in 2004-2005. This reform program has helped to underpin the country's strong economic performance and reductions in poverty. Still, further reforms to strengthen the environment for sustained private sector led growth – including structural reforms and privatization - will be vital to ensure living standards continue to converge with those in Europe. Particular efforts will be required to ensure that all people in Serbia have the opportunity to participate in and benefit from growth, including the large number of poor in rural areas, among minority groups, and in depressed regions formerly home to large industrial and mining industries. Further strengthening democratic institutions, public spending, the rule of law, and overcoming remaining political legacy issues will also be required.

3. **The proposed Country Partnership Strategy (CPS) builds on the experience of the World Bank Group in supporting Serbian Government led reform efforts since 2001**. The CPS aims to harness all parts of the World Bank Group, including IFC and MIGA, to support Serbia build on the progress of the past few years. Reflecting Serbia's strong economic progress, this CPS comes at a time of Serbia's graduation to IBRD. This will require the Bank to work even more closely with the Authorities to ensure that the Bank program is demand driven and focused on supporting the Government's own reform program. Over time, all parts of the Bank Group, including IFC, MIGA and WBI, are likely to play an increasingly central role in the Bank Group's program. The CPS aims to support the Government's key priorities, and is focused around the key, and inter-related, themes of (i) convergence with EU living standards through private sector led growth, (ii) broadening participation in growth; and (iii) managing emerging environmental and disaster risks.

## II. COUNTRY CONTEXT

### A. Political Background and Recent Developments

4. **The past few years have seen a degree of relative political stability in Serbia**. Parties from the 'democratic bloc' – in varying combinations – have provided the foundation for government since President Milosevic was forced to step aside in 2000. Democratic institutions have been strengthened. The current Government includes President Tadic's Democratic Party (DS), Prime Minister Kostunica's

Democratic Party of Serbia (DSS) and the G17+. This followed Presidential elections in 2004, and Parliamentary elections in January 2007. The Government is based on a new Serbian Constitution, adopted by national referendum in November 2006, following the dissolution of the State Union of Serbia and Montenegro in June 2006. Reflecting a growing political maturity in the Balkans, the dissolution of the State Union itself followed a democratic process, was generally smooth, and entirely peaceful – unlike the break-up of the former Yugoslavia in the 1990s. Under the terms of the new Constitution, Presidential elections need to be called before the end of 2007, and this could result in a degree of political uncertainty in the short term.

5. **Still, political differences remain evident**. The formation of a Government in early 2007, for instance, took several months of difficult negotiations between the parties. Similarly, although President Tadic and Prime Minister Kostunica have each been in their current offices since elections in early 2004, the changing formation of the governing coalition over the past few years (this is now the fourth Government since 2000), highlights the differences between the parties of the 'democratic bloc'. Divisions in society are also reflected in overtly nationalist parties continuing to win a significant minority of seats in Parliament, with the Serbian Radical Party the largest single party in Parliament.

6. **Advancing European integration is a stated priority of the Government, and major progress was made with the initialing of a Stabilization and Association Agreement (SAA) in early November 2007**. European integration is an objective supported by almost two thirds of society. The initialing of the SAA follows almost two years of negotiations, which started in October 2005. European Foreign Ministers initially set out principles for a European future for the Western Balkan countries at a Summit in Thessaloniki in 2003. Ministers reiterated this vision in Salzburg in June 2006, although noting that the European perspective for the Western Balkans needs to be considered in light of the European Union's absorptive capacity. Nevertheless, the political situation and the EU accession process in Serbia remains influenced by recent history. While an SAA has been initialed, signing and ratification will still take several months, and is likely to require Serbia to demonstrate even closer cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY). Still, Serbia's strong administrative capacity may allow quick progress towards candidacy status once political issues are resolved.

7. **Serbia is taking an active role in a range of international and regional initiatives**. At the regional level, Serbia is a signatory to Energy Community of South East Europe Treaty, which creates legal framework for an integrated energy market in the region. Serbia has recently ratified the Central Europe Free Trade Agreement (CEFTA), which replaces 32 bilateral free trade agreements and aims to establish a free trade zone in the region by the end of 2010. Serbia participates in the Stability Pact for South Eastern Europe. At the global level, Serbia has recently ratified the Kyoto Protocol, and is expected to have completed requirements to join the World Trade Organization in 2008

8. **The status of Kosovo has become an increasingly prominent issue in political discourse in Serbia**. Under United Nations Security Council Resolution 1244, Kosovo is a province of Serbia under the autonomous administration of the United Nations (Throughout the CPS the province is referred to as "Kosovo"). Efforts to reach a long term negotiated solution to Kosovo's status are currently being conducted under the auspices of the Contact Group, with a troika of negotiators from Germany (on behalf of the EU), the United States, and Russia. At this stage, the Kosovo and Serbian sides appear to have fundamental differences of views on how the situation should be resolved. Achieving a negotiated solution is likely to be extremely difficult. All parties in the Serbian governing coalition remain united that independence for Kosovo is not appropriate.

## B. Recent Economic Developments in Serbia

9. **After significant declines in the economy during the late 1980s and 1990s, reforms in Serbia since 2000 have resulted in renewed growth and the restoration of macro-economic stability.** In the past five years, growth has averaged approximately 5.5 percent per annum, and should reach 7.0 percent in 2007. Growth has been driven primarily by strong domestic demand. Consumption has particularly underpinned growth over the past five years, although the rate of increase is starting to slow. More recently, strong export performance has also supported growth. Investment has remained about 22 to 23 percent of GDP – a relatively solid performance, although below the level of the fast-growing transition economies, where investment shares have been about 30 percent (Bulgaria, Croatia, Slovakia) or higher (Estonia). Service sectors have particularly grown strongly. Growth in agriculture and industry was volatile and on average slower. Key macro-economic figures are set out in Table 1.

10. **Renewed growth has been underpinned by significant reform.** Stabilization measures introduced after 2000 have brought the hyper-inflation of the 1990s under control. A series of tax reforms since 2001 (including introduction of VAT in 2005) have created a more efficient and simpler tax system which has strengthened the revenue base. Extensive restructuring of the banking system has helped to improve the allocation of capital, and access to credit. The privatization of about 1,800 socially owned enterprises has given new life to sometimes moribund companies, and reduced the demand for state subsidies. Reflecting progress, Serbia was rated by the Bank's *Doing Business 2006* report as the top reformer in 2004-2005. Gains are particularly evident in major reductions in the time and cost required to start a business, which resulted in 40 percent more businesses being registered in 2005 compared to 2003, as well as a new civil procedure code that halved the time required to resolve business disputes. Serbia's rating slipped slightly in the 2008 report, as the reform agenda slowed in the lead up to elections and as other countries pushed ahead with reform. Governance indicators for Serbia also continue to improve, although from a low base, particularly perceptions of strengthened rule of law and control of corruption[1]. There was significant public sector reform including much improved public expenditure management with the passage of a number of critical laws including on budget systems, procurement and debt management and strengthening of institutions notably in Treasury. A public administration reform strategy is being implemented that lays the foundation for a shift to a merit-based and de-politicized civil service and for the rationalization of government structures. A reform of the pension system moves the system towards long run sustainability, and the ongoing health sector reform is one of the best in the region.

11. **Growth has flowed through to improvements in living standards for most Serbians.** In USD terms, GDP per capita has risen from about $2,700 in 2003 to just under $4,300 in 2006, with GDP per capita projected to be over $5,400 in 2007. Latest World Bank poverty measures suggest that the proportion of the population living below an absolute poverty line (roughly $2.15 per day) has fallen significantly during the CAS FY05 period, from 14.6 percent in 2004 to 8.8 percent in 2006. Nevertheless, poverty remains a persistent problem in rural areas, which are home to about two thirds of all poor people in Serbia. This is particularly evident in depressed regions that used to be home to major industries (often extractive and industrial) during the Yugoslav period. Poverty also remains very high among minority groups, with over half of the Roma population estimated to live in poverty. Real gains in poverty reduction, however, are accompanied by continued pessimism among much of the population, in part because average incomes are just returning to the high point reached during the late 1980s. Unemployment also remains a continuing problem, at about 20 percent of the labor force.

[1] World Bank Institute, *Governance Matters 2007: A Decade of Measuring the Quality of Governance*, July 2007.

**Table 1: Serbia – Key Economic Indicators**

| Key Economic Indicators | | | | | Estimated | Projected |
|---|---|---|---|---|---|---|
| **Indicator** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| **Economy** | | | | | | |
| GDP, bln USD | 15.8 | 20.3 | 24.5 | 26.2 | 31.8 | 40.8 |
| GDP per capita, USD | 2,107 | 2,719 | 3,285 | 3,511 | 4,245 | 5,435 |
| GDP real growth | 4.2 | 2.5 | 8.4 | 6.2 | 5.7 | 7.0 |
| **National accounts (%GDP)** | | | | | | |
| Consumption | 102.3 | 96.2 | 100.1 | 99.6 | 97.9 | 98.6 |
| Investments | 17.2 | 22.6 | 23.6 | 22.5 | 21.9 | 22.1 |
| Export of goods and services | 18.7 | 21.4 | 22.7 | 25.2 | 27.0 | 28.2 |
| Import of goods and services | 38.3 | 40.2 | 46.3 | 47.3 | 46.8 | 49.0 |
| **Public finances** | | | | | | |
| Public Revenues, %GDP | 39.1 | 40.5 | 41.4 | 41.3 | 40.7 | 41.2 |
| Public Expenditures, %GDP | 43.4 | 43.7 | 41.4 | 40.6 | 42.3 | 42.5 |
| Fiscal balance, as %GDP | -4.3 | -3.2 | 0.0 | 0.7 | -1.5 | -1.3 |
| **Prices** | | | | | | |
| Inflation (eop) | 14.8 | 7.7 | 13.7 | 17.7 | 6.6 | 8.8 |
| Core inflation (eop) | 5.9 | 5.4 | 10.3 | 14.5 | 5.9 | 4.5 |
| **Balance of Payments** | | | | | | |
| Export, mln USD | 2,420 | 3,150 | 4,082 | 4,971 | 6,487 | 8,585 |
| Import, mln USD | 5,440 | 7,340 | 10,551 | 10,260 | 12,716 | 17,086 |
| CAD after grants, as %GDP | -8.8 | -7.0 | -11.7 | -8.5 | -11.5 | -14.6 |
| FDI, as % GDP | 3.0 | 6.7 | 4.0 | 5.9 | 13.7 | 3.7 |
| Gross official reserves, mln USD | 2,280 | 3,550 | 4,245 | 5,843 | 11,888 | 13,700 |
| **Debt** | | | | | | |
| External debt, %GDP | 70.9 | 66.7 | 57.5 | 59.0 | 61.3 | 59.6 |
| Public debt, as %GDP | 76.4 | 68.4 | 53.7 | 46.4 | 39.6 | 35.8 |
| **Monetary** | | | | | | |
| M2, as %GDP | 12.1 | 11.4 | 11.2 | 11.8 | 14.2 | .. |
| Net domestic credit as %GDP | 18.1 | 19.5 | 24.4 | 28.0 | 23.8 | 22.3 |
| Credit to private sector, as %GDP | 17.8 | 20.3 | 23.9 | 29.6 | 28.5 | 28.0 |
| Average exchange rate, RSD/USD | 64.4 | 58.8 | 58.4 | 66.7 | 66.9 | .. |
| Average exchange rate, RSD/EUR | 60.7 | 65.1 | 72.7 | 83.2 | 84.1 | .. |

*Source: IMF, World Bank staff and authorities' estimates.*

12. **Despite Serbia's strong growth performance, significant challenges remain.** External weaknesses are apparent in double-digit and expanding current account deficits. External debt remains about 60 percent of GDP, despite past London and Paris Club debt write downs. Although public debt has declined significantly, private external liabilities continue to grow quickly. Surging capital inflows and large current account deficits have unsettled the focus of monetary and exchange rate policies, which have alternated between disinflation and exchange rate objectives. Although policy action will be

required to address external weaknesses, Serbia's reserves position is currently very comfortable as a result of strong private sector inflows including foreign direct investment. FDI averaged 6.7 percent of GDP over the last 5 years, resulting in Serbia being among the top countries in Europe and Central Asia with respect to attracting such investment. FDI was especially strong in 2006, as a result of several large privatization deals, including the sale of a mobile telephone operator. Nevertheless, the privatization agenda remains unfinished. Greater greenfield FDI would also be useful.

### C. Developments in Poverty Reduction, Social Issues and MDGs

13. **Poverty has fallen over the past four years, from about 14.6 percent of the population in 2004, to 8.8 percent in 2006.** Serbia is on track to meet the target, set out in its 2003 Poverty Reduction Strategy (PRS), to reduce poverty to 6.5 percent by 2010. Despite the significant decline in poverty, however, this needs to be seen in the context of Serbia only recently returning to the income and poverty levels enjoyed in the late 1980s. Partly because of this, a degree of pessimism is still evident[2].

14. **Serbia seems well-placed to meet most, if not all, the MDG targets by 2015.** Primary school completion rates are over 95 percent, and in terms of statistics do not differ significantly by gender. The proportion of the population with access to an improved water source is higher than the average for ECA countries, as is the share of the country's population with access to sanitation systems. Infant and child mortality rates in Serbia were quite low to start with in 1990 and have continued to fall since then, indicating the country is on track to achieve this MDG.[3] Finally, with regard to the arresting the spread of communicable diseases, prevalence rates of diseases like malaria, tuberculosis, and HIV/AIDS are quite low, though warrant close monitoring, particularly for vulnerable and high-risk groups.

15. **Regional differences in poverty, with particularly high levels of unemployment in former industrial centers, remain a particular challenge.** Unemployment remains stubbornly high at about 20 percent of the labor force, and poverty and unemployment are closely linked. Despite high economic growth in the country overall, poverty remains especially evident in rural areas (such as parts of Vojvodina and Central Serbia) and in depressed former mining and industrial regions (such as Bor and Resavica). As well as high unemployment, there appears to be a significant number of "working poor" in such regions. A large number of people in low wage jobs, often in the gray economy, remain just above the poverty line, and vulnerable to unexpected economic shocks (such as loss of employment). Poverty is also strongly correlated with education: highly educated workers enjoy considerable wage advantage compared to those with less education and lower skills. Raising employment rates, and worker productivity and wages, through a comprehensive approach, including by promoting mobility of workers from declining to growing sectors, and upgrading the education and training system to produce a highly-skilled and flexible workforce, are important challenges facing policymakers in the country.[4] Other challenges include very high levels of poverty among minorities, especially Roma, as well as a rapidly aging population, which will have implications for the healthcare system and the fiscal sustainability of the pension system.

## III. COUNTRY DEVELOPMENT AGENDA AND OUTSTANDING PRIORITIES

16. **The key economic priorities of the new Government are set out in the *Memorandum on the Budget and Economic and Fiscal Policy for the Year* (July 2007) and the 2008 Budget (November 2007).** Priorities outlined in these documents are set within the Serbia's strategy for EU integration,

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[2] In Serbia, for instance, only 20 percent of the population currently feels that the economic situation is better than in 1989, compared to almost 40 percent in other Eastern European transition economies.

[3] See http://www.prsp.sr.gov.yu/download/mdg_2002_eng.pdf The MDGs: How much is Serbia on track?

[4] World Bank 2006: Serbia Labor Market Assessment, Report No. 36576-YU, World Bank, Washington DC.

adopted in 2005, and the Poverty Reduction Strategy (PRS), adopted in 2003. Key economic policy priorities include:

i. Maintaining macroeconomic stability;

ii. Promoting dynamic economic growth, through accelerated implementation of economic reforms;

iii. Increased employment and living standards;

iv. More balanced regional development;

17. **Accelerated integration with the European Union remains a key over-arching priority that will shape economic strategy.** The new Government has stated that integration is a central policy goal, and that it is committed to undertake necessary actions to harmonize legislation and practices and to make necessary investments, such as in the environment sector, to accelerate the integration process. Serbia concluded technical discussions on a *Stabilization and Association Agreement* (SAA) with the EU in September 2007, and the SAA was initialed in November 2007. The Agreement is now ready to be signed conditional on an assessment of Serbia's cooperation with the ICTY. The Government has stated its commitment to further strengthen such cooperation. The SAA process will influence all aspects of the Government's reform program. Further progress on European integration is likely to be important to enhance trade and economic cooperation opportunities for Serbia, and to encourage continued foreign investment. European principles and standards will also need to flow through to a wide range of reform programs – from public administration reforms to environmental requirements.

*i. Macro-Economic Stability*

18. **The Government recognizes that maintaining macro-economic stability is critical to underpin Serbia's continued growth and development.** In order to maintain hard won macro-economic stability, the Government has committed itself to maintain appropriate fiscal and monetary policy and accelerate structural reforms in the financial and public sector. The Government's Budget Memorandum recognizes the problems associated with increasing external vulnerabilities, evident particularly in the persistent and growing current account deficit. It foresees a mix of macroeconomic measures (fiscal, monetary, and exchange rate policies) to reduce domestic demand, along with accelerated structural reforms.

19. **Conservative fiscal policy will help address emerging inflationary pressures and external imbalances**. The Authorities have been very confident of Serbia's prospects. While mindful of imbalances and the remaining reform agenda, the Authorities have seen these issues as reflecting normal transition strains. Focused on infrastructure bottlenecks, reflecting inadequate investment over the past 20 years, and high labor taxation, the Authorities have used the scope provided by strong VAT receipts and one-off privatization revenues to give precedence in their policy agenda to relaxing the fiscal position and reducing labor taxation. These policies are likely to have long-term benefits, provided investments are carefully prioritized. Incorporating investments proposed under the National Investment Plan (NIP) into the regular budget priority setting process will be critical. Nevertheless, care is required to ensure that hard won macro-economic stability is not put at risk. The public sector in Serbia still makes up a very significant proportion of the total economy, at about 42 percent of GDP. Fiscal adjustment over 2003-05 brought the fiscal position into a small surplus, before pre-election spending in 2006 led to a deficit of 1.5 percent of GDP, with a similar outcome expected for 2007.

20. **The Government's stated fiscal policy aim is to reduce public expenditure as a proportion of GDP and strengthen the revenue base**. The Budget Memorandum and 2008 Budget recognize the need to reduce the burden of a relatively large public sector. The Government acknowledges the reversals in fiscal policy after the significant gains in 2004 and 2005. In order to address recent public sector wage growth, for instance, the Government has indicated its intention to develop a wage policy that links wage

adjustments to productivity increases and the abandonment of a policy of equal pay for all within the public administration, public services and public enterprises. Implementation of the 2008 budget will provide an important indication of the ability of the coalition government to realize politically challenging economic policies. The Government also plans to reduce fiscal pressures through additional reductions in subsidies to state and socially owned enterprise. On the revenue side, further reforms should be aimed at better capturing of informal activities, reduction of tax compliance costs and improved collection of taxes at municipal level. This will be needed stimulate competitiveness and encourage stronger public revenues based on a growing economy and a wider tax base. Over the medium term, the Authorities anticipate a gradual decline in public expenditures as a proportion of GDP, with public revenues remaining relatively constant as a proportion of GDP. The IMF has suggested that additional fiscal measures beyond those currently anticipated may be required.

21. **The Government is committed to improving the quality of public spending.** Public investment has increased as a proportion of GDP over the past 4 years (from 2.4 percent in 2003 to an anticipated 4.3 percent in 2007). The share of investment in human capital (health care, education, science) and infrastructure (energy, transport environment) are targeted to increase, in order to provide the necessary environment to attract private capital and lay the foundations for sustainable economic development. Strengthening the operations of the National Investment Plan (NIP) to ensure that investments are appropriately assessed and prioritized, will be particularly important in this regard.

22. **Strengthened public financial management and reform of public administration remain key priorities.** The Budget Memorandum acknowledges that "management of public finance is subject to permanent improvement". Ensuring that the independent State Audit Institution (SAI) established in September 2007 is functioning effectively will be central to improve controls on public financial management. Although the Serbian Government's treasury system is relatively strong, there is a need for improvement in procurement and internal and external audit. Additional public administration reform is intended to continue the ongoing public administration reform program with a focus on creating a more efficient public administration, based on the principles of decentralization, depoliticization, professionalization and rationalization of the civil service.

23. **Monetary and exchange rate policies are targeted at stabilizing inflation and ensuring that the Dinar rate is established based on supply and demand in the foreign exchange market.** The National Bank of Serbia (NBS) will continue to implement a policy of a gradual reduction of core inflation and its stabilization at a level that is comparable with that of EU countries. Tensions in macro-economic policies do persist, however, as the authorities try to balance objectives of short-term price stability with the competitiveness of the Dinar.

***ii. Promote dynamic economic growth, through accelerated economic reform***

24. **Serbia's growth rate of 5.5 percent per annum over the past five years is, by international standards, a strong but not outstanding performance.** Despite impressive achievements, Serbia remains at an early stage of the transition process, having started later than most other countries in the region. Further reform efforts will be required to ensure that incomes can continue to converge with European averages. The Government has stated its commitment to encourage dynamic private sector led economic growth through further structural reform to improve the business environment and strengthen the enterprise and financial sectors, and by undertaking needed investments and reform to improve critical infrastructure bottlenecks.

*Improving the Business Environment*

25. **The Serbian Authorities have made significant progress toward improving competitiveness by improving the business environment**. As noted above Serbia was a top reformer in 2004-2005. Still, Serbia ranks only 86 out of 178 countries overall. The Government is committed to undertaking additional reform to streamline business entry, including by reducing the time to register a business to 5 days and introduce a one stop shop for business registration. The Government acknowledges the need to reduce the regulatory compliance burden, with the costs associated with the licensing and permit regime – and especially construction permits – highlighted by *Doing Business* as a particular problem in Serbia and much of the rest of the Western Balkans. Competition legislation will continue to be harmonized with EU regulations and strengthened, through the establishment in 2006 of a Competition Protection Commission, to ensure greater competition for public enterprises, particularly in the telecoms and energy sectors. A comprehensive regulatory reform strategy and "guillotine" process should also help to reduce compliance costs for business.

26. **Strengthening the capacity of the judicial system to address business issues will be important**. Contract enforcement and the bankruptcy procedures remain cumbersome and expensive. D*oing Business* suggests that enforcing a contract in the courts still takes 21 months, while bankruptcy cases take over 30 months, are very costly, and generally result in a recovery rate of less than 25 percent. Surveys continue to indicate that Serbia citizens are less than fully confident about the impartiality of the court system. The Government has prepared a strong judicial reform strategy, which will *inter alia* help to address key issues affecting the business environment, including contract enforcement and bankruptcy proceedings, as well as significantly reduce the current case backlog and delays. As with most reforms, however, implementation will be critical. As well as strengthening the impartiality of the judicial system, streamlining jurisdictions, and ensuring a capacity to deal with complex business and economic cases, significant infrastructure investments are likely to be required to modernize the court system.

*Enterprise Sector Reform*

27. **Further corporate reforms remain the key challenge outstanding from the pre-2000 period**. Despite the impressive progress evident in the sale of over 1,800 socially owned enterprises, more than 1,000 enterprises so far remain unsold (in some cases because they have not found buyers after one or more market tests). There appears to be a reluctance to date to use modern bankruptcy procedures introduced in 2005, even with the longer-term benefits such actions could generate by freeing up underutilized but productive assets. In addition, many large utility companies, such as the Naftna Industrija Srbije (NIS), Elektroprivreda Srbije (EPS), the railway company Zeleznice Srbije (ZS), Telecom Srbije, and JAT Airways, remain in public ownership. According to Serbian Government figures, remaining state, socially-owned, and mixed enterprises still require direct fiscal subsidies of about 2 percent of GDP, in addition to indirect subsidies provided through non-payment of arrears to state owned utilities. Subsidies are especially concentrated on a few companies, including RTB Bor and Zastava Group, which together accounted for nearly one-third of the subsidies paid in 2006.

28. **The Government has stated its strong commitment to continue with enterprise restructuring and privatization to improve the overall competitiveness of the Serbian economy**. In the new Government's first five months the privatization program for socially-owned enterprises has continued (all remaining enterprises are expected to have been offered for sale by end of 2008, with unsaleable companies going into liquidation procedure). The Government has stated its commitment to strengthening bankruptcy enforcement. Proposals for the privatization of large state-owned enterprises remain under discussion. The Government appears committed to proceeding with the privatization of JAT Airways and the airports. The privatization of RTB Bor is almost complete. Options for privatizing the oil company (NIS) are under consideration. Considerable further reform of the railways (ZS) is

anticipated, with further efforts to improve efficiency – including redundancies. Further reform of the electricity sector is also anticipated. Restructuring of EPS to allow for greater private sector participation in new generation investments is well underway. Further efforts to privatize approximately 400 municipal enterprises, following the adoption of the relevant legislation, are also anticipated. Overall, the Government expects that these measures will allow for a continuing reduction in direct subsidies from current levels of about 2 percent of GDP.

*Financial Sector Reform*

29. **Growing confidence in the economy, and relatively high levels of global liquidity – at least until very recently - has led to an increase in financial intermediation and has drawn large capital inflows to Serbia.** This has occurred mainly in the form of foreign exchange deposits in the banking system, and more recently of credits provided by foreign banks to their newly established affiliates (including leasing companies). These new resources have allowed banks to sharply increase lending. Credit to the private sector rose from about 18 percent of GDP in 2002 to about 28.5 percent of GDP by the end of 2006. External debt has increased since 2004 (from 57.5 to 61.3 percent of GDP at the end 2006), despite significant declines in public debt. This partially reflects a shift in corporate borrowing from European banks rather than their Serbian affiliates to avoid high reserve requirements imposed by the National Bank of Serbia, leading to a rise in the share of consumer borrowing from domestic banks. While foreign capital inflows have helped fuel Serbia's economic recovery, they do raise issues of the vulnerability of the financial sector to capital flow reversals and exchange rate risks.

30. **In the past several years the GoS and the National Bank of Serbia (NBS) have made significant progress in restructuring the financial sector**, notably through the resolution of a number of insolvent banks and insurers, the divestment of nearly half its banking sector holdings and strengthening the regulatory regime underlying the banking, insurance and more recently the securities sectors. The Government has stated its intention to privatize its remaining financial sector holdings in nine banks representing about 15 percent of the banking sector, and divest the remaining assets held by the Deposit Insurance Agency (DIA) as a result of previous bank sales and closures. The Government has indicated a commitment to insurance sector reform, including by enacting the new *Motor Third Party Liability Law* (MTPL) and amending the *Insurance Law* in order to ensure a level playing field between insurance companies, as well as to privatize the public owned insurer Dunav and its stake in DDOR (total Government holdings currently make up 60 percent of the insurance sector). Strengthening of capital markets would also help to consolidate and deepen financial sector reforms. By improving firms' access to equity and debt financing this could provide new sources of capital and potentially mitigate credit risks toward large enterprises currently held by banks. Enhancing the regulatory and enforcement capacity of the Securities and Exchange Commission (SEC) will be especially important.

*Meeting Serbia's Transport Infrastructure Needs*

31. **Improving the management of Serbia's transport assets is critical to increase economic growth and regional linkages.** Road and rail traffic has been growing significantly, although rail traffic has mostly been concentrated in the freight sector and remains well below levels experienced in the 1980s. In both cases, significant investment needs are evident. At the same time, however, there is also an urgent need to strengthen the management of current assets and improve the efficiency of public spending. Greater involvement of the private sector in all transport sub-sectors may also offer opportunities to encourage the construction of new infrastructure, where financially viable, and allow the Government to increasingly focus public investment on much needed maintenance. Transport investments will need to be made within the context of the European Commission's overall framework for South East Europe. Initiatives include the establishment of an Infrastructure Steering Group (ISG) in 2001, which also includes representation from all relevant multilateral development banks and the

Stability Pact. A Memorandum of Understanding on the development of the South East Europe Core Regional Transport Network was signed by the ministries of transports from SEE countries in June 2004 and a Five Year Multi-Annual Plan was agreed with specific actions for each transport mode. The Memorandum of Understanding also provides the institutional framework for cooperation through a Steering Committee which is served by a Secretariat (SEETO).

32. **Investments in the road sub-sector will need to balance the very high priority placed by the Government on constructing European Corridor X, with the urgent need for maintenance of existing assets**. Corridor X, which runs from Austria, through Serbia to Greece has significant potential to increase Serbia's overall integration into the European transport network, and considerable resources are being directed at the development of the road network on this route. At the same time, the overall road system is deteriorating, due to rapid traffic growth and limited maintenance, with about 40 percent of primary roads and 70 percent of secondary roads estimated to be in poor condition. Possible private sector involvement in major highway construction could potentially allow a reorientation of public spending toward road maintenance that could help clear a significant maintenance backlog and help to ensure roads are maintained before expensive rehabilitation is required. There is also an urgent need to strengthen the management of assets and improve the efficiency of public spending. Road quality is also a factor in Serbia's road safety record, with fatalities per vehicle about five times EU averages, although a substantial outreach campaign, a cross sectoral approach, and a strengthened legislative framework are also likely to be required to manage this concern.

33. **Railway traffic, especially freight, is increasing steadily – but a major reform effort remains to improve efficiency and to put the railways on a sustainable financial footing.** Commercial revenues cover only half of Zeleznice Srbije (ZS) working costs (excluding depreciation). ZS remains one of the largest recipients of state subsidies, totaling 0.5 per cent of GDP (1 per cent including uncompensated asset depreciation). There has been progress in the introduction of much needed reforms in the railway sector: all the countries in the region have initiated the process towards the separation of railway infrastructure from operations in accordance with the broad principles set out in EC Directive 91/440, and some have completed this process. The next stages of the reform process - the establishment of track access regimes and a common network statement - is starting, with the support of the EU and the World Bank - with an Addendum to the SEETO Treaty on this issue to be signed by all the Ministers of Transport in the region in Tirana on the 4th December 2007. Still, much remains to be done. Efforts to increase overall railway revenues and improve efficiency, particularly of the large labor force, will also need to be accompanied by a transparent system of public service contracts for necessary but loss making passenger services as well as a restructuring of the ZS's historical liabilities and additional maintenance financing to overcome bottlenecks. In addition, improving the urban transport system is becoming a priority, with the commuter rail services serving Belgrade representing an early priority. There is scope to engage the private sector in such services, which could potentially be undertaken without financing or guarantees from the State Government.

34. **The inland water transport system has the potential to play a larger role**. Annual traffic volumes have increased significantly, reaching 8.4 million tons in 2005, approximately double 2000 volumes. The Government is moving to finalize the privatization of river ports. Most ports have sufficient cargo handling capacity, but old and inefficient equipment. Privatization could help to bring in much needed investments to improve efficiency and undertake needed maintenance.

*Energy Sector Reform and Opportunities*

35. **Serbia has considerable scope to benefit from participation in the regional energy market established under the Energy Community of South East Europe (ECSEE) Treaty.** Serbia has made important progress in reforming and upgrading its energy sector over the last few years. The financial position of the power utility EPS has been strengthened by tariff increases and significantly improved payment collection – although further tariff reform will be required to allow EPS to cover its full costs including depreciation and return on capital. This will need to be accompanied by strengthening of appropriate social safety nets to ensure that the poorest consumers are not made more vulnerable. Restructuring of the energy sector consistent with EU guidelines and the ECSEE Treaty has resulted in the establishment in 2004 of an independent regulator (although still with limited tariff setting authority), and the separation of EPS's generation, transmission and distribution assets. While the Government is not currently considering the privatization of EPS assets, this structure should help to ensure that there is a level playing field to encourage private sector participation in new generation investments, such as the Kolubara plant which is among the least cost generation options in South East Europe. An energy policy framework that encourages new private investment in generation capacity will be especially important to resolve looming capacity shortages in Serbia, the region, and Europe more broadly, that threaten to undermine growth.

36. **Increased energy efficiency will be a critical element in managing future energy demand.** Relative to its GDP, the Serbian economy is four times more energy intensive than the EU average. The Government acknowledges the need to tap new opportunities for improving energy efficiency and for the development of renewable and alternative energy resources. The Government is introducing programs to improve energy efficiency, in particular in the public sector, as well as encouraging private financing schemes for energy efficiency investments. Recent ratification of the Kyoto Protocol could facilitate the development of renewable energy and improved energy efficiency through carbon financing opportunities. Expanded use of natural gas, including gasification of central heating for a significant number of cities and towns could also improve energy efficiency. This will, however, require increased security of supply in gas imports.

37. **Further reform of the petroleum industry offers scope for significant benefits**. The Government is currently reviewing possibilities to privatize NIS. An open and transparent process that allows for majority private control of NIS or a clear path toward majority control, has the potential to offer certainty to investors and ensure the best price for the Authorities. Appropriate Government influence over the sector could then still be based on regulation. Serbian consumers could also save several hundred million Euros per year through import competition in petroleum products, and the Government is considering options to replace the import ban on oil products with a system of import duties, scheduled to be gradually reduced to low EU levels by 2012.

***iii. Increasing Employment and Living Standards***

38. **The Government's employment strategy is focused on the private sector as the major generator of new jobs, particularly in competitive export oriented small and medium enterprises.** With sustained economic expansion the authorities are expecting to reverse the trend in recent years whereby employment growth in the "new" industries was counteracted by falling employment in the "old" industries. Nevertheless with some 250,000 workers (10 percent of total employment) still employed in state and socially owned enterprises, there is still likely to be a need for further redundancies – with up to 40,000 predicted over the next few years. The National Employment Strategy for the period 2005-2010 sets out the ambitious targets of employment growth of 1.5 percent a year with the unemployment rate decreasing from the current level of 21.6 percent to 15.5 percent in 2010.

39. **Increasing employment, especially higher-productivity employment, will be important for raising living standards.** The Government recognizes that significant reforms are still required to ensure that Serbia's labor market has access to competitive human capital and that labor markets operate more efficiently and flexibly. Expanding job opportunities is one of the Government's main economic policy priorities until 2010. Currently Serbia's employment rate lags well below many successful transition countries and EU targets. Recent official statistics show that unemployment in Serbia remains approximately 21.6 percent. While improved employment performance will require sustained economic growth and the completion of the restructuring associated with the privatization program, a number of reforms in the labor market will also be crucial. Further reductions in labor taxation will be important, but would need to be carried out in a fiscally responsible manner. Labor supply also needs to be upgraded and workers will require better opportunities for training and retraining to adjust to ongoing structural changes in the economy. Labor market regulations should also be made more flexible, specifically in terms of improving possibilities for fixed-term and part-time employment. This would have a particularly positive impact on job opportunities for women and young people.

40. **A particular challenge for Serbia will be to ensure education is linked more strongly with labor demand.** High youth unemployment (including tertiary graduates) and comparatively poor performance in international assessments of student learning, indicate that the education system is not yet providing young people with the most appropriate skills and knowledge for a modern economy. These difficulties are compounded by wide differences in access to quality education. The development of a comprehensive education strategy appears to be a high priority for the Government. This will need to focus on improving teaching and learning standards, promoting greater education coverage and the reform of resource allocation within the sector. The education system has a unique opportunity to use the expected dramatic decline in student numbers (due to falling birth rates) to reallocate resources towards improving quality, especially for the most disadvantaged students, including Roma population. At the secondary level, an important challenge will be to expand coverage, including by restructuring the school network to reflect the changing geographical distribution of the population, while scaling back the dominance of vocational schools. Tertiary education will need to be aligned along the lines of the Bologna process to ensure better harmonization with EU standards. There is considerable scope to promote greater regional cooperation in higher education, including greater recognition of degrees from regional institutions and by promoting specialized "centers of excellence" in individual countries.

41. **Strengthening training and retraining to increase the knowledge and skills of the labor force to adjust to ongoing structural changes in the economy and industry will be important.** Adult education and training, even for those employed, is scarce and does not allow for upgrading of human capital in response to market demands. Strengthened programs to support the school to work transition would be valuable. Supporting the reform of National Employment Service to reorient active labor market programs that advance female and youth participation in the job market towards those with a proven record of greater efficiency and success will be a priority.

42. **Ensuring that Serbia's social protection and pension systems is better targeted and put on a more financially sustainable footing will be important to protect the vulnerable.** Poverty has fallen from 14.6 percent of the population in 2003 to 8.8 percent in 2007.

43. **Estimates suggest that the social insurance and social welfare payments have been critical in ensuring that poverty is not one third larger than it is.** Pension spending makes up the vast bulk – over 75 percent – of total social protection payments. Nevertheless, ensuring that the system is financially sustainable will remain a challenge given large current deficits (equivalent to about 5 percent of GDP) which will be compounded by anticipated demographic changes and the expected aging of the population. The Government undertook substantive pension reforms in 2005, including parametric reforms which will move the pension system from a large deficit into surplus in the long run. As a result,

pensions will be linked to inflation rather than wage rises and the relatively low retirement age increased. Improving collections, however, remains a key issue to further improve the fiscal sustainability of the current "first pillar" pension system. In the medium to longer-term, the Government is also considering options to introduce voluntary – and eventually compulsory – private retirement savings schemes. International experience suggests, however, that the successful introduction of such "second" and "third" pillar pensions schemes, however, are likely to require further strengthening of the regulatory environment, and a deepening and broadening of financial markets to ensure appropriate longer-term investment opportunities are available.

44. **Further efforts may be needed to strengthen the targeting of other social benefits.** Social welfare schemes such as the family allowance (MOP) and child allowance cover approximately one in five households. Social welfare schemes in Serbia are of relatively limited total size relative to neighboring countries, and cover roughly half as many households as social insurance schemes such as pension and disability allowances. Except for the family allowance (MOP), social welfare schemes are not as closely targeted or as progressive as possible. Better targeting of such social welfare schemes, or an increase in the relative proportion provided through MOP rather than other mechanisms (possibly through the introduction of a single welfare benefit), could help to reduce poverty. Social safety nets to reduce the impact on poor households of needed increases in energy tariffs will also be critical.

45. **A good health sector strategy is in place, and the Government's focus is on continued implementation.** Health outcomes in Serbia are broadly comparable to other middle income countries with similar incomes. Costs, however, are high: with public and private payments making up approximately 10 percent of GDP. The Government is committed to a strategy that will increase the use of primary health care providers and outpatient services, while improving the management of expensive tertiary health care facilities. The reform program is complicated by the fact that the health care system needs to be rapidly modernized and reconfigured to make the system able to more adequately respond to the rapid ageing of the population, the increasing burden of non-communicable diseases and to meet the expectations for quality care of a well-educated and informed population. The enhancement of private sector participation in the health sector provides potential opportunities to improve overall coverage and services. At the same time, the process of decentralizing primary health care has to be managed carefully so as not to overload municipal capacities and to sustain reforms that have started in the rationalization of hospitals and in payment methods at the primary health care level.

### *iv. More Balanced Regional Development*

46. **The Government is focused on the need to overcome significant regional disparities in Serbia.** The Authorities recognize that economic growth in Serbia, while strong and reasonably broad based, has still been characterized by a lack of opportunities for people in underdeveloped regions in country. Despite significant reductions in the proportion of rural people living in poverty (from 20 percent in 2004 to 14 percent in 2006), the rural poverty rate remains more than treble the poverty rate in Belgrade (4.2%). Two thirds of poor households in Serbia live in rural areas and depressed regions. Poverty is particularly evident in depressed former mining and industrial centers in Southern and Eastern Serbia. Unemployment in parts of the Bor region, for instance, is as high as 40 percent of the labor force. To overcome these challenges, a Regional Development Strategy was adopted early 2007. The strategy focuses on the upgrading of regional infrastructure, the provision of economic incentives and the roll-out of active labor market programs to ensure more balanced country-wide development. The strategy is fully consistent with EU principles of localization.

47. **The Government recognizes that improved policy and management of Serbia's natural resources will be critical to improve the welfare of the rural population and to strengthen Serbia's participation in European markets.** Serbia is well endowed with natural resources, including abundant

agricultural land, forests and water resources. The authorities have developed and adopted an agricultural strategy in 2005 to increase competitiveness. Land consolidation could improve agricultural productivity, with over 70 percent of farms in Serbia smaller than five hectares. While recent trade reforms have contributed to the liberalization of the agricultural sector, more needs to be done to reduce the high levels of tariff protection and subsidies which continue to delay the inevitable transformation process of the agricultural sector. Serbia's anticipated joining of the World Trade Organization 2008 is an important milestone in this direction. This transformation will need to be managed in a way that ensures that small farmers continue to have opportunities, especially given the importance of the agricultural sector as a "safety net" for many rural families. Early retirement programs and other forms of income support for smaller farmers that encourage land consolidation and create new off-farm employment opportunities may be important elements of such a program.

48. **Reforms to ensure that EU pre-accession programs and financing can be utilized fully to support the transition of Serbian agriculture will be important**. This will require shifting fiscal support away from price based interventions towards support for on-farm investments. This approach is also consistent with the Instrument for Pre-Accession for Rural Development and the evolution of the Common Agricultural Policy. Further modernizing food safety and quality systems and agricultural pollution controls will also be essential to increase farmers' ability to meet rising consumer preferences for quality products and cross compliance requirements associated with Rural Development funds.

49. **Adapting to climate change effects will be especially important for rural communities dependent on agriculture**. Projected climate change effects could potentially allow greater agricultural production in Serbia if irrigation and other infrastructure is in place. Improved water resource management and infrastructure can also reduce the variability in agricultural yields, increase productivity, and reduce the risk of flooding. At the same time, there is a risk that the frequency and severity of natural disasters, such as floods, droughts, forest fires, and landslides could increase. A key challenge will be to shift public sector intervention from disaster response to disaster risk reduction and climate change adaptation. Addressing natural hazards effectively will require coordination within and between countries (such as in weather forecasting, early warning, the development of plans for river catchments, including flood protection measures, and coordinated response to disasters). Such cooperation is of particular importance for the countries sharing river basins such as the Danube. Disaster insurance schemes and strengthened building codes could also be a central element in strengthening Serbia's hazard risk mitigation and adaptation strategies.

50. **At the same time, significant environmental issues associated with the legacies from heavy mining and industrial industries in regional towns, as well as in urban areas such as Belgrade will also need to be addressed.** Mining operations such as Bor and Resavica have significant environmental legacies that will need to be addressed as part of a broader regional development strategy. Attracting credible international investors to the 1,000 or so socially or state-owned enterprises that are slated for privatization requires an inventory of environmental liabilities attached to them and a strategy to address these liabilities. The mining and energy sector will need particular attention based on global best practice. In addition, Belgrade is also confronting increasing environmental issues, including air quality.

51. **Effective fiscal decentralization and municipal reform and strengthening will be crucial to reduce regional disparities**. The new Local Government Finance Law that came into effect in January 2007 has improved the fiscal framework for municipalities by improving the transparency and predictability of revenue transfers to local governments, and more equitably distributing revenues between municipalities. Significant disparities in per capita municipal revenues remain, however. In addition, strengthening the capacities of municipalities and local service providers such as schools and hospitals to manage and implement their new responsibilities in an environment of decentralized service delivery will be critical. Finally, municipalities will need to increasingly take the opportunities available

to increase financing for investments or to reduce local tax burdens to encourage investment. Following the approval of the new Constitution, municipalities now also have more options to generate revenue from the sale of land and companies. Better management of approximately 400 municipally owned companies through restructuring, privatization or modernization could free up significant amount of resources. Currently, a significant share of municipality expenditure appears to be covering the operating losses and capital needs of municipality owned enterprises

# IV. WORLD BANK GROUP PARTNERSHIP STRATEGY

## A. Participation and Partnerships

### *i. Participatory Process Followed*

52. **A World Bank client survey was conducted in June 2007.** In order to actively include clients, stakeholders and partners in the World Bank's strategic planning processes and get feedback on the Bank's track record and future role in Serbia, a client survey was carried out in June 2007.

53. **The majority of the respondents assessed the World Bank's role in Serbia as positive.** The World Bank was seen as most effective in reinforcing the financial system. A total of 291 respondents responded to the survey, covering all economic sectors, organization types and geographical parts of Serbia. Some 63 percent of the respondents assessed the efficiency of the World Bank's work in Serbia in a positive manner, with most positive scores coming from Government representatives and other donors, and more negative assessments from academia, the media and NGOs. With regard to past activities, the respondents assessed the World Bank as having been the most effective in reinforcing the financial system. A sizable portion of respondents thought that the World Bank has not been efficient enough in increasing transparency in governance and in reinforcing the education sector. However, the World Bank was seen as effective in the reduction of corruption due to its strict procurement rules. The World Bank's technical expertise, its knowledge (studies and analyses) and its ability to share best practices were highly appreciated.

54. **More than half of respondents thought that economic growth is the most important development priority for Serbia**. Economic growth was followed by job creation and improved incomes as the most important priorities. Fighting corruption, improving government effectivness, reducing poverty and improving the justice system were also seen as important foci for Serbia. Increased employment possibilities and the development of the private sector were seen as two key development areas likely to contribute most to reduction of poverty.

55. **Respondents thought that the World Bank should play an active role in the future to support Serbia's development efforts.** An overwhelming majority (81 percent) of the respondents thought that the World Bank will play an important role in Serbia's economic development and convergence with Europe. Respondents agreed that the World Bank's mission in Serbia, as in other mid-income level countries, has yet to be completed. Respondents from governmental institutions attached the greatest importance to the World Bank contribution to Serbia's future development, while respondents from other donor organizations saw the World Bank's role as slowly diminishing. Respondents thought that the World Bank should focus its resources mainly on spurring economic growth and in promoting policies that stimulate foreign direct investment and create employment. Institutions who have worked closely with the World Bank believe that the Bank's future analytical work in Serbia should focus on job creation, enhanced business environment and poverty surveys. It was widely seen that South Eastern and Eastern Serbia are most in need of the World Bank's assistance.

56. **Consultations with the Serbian Government and key partners and stakeholders were held to discuss the priorities for the World Bank's engagement in Serbia.** A set of roundtable discussions were organized in July and October 2007 between the representatives of the World Bank and the Serbian Government to discuss the priorities for future cooperation and how the World Bank could best support Serbia in its development efforts. Discussions have also been held with other major donors in Serbia. The EU has been consulted in the preparatory process of the CPS, including in consultations on the World Bank's future engagement in Serbia held in Brussels in late October 2007.

*ii. Donor Coordination and Partner Roles*

57. **The Government manages and leads donor coordination in Serbia.** In order to promote country ownership, the World Bank, along with other major donors, has recently been encouraging, empowering and supporting the Government to adopt a leading role in donor coordination and harmonization. A Donor Assistance Coordination Unit (DACU), initially under the Ministry of International Economic Relations, was established in November 2000 to act as a focal point for donor assistance coordination. DACU was later transferred to the Ministry of Finance which also is charged with managing EU funds for Serbia. DACU is tasked with facilitating and coordinating all donor support for Serbia. Furthermore, an informal intra-donor group meets regularly, comprising the 15 biggest bilateral and multilateral donors in Serbia. This group's activities are jointly coordinated by UNDP and the World Bank. The Office of the Deputy Prime Minister has also now established a focal point for EU and PRS implementation, and this has helped to ensure a "whole of government" approach.

58. **Increased efforts are being made to harmonize the activities of different development partners in Serbia and to align their programs with the Government priorities.** After the adoption of the Paris Declaration on donor assistance harmonization and in line with Serbia's EU accession goals, DACU has been paying more attention to the harmonization of donor assistance. With Serbia beginning to benefit from the EU's Instrument for Pre-Accession Assistance (IPA) funds, greater efforts are needed to strengthen donor coordination. The Government, recognizing this need, is developing a three-year inter-sectoral programmatic planning tool, which will be updated on a yearly basis, aimed at facilitating the programming of donor funds. Donors have welcomed this approach and expressed their willingness to seek further alignment of their programs with the Government's own priorities and programs.

59. **Serbia has received a significant amount of international aid since the democratic transition in 2000, but aid volumes are decreasing.** The Bank and the EC jointly chaired two major donor conferences in 2001 and 2003 to support Serbia in its development efforts. Serbia has received a total of 4.1 billion Euros in international assistance between 2000 and 2007. Aid volumes are, however, expected to decline in the medium to long term. The Government's objective is to mobilize around 400 million Euros annually in external financing until it gains EU membership. The Government has expressed that it hopes to receive half of the sum in grants and the other half in loans and credits. A Serbia donor matrix (annex 4) gives an overview the activities of different donors in Serbia. In terms of disbursement volumes, the four biggest bilateral donors in Serbia are the USA, Italy, Germany and Sweden. Many other European donors also provide valuable EU pre-accession support. Additionally, the UK supports the Government's efforts to implement the PRS in Serbia. The United States, while maintaining a strong presence, plans to phase out support in 2010-2011. The IMF currently has no program with Serbia – the previous arrangement between the IMF and Serbia expired in February 2006. Regular Article IV monitoring, however, provides a platform for continuing discussion between the Authorities and the IMF.

60. **The European Union is clearly Serbia's most important current and future development partner.** In this regard, practically all World Bank assistance is aimed at helping Serbia in the process of convergence with the European Union. EC assistance is going through a transition from being provided through the European Agency for Reconstruction (EAR) to being channeled through IPA, with

Government responsibility for implementation. As much as 195 million Euros could be received through IPA on annual basis. A significant strengthening in public institutions is required across the Government, however, if IPA funds are to be effectively mobilized. IPA is made up of five components: (i) support for transition and institution building; (ii) cross-border cooperation; (iii) regional development, (iv) human resources development; and (v) rural development. The first two components concern all beneficiary countries, whereas the three latter components are aimed at EU candidate countries only. Therefore Serbia, being a potential candidate country to EU accession, only benefits from activities under the two first components.

**B. Implementation of the Last CAS**

61. **The previous CAS program from FY05 to FY07 was delivered largely as planned during the first half of the program period, although improvements in the Government's financial position led to the replacement of an ambitious serious of planned development policy operations in the second half of the CAS period by additional financing for well performing investments**. With Serbia still at the early stages of the transition process, continued support for policy reform will be required – although this may need to be pursued through analytical and advisory services as well as by the use of new instruments such as deferred drawdown DPL operations. Investment operations, when carefully targeted and designed, also provided considerable scope to support difficult and complex reforms, such as decentralization, rationalization of railways operations, and energy market reform. Even greater integration across all parts of the Bank Group can potentially offer synergies to support the reform process, including market opening of the rail sector and the private provision of infrastucture and social services, especially in an environment on relatively high public sector spending.

62. **The investment portfolio is generally performing well**. IEG has confirmed satisfactory or moderately satisfactory ratings for all activities exiting the portfolio since the Bank resumed engagement with Serbia in 2001. A Joint Portfolio Performance Review (JPPR) undertaken in March 2006, for instance, confirmed satisfactory progress on 10 out of 12 operations current at that time. Efforts to strengthen the portfolio ensured that only one current operation remains unsatisfactory. Operations in the social sectors, however, have proved to be subject to performance difficulties. Performance of the education, health and pension reform projects, for instance, have all been unsatisfactory at some period. The portfolio review also highlighted the importance of strictly assessing project readiness, with several investments subject to initial delays in effectiveness and disbursements – although performance on almost all has subsequently improved significantly.

63. The CAS Completion Report (Annex 2) identified a number of lessons that have been incorporated into the design of this CPS. These lessons include:

(i) **The areas of focus in the CAS were appropriate, and the mix of interventions ultimately approved supported objectives well**. Given the substantial progress made by Serbia, and the contributions made by the Bank to that progress, CAS implementation can be considered overall satisfactory.

(ii) **Bank support should focus increasingly on Serbia's integration with the EU**. With the initialing of a SAA in November 2007, support for EU integration should be an explicit objective for the Bank. Closer integration with the EU will require significant investments to harmonize legislation and standards and to meet stringent environment and food safety standards. Support to build the capacity of the Serbian Government to use potential increases in IPA financing will also be crucial, given the experience of other countries in the region, which were not able to utilize an average of 40 percent of the financing made available.

(iii) **With Serbia still at an early stage in the transition process, continuing the outstanding structural reform agenda must be a critical element in the forthcoming CPS, in order to encourage continued growth and increase jobs**. Further enterprise reform, financial sector reform and improvements in the business environment will be vital to help ensure current levels of growth can be sustained. Continuing efforts will also be required to help ensure that all parts of the population have the skills and ability to share in and benefit from economic growth.

(iv) **Development policy lending can be a useful instrument to support reform, although Serbia's current economic position will require the use of innovative financing modalities, such as potentially deferred drawdown DPLs**. The Government has indicated that a Bank program with specific benchmarks and timetables could assist them in pursuing a reform agenda, particularly on the private sector side. Nevertheless, the Government does not need significant balance of payments support at this stage. While development policy lending can play a valuable role, the experience in the last CAS also suggests that it should not be overused. Investment instruments, when well targeted and designed, can also be useful to assist the reform agenda.

(v) **The Bank will need to ensure that assistance is able to be provided in response to client demand**. With the transition from IDA to IBRD financing, as well as the range of financing options available to Serbia, it is imperative that the Bank be even more responsive to Serbian priorities. Careful dialog with the client will be required to ensure that the Bank can stay relevant, as will greater flexibility. Identification of new products, including deferred drawdown development policy operations, insurance and sub-national lending products will require close consideration. At the same time, care will be required to balance the need for flexibility and responsiveness with the need to ensure that Bank financing does indeed help to promote reform.

(vi) **Flexibility will be critical given regional uncertainties and risks of possible political instability**. Even in a time of relative stability, as during the past CAS period, the need to replace adjustment operations with new and scaled up investments emphasizes the need for flexibility.

(vii) **Engagement across the Bank Group, has been strong and will continue to be important in meeting varied client demands through combining a depth of country knowledge with global expertise.** IFC and MIGA will become an increasingly central element of the Bank Group's engagement in Serbia over the coming years. There is considerable scope to exploit potential synergies between different parts of the institution to encourage the further development of the financial sector (pensions, insurance, housing), and to support the private provision of infrastructure and social services.

## C. The World Bank Group Partnership Strategy FY08 to FY11

### *i. Key Features and Themes of the Partnership Strategy*

64. **A four year program of support is designed to ensure that the World Bank programming cycle is consistent with the anticipated political cycle in Serbia**. Following Parliamentary elections in January 2007, the normal Parliamentary term in Serbia would run until the end of 2010. The CPS consequently coincides with the current Parliamentary mandate.

65. **The World Bank Group will support Government priorities in three key areas:**

i. encouraging dynamic private sector led growth to ensure incomes continue to converge with European levels;

ii. providing opportunities and broadening participation in growth; and

iii. managing emerging environmental and disaster risks.

66. **The Bank Group's strategy is broadly structured around the Serbian Government's development strategy as set out in the PRS, EU integration strategy, and the 2008 Budget Memorandum and 2008 Budget.** The Government's strategy has the key aims of: (i) maintaining macro-economic stability, (ii) promoting dynamic private sector led growth through accelerated economic reform, and (iii) increasing employment and living standards and encouraging more balanced regional development. Among the international community, key responsibility for supporting Serbian Government efforts to maintain macro-economic stability rests with the IMF, although the Bank Group will provide advice and support consistent with its mandate. Other themes in the Bank Group strategy correspond with the Government's overall priorities. The Bank will also work with the Serbian Government to manage emerging environmental and disaster risks in order to address key global and regional public goods.

67. **The World Bank Group program will support Serbia in its efforts to join the European Union, consistent with the Bank Group's comparative advantages.** Integration with Europe will require significant efforts to harmonize regulations and standards as well as significant investments, including to improve environmental management. EU accession requirements will be integrated into all aspects of the Bank Group's program, and there is scope for the Bank to assist the Authorities to strengthen the structures and systems that will allow Serbia to take full advantage of the opportunities potentially offered by EU IPA financing, should Serbia continue along the European process. At the same time, Bank support will need to be carefully targeted to complement the Government's own resources and financing, support available from the EC, and other multilateral and bilateral assistance. Bank support is <u>not</u> intended to address all aspects of Serbia's outstanding reform agenda. The EU, for instance, is generally best placed among the international community to support overall reform of public administration, with the Bank enhancing capacity and promoting reform at the sectoral level. Similarly, the Bank will support the IMF in its lead role in working with the Authorities to maintain macro-economic stability.

68. **Support for Serbian Government priorities will be coordinated and integrated across all parts of the World Bank Group.** Bank Group support is intended to be mutually reinforcing and complementary. Interventions from IBRD, IFC and MIGA will be coordinated closely and are expected to have strong synergies – although it also needs to be recognized that IFC financing and MIGA guarantee products are to some degree driven by private sector demand, investment opportunities available through the privatization process, and the scope made available by legislative reform in Serbia to widen options for public-private partnerships and expand. MIGA's involvement will also be affected by investors' perceptions of political risk. Particular scope exists for collaboration on sub-national financing, including to the City of Belgrade. Joint analytical products are also proposed, such as to explore opportunities for encouraging greater private sector involvement in the delivery of social services such as health, education, and private pension funds. Scope also exists for complementary support in the energy and transport sectors, particularly with the greater use by the Serbian Government of public-private financing arrangements for new infrastructure investments.

69. **Support will need to use a full range of financial and non-financial instruments to respond to client demand.** Particularly with Serbia's graduation to IBRD, the Bank will need to be even more flexible to ensure that support is responsive to Government priorities. New pricing of IBRD financing products will especially help to ensure that the Bank is competitive with other sources of financing available to Serbia. The Government has expressed its preference for a continued relationship with the Bank Group, involving both financial and analytical assistance, as well as support to encourage further private sector led investment. The Government recognizes the value added and comparative advantages that can be brought by the Bank Group. Nevertheless, given Serbia strong financial position, access to alternative sources of financing, and significant EC grant funds, the Bank will need to continue to adjust its business model to remain responsive to Serbian requirements. This is likely to require the deployment

of a range of financial instruments beyond traditional lending. Options such as deferred drawdown development policy operations to support the Government's reform program while allowing for disbursement flexibility are likely to be central to the IBRD program. The Bank will also explore innovative financial products, including disaster and catastrophe risk insurance. Options to use fee for service arrangements might also allow greater scope to respond to Serbian Government requirements for analytical support in specialized areas, including privatization.

70. **World Bank support will need to be flexible to respond to changing demand and the evolving situation in Serbia and the Western Balkans region.** Within the strategic framework outlines in this CPS, mechanisms have been introduced to ensure that support is able to be tailored and adjusted to meet emerging needs. This CPS outlines a set of agreed investments and analytical support for FY08 and FY09. Indicative areas for potential engagement in the second half of the CPS period are also set out. Nevertheless, decisions on interventions in the latter half of the CPS period will be made as part of a mid-term review process anticipated for late calendar year 2008. Additional financing options also provide scope to respond flexibly and scale up support for well performing investments, within the total financing envelope available. Adjustments will be possible within the CPS period.

71. **As well as a core program of IBRD and IFC financing and MIGA guarantees, the World Bank Group will undertake analytical work and advisory services to help encourage an authorizing environment for reform.** A large element of the World Bank's analytical work and technical assistance will be linked to the proposed lending and investment program. At the same time, however, analytical work and technical assistance can also be provided in areas that the Bank Group considers critical, but where there may not yet be a clear consensus for reform. The *Serbia Economic Memorandum*, scheduled for FY08, and a *Public Investment and Expenditure Management Review* scheduled for FY09 particularly provide vehicles for the Bank to engage the Government in a broad based dialogue on policy issues. This will be supplemented by separate analytical pieces considering specific policy issues. Analytical services and technical assistance can also potentially be provided in areas in which financing limitations may prevent investments in the early years of the CPS period. IFC advisory services will continue to be focused in 4 business lines: SMEs and linkages; business enabling environment; access to finance; and infrastructure advisory operations

*Priority 1: Dynamic Private Sector Led Growth to Ensure Incomes Converge with Europe*

72. **Although Serbia's economic transition is relatively recent, the country has come a long way.** Economic growth has been strong, and average incomes continue to increase. Progress has been underpinned by significant structural economic reform, with major improvements in the business environment, a vibrant financial sector, and significant enterprise restructuring and privatization. Continuing the next stage of the transition agenda, however, will be vital if Serbia is to encourage dynamic private sector led growth that will be able to ensure that average GDP per capita, currently about $5,400, continues to converge with EU member states.

73. **A proposed series of development policy operations (DPLs) are intended to anchor IBRD's support to Serbia through the initial stages of the CPS period.** While Serbia currently has limited financing needs, the Government has suggested that a World Bank DPL program could support the overall reform program. At least in the initial stages of the CPS period, the Government's limited financing requirements mean that such a DPL series might be structured as deferred drawdown operations (DDOs), although DPLs could also involve direct financing if required (further details of how DPLs might be structured is provided in paragraph 102 below). A maximum of one DPL would be disbursed in the first half of the CPS period, and only one DDO would be outstanding at any one time. The potential use of DPLs in the second half of the CPS period will be considered in the mid-term review. Even if DDOs are not drawn down, Bank engagement could potentially provide an important signaling effect to

other international actors to help demonstrate the seriousness and commitment with which the Government plans to pursue reform. As with all DPLs, such operations will depend on a satisfactory assessment on the overall macro-economic situation in Serbia, and the completion of appropriate reforms to justify financing before operations are brought to the Board. It will be important that these operations are not overloaded and concentrate on supporting reforms which are both critical for Serbia's overall development as well as in which the Government is committed to moving forward.

74. **Initially, DPL operations will focus on supporting Government efforts to promote private sector led growth.** This will include: (i) further improving the business environment, particularly cumbersome licensing and permit arrangements identified by *Doing Business* as a difficulty throughout the Balkans region; (ii) completing divestiture of socially-owned enterprises; (iii) strengthening enforcement of bankruptcy and other mechanisms to ensure the assets of insolvent socially-owned enterprises unable to be sold can be freed up for productive use; (iv) divest remaining financial sector holdings; and (v) continuing the process of privatizing and restructuring of large state-owned enterprises following the sale in 2006 of the mobile telephone operator.

75. **There is scope for development policy operations and investments in future years to support Serbian Government efforts to strengthen governance, which will facilitate growth.** Strengthening the functioning of the State Audit Institution (SAI) will be central to the Bank's DPL series of operations, and associated technical assistance in this regard will also be provided. The Bank will also engage through its analytical and advisory services to highlight areas in which further streamlining of public administration could help to reduce the overall fiscal burden in Serbia. This work, however, will need to be undertaken in support of the IMF's lead role in this area. Should the Government demand, DPL operations could also increasingly be focused on supporting the public sector reform agenda. A strategy to strengthen governance and anti-corruption might focus on: (i) justice sector modernization; (ii) controlling corruption; and (iii) improving economic transparency including public sector financial management, the business environment and the privatization process. The Government has initiated efforts to improve on all three dimensions, and Bank support will work in coordination with other donors to accelerate reforms. In addition, following the completion of the Accounting and Auditing Report on Standards and Codes (ROSC), the Bank will provide assistance, through an institutional development fund (IDF) grant, to support the establishment of a Steering Committee to develop a Country Action Plan (CAP) to enhance the quality of corporate financial reporting. This will need to be done within the framework of the EU body of law related to companies, financial reporting, auditing, and financial institutions complemented by International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA) and good international practice. In addition, consistent with the Governance and Anti-Corruption (GAC) Strategy Implementation Plan being developed for the Europe and Central Asia region, opportunities for individual investments to strengthen governance and reduce rent seeking opportunities in specific sectors will be considered at the time of project development.

76. **All parts of the Bank Group, including IFC, MIGA and WBI are likely to play an increasingly central role in the Bank Group's overall efforts to support the remaining transition agenda and stronger growth in Serbia.** IFC's focus in Serbia includes two major objectives: (i) facilitating restructuring and ownership change in the enterprise sector; and (ii) helping Serbia improve its competitiveness. IFC, in cooperation with the IBRD, will offer its global expertise and analytical capacity to support government's initiatives to speed up the process of restructuring and ownership change. IFC expect to play a crucial role in infrastructure (airports, ports, and logistics), and the further development of the financial sector. At the national level, IFC advisory services jointly with the Bank, is providing assistance on the regulatory reform to improve the quality of regulations affecting the cost and risk of doing business in Serbia. In addition, Sweden has provided trust fund financing to assist the World Bank Group (including IFC and WBI) to assist in the design and implementation of a guillotine review of the existing regulations and to provide technical assistance to encourage regulatory reform in

order to improve the existing regulatory environment, and to introduce a regulatory impact assessment to ensure new regulations are not unduly burdensome for business. At the sub-national level, IFC has embarked on a pilot project to assist 4 municipalities in streamlining and simplifying regulations affecting business operations. Through the alternative dispute resolution (ADR) program, the stock of outstanding disputes will also be addressed, thereby releasing additional capital for investment. Also, IFC is commercializing through its recycling linkage program the small street collectors who in Serbia are significantly comprised of the Roma population. MIGA will also continue to support foreign investors through the provision of political risk guarantees.

77. **The Bank Group will support further strengthening of the Serbian financial sector**. The financial sector is vibrant, with extensive participation by foreign institutions. Extremely strong credit growth, although from a relatively low base, has helped to drive recent economic growth in Serbia. IFC will seek opportunities to offer analytical and advisory support for the privatization of some remaining state owned banks and insurance companies though pre-privatization investments and advisory services. IFC proposes to partner with its existing and new bank clients to expand access to finance for key segments such as energy efficiency, housing, agribusiness and SME sectors. In addition IFC can support development of non-bank financial institutions such as private voluntary pension funds, leasing companies, factoring companies and insurance companies. IFC will consider opportunities to support the state owned First Mortgage Insurance Company through technical assistance and, if the company is privatized, through an investment. By improving corporate governance, and introducing/supporting new financial instruments, IFC could also play a role in facilitating capital markets development. For example, IFC will continue to provide its support to the government to improve the legal framework in the financial sector such as the preparation of the new securitization law. MIGA will consider opportunities to support foreign investors in the financial sector, focusing on projects which promote the development of non-bank financial institutions, such as leasing companies, improve SMEs' access to finance, and strengthen banks' capitalization.

78. **Improving infrastructure will be important to support economic growth and promote regional integration**. Greater use of public-private partnerships (PPPs) offer particular scope to improve infrastructure given public sector budgetary limitations, and the scope for greater efficiency in the delivery of infrastructure services. The Bank Group is providing coordinated advice to the Government on options for strengthening such engagement in a way that also minimizes contingent liabilities on the budget. In addition, IFC, in cooperation with the Bank and in coordination with EBRD, EIB and the EU, is open to offer its advice to the Government to structure PPP transactions in a transparent, competitive, sustainable and prompt manner. IFC will seek opportunities to offer support through its pre-privatization investments as well as advisory services in the oil and transportation sectors. This can build on the work undertaken by IFC in the JAT airways pre-privatization process.

79. A proposed IBRD **railways investment**, potentially in the form of 2 phase Adjustable Programmatic Loan (APL), will support key infrastructure needs, as well as supporting the significant outstanding reform agenda of the authorities. Currently, the Serbian railways sector is a significant loss maker, with annual operating losses in the order of \$200m. The "balkanization" of the former Yugoslav railways system has fragmented rail services and led to declining competitiveness and considerable inefficiencies. As well as financing needed infrastructure investments on the primary rail corridors, this will support the rationalization and potential privatization of parts of the rail operating system, and encourage greater regional cooperation in the Balkans (such as equipment pooling and joint marketing).

80. Support for the **energy sector** could assist Serbia to maximize the potential benefits from participation in the South East Europe regional energy market. Serbia, with Bank support, is continuing with the restructuring of Elektroprivreda Srbije, in order to allow an equal playing field for private investments and better cost recovery. A potential additional IBRD financed investment to rehabilitate the

Zvornik hydro-power plant offers scope to increase generating capacity, although Bank support is likely to have to be based on Serbia's continued participation in the Energy Community of South East Europe. Planned new thermal generation investments are likely to be more appropriately financed by new private sector investment, although there may be some need for continued public financing. Subject to government's progress with the reforms in this sector, the Bank Group could potentially support such investments through the provision of a partial risk guarantee, or through a MIGA guarantee or IFC financing for potential private sector investors. IFC will also actively pursue opportunities for investments to support other private sector infrastructure provision. At the same time, the Bank will also provide analytical and advisory support to the Authorities regarding options to strengthen the social safety net to offset the impact of required tariff increases on the poorest households.

81. Financing and analytical support to strengthen Serbia **road transport** links with the region could be provided in the latter part of the CPS period. In particular, the completion of Corridor X from Austria, through Serbia to Greece remains a very high priority for the Government. This link is part of the European highway network. Completion is likely to require some form of public-private partnership. Bank financing could potentially support the public sector engagement in such a development. IFC and MIGA could also potentially support private investments. Further support for maintenance, and a much needed investment in road safety, have also been requested by the Government of Serbia.

82. At the **sub-national level**, there is scope for further Bank Group support for needed infrastructure investments without a sovereign guarantee. IFC expects to continue its successful cooperation with the City of Belgrade and work on completing the concession of the Belgrade solid waste services by March 2008, and will explore opportunities for extending such support to other municipalities, either directly or in partnership with banks. There is also potentially scope for support to strengthen urban transportation systems in Belgrade. One of the impediments to PSP at the sub-national level has been the legislative framework, including requirements in the *Concession Law* for extensive and detailed involvement of the Central Government, including in municipal projects. MIGA could potentially play a role in promoting foreign infrastructure investments at the sub-national level through the provision of political risk guarantees, including in the solid waste sector.

83. **There is scope for IFC and MIGA to provide additional support for successful and growing local companies**. IFC investments are likely to focus particularly in sectors where Serbia has been competitive in the regional market such as agribusiness and IT sectors, in sectors that have a multiplier affect on economic growth such as real estate and construction materials, as well as in sectors which generate significant employment. In addition, IFC will support green-field FDI, including the expansion of regional players in Serbia, which are important to balance the large current account deficit. IFC will continue to target SMEs, channeling more financing to them through commercial banks and micro-lending institutions. In addition, IFC is looking for other instruments to support SMEs such as through risk sharing facilities and leasing. MIGA is open to support foreign investment in the manufacturing and agri-business sectors. MIGA will also consider opportunities to support SME development through its Small Investment Program.

*Priority 2: Providing Opportunities and Broadening Participation in Growth*

84. **Strong and broad-based growth needs to be accompanied by measures to ensure wider participation in productive economic activities**. Growth in Serbia has flowed through to significant increases in average incomes and reductions in poverty. Still unemployment remains stubbornly high. Regional differences in poverty remain a challenge, particularly in depressed former industrial and mining centers. Providing opportunities and retraining to allow mobility of workers from declining to growing sectors will be important, especially given the urgent need for further restructuring of the enterprise sector. Ensuring young people have the necessary skills join the workforce will be crucial to overcome

high youth unemployment and maintain social cohesion. And further efforts will be needed to strengthen the provision of social services, particularly, but not only, in the context of decentralization.

85. **The Bank will support Serbian Government efforts to strengthen the delivery of improved social services at a decentralized level.** The decentralization process in Serbia enjoys broad political support, and should help to bring service delivery closer to clients, consistent with European principles. Experience elsewhere in Eastern Europe suggests that careful implementation is needed to ensure that limited capacities at the local level do not adversely impact service delivery in the short term. The Bank will work with the Authorities to help to ensure that education, health and social protection service quality can be maintained as financing and responsibilities are transferred to the municipal level. This will build on the Bank's previous and current engagement in the education, health and pensions sectors. Such an investment will help to increase the access of households – and particularly households from marginalized groups – to quality health, education and social protection services delivered at the local level.

86. **The Bank will respond to Government requests for support to provide opportunities for people in poorer areas in Southern and Eastern Serbia.** Bank support will extend the model currently being used in the former mining region of Bor to the Resavica region. In addition to assisting the Government to restructure loss-making state owned mining companies and address environmental and social legacies associated with restructuring of mining and other heavy industries, investments will focus on fostering new sources of economic growth and job creation in the region. This could include micro-finance and SME development, retraining and targeted active labor market programs for former mine workers. The investment will build on the Bank's extensive experience in supporting mining sector restructuring, including in Poland, Romania and Russia.

87. **Additional support could be provided during the CPS period to support educational reform aimed at ensuring that school leavers have the skills to more easily enter the job market and participate in the growing economy.** Options might include support to restructure the secondary vocational education system to ensure that skills provided better meet the need of a rapidly changing economy, assistance to help school leavers make the transition from school to work, and support to refocus active labor market programs toward those activities that have been proven to be relatively more effective. This could build on the Bank's previous engagement in education reform, as well as testing of active labor market approaches. Options are also being explored to encourage greater regional cooperation in reform of the higher education system, possibly including greater specialization between institutions, as well as efforts to ensure wider recognition of degrees, and reform consistent with the European Bologna process. Some targeted support may be provided to continue reforms of hospital payment methods, which have just started and need to be sustained over the medium term to result into more efficient use of resources and better quality of services

88. **IFC and the Bank propose to collaboratively explore the opportunities for greater private participation in social service delivery.** Introducing private health and education services could strengthen overall service delivery. The introduction of private pension schemes also potentially offers scope for greater engagement by the private sector. This work will build on the Bank's extensive engagement in each of the sectors in Serbia. Such an analysis could provide a platform to support greater investments by IFC in these sectors.

*Priority 3: Managing Emerging Environmental and Disaster Risks*

89. **Addressing emerging environmental issues and managing risks of natural disasters are becoming increasing priorities in Serbia.** Since the early 2000s, Serbia has made significant progress in reforming its legal and institutional framework for environmental management along EU lines. Also notable is the progress made in incorporating environmental concerns into key economic sectors, through

strategies and investment projects, such as in agriculture (sustainable landscape management as integral part of rural development in South-East Serbia and agricultural pollution control) and energy (notably energy efficiency and dust reduction at a thermal power plant). Serbia also distinguishes itself in the Western Balkans by beginning to address ongoing and legacy environmental issues as part of the privatization process (Bor mining and smelting complex). However, significant policy, implementation and enforcement challenges remain with regard to water pollution from municipal and industrial sources, air pollution from industry, thermal energy generation and transportation, municipal and hazardous waste management, biodiversity and natural resource management. Increasing investments will be needed to implement the EU environment *Acquis* as it is transposed into Serbian legislation. Recent floods, droughts and fires have highlighted the need for effective regional disaster preparedness and response capabilities. These issues are also thrown into relief by the increasingly apparent need for climate change mitigation and adaptation measures.

90. A **South East Europe Regional Disaster Mitigation Initiative** has the potential to reduce the vulnerability of countries in the region to natural disasters by building preparation and response capacities and promoting a coordinated approach to disaster risk mitigation. Initial investment could potentially support hydrological and meteorological forecasting and flood early warning systems, strengthening regional disaster response capacities, and using innovative insurance and other financial products to finance disaster losses and spread risk. A framework for such an initiative is already under discussion among regional countries, and there is scope for the Bank in partnership with other bodies – particularly the EC – to support these common efforts. Serbia is also starting to be affected by climate change. Strengthened irrigation facilities will be especially important for Serbia to manage climate change, and to potentially increase crop yields. The Bank has been extensively engaged in supporting irrigation and flood control work in Serbia, but this could potentially be expanded even further in the latter period of the CPS through efforts to scale up an initial disaster preparedness investment.

91. The introduction of an **energy efficiency** fund, similar to that supported by the GEF in Bulgaria, could provide opportunities for Serbia. Such an investment could potentially support a large increase in energy efficiency investments in Serbia through initial grant support to establish a self-sustaining, market based financing mechanism that could develop and implement financially profitable energy efficiency activities, which could help to ensure sustainable reductions in greenhouse gas emissions without relying on public subsidies. Such a fund would be complementary to, and could work in parallel with, potential credit lines to commercial banks for energy efficiency activities being explored by EBRD. IFC also proposes to play an increasing role in Serbia in commercialization of new climate friendly technologies especially in sectors such as power generation, transportation and energy use. Recently, IFC provided a loan and advisory services to ProCredit Bank Serbia to implement its energy efficiency improvements program. The project, the first IFC's loan in Serbia promoting energy efficiency improvements and facilitating the use of cleaner and renewable sources of energy in housing and in micro and small enterprises, is expected to have significant demonstration effect in the market in Serbia. IFC will continue to provide both funding and advisory services to local institutions to develop and mainstream energy efficiency focused funding programs.

92. Serbian Parliamentary ratification of the **Kyoto Protocol** in September 2007 sets the stage for the country to participate in flexible carbon trading mechanisms. This could potentially allow Serbia to benefit from the sale of emission reduction units associated with new project investments. The ability to benefit from the Kyoto Protocol will also provide incentives for the publicly owned forest utility to undertake increases re-forestation. Grant funds are available from the Global Environment Facility (GEF) to assist countries that have ratified or acceded to the Stockholm Convention on **persistent organic pollutants (POPs).** This could potentially assist Serbia to manage obsolete stockpiles of POPs (such as pesticides, industrial chemicals, and unintentional toxic industrial byproducts which are of global concern and which remain active over long periods of time) and demonstrate best available technologies to

mitigate unintended chemicals release. Once Serbia has ratified the Stockholm Convention and prepared national implementation plan for POPs (currently underway with UNEP support), the Bank would be prepared to assist the Government to access GEF funds for implementation.

### *ii. The Financing Framework: Creditworthiness and Terms*

93. **Serbia continues to face external financing needs, although the Government's significantly improved financial position means these are more limited than in the past.** The Government has indicated that it particularly values the "bundled" knowledge and lending products able to be offered by the Bank. New pricing of IBRD financing products will especially help to ensure that the Bank is competitive with other sources of financing available to Serbia. To remain responsive, however, the Bank will need to deploy a range of financial instruments beyond traditional lending. Options such as deferred drawdown development policy operations to support the Government's reform program while allowing for disbursement flexibility are likely to be central to the IBRD program. The Bank will also explore innovative financial products, including disaster and catastrophe risk insurance.

**Table 2. Indicative IBRD Lending and Analytical Products FY08-FY11**

| | Lending | | AAA/ESW |
|---|---|---|---|
| **FY08** | | US$M | |
| | • Private Sector DPL | 50 | • Serbia Economic Memorandum |
| | • Railways | 75 | • Justice and Governance IDF |
| | • Delivery Integrated Local Services | 40 | • Disaster Risk Mitigation and Adaptation (Regional) |
| | • Health Improvement Add Financing | 15 | • South East Europe Regional Higher Education Study |
| | | | • Road financing and institutional study |
| | | | • Programmatic poverty assessments |
| **FY09** | | US$M | |
| | • DPL | 50 | • Public Investment and Expenditure Management Review |
| | • Resavica Regional Development | 40 | • Employment Generation Options |
| | • Regional Disaster Preparedness | 25 | • Private Sector Participation in Social Services (with IFC) |
| | • Energy Generation Rehabilitation | 55 | • PPP Analysis: Opportunities and Contingent Liabilities |
| | | | • Capital Markets Development TA |
| | | | • Public Financial Management (SAI) TA |
| | | | • Corporate Financial Reporting IDF |
| | | | • Municipal Enterprise Restructuring/ Privatization |
| | | | • Programmatic poverty assessments |
| **FY10 - FY11 (indicative)** | • DPL | | • TBD according to the Government's needs |
| | • Road Safety/Highways | | • Potential Options |
| | • Potential options: | | - Knowledge economy assessment |
| | - Judicial Sector and e-Government | | - Education reform options |
| | - Employment Promotion | | - Health/ Pensions Fiscal Sustainability and Efficiency |
| | - Railways APL II | | - Managing Environmental Liabilities |
| | - Danube Ports/ Inland Water Transport | | |
| | - Gasification | | |
| | - Renewable Energy/ Environment | | |
| | - Water Supply, Flood Control, Irrigation (2nd phase Regional Disaster Mangmnt) | | |
| | - Regional Higher Education | | |
| | - Pensions Reform | | |

94. **The CPS envisages an indicative base-case lending envelope of $600 million over four years, distributed relatively evenly between years.** Reflecting Serbia's improved economic position, financing will be on IBRD terms, as with other middle-income countries. The availability of IBRD financing will allow an increase in the envelope that would have been available from constrained IDA resources. At $150 million per annum, the base case envelope is equivalent to a 25 percent increase on the average provided in the previous CAS period from 2004 to 2007. Proposed investments and analytical and advisory support during the course of the CPS are set out in Table 2 (above). Investments in the latter part of the CPS period will be decided flexibly based on priorities determined in a CPS mid-term review scheduled for late calendar 2009.

*Creditworthiness Issues*

95. **Anticipated lending volumes are based on Serbia's creditworthiness position continuing to improve from the current situation.** Serbia's creditworthiness has improved considerably since it became a member of the Bank in 2001. In USD terms, GDP in 2007 is more than double that in 2002. Growth has been accompanied by serious structural reforms to improve the business environment and the functioning of the enterprise sector. Public debt has almost halved as a proportion of GDP. Reserves have increased significantly, to now stand at $13.7 billion - over 30 percent of GDP, or more than Serbia's total stock of public external debt. In 2006, Serbia prepaid approximately Euro 320 million to the World Bank to cover obligations falling due on 2 of 3 IBRD consolidation loans until the end of 2009. On the other hand, risks to Serbia's creditworthiness position remain, particularly given external imbalances. This is evident, in the rapid increase in private external debt, resulting in overall external debt falling only slightly over the past five years despite a significant improvement in the Government's own debt position. Real exchange rate appreciation and, after a significant adjustment between 2003 and 2005, recent relaxation in fiscal policy, is also putting pressure on a persistent double digit current account deficit that is starting to again widen. And total World Bank (IDA and IBRD) exposure, at approximately $2.8 billion, remains significant - although is projected to continue to decline as share of GDP. Historical data and projections regarding key macro-economic indicators are set out in Table 3.

**Table 3: Serbia Key Creditworthiness Indicators**

| *Indicators* | *2003* | *2004* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | *Projections* | | | | |
| GDP Real Growth | 2.5 | 8.4 | 6.2 | 5.7 | 7.0 | 6.0 | 5.5 | 5.5 | 5.5 |
| **Public Finance** | | | | | | | | | |
| Revenues (%GDP) | 40.7 | 41.4 | 41.3 | 40.5 | 41.2 | 40.9 | 40.6 | 40.4 | 40.2 |
| Expenditure (%GDP) | 43.7 | 41.4 | 40.6 | 42.0 | 42.5 | 42.8 | 42.3 | 41.8 | 41.5 |
| Fiscal Balance, before grants (%GDP) | -3.0 | 0.0 | 0.7 | -1.5 | -1.3 | -1.8 | -1.7 | -1.4 | -1.3 |
| **External Position** | | | | | | | | | |
| CAD after grant (%GDP) | -7.0 | -11.7 | -8.5 | -11.5 | -14.6 | -14.9 | -14.5 | -14.1 | -13.7 |
| Reserves ($billion) | 3.6 | 4.2 | 5.8 | 11.9 | 13.7 | 13.7 | 13.7 | 13.7 | 13.7 |
| **Debt** | | | | | | | | | |
| Gen Govt Debt (%GDP) | 74.7 | 63.1 | 54.2 | 39.6 | 35.8 | 33.1 | 32.4 | 31.8 | 31.4 |
| External debt (%GDP) | 66.7 | 57.5 | 59.0 | 61.3 | 59.6 | 58.5 | 60.8 | 61.4 | 61.2 |
| - Public external debt | | 39.4 | 34.9 | 26.6 | 20.5 | 18.5 | 17.3 | 16.1 | 15.1 |
| World Bank Exposure | | | | | | | | | |
| IDA ($ billion) | 0.3 | 0.4 | 0.5 | 0.6 | 0.6 | 0.6 | 0.7 | 0.7 | 0.7 |
| IBRD ($ billion) | 2.3 | 2.5 | 2.1 | 2.2 | 2.2 | 2.2 | 2.3 | 2.3 | 2.3 |

96. **Projections are based on a continuation of the reform program, as outlined in Serbian Government economic policy documents.** Growth is projected to decline from 7.0 percent in 2007 to an average of 5.5 percent in 2009-11, close to historical levels for the first half of the decade. Due to modest declines in both the tax burden and public expenditures relative to GDP, the consolidated fiscal deficit is projected to remain broadly unchanged. Modest deficits, combined with the effects of continued growth and availability of non-debt financing (esp. privatization proceeds), are projected to lead to further decreases in public debt as a share of GDP. Current account deficits are set to decline slightly from a high 14.6 percent of GDP in 2007, but to levels which still remain significantly above those observed in the first half of the decade. Following their massive buildup in the period to 2007, external reserves are projected to remain constant during 2007-11, working to curtail external financing needs. Inflows of foreign direct investment are projected to average 4.3 percent of GDP over the period 2007-11, partly supported by a still significant pipeline of large-scale privatizations, including the Bor mining complex, two large insurance companies, half of the oil and gas company NIS, and minority stakes in the power company EPS, the main telecoms utility, and other large firms. While below levels observed in the recent past (FDI averaged 6.7 percent of GDP over 2002-06), such FDI projections would be sufficient to maintain external debt as a share of GDP at broadly current levels.

97. **The perceived level of political uncertainties creates scope for divergences between these projections and actual outcomes.** In the event of serious regional instability or perceived risks to Serbia's European prospects, capital inflows could become more limited and/or more skewed towards debt-creating forms. This could slow growth, increase risk perceptions and erode Serbia's creditworthiness. In contrast, a more favorable evolution in these areas, combined with sustained progress in economic reforms, could raise non-debt creating flows above projected levels, leading to reduced risks and further improved creditworthiness. Such projections will continue being reviewed.

98. **Continued policy reform will be central to the design of the CPS program**. The policy priorities of the Government and reform efforts will flow through directly to the DPL program. In addition, individual sectoral investments will be structured to support the Government's reform program and regional integration. Decentralization of social services and railways reform investments planned in 2007, for instance, are critical, sensitive and complex reforms being undertaken by the Authorities. Similarly, engagement in the energy sector is intended to support, and will be dependent upon, Serbia's continued efforts to position itself as a supplier of energy to an integrated South East Europe regional market, as established by the Athens Treaty.

99. **A substantive review of creditworthiness and overall lending volumes will be undertaken during the mid-term review in late calendar year 2008.** Should creditworthiness improve substantially, there is scope at that stage for the Bank to consider moving to a high case lending program. This will, however, require a significant improvement in Serbia's overall economic position from that currently anticipated. Strong implementation of the Government's enunciated reform program will also be important to ensure that creditworthiness improves. This is likely to include: (i) public expenditure declining as a proportion of GDP, (ii) Serbia's overall external debt declining as a proportion of GDP; (iii) strengthened financial management, particularly the effective functioning of the newly established State Audit Institution and the integration of the National Investment Plan into the budget process; and (iv) continued structural reform, particularly efforts to privatize and restructure large state owned enterprises and strengthened resolution to free up the assets of unsold socially owned enterprises through bankruptcy and other proceedings. Increases in lending volumes will also need to be dependent on increased demand for financing from Serbia.

100. **Any significant deterioration in Serbia's policy and macroeconomic performance against base case creditworthiness considerations would require careful consideration of lending volumes, and a reduction in the financing that could be made available.**

101. **The continued servicing of obligations associated with IBRD Consolidation Loan C will be crucial to allow continued Bank engagement**. Loan C is linked with IBRD loans taken out by the former Socialist Federal Republic of Yugoslavia (SFRY) for activities in Kosovo. As the borrower of record, Serbia currently has legal responsibility to ensure continued service of this loan, as well as similar Paris and London Club obligations.

*Development Policy Loans, and possible Deferred Drawdown Options*

102. **The lending program is anticipated to be anchored, at least in the initial years of the CPS program, by a series of annual development policy loans (DPLs).** While Serbia currently has limited financing needs, the Authorities have requested such a program in order to set benchmarks that can strengthen the credibility and implementation of their own reform program. Such operations are most likely to be provided as deferred drawdown operations (DDOs), at least in the initial stages of the CPS, although the Government has indicated a possible interest in drawing down funds in 2009 and beyond. As with all DPL instruments, the presentation of any DPL operation (DDO or otherwise) will be subject to a satisfactory macroeconomic assessment by the Bank, and the completion of appropriate policy reforms to justify a DPL prior to presentation of such an operation to the Board. As DDOs are anticipated to be a series of annual operations, expiring after 12 months if not utilized, it is envisaged that only the value of the exposure held by the Bank at any particular time will be counted against the CPS lending envelope. While any such DDO DPL is active, or should financing be drawn down by the Authorities, it would count against the CPS envelope. Should a loan lapse after 12 months without being drawn down, however, it would no longer be counted against the overall envelope. At this stage, such operations are not expected to exceed approximately $50 million per annum. A maximum of one DPL would be disbursed in the first half of the CPS period, and only one DDO would be outstanding at any one time. The use of DPLs in the second half of the CPS will be considered in the mid-term review.

## V. RESULTS-BASED MONITORING AND EVALUATION

### Box 1. Anticipated Development Challenges which the CPS is Designed to Address

*Priority 1: Encouraging dynamic private sector led growth to ensure incomes converge with Europe*

- Improve the business environment
- Strengthen the competitiveness of the enterprise sector
- Strengthen financial sector intermediation
- Contribute to improved, well maintained and efficient infrastructure

*Priority 2: Providing opportunities and broadening participation in growth*

- Contribute to balanced regional development
- Improve effective social protection for the vulnerable
- Strengthen social service quality and access in a decentralized environment

Priority 3: Managing emerging environmental and disaster risks

- Improve environmental management
- Enhance the efficiency in the use of natural resources
- Stronger ability to prepare for, manage and mitigate unexpected environmental and disaster risks

103. **The measurement of results is an essential component to improve accountability and effectiveness of the Bank involvement in Serbia.** Box 1 aggregates the major results and outcomes expected to be achieved by the Government, with the World Bank support, during the CPS period. A more detailed results framework setting out the expected outcomes of individual interventions under each Pillar is included in Annex 1. The Bank will rigorously monitor the progress made under each pillar throughout the CPS period.

104. **The Bank and the Government will engage in annual consultation process to assess progress of the CPS and make possible adjustments to the Bank program.** The authorities have indicated their wish to hold annual round table discussions with the World Bank on outstanding sectoral reform issues and the overall status of the Bank portfolio in Serbia. These discussions provide an opportunity to review the status and assess progress of the CPS, make possible adjustments to both the Government and the Bank program and reflect new information and developments that might affect the Bank's portfolio. Consultations will also provide input for updating the CPS results framework to reflect possible adjustments to the individual sectoral objectives and milestones.

105. **The Bank will monitor results in the framework of its own monitoring mechanisms.** With regard to lending volumes, the Bank will undertake an annual creditworthiness review and adjustments to the base case lending scenario will be made on the basis of the review outcomes, within the lending parameters established above. A CPS mid-term review is foreseen to take place in mid-FY09. This will provide an opportunity to assess CPS progress and, as appropriate, move to high case lending, or reallocate resources and fine-tune the directions and objectives for the outer years of the program. In addition, the Bank will carry out results based portfolio reviews on an annual basis to assess the status of the various projects in the portfolio. The results and monitoring frameworks for individual Bank interventions will be aligned with the CPS results framework to facilitate portfolio monitoring.

106. **The Bank will primarily depend on Government systems and agencies for obtaining statistical data for the compilation and verification of CPS results and milestones.** Serbia has strong statistical capacities and the Statistical Office of the Republic of Serbia is a well organized unit that provides reliable and accurate statistical data. The EU and Eurostat are supporting the Statistical Office to adopt European standards in data gathering and processing. A British trust fund administrated by the World Bank is assisting the Statistical Office to strengthen its capacities in carrying out poverty measurements with the aim to produce better quality data on poverty in Serbia. However, mainly IMF figures will be used when assessing the macroeconomic developments in Serbia.

## VI. POTENTIAL RISKS AND MITIGATION MEASURES

107. **Regional stability**. The potential for regional instability and political uncertainty in Serbia arising from unresolved Kosovo status issues is the key risk to the CPS. Efforts to reach a long-term negotiated solution to Kosovo's status are currently being conducted, but the scope for agreement appears extremely limited. At this stage, the Serbian and Kosovo sides have fundamental differences of views on the basic question of autonomy or independence. Divisions are also apparent within the international community. The possibility exists of a unilateral declaration of independence by Kosovo. The status of Kosovo has become an increasingly prominent issue in Serbia, to the extent that this may override the Government's other stated reform priorities. Regional uncertainty could potentially deter investment, leading to a deterioration in Serbia's overall economic position. A potential reduction in regional cooperation, including in sectors such as energy where Serbia has considerable potential, could have an adverse economic effect. At the extreme, isolated violence associated with continued uncertainty remains a possibility. Kosovo is likely to be an issue in forthcoming Presidential elections, and have the potential to lead to an increasing radicalization of Serbian society.

108. **Serbia remains vulnerable to exogenous economic shocks.** Economic performance over the past few years has been very strong. Nevertheless, rapidly growing credit and associated private external debt and a stubborn current account deficit illustrate Serbia's continuing vulnerability to external shocks. A sudden increase in lending spreads or a decrease in liquidity could limit continued growth in Serbia and projected improvements in overall creditworthiness.

109. **Continued policy reform will be required to strengthen macro-economic stability and further improve Serbia's creditworthiness.** In particular, the government will need to recalibrate macroeconomic policy in order to reduce the imbalances that have emerged over the last two years, primarily due to fiscal stimulus. Greater fiscal restraint, consistent with the Government's stated intentions, will be important to reduce risks, as will continued structural reform. In addition further efforts to ensure rapid domestic credit growth and increases in private external borrowing are put on a more sustainable footing, and that credit increasingly finances productive investment rather than consumption. If these issues are not tackled, real vulnerabilities remain from the widening current account deficit and rapidly growing private external debt.

110. **Managing risks will require that the Bank Group work cooperatively with the Serbian Authorities in a highly flexible manner in order to encourage Serbia's continued international engagement and integration at a particularly sensitive time.** At the same time, Bank Group support is necessarily dependent on Serbia meeting international responsibilities, particularly in relation to debt servicing, or an agreement being reached that allows an orderly resolution of this issue. Given the very high level of uncertainty in the region, this CPS is perhaps best seen as setting out broad "rules of engagement" rather than as a detailed blueprint for Bank Group support.

## VII. CONCLUSION

111. **Serbia is well poised to continue its strong economic performance and make progress toward the goal of full European integration.** While the transition program began relatively recently, significant economic reform has underpinned strong economic growth and real reductions in poverty in Serbia over the past few years. The Government has demonstrated a degree of commitment to undertake difficult but necessary "second generation" reforms that should help to ensure a sustainable growth path for the economy led by a dynamic private sector. Efforts are also evident to ensure that the benefits of growth are distributed widely, and that opportunities for disadvantaged households to participate in the economy are increased. Nevertheless, Serbia and the region have not yet fully moved beyond the difficult legacies resulting from the turmoil of the 1990s. A key challenge will be to ensure that this reform momentum is able to be continued, and that international confidence and regional stability is maintained, at a particularly sensitive time for Serbia. The World Bank Group has the potential to continue to be a strong partner for Serbia as it faces these challenges. This will, however, require the Bank Group to be even more responsive to the demands of a sophisticated middle income client. Further strengthened cooperation with other multilateral and bilateral partners, particularly but not only the EC, will also be critical to strengthen the overall effectiveness of the support that can be provided. Most critically, the World Bank Group will need to be able to respond flexibly in order to calibrate engagement with Serbia in an environment of high uncertainty.

# Republic of Serbia
# Country Partnership Strategy Results Matrix

| COUNTRY DEVELOPMENT GOALS | ISSUES AND OBSTACLES | CPS OUTCOMES | INDICATORS | BANK ACTIVITIES & PARTNER ACTIVITIES |
|---|---|---|---|---|
| **PRIORITY 1: DYNAMIC PRIVATE SECTOR LEAD GROWTH TO ENSURE INCOME CONVERGENCE WITH EUROPE** | | | | |
| **Strengthen the competitiveness of the enterprise sector.** | Substantial structural reform has improved the competitiveness of the Serbian economy, but a significant transition agenda remains. Addressing these issues is of very high importance for the Government. | Complete the privatization and restructuring program for socially-owned enterprises. Baseline: 1,800 socially owned enterprises sold, but 1,000 remaining in Privatization Agency database. | Complete the process of offering all socially-owned enterprises for sale by end-2008.<br><br>Greater use of flexibility available in *Bankruptcy Law* (2007 baseline: 450 SOEs currently in Privatization Agency Bankruptcy Unit). | **Lending:**<br>Development Policy Loans<br>Railways APL<br>Transport Rehabilitation<br>Energy Community of South East Europe (ECSEE)<br>Energy project (Zvornik rehab)<br>Real Estate Cadastre Project<br><br>IFC investments<br>MIGA guarantees |
| | | Continue restructuring and privatization of large state-owned enterprises. | Reduce direct financial subsidies provided by MoE to state and socially owned enterprises. 2007 baseline: 1.9% of GDP, target: 1.0%. | **AAA/ESW:**<br>Capital Markets TA<br>PPP analysis on opportunities and contingent liabilities<br>Serbia Economic Memorandum |
| **Improve the business environment.** | Serbia has undertaken significant reform, with *Doing Business 2006* ranking the country as the top global reformer. Nevertheless, constraints remain - particularly in regard to complex business licensing and permit requirements. | Reduce regulatory compliance burden for businesses and enhance business entry. | Simplify procedures for obtaining construction permits and reduce compliance costs. 2007 baselines: (20 procedures; 204 days; Cost: 2,700% GNI/capita).<br><br>Reduce business registration time from 23 to 5 days. | Public Expenditure review<br>Accounting & Auditing ROSC<br>IFC regulatory reform<br>IFC/FIAS guillotine review<br>IFC Corporate Governance Program<br>IFC Alternative Dispute Resolution (ADR ) Program<br><br>**Partners:**<br>EU, EBRD, EIB, IMF, UNDP, Austria, Germany, Sweden, United Kingdom, United States |

| COUNTRY DEVELOPMENT GOALS | ISSUES AND OBSTACLES | CPS OUTCOMES | INDICATORS | BANK ACTIVITIES & PARTNER ACTIVITIES |
|---|---|---|---|---|
| **Strengthen financial sector intermediation** | | Divestment of remaining financial sector holdings. | Full divestment of majority stakes in 4 banks, minority stakes in 5 banks, and insurance sector holdings. | |
| | | Lower property market transaction costs, and increase availability of mortgage backed financing. | The real estate cadastre is operational in the whole country (Oct 2007: 83%).<br><br>Mortgage financing provided for 15% of all land transactions. Baseline: 5%. | |
| **Improved, well maintained and efficient infrastructure.** | Serbia has considerable infrastructure bottlenecks as a result of over a decade of relative neglect and low levels of public investment spending despite relatively high overall public expenditure. | Rationalized and financially sustainable rail operating system, in context of market opening for freight and passenger carriers. | Ratio of traffic unit kms to the number of Zeleznice Srbije (ZS) employees to increase to 270,000 (2006 baseline: 235,000)<br><br>50km of track rehabilitated . (2007 baseline: 0 km). | |
| | Many state owned utilities continue to be significant loss makers. Scope for private provision of infrastructure is limited, although increasing. | Strengthened road links, better condition of the road network and improved road safety, with greater efficiency in spending. | Performance based contracting used in all regions (baseline 2), with 20% reduction in winter maintenance unit costs (baseline Euro 570/ km).<br><br>350km of roads to be rehabilitated, with road roughness declining on IRI scale (baseline roughness: 5) | |
| | | Improved financial sustainability of the energy sector. | Energy prices move towards full cost recovery and investment needs of EPS. | |

| COUNTRY DEVELOPMENT GOALS | ISSUES AND OBSTACLES | CPS OUTCOMES | INDICATORS | BANK ACTIVITIES & PARTNER ACTIVITIES |
|---|---|---|---|---|
| | | Improved electricity market access for consumers and suppliers and strengthened capacity of the institutions to participate in the regional electricity market. | Electricity markets in Serbia are liberalized in accordance with ECSEE treaty, EPS restructuring continues, allowing private investment in new generation capacity. | |
| **PRIORITY 2: PROVIDING OPPORTUNITIES AND BROADENING PARTICIPATION IN GROWTH** | | | | |
| **More balanced regional development** | Poverty in regional areas (14% of the population) continues to remain significantly higher than in urban areas (about 5%). Disparities are especially severe in depressed former mining and industrial areas of Bor and Resavica, where mining enterprise restructuring could exacerbate differentials.<br><br>Improve agricultural outputs and exports, with increasingly able to meet EU standards and take advantage of EU export opportunities. | Provide economic opportunities in the depressed areas of Bor and Resavica by fostering new sources of economic growth to overcome social legacy of mining. Currently 15,000 unemployed in Bor region, with over 2,000 additional layoffs expected. Improve incomes, currently 40% of national average.<br><br>High domestic levels of protection and lack of efficiency in administration of budget resources reduce potential sector competitiveness. Widely fluctuating sector performance due to varying weather conditions. | 2,500 people to be supported into employment through ALMPs in Bor region.<br><br>Support SMEs through 1,000 micro-credit loans in Bor region.<br><br>Market support for agriculture falls from 30% of MAFWE budget to 10%.<br><br>5000 ha benefiting from irrigation development with 10% increase in corn and wheat production. | **Lending:**<br>Bor Regional Development Project<br>Resavica Regional Development<br>Transitional Agriculture Reform<br>Irrigation and Drainage Project<br>Health Improvement Project<br>Consolidated Pension Collection and Reform Project<br>Delivery of Integrated Social Services Project<br><br>**AAA/ESW:**<br>Programmatic poverty assessments<br>Employment Generation Options<br>Private Sector Participation in Social Services (with IFC)<br>South East Europe Regional Higher Education Study<br>IFC Recycling Linkages Program<br><br>**Partners:**<br>EU, Italy, Netherlands, Switzerland, Norway, United Kingdom |

| COUNTRY DEVELOPMENT GOALS | ISSUES AND OBSTACLES | CPS OUTCOMES | INDICATORS | BANK ACTIVITIES & PARTNER ACTIVITIES |
|---|---|---|---|---|
| | | Creation of an efficient and transparent rural development program consistent with EU pre-accession rural development programs | Rural paying agency established and operating. EU compliant rural development program operational, including management, monitoring and payment institutions and procedures. | |
| **Improve effective social protection for the vulnerable** | Poverty has declined from 14.6% of the population in 2004 to 8.8% in 2007, but many households remain vulnerable to shocks. | More effective, efficient and financially sustainable pension system | Pension contribution collections increase by 5%.<br><br>Pension payments to decline as a share of GDP (Baseline: 2004-06 average: 13.5%) | |
| **Strengthen social service quality and access in an increasingly decentralized environment** | | Efficient, sustainable and decentralized delivery of integrated health, education and social protection services at the local level in municipalities supported under DILS project. | Increased take up of targeted cash benefits and social services among eligible households in municipalities benefiting from the DILS project, relative to other municipalities<br><br>Among the poorest 25% of municipalities, improved access to primary and secondary education and primary healthcare in municipalities supported by the DILS project, compared to other municipalities. | |

| COUNTRY DEVELOPMENT GOALS | ISSUES AND OBSTACLES | CPS OUTCOMES | INDICATORS | BANK ACTIVITIES & PARTNER ACTIVITIES |
|---|---|---|---|---|
| **PRIORITY 3: MANAGING DISASTER RISKS AND PROMOTING ENVIRONMENTALLY FRIENDLY DEVELOPMENT** | | | | |
| **Strengthened environmental management.** | Major environmental legacy associated with mining operations in Bor and Resavica. | Remediation of urgent environmental hazards, including tailing ponds and wastewater discharge. | Environmental remediation works completed in all 4 sites in Bor region (with 2 tailings ponds closed), and 5 of 9 sites in Resavica region. | **Lending:**<br>Energy Efficiency project<br>Irrigation and Drainage project<br>Bor Regional Development project<br>Resavica Regional Development<br>Danube River Pollution GEF<br>Regional Disaster Management and Preparedness<br><br>**AAA/ESW:**<br>Regional Disaster Risk Mitigation and Adaptation<br><br>**Partners:**<br>EU, USAID, UNDP, Finland, Sweden |
| | The Serbian economy is highly energy intensive, with heating of buildings a major source of consumption. | Improve energy efficiency in over 200 public buildings by 45% (with overall improvement in public energy efficiency of 0.5%). | Replace heating supply at Clinical Center of Serbia and Nis Clinical center. Energy efficiency retrofitting of 117 public buildings.. | |
| | Serbia is a major source for pollution to the Danube/ Black Sea River basin. | Reduce nitrogen and phosphorus pollution flows to Danube and tributaries. | 60 farms implementing nutrient management plans.<br>4 slaughterhouses have invested in animal waste management technology.<br>20% decrease in non-point source pollution flows from 2008 baseline (TBD). | |
| **Strengthened ability to prepare for, manage, and mitigate unexpected risks, including those arising for climate change.** | Recent floods, droughts and fires have highlighted the need to prepare and respond to natural disasters to avoid loss of life and economic losses. | Better preparation for natural disasters and improved readiness to mitigate their harmful effects | National strategy for disaster and risk mitigation adopted and institutional arrangements for disaster and risk mitigation strengthened. | |
| | | Reduced risk of damage from flooding to land, crops, property, infrastructure, as well as reduced risk of loss of life from flooding. | Flood protection schemes strengthened for 550,000 ha and 2 million people along Danube, Sava, Tisa and Tamis rivers. | |

# REPUBLIC OF SERBIA CAS COMPLETION REPORT

**Country:** Republic of Serbia **Date of CAS:** November 19, 2004

**Period Covered by the CAS Completion Report:** November 2004 – November 2007

**CAS Completion Report prepared by:** Robert Jauncey, Senior Country Officer

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## I. Introduction

1. This CAS Completion Report evaluates the impact and effectiveness of the World Bank Group's Country Assistance Strategy (CAS) prepared for Serbia and Montenegro approved in November 2004 (hereafter referred to as CAS FY05). Serbia was the successor state to the Union of Serbia and Montenegro and retained membership of the World Bank following the dissolution of the State Union in 2006. A separate CAS Completion Report was prepared for Montenegro as part of a new Country Partnership Strategy for Montenegro discussed by the Bank's Executive Board in June 2007.

2. This CAS Completion Report has been retrofitted to evaluate the results from the previous Serbia and Montenegro CAS that correspond to Serbia alone. This is feasible since all new lending and advisory services in CAS FY05 were designed separately for each of Serbia and Montenegro. In volume terms, just under 90 percent of lending during the CAS was for operations in Serbia.

3. While the CAS FY05 was not prepared using a formal results-based methodology, this report attempts to retrofit a results-based framework in order to provide a basis for a new Country Partnership Strategy (CPS) covering FY08 to FY11. The retrofitted CAS FY05 Results Matrix has been prepared as if it had been done when the CAS was originally prepared in FY05.

## II. Country Context

### *A. Political Developments*

4. The past three years have seen a degree of relative political stability in Serbia, at least compared to the tumult throughout Balkans during the 1990s and early 2000s, and in Serbia following the 2003 assassination of President Djindjic. Reflecting a growing political maturity in the Balkans, the dissolution of the State Union of Serbia and Montenegro in June 2006 followed a democratic process, was generally smooth, and entirely peaceful – unlike the break-up of the former Yugoslavia in the 1990s. Serbia adopted a new Constitution in November 2006, following a national referendum.

5. Elections in January 2007 resulted in the formation of a coalition government by the 'democratic bloc' of parties, comprising President Tadic's Democratic Party (DS), Prime Minister Kostunica's Democratic Party of Serbia (DSS) and the G17+, led by current Minister of Economy Dinkic. Some combination of parties from this bloc have made the Government in Serbia since late 2000, when the nationalist President Milosevic was forced to step aside following allegations of electoral fraud. Nevertheless, political differences remain evident. The formation of a Government in early 2007, for instance, took several months of difficult negotiations between the parties. Similarly, although President Tadic and Prime Minister Kostunica have each been in their current offices since elections in early 2004, the changing formation of the governing coalition over the past few years (this is now the fourth Government since 2000), highlights the differences between the parties of the 'democratic bloc'.

Divisions in society are also reflected in overtly nationalist parties continuing to win a significant minority of seats in Parliament, with the Serbian Radical Party the largest single party in Parliament. New Presidential and municipal elections are due, most likely in early 2008.

6. Advancing European integration is a stated priority of the Government, and is an objective supported by almost two thirds of society. Serbia recently resumed negotiations with the European Union on a *Stabilization and Association Agreement* (SAA). Technical discussions regarding the SAA were concluded in September 2007, and initialing of the SAA occurred in November 2007. European Foreign Ministers initially set out principles for a European future for the Western Balkan countries at a Summit in Thessaloniki in 2003. Ministers reiterated this vision in Salzburg in June 2006, although noting that the European perspective for the Western Balkans needs to be considered in light of the European Union's absorptive capacity.

7. Nevertheless, the political situation and the EU accession process in Serbia remains influenced by recent history. While technical talks on an SAA have been concluded, initialing of a document will require Serbia to demonstrate cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY). Recent moves by Serbia on this front did allow the resumption and conclusion of technical discussions, but further efforts are likely to be required. Serbia remains, with Bosnia and Herzegovina, one of only two countries in the region not to have yet signed a SAA. Still, Serbia's strong administrative capacity may allow quick progress along the European path once political issues are resolved.

8. The status of Kosovo has become an increasingly prominent issue in political discourse in Serbia. Under United Nations Security Council Resolution 1244, Kosovo is province of Serbia under the autonomous administration of the United Nations. Efforts to reach a long term negotiated solution to Kosovo's status are currently being conducted under the auspices of the Working Group, comprising the US, Russia, Germany, France, Italy and the UK. This followed an impasse in discussions in the United Nations. The "troika" of negotiators from Germany (for the EU), the US and Russia are to report back to the UN Secretary General on progress by December 10, 2007. At this stage, however, the Kosovo and Serbian sides appear to have fundamental differences of views on how the situation should be resolved. Achieving a negotiated solution is likely to be extremely difficult.

### *B. Economic Developments*

9. After two decades of decline, reforms in Serbia since 2000 have resulted in renewed growth. Since the last CAS was approved in late 2004, growth has averaged about 7 percent per annum. Growth has been driven by large capital inflows, and significant reform to improve the business environment. Nevertheless, external imbalances are widening and remain a potential risk for sustained growth.

10. Renewed growth has been underpinned by significant reform. Stabilization measures introduced after 2000, have brought the hyper-inflation of the 1990s under control. A value added tax (VAT) introduced in 2005 has simplified tax procedures and strengthened the revenue base. Extensive restructuring of the banking system has helped to improve the allocation of capital, and access to credit. The privatization of about 1,800 state and socially owned enterprises has given new life to sometimes moribund companies, with all small and medium sized socially owned enterprises expected to have been offered for sale by 2008. Reflecting progress, Serbia was rated by the Bank's *Doing Business 2006* report as the top reformer in 2004-2005. Gains are particularly evident in major reductions in the time and cost required to start a business, which resulted in 40 percent more businesses being registered in 2005 compared to 2003, as well as a new civil procedure code that halved the time required to resolve business

disputes. Governance indicators for Serbia also continue to improve, although from a low base, particularly perceptions of strengthened rule of law and control of corruption[5].

11. Growth has flowed through to improvements in living standards for most Serbians. In USD terms, GDP per capita has risen from about $2,700 in 2003 to just under $4,300 in 2006 and a projected $5,400 in 2007. Latest World Bank poverty measures suggest that the proportion of the population living below an absolute poverty line of approximately $2.15 per day has fallen significantly during the CAS FY05 period, from 14.6 percent in 2004 to 8.8 percent in 2006. Nevertheless, poverty remains a persistent problem in rural areas, which are home to about two thirds of all poor people in Serbia. This is particularly evident in depressed regions that used to be home to major industries (often extractive and industrial) during the Yugoslav period. Poverty also remains very high among minority groups, with over half of the Roma population estimated to live in poverty. Real gains in poverty reduction, however, are accompanied by continued pessimism among much of the population, in part because average incomes are just returning to the high point reached during the late 1980s[6].

12. Despite Serbia's strong growth performance, significant challenges remain. External weaknesses are apparent in double-digit and expanding current account deficits. External debt remains about 60 percent of GDP, despite a series of London and Paris Club debt write downs. Although public debt has declined significantly, private external liabilities continue to grow quickly. Large current account deficits have unsettled the focus of monetary and exchange rate policies, which have alternated between disinflation and exchange rate objectives. As with much of the Western Balkans, unemployment remains high at approximately 20 percent of the labor force.

13. To address these issues, further corporate reforms remain the key challenge outstanding from the pre-2000 period. While all small and medium sized socially owned enterprises are expected to be offered for sale by 2008, buyers have not been found for many of these. Despite the adoption of considerably strengthened bankruptcy legislation in 2004, there has been a reluctance to use such procedures for companies which have not been able to be successfully sold, even with the longer-term benefits such actions could generate by freeing up underutilized but productive assets. Many of the largest and most difficult state-owned companies also still remain in public ownership. Despite restructuring, large state-owned enterprises such as the Oil Industry of Serbia (NIS), Electroprivreda Srbije (EPS) and the railways remain in public ownership. According to Serbian Government figures, remaining state, socially-owned, and mixed enterprises generate corporate losses equivalent to 1.9 percent of GDP in 2006, although this is a significant reduction on 2003 (estimates of subsidies in 2003 ranged from 3 percent by the Government to as much as 5 percent of GDP by the IMF based on data from the National Bank of Serbia's Solvency center). In addition, while significant improvements have been made in the overall business environment, further gains are possible: Serbia still ranks only 86 out of 178 countries in overall *Doing Business* indicators, in large part because of complicated business licensing permit procedures that generate opportunities for rent-seeking behavior.

14. The Authorities have been very confident of Serbia's prospects. While mindful of imbalances and the remaining reform agenda, the Authorities have seen these issues as reflecting normal transition strains. Focused on infrastructure bottlenecks, reflecting inadequate investment over the past 20 years, and high labor taxation, the Authorities have used the scope provided by strong VAT receipts and one-off privatization revenues to give precedence in their policy agenda to relaxing the fiscal position and reducing labor taxation. These policies are likely to have long-term benefits, provided investments are carefully prioritized. Nevertheless, care is required to ensure that hard won macro-economic stability is not put at risk. The public sector in Serbia still makes up a very significant proportion of the total

[5] World Bank Institute, *Governance Matters 2007: A Decade of Measuring the Quality of Governance*, July 2007.

[6] In Serbia, for instance, only 20 percent of the population feel that the economic situation is better than in 1989, compared to almost 40 percent of the population in other Eastern Europe transition economies.

economy. While public expenditure declined from 43.7 percent of GDP in 2002 to 40.7 percent in 2005 (with a fiscal deficit of 3.0 percent of GDP in 2003 being transformed into a small surplus in 2005), spending in 2006 and 2007 is again starting to increase. In 2006, public expenditure reached 42.3 percent of GDP, and is expected to remain at comparable levels in 2007 – although this is still 1 percent of GDP below 2003. After a small surplus in 2005, a limited deficit of 1.5% of GDP remerged in 2006, and a similar figure is expected for 2007. Still, deficits are considerable smaller than in the period immediately prior to the CPS. There has, however, been a reorientation in spending. Government investment spending has increased as a proportion of GDP over the CAS period, from 2.4 percent in 2003 to a projected 4.3 percent in 2007.

## III. Serbian Government Priorities

15. Serbia's development priorities are defined by two pillars - the European Integration process and the Poverty Reduction Strategy Paper. These are complementary and compatible.

16. In June 2005 the Government of Serbia's Council for European Integration adopted the National Strategy of Serbia for Serbia and Montenegro's Accession to the European Union. This Strategy was subsequently adopted by the Government. Serbia also subsequently completed technical discussions on a European SAA in September 2007.

17. Serbia's *Poverty Reduction Strategy Paper* was completed in late 2003. A new Strategy is currently under preparation. Responsibility for "whole of government" coordination of the implementation of the PRS rests with the Deputy Prime Minister, who also has responsibility for coordinating European integration efforts. This has ensured a strong degree of consistency between the key strategies. Probably more than anywhere else in the Western Balkans, the PRS has been embedded in Serbian Government decision-making processes, and has reflected broad government priorities. The PRS sets out three over-arching goals for Serbia:

(i) establishing the conditions for dynamic and equitable economic growth, through the creation of a stable macro-economic environment and favorable investment climate, that will create employment and reduce economic vulnerability, as well as the establishment of key programs to directly promote employment among the poor;

(ii) preventing new poverty resulting from the modernization and restructuring of the economy through targeted training and social measures enhancing this group's ability to take advantage of new opportunities created in the reformed market economy.

(iii) improve access to social services by the poor, such as health, education, water and other key infrastructure needs, through improved targeting of existing programs, and actions that improve the efficiency and quality of services delivered, particularly to the most vulnerable groups in society. The goal of these activities is to initiate a long- term process of empowering vulnerable groups to move out of poverty, through the development of new market-oriented skills, and the provision of minimum standards of living.

18. Key success measures set out in the PRS are on track to be met. At the time of preparing the PRS, the Government noted that the successful implementation of the Poverty Reduction Strategy should result in a reduction in poverty to around 6.5 percent of the population by 2010 with average annual growth of around 4 to 4.5 percent, without an increase in overall inequality in society.

## IV. World Bank CAS FY05 Objectives

19. The CAS FY05 was built around the Government's complementary European integration priorities and the PRS. Reflecting the aims of the PRS, the CAS was structured to support Serbian Government efforts to:

(i) Create a smaller, more sustainable, more efficient public sector, through: fiscal consolidation, leaner and more efficient public administration, better delivery of state services and improved financial sustainability of pensions, healthcare and education.

(ii) Create a larger, more dynamic private sector, through: continued progress on restructuring and privatization of real and financial sector assets, restructuring and resolution of large loss-making state-owned enterprises, improved access to finance, particularly for the SME sector, energy sector restructuring and, where appropriate, private participation in infrastructure.

(iii) Reduce poverty levels, and improving social protection and access to public services, through improvements in support for rural communities, the coverage, targeting, and reliability of transfers for social protection and the quality, access, and financial sustainability of health and education for all citizens.

### *A. IDA/IBRD Engagement*

20. CAS FY05 objectives were supported by IDA credits and IBRD loans that utilized the Bank's comparative advantage and experience, backed up by analytical and advisory support. During the period from FY05 to FY07, much of the Serbia portfolio was made up of continuing activities approved prior to the CAS. These pre-CAS FY05 projects include both the trade and transport facilitation program (TTFSE) and export finance facilitation (SMECA) IDA credits that supported investments in both Serbia and Montenegro, as well as seven discrete IDA credits for Serbia, including: support for reform in the education and health sectors, efforts to encourage corporate restructuring, reform of employment services, and property registration, as well as infrastructure investments in transport and energy efficiency. Details of lending activities current at the time CAS FY05 was presented to the Board are set out in Table 1.

**Table 1: Active Operations During FY05-07, Approved Prior to CAS FY05**

| *Activity* | *Funding USD million* | *Started* | *Finished/ Due to finish* |
|---|---|---|---|
| ***Serbia and Montenegro*** | | | |
| Trade/ Trans Facilitation | 5.4 | FY02 | FY07 |
| Export Fin Facilitation | 12.3 | FY03 | FY07 |
| ***Serbia*** | | | |
| Education Improvement | 10.0 | FY02 | FY07 |
| Employment Promotion LIL | 2.8 | FY03 | FY07 |
| Privatization/ Restructuring Banks & Enterprises TA | 11.0 | FY03 | FY07 |
| Health | 20.0 | FY03 | FY08 |
| Energy Efficiency | 21.0 | FY04 | FY10 |
| Real Estate Cadastre | 30.0 | FY04 | FY11 |
| Transport Rehabilitation | 55.0 | FY04 | FY11 |

22. New financing anticipated during the course of the CAS FY05 included a mix of policy based lending and investment operations. Given the outstanding policy reform agenda, as well as Serbia's

external financing needs at the time of CAS preparation, the CAS envisaged a very substantial program of development policy lending. A series of programmatic development policy loans (DPLs) were intended to anchor the CAS program and World Bank policy dialogue, and were initially envisaged to make up over half of all base-case lending. With a high-case linked to Serbia meeting policy triggers, the CAS FY05 high case scenario envisaged policy based lending making up as much as 70 percent of the total financing package. Supporting policy based finance, the CAS FY05 anticipated investment financing in strategic sectors, including: (i) support for Serbia to enter the South East Europe regional energy market; (ii) irrigation and drainage rehabilitation to strengthen food security and flood protection given recurrent floods and drought; (iii) investments to promote agricultural production and reform, especially in light of the requirements and opportunities posed by Serbia moving toward the European Union; (iv) pension and health sector reform to strengthen the quality of service and the financial sustainability of these sectors; and (v) regional development activities in the depressed former mining region of Bor. Planned and actual lending during the course of the CAS is set out in Table 2.

**Table 2. Active and planned base-case lending during the CAS FY05-07 period**

| FY | Planned Program | IDA | IBRD | Total | Actual Program | IDA | IBRD | GEF | Total |
|---|---|---|---|---|---|---|---|---|---|
| FY05 | Structural Adjustment 2 | 47 | | 47 | Structural Adjustment 2 | 47 | | | 47 |
| | Regional Energy* | 21 | | 21 | Regional Energy* | 21 | | | 21 |
| | Pension Reform | 25 | | 25 | Pension Reform | 25 | | | 25 |
| | | | | | Danube River Pollution | | | 9 | 9 |
| | **TOTAL FY05** | **93** | | **93** | **TOTAL FY05** | **93** | | **9** | **102** |
| FY06 | Programmatic DPL 1 | 41 | 14 | 55 | Programmatic DPL 1 | 55 | | | 55 |
| | Irrigation/ Drainage | 25 | | 25 | Irrigation/ Drainage | 25 | | | 25 |
| | Bor Regional Develop | | 30 | 30 | | | | | |
| | **TOTAL FY06** | **66** | **44** | **110** | **TOTAL FY06** | **80** | | | **80** |
| FY07 | Programmatic DPL 2 | 46 | 44 | 90 | Bor Regional Develop | 10 | 33 | | 43 |
| | Primary Health Care | | 35 | 35 | Transition Agriculture | | 16 | 4.5 | 20.5 |
| | Rural Business Envt. | | 40 | 40 | Energy Efficiency AF | 10 | 18 | | 28 |
| | | | | | Irrigation/ Drainage AF | | 50 | | 50 |
| | | | | | Transport Rehab AF | | 50 | | 50 |
| | **TOTAL FY07** | **46** | **119** | **165** | **TOTAL FY07** | **20** | **167** | **4.5** | **191.5** |
| ***TOTAL CAS FY05-07*** | | ***205*** | ***163*** | ***368*** | | ***193*** | ***167*** | ***13.5*** | ***373.5*** |

* Two thirds of the financing for the South East Europe regional energy APL for Serbia was provided in regional IDA financing additional to Serbia's performance-based IDA allocation

23. The CAS lending program was delivered largely as planned during approximately the first 18 months of implementation, although with some delays associated with preparation for the complex Bor regional development project. Nevertheless, the increasingly strong financial position of the Authorities as a result of VAT introduction, strong growth, and privatization receipts resulted in development policy lending becoming less relevant during the course of the CAS. This was compounded by the difficulty of proceeding with development policy loans during FY07, given internal differences between the coalition partners, and electoral uncertainty resulting from the Constitutional Referendum in November 2006 and subsequent Parliamentary elections in January 2007. Given this uncertainty, a conscious decision was made to reorient lending toward investment activities and to use the flexibility available under the new additional financing instrument to scale up well performing energy efficiency, irrigation and drainage, and transport rehabilitation activities. The use of additional financing and adjustment instruments has also resulted in a relatively streamlined portfolio of continuing operations in Serbia: as of September 2007, for instance, there are 10 active investment operations, with a total commitment value of $398 million (including IDA, IBRD and GEF). This is both the smallest number of activities, as well as the highest commitment value, for any portfolio in the Western Balkans.

24. The additional financing instrument proved particular useful given the relatively strong performance of the investment portfolio. A Joint Portfolio Performance Review (JPPR) undertaken in March 2006, for instance, confirmed satisfactory progress on 10 out of 12 operations current at that time. Operations in the social sectors, however, have proved to be subject to performance difficulties. Performance of the education, health and pension reform projects, for instance, have all been unsatisfactory at some period. Nevertheless, significant efforts have seen a turn around in education and health investments identified in the JPPR as experiencing difficulties. The consolidated collection and pension administration reform project is now the only activity in the portfolio where performance remains unsatisfactory. The portfolio review also highlighted the importance of strictly assessing project readiness, with several investments subject to initial delays in effectiveness and disbursements – although performance on almost all has subsequently improved significantly. To date, IEG has endorsed satisfactory or moderately satisfactory ratings for all projects that have closed in Serbia.

25. The CAS FY05 was noticeable for Serbia's graduation from IDA to IBRD financing. Serbia had previously received exceptional access to IDA on modified terms due to creditworthiness concerns resulting from the large external public debt overhang from the former Yugoslavia, compounded by significant declines in capacity to service such debt as a result of the tumult of the 1990s. Nevertheless, relatively strong economic performance since 2000 allowed a transition to IBRD financing during the course of the CAS period. Initially, it was envisaged that IBRD financing would be made available in FY06, although this was ultimately delayed by a year due to delays in project preparation. Serbia did, however, gain access to IBRD in FY07. From FY08, all new financing will be on IBRD terms. Serbia's successful graduation to IBRD, together with renewed access to financing from international markets, has been a particular success during the CAS period.

26. Improvements in Serbia's credit-worthiness were highlighted during the CAS FY05 period by a decision by the Serbian Government to pre-pay outstanding debt to the IMF and the World Bank. During 2006, Serbia pre-paid approximately $1.2 billion in obligations to the IMF, and now has no outstanding liabilities to the Fund. In late 2006, the Serbian Government also paid Euro 320 million (over $410 million based on exchange rates at the time) into a trust fund to support payments falling due over the next few years on IBRD loans inherited from the former Yugoslavia. As a result, Serbia's outstanding obligations to the Bank are now smaller than at the beginning of the CAS FY05 period. These pre-payments were allowed by significant privatization revenues.

## Table 3. Key Analytical and Advisory Work

| | **Planned in CAS FY05** | **Status at September 2007** |
|---|---|---|
| FY05 | Serbia Economic Memorandum<br>Debt Sustainability Analysis<br>Financial Sector Assessment Program<br>Private Sector Study | Completed December 2004<br>Completed August 2005<br>Completed April 2005<br>Investment Climate Assess: Dec 2004<br>Privatization Study: February 2005 |
| FY06 | Public Expenditure Update<br>Agricultural Competitiveness Study<br>Labor Market Study<br>Social Services Delivery | Completed March 2006<br>Completed June 2006<br>Completed June 2006<br>Completed June 2006 |
| FY07 | Integrated Public Financial Management | November 2006 |
| Ongoing | Programmatic Poverty Assessments | Continuing |
| Additional | Decentralization and Local Services | Completed June 2007 |

27. World Bank dialogue and lending has been underpinned by a comprehensive program of analytical and advisory services. Key analytical work (as set out in CAS FY05), was delivered essentially

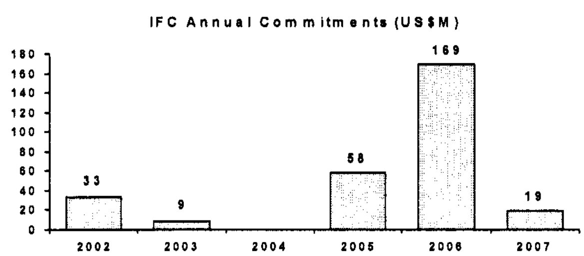
as planned (Table 3). Analytical work allowed the Bank to prepare a series of very well received policy notes for the incoming Government, discussed in July 2007. These notes, highly commended by the Serbian Deputy Prime Minister and his colleagues, have formed the basis for discussions about the shape of the Bank's new partnership strategy. Notes covered: (i) overall public investment planning and priorities, (ii) private and financial sector development issues, (iii) decentralization, (iv) governance and anti-corruption programs, (v) infrastructure issues, (vi) agriculture, and (vii) health and education.

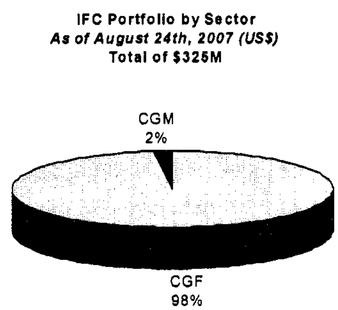
*B. IFC Engagement*

28. The International Finance Corporation (IFC) has a significant investment portfolio in Serbia, which has contributed to strong private sector led economic growth. As of June 30 2007, IFC had 16 projects in its Serbia portfolio, with total commitment of $321 million. The vast bulk of this investment has occurred during the period of the past CAS. During FY05-07, IFC committed $264 million in Serbia, compared to $41 million during FY02-04. In addition to Serbia specific investments, IFC has also invested in three private equity funds, which operate in Southeast Europe, including Serbia. Details of IFC's investment portfolio in Serbia are provided in Figure 1.

**Figure 1: IFC Investments in Serbia**

<ins>**IFC In Serbia**</ins>




< **Macro Spreads = 175**
< **Foreign Currency Risk Rating: Moody's = Not Rated and S&P = BB-**

| *Committed Portfolio* | Equity-EQ | Loan-GR | TOTAL | *% of Total* |
|---|---|---|---|---|
| *CGF* | | | | |
| BANCA INTESA SPA | 51,879,252 | 81,915,000 | 133,794,252 | |
| Continental Bank | - | 30,489,556 | 30,489,556 | |
| Panonska | - | 3,384,631 | 3,384,631 | |
| Pnvredna Banka | - | 1,049,030 | 1,049,030 | |
| ProCredit Serbia | - | 24,733,605 | 24,733,605 | |
| Raiffeisen Yug | - | 12,790,362 | 12,790,362 | |
| RBKO | - | 13,652,500 | 13,652,500 | |
| RIB II | - | 13,652,500 | 13,652,500 | |
| RLSerbia | - | 40,957,500 | 40,957,500 | |
| Unicredit Bank | - | 39,674,697 | 39,674,697 | |
| Vojvodjanska | - | 5,337,370 | 5,337,370 | |
| ***Total CGF*** | ***51,879,252*** | ***267,636,751*** | ***319,516,003*** | ***98%*** |
| *CGM* | | | | |
| Tigar M.H. | 5,974,360 | - | 5,974,360 | |
| ***Total CGM*** | ***5,974,360*** | - | ***5,974,360*** | ***2%*** |
| **Total Committed** | **57,853,612** | **267,636,751** | **325,490,363** | *100.0%* |
| ***Total Outstanding*** | ***52,402,716*** | ***196,140,641*** | ***248,543,357*** | |
| ***Total Committed Syndications*** | | | ***7,104,063*** | |

29. IFC investments have particularly focused on the ***financial sector***. IFC has supported development of microfinance institutions, the introduction and expansion of new financial products including mortgage financing, consumer finance, energy efficiency financing and SME finance. IFC contributed to the cleaning-up, rehabilitation and privatization of the banking sector through restructuring its claims to a few Serbian banks. IFC's largest single investment has been made with Banca Intesa, enabling the Bank to strengthen its capital base and significantly increase its lending and financial service

activities particularly to SMEs, retail clients and residential mortgages. Other investments have included Raiffeisen Bank, Continental Bank, HVB Serbia, and Pro-Credit Bank. Investments have particularly encouraged the expansion of long-term lending, particularly to SMEs, mortgage operations, and lending relating to commercial and residential real estate development, and the development of energy efficiency products. IFC has also invested $37 million in the European Fund for Southeast Europe (EFSE), $7.4 million of which is for Serbia. This collective debt investment will channel long term resources for on-lending to SMEs through banks, specialized microfinance institutions, and viable microfinance non-profit organizations in the Southeast European region including in Serbia.

## Table 4: IFC's CAS Objectives

| CAS Objectives | Completion |
|---|---|
| **Creating a larger, more dynamic private sector** | |
| *Financial sector and SME:*<br>• Continued progress on restructuring and privatization of financial sector<br>• Improved access to finance particularly for SME sector<br>• Promote participation of foreign strategic investors in the financial sector<br>• Support development of housing finance, leasing, and securities market development<br>• Continue with efforts aimed at institution building and the introduction of new products. | • Committed US$228 million in the financial sector in Serbia.<br>• Contributed to the cleaning-up, rehabilitation and privatization of the banking sector through restructuring of IFC's claims on Serbian banks.<br>• Supported strong foreign strategic investors to establish new financial institutions (Banka Intesa, HVB Serbia);<br>• Supported the introduction and expansion of financial services including mortgage financing, consumer finance, and SME finance;<br>• Introduced new products to the market, such as credit lines to support energy efficiency program with micro and small companies;<br>• Helped the government with leasing regulation;<br>• Started in June 2005 the Private Enterprise Partnership Southeast Europe (PEP-SE) facility which is focused in 4 business lines: SMEs support and linkages; business enabling environment; access to finance; and infrastructure advisory operations. |
| *Corporate sector:*<br>• Post privatization support to export-oriented companies to enhance their competitiveness in the EU markets | • Equity investment to support the growth and strategic development of Tigar, an IFC's existing client and a leading regional producer of high quality car tires.<br>• Mercator will also support the Slovenian company's expansion to establish new hypermarket stores in Southern Europe, including $30 million in Serbia.<br>• Through its investments in regional Private Equity Funds, IFC has supported 3 companies in the manufacturing sector. |
| *Infrastructure sector:*<br>• Attract private sector financing through public private partnership (PPP). | • Through PEP Southeast Europe Infrastructure, IFC was engaged in 3 signed advisory mandates: (i) Belgrade Municipal Solid Waste (MSW); (ii) Belgrade Water and Waste Water; and (iii) JAT Airways, advising the Government and the Company in a restructuring plan aimed at the participation of the private sector at a later stage.<br>• IFC activities in this sector were limited due to slow paste of Government's reform agenda in this sector. As mentioned in the CAS document, IFC's investments in the infrastructure sector, including in the energy and telecommunication sectors, would most likely happen in the longer term. |

30. In the ***real sector***, IFC supported the growth and strategic development of Tigar, a leading regional producer of high quality car tires. Also, IFC supported Mercator, a Slovenian company, to establish a new hypermarket stores in Serbia. This investment is expected to stimulate competition in the sector and improve the variety, price, quality and delivery of consumer goods. In addition, through its investments in regional Private Equity Funds, IFC has supported 3 other companies in the manufacturing sector. IFC has been looking for opportunities to support companies in the pharmaceutical and paper sectors. Nevertheless, investments being considered in both sectors did not proceed given issues regarding minority shareholder rights and reputational considerations. As a result, IFC's strategy is to focus selectively on direct investments in mid-sized companies as well as to support reputable investors.

31. Serbia is among IFC's client countries which most benefit from IFC's ***advisory services*** program. To support SMEs, IFC started the Private Enterprise Partnership Southeast Europe (PEP-SE) facility in June 2005. This is focused on: SME support and linkages; business enabling environment; access to finance; and infrastructure advisory operations. Through PEP-SE, IFC has also been active in supporting judicial reform, particularly alternative dispute resolution mechanisms. Three mediation centers in Serbia, supported by PEP-SE, have helped to resolve over 1,600 cases. Under the recycling linkage program, IFC is commercializing the small street collectors, who in Serbia are significantly comprised of the Roma population. IFC Advisory Services assistance projects are set out in Table 5.

32. IFC is committed to providing advisory services aimed at the participation of the private sector in the infrastructure projects through concessions. PEP-SE Infrastructure (PEP-SE I) was appointed lead advisor in the restructuring of Serbia's national carrier, JAT Airways. PEP-SE I provided the government with a review of the airline and the sector, identifying critical issues and suggesting recommendations aimed at transforming JAT into a viable enterprise through private sector participation. Based on IFC study the Government has launched the privatizations of JAT Airways and JAT Tehnika (the maintenance company). The Government has now sought offers for advisory services from commercial institutions, and both privatizations are currently being implemented.

33. In addition, IFC has been helping the City of Belgrade with the privatization (concession) of the Belgrade solid waste disposal services, scheduled to be completed this fiscal year after some delays. IFC also has a mandate to advise the City of Belgrade on the implementation of PPP for the water and wastewater sector, although this faces legislative impediments associated with the cumbersome *Concession Law*, which requires extensive and detailed involvement of the Central Government, including in municipal projects. The Ministry of Economy and Regional Development expressed its willingness to amend the law. PEP-SEI has offered to help to help the Government to amend the law, to establish a PPP unit within the Government, and to implement one or more pilot transaction – although this would require the Government to contribute one fifth of the total cost.

34. While Serbia has developed its institutions framework to implement the privatization reform in the real sector, still it is lacking capacity to structure and attract PSP in the infrastructure sectors. The institutional bottleneck in this area has been the main reason of serious issues experienced with the concession of Horgos-Pozega highway.

35. Through the Foreign Investment Advisory Service (FIAS), analytical and advisory support has also been provided to assist the Serbian authorities in their successful efforts to improve the investment climate. With support from the European Agency for Reconstruction, FIAS has been engaged in assisting the Serbian Investment and Export Promotion Agency, as well as in following up on Doing Business reports to analyze investment constraints in Serbia, especially at the sub-national level.

**Table 5: IFC's PEP-SE Advisory Services Projects in Serbia**

| FY | Focus | Donor | *Description* |
|---|---|---|---|
| 2005-07 | Alternative Dispute Resolution (ADR) | Canada and the Netherlands | ***Objective***: Improving businesses enabling environment by offering faster, less expensive and more efficient access to justice for businesses.<br>***Results***: IFC advised on necessary changes in legislation. Four pilot centers were opened and 120 mediators and 90 judges were trained. Over 1600 cases have so far been resolved, releasing over Euros7 million in value. |
| 2006-07 | Recycling Linkages | Austria | ***Objective***: SME promotion, focusing on the financial, training, consulting, and market needs of every segment of the scrap metal, paper, plastic and glass value-chains.<br>***Results***: Contracts signed with the Recycling Association and the Plastics Industries Association. Started advisory mandates with several companies (including a Roma cooperative). Will support the Chamber of Commerce to promote recycling. |
| 2006-07 | Corporate Governance | Switzerland | ***Objective***: Enhancing corporate governance practices through company-level interventions, workshops and strengthening knowledge/awareness of corporate governance among the key stakeholders/players, including board of directors, management board members and shareholders.<br>***Results***: Started in January 2006. Four signed mandates, including Tigar, a leading regional producer of high quality car tires. Co-organizing the Economist Conference on Financial Sector in December. |
| 2006-07 | International Standards | Norway | ***Objective***: Build awareness of international standards and technical regulations and provide both companies and local business service providers with a range of topical training and consulting services relevant to specific industries.<br>***Results:*** 4 company mandates signed. Will support the Chamber of Commerce to promote adoption of standards. |

### *C. MIGA Engagement*

36. The Multilateral Investment Guarantee Agency (MIGA) has been active in providing guarantees, mostly in financial sector, and also in providing technical assistance aimed at capacity building. During the period of the CAS FY05, MIGA issued six contacts of guarantee for investments in Serbia, with a total value of $229 million. Guarantees supported foreign investments to develop and expand the Serbian banking and leasing system. MIGA's focus on finance projects in a country like Serbia with a young financial sector are intended to deepen and broaden a market currently dominated by banking. Guarantees are especially focused on helping financial institutions to expand the range of loan options available to clients, including SMEs, and particularly to widen options for longer-maturity loans. Four of the guarantees during the CAS FY05 period, totaling $213 million, were provided to Raiffeisenbank. The fifth, worth approximately $12 million, was provided to Bank Austria Creditanstalt, and the sixth of nearly $4 milion in the manufacturing sector was issued to Alpos, a Slovenian investor. Prior to the CAS

FY05 period, MIGA had developed a close relationship in Serbia and the region with Raiffeisenbank, Bank Austria Creditanstalt, and Hypo-Alpe-Adria Bank.

## V. Retrofitting the Results Framework

*A. Goal 1: Create a smaller more sustainable, more efficient public sector*
*Performance: Moderately Satisfactory*

37. Serbia made progress in the period between 2003 and 2005 in fiscal consolidation, increasing the efficiency of the public sector, providing quality services more efficiently and improving the longer-term sustainability of the pension system. Nevertheless, gains in the overall fiscal situation 2004 and 2005 started to be reversed in late 2006 and 2007.

38. A significant fiscal consolidation in 2004 and 2005, under the auspices of an IMF program, resulted in the overall public expenditure falling from 43.7 percent of GDP in 2003 to 40.7 percent in 2005. Persistent fiscal deficits were turned into a modest surplus, due to a combination of fiscal restraint in this period and the introduction of a VAT in 2005, which simplified tax collection and ensured a sound revenue foundation. Nevertheless, expenditure pressures remerged in late 2006 and 2007, with expenditures again rising to 42.3 percent of GDP in 2006, with a similar proportion of GDP expected in 2007. The budget has again slipped slightly into deficit, of about 1.5 percent of GDP – still less than half the size in 2003. Expenditure pressures have been driven in part by rapid wage growth, with the total public sector wage bill increasing over the CAS period from 9.5 percent of GDP in 2003 to an estimate of 10 percent of GDP in 2007. Nevertheless, the budget is increasingly focused on longer-term investments rather than transfers or consumption: public investment, for instance, has increased from 2.4 percent of GDP in 2003 to a projected 4.3 percent of GDP in 2007. The Authorities are also increasingly moving to ensure that investment promises made during the election campaign are integrated into a cohesive overall national priority setting mechanism. Partly as a result of this expansion, inflation is again starting to increase, with the burden for ensuring price stability falling on to monetary policy.

39. The World Bank's overall policy dialogue with the Authorities on broad fiscal and public administration issues was underpinned in the initial stages of the CAS period by the Structural Adjustment Credit 2, approved in December 2004, as well as by a series of analytical products, including the PEIR update PEIR Update (March 2006), and an integrated public financial management analysis (November 2006). This dialogue helped to encourage the authorities to undertake a significant public administration reform program designed to lay the foundation for a professional, merit-based civil service based on European standards, while rationalizing administrative bodies and decompressing salaries to better attract high quality professionals. Some gains were made in all of these areas.

40. Through the CAS period, public sector development policy loans (envisaged in the high case in FY06 and the base case in FY07) were initially intended to support the authorities to take this agenda forward. Reduced need for fast disbursing financing, governmental reconfigurations and electoral uncertainty, the increase in the wage bill in late 2006 (and associated fiscal loosening), and the limited movement until very recently in establishing a State Audit Institution and strengthening overall fiscal oversight, however, meant that these operations did not proceed as planned. Despite these difficulties, however, a reasonable degree of reform continued on the public administration front, including substantive pension and health insurance reform that will make these systems more fiscally sustainable over the longer term, and continued efforts to promote further civil service reform. Serbia has also not had an IMF program since the conclusion of the last arrangement in early 2006.

41. Investment operations helped to make a contribution to strengthened fiscal sustainability during the period of the CAS FY05. Health service reform, for instance, has helped to improve quality of service

delivery while containing costs. Similarly, pension reform, including efforts to undertake parameter changes and strengthen collections, has significantly improved the medium-term fiscal sustainability of the pension system, although the short-term impact has been more modest.

42. The *Serbia health project* (FY03) has assisted the Authorities to restructure health services to improve quality (discussed in greater detail under goal 3) and to reform health finance and management. Expenditures on health in Serbia are relatively high as a proportion of GDP, with about 10 percent of GDP spent on health, about half of which is public financing. On the other hand, expenditures remain relatively low in absolute terms when compared with OECD countries. The Bank's health investment is consequently focused on reducing inefficiencies in the health system to control expenditure growth, while also improving care. The central thrust of the project has been to increase the use of primary health care providers, with less of the burden falling on relatively high cost treatment at tertiary health care institutions, such as hospitals and the Belgrade Clinical Centre. At the same, it is also promoting improved hospital management, with greater use of outpatient services and better utilization of facilities. Performance of the Health Insurance Fund has also improved, with arrears being cleared in 2006. Financial audits of 15 major health facilities are underway to help ensure arrears do not reemerge. Overall, this project has been successful in assisting the authorities to contain Health Insurance Fund expenditures at about 5.5 percent of GDP while at the same time increasing client satisfaction with their health providers.

43. The *pension administration reform project* (FY05) aims to improve collections and enforcement of pension contributions, including by consolidating pension collection. On the legislative side, a new pension law was passed in October 2005 and became effective in January 2006. This will gradually eliminate the fiscal deficit in the pension system. Parametric changes introduced under this legislation eliminate the option of retiring at 63/60, reduces indexation to semiannual increases rather than quarterly, and reduces indexation of both the pension post-retirement and the pension point to inflation. These changes are significant and will have important impact in the medium and long term. Nevertheless, changes have yet to show up in current pension spending. For 2006, the law envisaged a one time increase in minimum pension, which raises costs, and which will only gradually be reduced by the other measures in the law. Between 2003 and 2005, pension spending fluctuated between 13 percent and 14.5 percent of GDP, with no clear trend. In addition, implementation of administrative changes to consolidate pension collections have been significantly delayed. Despite these difficulties, however, the medium term outlook is much improved by the passage of the pension law.

*B. Goal 2: Create a larger, more dynamic private sector*
*Performance: Satisfactory*

44. Serbia was one of the last countries in the region to embark on the transition process, which did not begin until 2001. As a country that is still in the relatively early stages of transition, the outstanding reform agenda remains significant. Nevertheless, progress over the period of the CAS FY05 has been very strong.

45. Most notably, the **business environment** in Serbia is very substantially improved since the CAS was presented to the Board in November 2004. D*oing Business 2006* indicates that Serbia was the faster reformer globally in 2005. Major reductions in the time (from 51 to 15 days) and cost required to start a business resulted in 40 percent more businesses being registered in 2005 compared to 2003. A new civil procedure code halved the time required to resolve business disputes through court processes (from about 4 years to less than 2), with IFC support for alternative dispute resolution mechanisms further streamlining process for over 1,500 disputes. Improvements in the Labor Law increased labor market flexibility. More recently, during the course of 2007, there have been significant improvements in the availability of credit information, particularly the quality of information available through private credit

bureaus. Still, business licensing and permits remains a key challenge, as with other countries in the Western Balkans. The current Government has indicated a strong willingness to engage on this issue.

46. **Enterprise sector reform** has been significant. Although again a large reform agenda remains, this should be seen in light of the gains over a relatively short period. The overall scope, pace and transaction quality of the privatization process compares very favorably to similar stages of reform in other transition economies. Over the CAS period, the Privatization Agency, assisted by the World Bank and other donors, achieved significant progress in implementing the Government's privatization program. Since mid-2004, more than 1,800 socially-owned SMEs have been sold in open auctions and tenders, with all remaining socially-owned enterprises expected to have been offered for sale by end 2008. A new Bankruptcy Law passed in 2004 provides a strong instrument for dealing with SOEs for which buyers cannot be found. Full utilization of this instrument, however, will require strengthening of the capacity of commercial courts to deal with complex bankruptcy cases, and a commitment by the state creditors to initiate bankruptcy proceedings.

47. Over 60 large SOEs have been sold without restructuring, many of them to international strategic investors. The largest was the sale completed in July, 2006, of the mobile telecoms network to Telenor of Norway for over Euro 1.5 billion. Another 50 large SOEs were restructured and offered for sale, of which 25 were sold. This includes RTB Bor, the large copper mining and processing complex in eastern Serbia, which the Government is again offering for sale after the first attempt fell through in early 2007 due to the buyer's failure to come up with adequate financing for the deal. RTB Bor is one of the main loss making industrial conglomerates and the second largest recipient of state subsidies, averaging over $10 million per annum with approximately the same amount in arrears to state owned energy utilities. Still, restructuring and subsequent divestiture of a number of large, loss-making industrial conglomerates continues to present a major challenge, even following the passage in Spring 2005 of the debt restructuring amendments to the Privatization Law. Privatization of major companies, such as the Oil Refinery of Serbia (Nis) remains subject to political differences within the governing coalition, while the core assets of the largest recipient of subsidies, Zastava Group, still have not found a buyer. Over the period of the CAS, however, the Government has reduced its subsidies to loss making SOEs from approximately 3 percent to just under 2 percent of GDP.

48. **Energy Sector Restructuring:** Although private sector involvement in the energy utility sectors (power and gas) still is very small, steps have been taken to facilitate such involvement and competition in the future. Consistent with Serbia's commitments as part of the Energy Community of South East Europe, establishing a regional energy market, a regulatory agency has been established which works on developing adequate tariff structures for incumbents and new entrants. Power transmission services have been separated out from EPS into a new transmission company EMS. EPS has been separated into individual legal entities for generation and distribution. Commercial losses are moderate for both gas and power, and collections are high for virtually all consumer groups. The private sector is present in the oil sector in retail marketing (notably gasoline stations). The Government also appears committed to accepting private investment in generation activities, such as the Kolubara lignite mine and associated power plant – although this significant private investments in the sector have yet to be realized.

49. **Financial Sector Reform:** The Government has divested most of its banking sector holdings to international strategic investors, retaining control over 4 (small) majority owned banks and minority stakes in 5 other banks, which respectively total 3% and 12% of the banking system assets at end-June 2006. In addition, the Deposit Insurance Agency has launched the sale of Serbia's second largest insurer, DDOR. The banking sector is predominantly privately owned, with a large influx of foreign banks. Through implementation of the recently effective new Law on Banks, the National Bank of Serbia has continued to strengthen its bank and insurance supervisory regimes with external inputs provided by a

number of donors. Partly as a result of these reforms, credit growth in Serbia has been extremely rapid, although from a low base, increasing from 20 percent of GDP in 2003 to over 80 percent of GDP in 2007.

50. World Bank Group engagement has played a considerable role in assisting the Authorities undertake such reform efforts. Much of the overarching framework for Bank engagement was set in the 2004 Serbia Economic Memorandum "An Agenda for Economic Growth and Employment" as well as analysis conducted in FY05 on the privatization process and the Investment Climate Assessment. The Structural Adjustment Credit 2 (FY05) supported the enactment of a new Company Law, significantly easing business entry by reducing minimum capital requirements and strengthening corporate governance requirements, strengthening the scope for creditors to seek redress, and building regulatory impact assessment capacity. A private and financial sector development policy credit (FY06) supported efforts by the Authorities to reduce subsidies to corporate loss makers, continue the privatization program, and strengthening bankruptcy procedures, and deepen financial sector reforms. Energy sector reform was supported through both the SAC 2 and the PPFDPL, as well as an energy investment operation (FY05) supporting unbundling and restructuring of energy assets consistent with the South East Europe regional energy market treaty signed in Athens. Technical assistance investments by the Bank have supported the work of the Privatization Agency. IFC has provided technical assistance to help prepare JAT, the state airline company, for privatization. IFC investments and MIGA guarantees have significantly expanded foreign investment in the financial sector and the scope for SMEs to access credit to build their businesses.

51. In addition to support for overall reform efforts, Bank investments (FY02) and MIGA technical assistance supported the establishment of the Serbian Export Credit Agency (SMECA). In 2006, SMECA provided insurance to support exports of over Euro 510 million, or 13 percent of Serbia's total exports.

52. Bank support through a cadastre investment (FY04) has made registering property easier, with an associated rapid growth in property transactions and the use of mortgages. The real estate cadastre now covers over 80 percent of the country. Transactions involving land increased from just under 300,000 in 2005 to 330,000 in 2006, and are likely to reach almost 400,000 in 2007 (the original target for 2010). Improved cadastral services have resulted in mortgages being provided for over 5 percent of all land transactions in 2007, compared to less than 3 percent in 2006 (exceeding conservative original targets). Registration times have fallen from 27 to 23 days for land sales, and from 13 to 9 days for mortgages.

53. The trade and transport facilitation project (FY02) has helped to reduce customs processing times by an average of 73 percent. Revenue collected per staff member increased from $50,000 in 2000 to $1.3 million in 2006. Declarations per customs staff increased to 373. 75 percent of importers surveyed noted an improvement in transparency of customs services since 2002. BEEPS also highlights significant improvements in perceptions by users of the extent of corruption at customs. The Transport Rehabilitation Project (FY04) has supported the institutional strengthening of the Public Enterprise 'Putevi Srbije' (PEPS), after its establishment following the passage of the new Law on Public Roads in November 2005. The project has assisted the establishment with technical assistance, training, services, and goods to strengthen the management and planning of the road network in Serbia. The project has also supported the rehabilitation of priority sections of the primary and secondary road network, totaling 140 km in length, and assisted the PEPS staff to pilot performance based contracts for winter maintenance and routine maintenance for 1,200 km of roads in the Mačva and Kolubara regions. These contracts proved so successful, in terms of the efficiency gains - comparison of unit costs for pilot regions with average costs for Serbia in the winter season of 2006-2007 reveals salt consumption in the pilot regions was 0.685 ton/km compared to 2.536 ton/km in Serbia; unit cost of winter maintenance in pilot territory was 207.806 Euro/km, while overall in Serbia it was 572.328 Euro/km – the approach has recently been extended to the remaining twenty five regions of Serbia, starting from April 2008.

*C. Goal 3: Reduce Poverty and Improve Social Protection and Social Services Performance: Satisfactory*

54. Poverty has fallen from 14.6 percent of the population in 2004 to 8.8 percent in 2006 – well on track to meet Government's target – set out in the 2003 PRS – to reduce poverty to 6.5 percent by 2010.

55. The Bank's support for Serbia's successful efforts to reduce poverty has been provided in the framework of the **Government of Serbia's Poverty Reduction Strategy Paper (2003)**. The PRS recognizes the need to focus on economic development and it represents a plan of activities aimed at reducing key types of poverty by creating financial and other preconditions and by offering everyone the opportunity to support themselves and their families. Key pillars of the PRS include: (i) dynamic economic growth and development with an emphasis on job creation; (ii) the prevention of new poverty that will result from necessary modernization and restructuring of the economy; and (iii) the efficient implementation of existing programs and development of new programs directly targeting the poorest and the most vulnerable groups, particularly in the least developed regions. Responsibility for implementing the PRS currently rests with the Deputy Prime Minister. This has allowed the PRS objectives and activities to be integrated into overall Government programs in Serbia more effectively than perhaps any other country in the Western Balkans region. A first PRS progress report was submitted to the World Bank and IMF in October 2005 and the joint IDA-IMF staff advisory note was issued on February 16, 2006. The Bank has been actively supporting PRS Team working under DPM's office. The Bank has been managing a donor supported Trust Fund to support PRS implementation.

56. A particular concern in Serbia, given already high unemployment (which remains a persistent problem at about 20 percent of the labor force) and the correlation between poverty and employment, has been to strengthen opportunities for workers made redundant from the necessary but painful process of privatization and corporate restructuring. Under the employment promotion learning and investment credit (FY03) the Bank supported the establishment of 13 Work Transition Centers (WTCs) in 10 regions established (rather than 10 in 4 regions as planned). WTCs assisted those laid off as a result of restructuring and privatization. Support to redundant workers included financial compensation as well as the opportunity for redeployment, training and self-employment. An estimated 7,000 workers received counseling services and information, 2,000 workers were retrained, and around 800 new jobs were created or saved in pilot enterprises. Previously, such services were nonexistent. Government amended relevant legislation to recommend that all enterprises undergoing restructuring and privatization establish WTCs. Piloting and testing of a full range of employment services under this investment has also allowed the Government to restructure ALMPs towards those with greater demonstrated effectiveness. The results of three waves of tracer surveys of redundant workers confirm much lower placement rates of non-participants than almost any of the ALMPs implemented (except vacancy fairs).

57. Despite considerable improvements, poverty remains persistent in rural areas and among minorities, particularly Roma. Rural poverty declined from 20 percent in 2004 to 14 percent in 2006, but is significantly higher than urban (5 percent). The depth of poverty is also more severe in rural areas. Responding to this, the Bank has prepared a new investment aimed to assist predominantly small farmers in Serbia make the most of the opportunities offered by greater European integration, and to respond to increasingly stringent food safety and quality standards being imposed. Scheduled for FY07, this investment was approved in June 2007. Impact has consequently been limited. Irrigation and flood control investments, however, have helped to improve crop yields by approximately 10 percent in 5,000 hectares under irrigation – especially important given widespread drought in 2007 - as well as to reduce the risks associated with floods. Reflecting solid performance, this project was scaled up in 2007.

58. Financing for social protection schemes in Serbia continued at approximately 17 percent of GDP for the course of the CAS period (including pensions). Social assistance programs are well targeted.

Estimates suggest that poverty would increase by a third on current levels if it was not for such social protection programs. Nevertheless, while well targeted, coverage is limited, and not all the poor receive social assistance. During the course of the CAS, SAC2 supported the expansion of Serbia's main social safety net program, the Material Support to Families program (MOP), allowing a modest expansion of coverage from 43,000 to 56,000 families. SAC2 also supported Government efforts to introduce a new scheme to mitigate the impact of electricity tariff increases on the most vulnerable. Under this program, recipients of child benefits, the minimum pension, and the MOP, receive a 30% discount on the first 300kW of monthly electricity consumption. This has provided additional support to between 80,000 and 100,000 poor families. As discussed under goal 1, changes in parametric pension parameters have also increased pensions initially for current retirees, in part by raising the retirement age for current workers. Nevertheless, while ensuring the pension system is more fiscally sustainable, this is likely to have to be accompanied in the medium-term with the introduction of greater voluntary retirement savings options for those currently in the workforce.

59. Health and education investments approved immediately prior to the CAS FY05 period have also helped to improve the quality of social service delivery. Serbia is on track to meet education MDGs. Primary school completion rates are over 95 percent and do not differ significantly by gender. Nevertheless, education investments have been particularly important to strengthen curricula and to ensure that the skills provided through the school system adequately prepare young people for the workforce. There have been some gains in this regard, although further efforts to reform secondary schools, particularly the vocational education system, is likely to be required. Nevertheless, national standards have been established for grades 3, 4 and 8 and sample based assessments have been conducted. In 2006, national average for mathematics was 60 percent, and Serbian 69 percent. Approximately half of Serbia's 1,600 primary schools have met standards, and were provided with grants under the project – exceeding the target of 700. Serbia is also track to meet health MDGs. Infant and maternal mortality is low and falling. Communicable disease prevalence is low, although monitoring is warranted, especially for high risk groups. Building on this, a health investment has helped to ensure increased use of primary care physicians rather than expensive tertiary clinical centers, while also improving management of key hospitals. This has helped to improve service quality, with higher numbers of visits to, and better service from, primary health physicians. Users surveyed have generally indicated improved satisfaction with health services: a NHS survey shows increase in user satisfaction from 74 percent in 2005 to 79 percent in 2006, and a USS survey shows increase from 79 percent to 81 percent between 2005 and 2006. A particular challenge will be to maintain the quality of health and education service delivery in an increasing decentralized system. A new Delivery of Local Social Services (DILS) investment, scheduled late 2007, is intended to assist the Authorities with this challenge.

60. Investments have been supported by analytical work, including: (i) annual programmatic poverty assessments, (ii) monitoring of, and reporting on PRS implementation, and (iii) notes on social service delivery, delivery of social services in a decentralized environment, and rural and Roma poverty issues.

## V. Overall Bank Performance

61. Overall Bank performance is considered to be satisfactory. At the highest level, CAS indicators have essentially been met. Public expenditure has fallen from 47 percent of GDP in 2002 to 42 percent in 2006 – although with recent slippages likely to see expenditures creep slightly over the 43 percent target in 2007. Growth averaging 7 percent during the CAS period has been strong, underpinned by significant structural reforms. While a large reform agenda remains, the extent of reform at this early stage of the transition period has been impressive. From 2003 to 2006, poverty fell from 14.6 percent to 8.8 percent of the population, and the Government is already close to meeting the target of 7 percent set in the PRS for 2010. In all cases, although direct causality can sometimes be difficult to determine exactly, Bank

development policy loans, investments and analytical services appear to have made a contribution to these outcomes.

62. The CAS FY05 was, in retrospect, overly ambitious in the anticipated delivery of development policy operations at a time when the overall financial and economic situation in Serbia improved to the extent that Serbia was able to pre-pay the Bank, and given political uncertainty even in a time of relative political stability – at least by the standards of the Balkans in recent history. On the other hand, the Bank was able to respond effectively by meeting demand to scale up well performing activities. Although the need to replace development policy operations with new and scaled up investments resulted in some delays in the delivery of operations, the base case program was fully delivered. Delays were also due in large part to the political uncertainty in late 2006 and early 2007 associated with the Parliamentary elections and the formation of a new Government.

63. Portfolio performance has generally been strong, with problems that did emerge being quickly and, in most cases effectively, addressed. Particular problems identified in the JPPR related to the education and health investments, for instance, have been addressed. In the current portfolio, only one investment – pensions reform – is currently under-performing, although even that has helped to support significant legislative and parametric reform. IEG has considered that all projects exiting the portfolio have had a satisfactory or moderately satisfactory development outcome. Disbursement rates have also improved significantly since the JPPR, and the conclusion of the JPPR that low disbursement rates in mid-2006 generally reflected the young age of the portfolio seems justified. Current disbursement rates of approximately 20 percent suggest that implementation of the portfolio is proceeding approximately as planned. Nevertheless, further attention will be required to address some of the reasons for initial delays identified by the JPPR in project implementation after Board approval and effectiveness. These include: cumbersome effectiveness procedures, projects not being sufficiently ready for implementation at the time of Board approval, inadequate procurement and project management capacity, high turnover of key staff (both Government and Bank), unclear roles and responsibilities, and vested interests.

64. The Bank made good use of analytical products. The program of economic and sector work was delivered in full. Core analytical work, including the Serbia Economic Memorandum, the Public Expenditure and Institutional Review update, the integrated public financial management assessment, as well as notes on privatization, financial sector, and labor market issues, underpinned the Bank's policy dialogue, including that conducted as part of the successful SAC2 and PPFDPL programs. Other analytical work, including on decentralization and service delivery, and agricultural competitiveness in the European context, have led directly to investment operations.

65. The work of different parts of the Bank Group has generally been mutually complementary. Bank engagement on financial sector issues has helped to open the way for financial sector investments by IFC and MIGA, and such investments have in turn strengthened the overall banking and financial sector in Serbia. At a time when the National bank of Serbia is now becoming increasingly concerned about overly rapid credit growth, however, there will be continuing needs to ensure that Bank policy advice and investments and guarantees by other parts of the Bank group are well coordinated. Over time, new investments by IFC and guarantees by MIGA are likely to become and increasingly central element of overall Bank Group engagement with Serbia. There is considerable scope for the Bank and IFC to work closely as IFC seeks to expand investments beyond a traditional focus on the financial sector to support private provision of infrastructure services (including roads and energy), as well as private provision of social services (including education, health, private pensions). Efforts will be required to ensure coordination of IFC, MIGA and Bank technical assistance, although MIGA's support to SMECA and to analyze business environment issues, IFC's engagement on the privatization of JAT, and Bank assistance for SMECA and the privatization agency demonstrate the scope for synergies.

66. Donor coordination has been gradually improved. The central role being played by the office of the Deputy Prime Minister in the coordination of the PRS strategy and implementation has particularly helped to ensure that these issues are better integrated across "whole of Government" policy than in many neighboring countries. Still, there remains space for further enhancement. Given Serbia's European perspective, the SAA agenda and the European Commission is likely to be taking an increasingly central role. Further linking Bank support to EU priorities and improving coordination with the EC will be important to ensure complementarity. With the EC, the Bank is also working with Serbian authorities in order to facilitate harmonization and public sector reform. Cooperation with EBRD and EIB is mostly focused on private sector development, while PRS agenda is supported jointly by the Bank, UNDP, DFID and bilateral donors. The Bank has generally worked closely with the IMF, although even closer coordination will be important, especially given the centrality of the structural reform agenda in Serbia.

## VI. Lessons for Subsequent CPS Design

67. **The areas of focus in the CAS were appropriate, and the mix of interventions ultimately approved supported objectives well.** Given the substantial progress made by Serbia, and the contributions made by the Bank to that progress, CAS implementation can be considered overall satisfactory.

68. **Bank support should focus increasingly on Serbia's integration with the EU.** With the conclusion of technical discussions on the SAA, support for EU integration should be an explicit objective for the Bank. Closer integration with the EU will require significant investments to harmonize legislation and standards and to meet stringent environment and food safety standards. Support to build the capacity of the Serbian Government to use potential increases in IPA financing will also be crucial, given the experience of other countries in the region, which were not able to utilize an average of 40 percent of the financing made available.

69. **With Serbia still at an early stage in the transition process, continuing the outstanding structural reform agenda must be a critical element in the forthcoming CPS, in order to encourage continued growth and increase jobs.** Further enterprise reform, financial sector reform and improvements in the business environment will be vital to help ensure current levels of growth can be sustained. Continuing efforts will also be required to help ensure that all parts of the population have the skills and ability to share in and benefit from economic growth.

70. **Development policy lending can prove to be a useful instrument to support reform efforts, although Serbia's current economic position will require the use of innovative instruments, such as potentially deferred drawdown operations.** The Government has indicated that Bank program with specific benchmarks and timetables could assist them in pursuing a reform agenda, particularly on the private sector side. Nevertheless, the Government does not need significant balance of payments support at this stage. While development policy lending can play a valuable role, the experience in the last CAS also suggests that it should not be overused. Investment instruments, when well targeted and designed, can also be useful to assist the reform agenda.

71. **The Bank will need to ensure that assistance is able to be provided even more flexibly and in response to client demand.** With the transition from IDA to IBRD financing, as well as the range of financing options available Serbia, it is imperative that the Bank be even more responsive to Serbian priorities. Careful dialog with the client will be required to ensure that the Bank can stay relevant, as will greater flexibility. Careful exploration of new products, including deferred drawdown development policy operations, insurance and sub-national lending products will require close consideration. At the same time, care will be required to balance the need for flexibility and responsiveness with the need to ensure that Bank financing does indeed help to promote reform.

72. **Flexibility will be critical given regional uncertainties and risks of possible political instability**. Even in a time of relative stability, as during the past CAS period, the need to replace adjustment operations with new and scaled up investments emphasizes the need for flexibility.

73. **Engagement across the Bank Group has been strong and will continue to be important in meeting varied client demands through combining a depth of country knowledge with global expertise**. IFC and MIGA will become an increasingly central element of the Bank Group's engagement in Serbia over the coming years. There is considerable scope to exploit potential synergies between different parts of the institution to encourage the further development of the financial sector (pensions, insurance, housing), and to support the private provision of infrastructure and social services.

## CAS Completion Matrix
## CAS FY05 Outcomes and Intermediate Indicators Results

| GOAL 1: Creating a smaller, more sustainable, more efficient public sector | | |
|---|---|---|
| **CAS Outcomes the Bank expects to influence** | **Intermediate indicators to track implementation** | **Results** |
| Reduction in public expenditures to GDP from 47% (2003) to 43% | | Public expenditure fell to less than 41% of GDP in 2004 and 2005, but has since started to rise to just over 42% of GDP in 2006 and 2007 (projected). Nevertheless, GDP adjustments during the course of the CAS period lowered the 2003 starting point from 47% to 43.7%. As well as an overall decline in total public expenditure, strengthened public revenues transformed a deficit of 3% of GDP in 2003 into a small surplus in 2005, before a limited deficit of 1.5% of GDP re-emerged in 2006. Public expenditure is increasingly oriented toward investment, which now comprises 4.3% of GDP – double the level of 2003. |
| Public expenditure reoriented toward investment, with salaries more closely linked to performance. | Reduction in public sector wage bill as a share of GDP by 1 to 1.5 percent. | After a decline in 2004 and 2005, public sector wages grew sharply in 2006-2007. Between 2003 and 2006, public sector wages remained constant at 9.6% of GDP, but are projected by the IMF to increase to 10% of GDP in 2007. |
| | Progress on wage decompression | Public sector wage decompression has improved. Ratio now 1:7 compared to baseline of 1:6. |
| Improved fiscal sustainability of pensions, health. | Pension contribution collections up 5% by end of 2006<br><br>Pension deficit reduced by 1% of GDP, with expenditures on pensions to decline between 2004 and 2005. | A new Pensions Law passed in October 2005 and made effective in January 2006 will gradually eliminate the fiscal deficit of the pension system. For 2006, the Law envisaged a one time increase in minimum pensions, to be offset over time by other measures. The number of retirees has also increased faster than anticipated, in part due to job losses associated with privatization. While the medium-term outlook has been significantly improved by the new Pensions Law, short-term indicators in the CAS FY05 have proved overly optimistic. |
| | Health Insurance Fund expenditures contained as a proportion of GDP. | HIF expenditures have remained relatively constant between 5.3% and 5.5% of GDP, at a time when quality of health service delivery has been improved (see goal 3). |
| | HIF annual deficit reduced. Baseline: Euro 9 million (2002). | Arrears cleared in 2006. Financial audits of 15 major health facilities underway to ensure arrears do not re-emerge. |
| | Reduction in drug expenditures paid by HIF. Baseline: Euro 25 million (2003) | Pharmaceutical expenditures since 2001 have fluctuated between 10.8% and 15.5% of total expenditures, but are generally on a downward trend. Expenditure control is a result of streamlined procedures for registration and licensing of imported drugs to reduce market entry barriers, and new procurement practices for pharmaceuticals consistent with the new *Law on Public Procurement.* |

| GOAL 2: Creating a larger, more dynamic private sector | | |
|---|---|---|
| **CAS Outcomes the Bank expects to influence** | **Intermediate indicators to track implementation** | **Results** |
| Improve the business environment | | *Doing Business 2006* suggests Serbia was the faster reformer globally in 2004-2005. Major reductions in the time (from 51 to 15 days) and cost required to start a business resulted in 40 percent more businesses being registered in 2005 compared to 2003. A new civil procedure code halved the time required to resolve business disputes. Improvements in the Labor Law increased flexibility. |
| Accelerate privatization, including restructuring of the financial sector | Increased number and/or value of large conglomerates restructured and business units and assets sold, and/or put into bankruptcy with at least 3 large SOEs offered for sale/three majority state/owned banks offered for sale | More than 1,800 socially owned enterprises sold, with all remaining enterprises to be offered for sale by end 2008.<br><br>Over 60 large SOEs have been sold without restructuring. The largest was the sale in July 2006 of the mobile telecoms network to Telenor of Norway for over Euro 1.5 billion.<br>Another 50 large SOEs were restructured and offered for sale, of which 25 were sold. This includes RTB Bor, the large copper mining and processing complex in eastern Serbia ( the 2nd largest recipient of subsidies – at over $10m per annum)<br><br>The government has divested most of its banking sector holdings to strategic foreign investors, retaining stake only o 4 (small) majority owned banks and minority stakes in 5 other banks, which respectively total 3% and 12% of the banking system assets at end-June 2006.<br><br>Total privatization receipts between 2002 and 2006 amounted to approximately Euro 3 billion.<br><br>Overall subsidies to SOEs declined from 2.7% of GDP in 2004 to 1.9% in 2006 (Serbian Government Data). |
| Improved access to finance | Increased volume of finance available for exports | Access to finance has been markedly improved through the entry of new foreign owned banks. Total banking sector assets have more than doubled since 2004. Doing Business 2008 ranks Serbia as 13 globally in terms of ease of obtaining credit in 2006-07, a significant improvement even over the previous year. |
| Export activities expanded with support of Serbian and Montenegrin Export Credit Agency | Increased value of insurance for political risk, import credit and exporter performance | Serbian export credit agency (SMECA) insured transactions totaling Euro 510 million in 2005, or 13% of total exports – a significant expansion on previous years. Exports increasing from 16% to 20% of GDP from 2003 to 2006. |
| Reduced non-tariff costs to trade and transport | Decrease in import clearance time<br><br>Annual number of declarations/customs staff | Customs processing times reduced by an average of 73%. Revenue collected per staff member increased from $50,000 in 2000 to $1.3 million in 2006. Declarations per customs staff increased to 373. 75% of importers surveyed noted an improvement in transparency of customs services since 2002. |

| | | |
|---|---|---|
| | systematically increased: from baseline of 148 | BEEPS also highlights significant improvements in corruption perceptions at customs. |
| Improved road infrastructure and safety. | Reduction in roughness on rehabilitated road segments and roads in pilot areas (baselines: 5 and 6 respectively on the IRI scale). | Average on rehabilitated sections now 3.7 on the IRI scale and 4.26 on the roads included in the pilot regions |
| | Fewer traffic deaths. 2003 baseline: 6 per 10,000 vehicles | Average on rehabilitated and maintained road segments 3.5 per 10,000 vehicles during 2006. |
| | Reduced transport cost principal commodity traded with 3 main trading partners (baseline $100) | No data |
| Improve agricultural outputs and exports, with farmers meeting EU standards. | Increased competitiveness of farmers and agro-processors. | Gross agricultural output has increased by about 10% since 2000 – but remain subject to annual weather variations. Yields are increasing, but remain below EU averages. Growth in agricultural exports resulted in an agricultural trade surplus in 2005. Tariff and non-tariff barriers plus market support continue to limit exposure of farmers to competitive forces. Nevertheless, continued implementation of the Government's agricultural reform program is increasingly requiring predominantly small scale farmers to improve productivity and quality and meet stringent EU food safety requirements. |
| Increase in private sector involvement in infrastructure. | Restructuring in the energy sector, measured by the separation of ownership of generation, distribution and transmission assets, and a reduction in EPS staffing. | A regulatory agency has been established to develop tariff structures for incumbents and new entrants. In line with Energy Community of South East Europe requirements, power transmission services have been separated from EPS into a new transmission company, EMS. EPS has been separated into individual legal entities for generation and distribution. Commercial losses are moderate, and collections are high for virtually all consumer groups. Private sector participation is noticeable in the oil sector in retail marketing. Privatization of the State Oil Company (NIS) is still being considered. Private involvement in new generation investments (such as the Kolubara mine and plant) is likely. |
| Improved land titling. | Lowered property market transaction costs. | The real estate cadastre now covers over 80% of the country. Transactions involving land increased from just under 300,000 in 2005 to 330,000 in 2006, and are likely to reach almost 400,000 in 2007 (the original target for 2010). Improved cadastral services have resulted in mortgages being provided for over 5% of all land transactions in 2007, compared to less than 3% in 2006 (exceeding conservative original targets). Registration times have fallen from 27 to 23 days for land sales, and from 13 to 9 days for mortgages. |

| GOAL 3: Reducing poverty levels, and improving social protection and access to social services | | |
|---|---|---|
| **CAS Outcomes the Bank expects to influence** | **Intermediate indicators to track implementation** | **Results** |
| Reduce poor and "at risk" population. | | Poverty has fallen from 14.6% of the population in 2004 to 8.8% in 2006. Nevertheless, poverty remains persistent in rural areas and among minorities, particularly Roma. |
| | Reduction in rural poverty, including in Bor region, and increased agricultural competitiveness | Rural poverty declined from 20% in 2004 to 14% in 2006. Rural poverty rates remain significantly higher than urban (5%), and two thirds of the poor are located in rural areas. Poverty is also more severe in rural areas. Poverty in the Bor region is worse than the national average, and shows limited improvement (a bank investment scheduled for FY06 was approved in June 2007). Agricultural productivity is improving slightly (see goal 2) although challenges remain. World Bank irrigation investments have helped to improve crop production by 10% on over 5,000 ha. |
| Mitigate social impacts of economic modernization and restructuring. | More effective labor market interventions and more innovative employment services. | 13 Work Transition Centers in 10 regions established, rather than 10 in 4 regions as planned. WTCs assisted those laid off as a result of restructuring and privatization. Support to redundant workers included financial compensation as well as the opportunity for redeployment, training and self-employment. An estimated 7,000 workers received counseling services and information, 2,000 workers were retrained, and around 800 new jobs were created or saved in pilot enterprises. Previously, such services were nonexistent. Government amended relevant legislation to recommend that all enterprises undergoing restructuring and privatization establish WTCs. |
| | New menu of ALMPs developed and tested to allow introduction of more cost-effective interventions and innovative employment services. | Piloting and testing of a full range of employment services has allowed the Government to restructure ALMPs towards those with greater demonstrated effectiveness. The results of three waves of tracer surveys of redundant workers confirm much lower placement rates of non-participants than almost any of the ALMPs implemented (except vacancy fairs). |
| Improve delivery of social services for the poor and vulnerable. | Improved coverage and targeting of social protection programs. | 2003 LSMS data: social insurance programs (predominantly pensions) provided to individuals in 51% of households, including 89% in the poorest quintile, declining to 21% of the richest quintile. Social welfare and child assistance payments cover 21% of households, and 23% of poor households. 2007 LSMS data not yet available. |
| Strengthened capacity of the education system to make continuous improvements in the quality of teaching and learning at schools and in the efficient use of budgetary resources | Systematic information to support education reforms: (i) independent assessment established and standards set for selected grades based on curriculum objectives. | Serbia is on track to meet education MDGs. Primary school completion rates are over 95% and do not differ significantly by gender.<br><br>National standards have been established for grades 3, 4 and 8 and sample based assessments have been conducted. In 2006, national average for mathematics was 60%, and Serbian 69% |

| | | |
|---|---|---|
| | (ii) 700 schools have approved development plans | Education information system operational.<br>832 schools approved through successive grant applications rounds, out of a total of 1,680. |
| Improved health care service delivery:<br>(i)<br>(ii) | | Serbia on track to meet MDGs. Infant and maternal mortality low and falling. Communicable disease prevalence low, although warrant monitoring, especially for high risk groups. |
| (iii) increased effectiveness of health insurance | Increased utilization rates for Primary Health Care (PHC) especially by the poor (including the Roma and IDPs) | Annual utilization levels in PHC centers are relatively high with 7 visits per capita per year.<br><br>2007: Utilization rates of PHCs is 90% (2003 baseline: 79% of the population utilize PHC centers). U<br>Use by the Roma populations was 52% in 2003. 2007 LSMS data for Roma not yet available. |
| | Proportion of patients satisfied with PHC doctor | NHS survey shows increase in user satisfaction from 74% in 2005 to 79% in 2006. USS survey shows increase from 79% to 81% between 2005 and 2006. |
| | In four pilot hospitals, improvements in occupancy, beds per patient, average length of stay and outpatient visits. | Improvements in all indicators. Between 2005 and 2006, beds reduced from 2,300 to 2,200, average length of stay declining from 7.8 to 7.5 days, occupancy rate increased for 68% to 70%, over 3.6 million outpatient visits. |
| | Licensing bodies are established, staffed and operating for health professionals. | Chamber of MDs and Chamber of Nurses established in 2006. |
| | Increased utilization of day care services by the elderly | The elderly (60+) are more likely to seek outpatient care (83% in 2007 compared to 57% in 2003) than the average population (76% in 2007 compared to 54% in 2003). |

**Annex 3**

# Republic of Serbia Donor Matrix, 2004-2006*

| Partner | Available Amounts (Million Euros)** Includes Loans & Grants | Agriculture | Banking | Budget | Civil Society | Construction | Culture | Economic Relations | Education | Energy | Environment | Finance | Health | Home Affairs | Justice | Labour | Local Self-government | Private Sector | Public Administration | Telecommunications | Trade, Tourism and Services | Transport | Water and Irrigation | Welfare | Other sectors |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Bilateral Total Average** | **157.56** | | | | | | | | | | | | | | | | | | | | | | | | |
| Austria | 2.12 | X | | | X | | | | X | | | | | | | | X | | X | | | | X | X | X |
| Canada | 1.22 | | | | | | | | X | | | | X | X | X | | | X | X | | | | | | |
| Czech Republic | 1.71 | | | | | | | | | X | X | | X | | | | X | | X | | | X | X | X | |
| Germany | 19.63 | | X | | X | X | X | | X | X | X | X | | X | X | | X | X | X | | | | X | X | |
| Italy | 22.50 | X | | | X | X | X | X | | X | X | | X | X | | X | X | X | X | | | X | | X | X |
| Japan | 3.56 | | | | | | X | X | X | | X | | X | | | | | X | X | | X | | X | | |
| Luxemburg | 1.67 | | | | | | | | X | | | X | X | | | | X | | | | | | X | X | |
| Netherlands | 5.14 | X | | | X | | | X | | | | | | X | X | X | | X | X | | | | | X | |
| Norway | 12.82 | X | | | | X | | X | X | X | X | X | X | X | | | X | X | X | | X | X | X | X | X |
| Sweden | 16.62 | X | | | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | | X | X | | X |
| Switzerland | 6.89 | X | | | X | X | | X | X | X | | | X | X | | | X | X | X | | | X | | X | X |
| Untied Kingdom | 5.36 | | X | | | | | | | | | X | X | X | X | X | | | X | | | | | X | X |
| United States | 58.32 | | X | | X | | | X | X | X | | X | | | X | | X | X | X | | | | | X | X |
| **Multilateral Total Average** | **417.59** | | | | | | | | | | | | | | | | | | | | | | | | |
| EU *** | 198.35 | X | | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | | | X | X | X | X |
| EBRD | 54.99 | | | | | | | | | X | | | | | | | | | | | | X | X | | |
| EIB | 78.69 | | | | | | | | X | X | | | X | | | | | X | | | | X | | | |
| World Bank Group | 82.47 | X | | X | | X | | | X | X | | X | X | | X | X | | X | X | | | X | X | X | |
| OSCE | 1.70 | | | | X | | | X | | | | | | X | X | | | | | | | | | | X |
| UNICEF | 0.54 | | | | | | | | | | | | | | | | | | | | | | | X | |
| UNDP | 0.85 | | | | X | X | | X | | | X | | X | X | X | X | X | X | X | X | | | | X | X |
| **TOTAL ANNUAL AVERAGE** | **575.15** | 10.63 | 7.93 | 92.31 | 36.70 | 8.16 | 2.03 | 6.62 | 14.45 | 63.24 | 13.15 | 13.62 | 30.61 | 11.27 | 13.07 | 5.81 | 25.39 | 48.02 | 25.81 | 0.15 | 0.40 | 103.45 | 10.54 | 23.66 | 8.09 |

* Drawing from active donor projects during the period 2004-2006 Bilateral donors with average annual disbursements above one million euros are included in the table

** Annual disbursement average, 2004-2006

*** Includes EAR and EU macrofinancial assistance

*Source: Information System ISDACON, Government of Serbia*

*The table does not include projects that are being implemented in Kosovo*

## Relations with the European Union and Progress on the Stabilization and Association Process (SAP)

### I. SAP and SAA

The Stabilization and Association Process (SAP) is a special regional approach of the European Union (EU) designed exclusively for the Western Balkan countries to pave their way for membership in the EU. It is the cornerstone of the EU's policy towards the region and it aims to promote stability while also facilitating closer association with the EU.

The concept of SAP dates back to the Zagreb summit in November 2000 when the EU and the Western Balkan countries agreed on the guiding principles of SAP. These principles include the recognition that: i) the main motivator for reform in these countries is a relationship with the EU, based on the credible prospect of membership; ii) the countries need to establish bilateral relationships between themselves to allow greater economic and political stability in the region to develop, and iii) given the diversity of the countries in the region, a more flexible approach is needed from the EU's side to allows each country to move ahead at its own pace.

The EU had previously stated in its Council meeting in Feira in June 2000 that the future of the Western Balkans countries lies within the European Union. The Zagreb summit provided the necessary instruments for the EU to fulfill the Feira commitments. Since then the EU has reaffirmed on many occasions that its ultimate goal is the full integration of the Western Balkan countries into the EU, once the countries have fulfilled the necessary conditions for membership.[7]

A key element of the SAP is the Stabilization and Association Agreement (SAA) which represents a far-reaching contractual relationship between the EU and the candidate country, entailing mutual rights and obligations. The SAA is signed with countries that have made sufficient progress in terms of political and economic reform and building administrative capacities necessary for convergence with Europe. The SAP also offers a mixture of trade concessions and a financial assistance programs to the countries included in the SAP. Once the SAA has been signed and ratified, the country is eligible to become a candidate country. The SAA foresees the establishment of a free trade area between the candidate country and the EU by the end of a five-year transition period and enhanced cooperation in the economic field. The SAA also stipulates increased cooperation in the fields of environmental protection, justice and security.

According to the EU, the main benefits of the SAA: i) economic development through enhanced trade and economic cooperation and the creation of a business environment facilitating investments, encouraging individual entrepreneurial initiatives and generating employment; ii) enhanced political stability and security due to good relations with neighbors, greater regional co-operation and deeper integration into the EU; and iii) progress in the process of political and economic reforms, including in the areas of institution building, public administration reform, respect of human rights and the rule of law, which are necessary to improve the quality of life for all citizens. The SAP was expanded to include a new instrument, the European Partnership, at the EU Thessaloniki Council meeting in 2003.

[7] These conditions include the Copenhagen criteria that outlines the core accession conditions for candidate countries: i) stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; ii) existence of functioning market economy, as well as capacity to cope with competitive pressure and market forces within the EU; and iii) ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

## II. Current status of the SAP in Serbia

Serbia initialed a Stabilization and Association Agreement (SAA) with the European Commission in November 2007.

The SAP process was officially launched in Serbia in 2001. Relations between Serbia and the EU followed a generally positive trend until 2006. The country made rapid advances on the EU's political and economic criteria and implemented several key reforms urged by the EU. An EC feasibility report recommending the launch of SAA negotiations with Serbia was endorsed by the EU Council in May 2005. This was based on the conclusion that Serbia had advanced sufficiently in key areas to start SAA negotiations.

SAA negotiations were officially launched on October 10, 2005, using a twin-track approach, with negotiations conducted with the Serbia and Montenegro State Union and individually each of the constituent republics, depending on the field of competence. The EC and the EU Council, however, stated explicitly that the continuation and the pace of the SAA talks would depend on Serbia's compliance in highlighted issues, especially with regard to Serbia's cooperation with the International Criminal Tribunal for the Former Yugoslavia (ICTY). During the first eight months of the SAA negotiations the technical talks advanced quickly and large parts of the agreement text were agreed upon. However, following a negative assessment on Serbia's cooperation with the ICTY, the SAA negotiations were put on hold in May 2006. Negotiations resumed in June 2007 following improvements in Serbia's cooperation with the ICTY, including the arrests two ICTY fugitives. Upon restarting the SAA negotiations, the EC stated that the conclusion of the SAA negotiations would depend on Serbia's progress in developing the necessary legislative framework and administrative capacity to implement its obligations under the SAA, as well as on its future cooperation with the ICTY.[8] Technical negotiations were concluded in September 2007.

The next step will be for the SAA to be signed, which should occur in early 2008, subject to continued Serbian cooperation with ICTY. Ratification will then require the SAA to be approved by national parliaments in EU member states. The Serbian government has stated that it hopes to receive the status of candidate country during 2008 and enter the EU between 2012 and 2014.

In its latest progress report released in November 2007, the EU Commission commended Serbia for its good economic performance, constructive approach to regional cooperation projects and for showing that it has a good administrative capacity to progress towards the EU and to implement a future SAA. Progress was also achieved in areas such as free movement of goods, customs and taxation, Industry and SMEs, agriculture and visa facilitation. Nevertheless, the EC is concerned about lack of process in judicial reform, enforcement of human rights (especially minority rights), high unemployment, lack of flexibility in the labor market, and widespread corruption.[9]

## III. EU financial assistance to Serbia

Since 2001, the EC has provided very significant financial assistance to Serbia. Between 1998 and 2006, the EC committed nearly 1.3 billion euros to support reforms in Serbia alone, with annual commitments between 150 and 220 million euros. These figures include the EC's macro-financial support and funds disbursed under the CARDS program.

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[8] EU Council Conclusions on Western Balkans, External Relations Council Meeting, 18 June 2007, Luxembourg
[9] Serbia 2007 Progress Report, November 6, 2007.

The focus areas of EC financial assistance has evolved since the 1990s, switching from humanitarian aid, conflict management and post-conflict reconstruction towards supporting political, institutional and economic reforms, with the overall objective to facilitate a closer association with the EU. In recent years the CARDS assistance program has focused mainly on the European Partnership priorities, while taking also into account the requirements Serbia will have to meet to conclude the SAA negotiations and implement the agreement. In addition to having its own CARDS program, Serbia also benefits from a regional CARDS scheme that supports actions in the interest for the whole Western Balkans region in the fields of infrastructure, institution building and cross-border cooperation.

In order to simplify and harmonize the different external aid components, to facilitate coherence and improve consistency and to achieve better results and to improve consistency, the EU is currently adopting a new financial aid mechanism to replace all previous external assistance programs for candidate and potential candidate countries. The new mechanism, called IPA (Instrument for Pre-Accession Assistance) will replace the CARDS program in the Western Balkan region and it will be operative during the period of 2007-2013.

The total financial allocation granted to Serbia under IPA amount to 976,8 million Euros during the period of 2007 – 2011, with average annual allocation of around 195 million Euros during the five-year period.[10] IPA is made up of five components: (i) support for transition and institution building; (ii) cross-border cooperation; (iii) regional development, (iv) human resources development; and (v) rural development. The first two components concern all beneficiary countries, whereas the three latter components are aimed at EU candidate countries only. Therefore Serbia, being a potential candidate country, only benefits at this stage from activities under the two first components. In this framework, IPA will support Serbia to:

1. **Fulfill the political requirements of the SAP and lay foundations for the fulfillment of the Copenhagen criteria**. In order to achieve this goal, the EC will focus on the following areas in Serbia: i) strengthening democratic institutions, decentralization and local governments, budget and fiscal management, rule of law, reform of the judiciary and public administration reform; ii) intensify the fight against corruption, reform of the police; iii) advancing human rights and protection of minorities, antidiscrimination; and iv) supporting civil society and the media.
2. **Improve the socio-economic situation.** IPA will finance activities in the areas of i) employment generation; ii) education; iii) social inclusion; iv) health; v) business environment, SME restructuring and competitiveness; vi) infrastructure and inland waterway transport; vii) flood prevention; and viii) rural development.
3. **Approximate to European Standards in sectors related to the introduction and implementation of the EU *Acquis* in all areas, including the overall coordination of the European integration process.** This component aims to strengthen Serbian administrative capacities to implement the SAA once it has been signed.

With IPA, the EC also wants to develop local ownership in the fund management framework and to help prepare the authorities for the introduction of the Decentralized Implementation System (DIS) to self-manage EC funds. However, administrative capacities need to be further strengthened throughout the administration in Serbia to implement the IPA program. According to the EC, further measures should also be identified to address the continued weak inter-ministerial relations, coordination and communication which undermine implementation of EU policies.

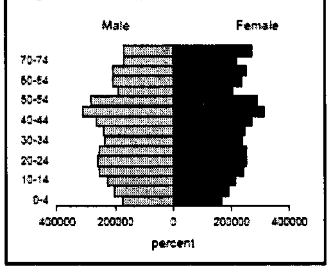
[10] EU Commission MEMO/07-446, November 6, 2007.

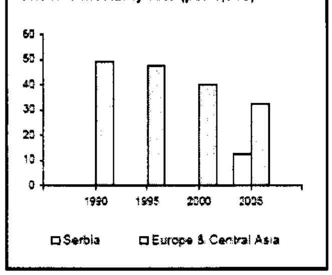
**Annex 5**

# Serbia at a glance

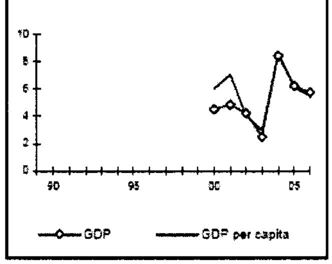
11/5/07

| **Key Development Indicators** | Serbia | Europe & Central Asia | Upper middle income |
|---|---|---|---|
| *(2006)* | | | |
| Population, mid-year (millions) | 7.5 | 460 | 810 |
| Surface area (thousand sq. km) | 77 | 24,114 | 41,460 |
| Population growth (%) | 0.2 | 0.0 | 0.7 |
| Urban population (% of total population) | 56 | 64 | 75 |
| GNI (Atlas method, US$ billions) | 30.0 | 2,206 | 4,790 |
| GNI per capita (Atlas method, US$) | 4,000 | 4,796 | 5,913 |
| GNI per capita (PPP, international $) | .. | 9,662 | 10,817 |
| GDP growth (%) | 5.7 | 6.8 | 5.6 |
| GDP per capita growth (%) | 5.5 | 6.8 | 4.9 |
| *(most recent estimate, 2000–2006)* | | | |
| Poverty headcount ratio at $1 a day (PPP, %) | .. | 1 | .. |
| Poverty headcount ratio at $2 a day (PPP, %) | .. | 10 | .. |
| Life expectancy at birth (years) | 73 | 69 | 70 |
| Infant mortality (per 1,000 live births) | 8 | 28 | 26 |
| Child malnutrition (% of children under 5) | .. | 5 | .. |
| Adult literacy, male (% of ages 15 and older) | 99 | 99 | 94 |
| Adult literacy, female (% of ages 15 and older) | 94 | 96 | 92 |
| Gross primary enrollment, male (% of age group) | .. | 103 | 106 |
| Gross primary enrollment, female (% of age group) | .. | 100 | 104 |
| Access to an improved water source (% of population) | 69 | 92 | 93 |
| Access to improved sanitation facilities (% of population) | .. | 85 | 81 |


Age distribution, 2006



Under-5 mortality rate (per 1,000)


| **Net Aid Flows** | 1980 | 1990 | 2000 | 2006 [a] |
|---|---|---|---|---|
| *(US$ millions)* | | | | |
| Net ODA and official aid | .. | .. | 184 | 652 |
| *Top 3 donors (in 2005):* | | | | |
| European Union | .. | .. | .. | 418 |
| World Bank | .. | .. | .. | 87 |
| EBRD | .. | .. | .. | 71 |
| Aid (% of GNI) | .. | .. | 2.1 | 2.1 |
| Aid per capita (US$) | .. | .. | 24 | 87 |


Growth of GDP and GDP per capita (%)


| **Long-Term Economic Trends** | 1980 | 1990 | 2000 | 2006 | 1980–90 | 1990–2000 | 2000–06 |
|---|---|---|---|---|---|---|---|
| | | | | | *(average annual growth %)* | | |
| Consumer prices (annual % change) | *30.0* | *590.2* | 68.7 | 12.7 | | | |
| GDP implicit deflator (annual % change) | .. | .. | 81.0 | 15.6 | | | |
| Exchange rate (annual average, local per US$) | .. | .. | 44.4 | 66.9 | | | |
| Terms of trade index (2000 = 100) | .. | .. | .. | .. | | | |
| Population, mid-year (millions) | 7.7 | 7.6 | 7.7 | 7.5 | .. | .. | -0.4 |
| GDP (US$ millions) | .. | .. | 8,963 | 31,989 | .. | .. | 5.3 |
| | | *(% of GDP)* | | | | | |
| Agriculture | .. | .. | 19.4 | *12.7* | .. | .. | .. |
| Industry | .. | .. | 29.6 | *25.5* | .. | .. | .. |
| Manufacturing | .. | .. | .. | .. | .. | .. | .. |
| Services | .. | .. | 51.0 | *61.9* | .. | .. | .. |
| Household final consumption expenditure | .. | .. | 88.7 | 77.6 | .. | .. | 4.6 |
| General gov't final consumption expenditure | .. | .. | 18.9 | 20.9 | .. | .. | 3.4 |
| Gross capital formation | .. | .. | 8.4 | 21.2 | .. | .. | 20.9 |
| Exports of goods and services | .. | .. | 23.0 | 26.9 | .. | .. | 11.8 |
| Imports of goods and services | .. | .. | 39.1 | 46.5 | .. | .. | 13.6 |
| Gross savings | .. | .. | 3.7 | 9.0 | | | |

Note: Figures in italics are for years other than those specified. 2006 data are preliminary. .. indicates data are not available.
a. Aid data are for 2005.

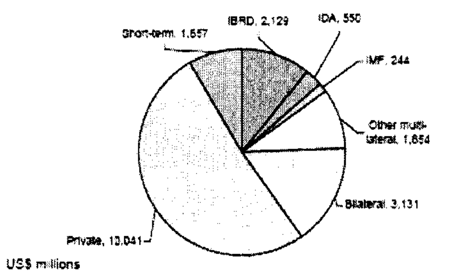
Development Economics, Development Data Group (DECDG).

| Balance of Payments and Trade | 2000 | 2006 |
|---|---|---|
| *(US$ millions)* | | |
| Total merchandise exports (fob) | 1,645 | 6,486 |
| Total merchandise imports (cif) | 3,227 | 12,716 |
| Net trade in goods and services | -1,441 | -6,292 |
| Current account balance | -153 | -3,664 |
| as a % of GDP | -1.7 | -11.5 |
| Workers' remittances and compensation of employees (receipts) | 1,302 | 4,355 |
| Reserves, including gold | 524 | 11,888 |

| Central Government Finance | 2000 | 2006 |
|---|---|---|
| *(% of GDP)* | | |
| Current revenue (including grants) | 32.4 | 40.1 |
| Tax revenue | 23.9 | 33.9 |
| Current expenditure | 29.8 | 37.7 |
| Overall surplus/deficit | -0.2 | -1.5 |
| Highest marginal tax rate (%) | | |
| Individual | .. | .. |
| Corporate | .. | .. |

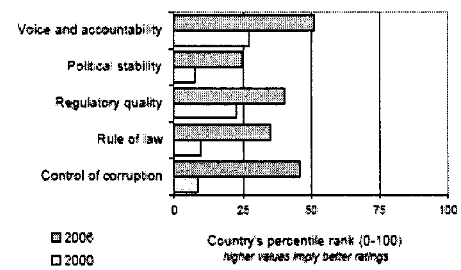
| External Debt and Resource Flows | 2000 | 2006 |
|---|---|---|
| *(US$ millions)* | | |
| Total debt outstanding and disbursed | 10,830 | 19,606 |
| Total debt service | -65 | -3,156 |
| Debt relief (HIPC, MDRI) | – | – |
| Total debt (% of GDP) | 120.8 | 61.3 |
| Total debt service (% of exports) | -1.9 | -24.0 |
| Foreign direct investment (net inflows) | 50 | 4,389 |
| Portfolio equity (net inflows) | .. | 200 |

Composition of total external debt, 2006




| Private Sector Development | 2000 | 2006 |
|---|---|---|
| Time required to start a business (days) | – | 23 |
| Cost to start a business (% of GNI per capita) | – | 10.2 |
| Time required to register property (days) | – | 111 |
| Ranked as a major constraint to business (% of managers surveyed who agreed) | | |
| n.a. | .. | .. |
| n.a. | .. | .. |
| Stock market capitalization (% of GDP) | *4.6* | *20.6* |
| Bank capital to asset ratio (%) | *18.3* | *17.2* |

Governance indicators, 2000 and 2006




Source: Kaufmann-Kraay-Mastruzzi, World Bank

| Technology and Infrastructure | 2000 | 2005 |
|---|---|---|
| Paved roads (% of total) | .. | .. |
| Fixed line and mobile phone subscribers (per 1,000 people) | .. | .. |
| High technology exports (% of manufactured exports) | 3.2 | 5.6 |

| Environment | | |
|---|---|---|
| Agricultural land (% of land area) | .. | .. |
| Forest area (% of land area) | .. | .. |
| Nationally protected areas (% of land area) | .. | .. |
| Freshwater resources per capita (cu. meters) | .. | .. |
| Freshwater withdrawal (% of internal resources) | .. | .. |
| CO2 emissions per capita (mt) | .. | .. |
| GDP per unit of energy use (2000 PPP $ per kg of oil equivalent) | .. | .. |
| Energy use per capita (kg of oil equivalent) | .. | .. |

| World Bank Group portfolio | 2000 | 2006 |
|---|---|---|
| *(US$ millions)* | | |
| IBRD | | |
| Total debt outstanding and disbursed | 1,538 | 2,129 |
| Disbursements | 0 | – |
| Principal repayments | 0 | 242 |
| Interest payments | 0 | 104 |
| IDA | | |
| Total debt outstanding and disbursed | 0 | 550 |
| Disbursements | 0 | 40 |
| Total debt service | 0 | 4 |
| IFC *(fiscal year)* | | |
| Total disbursed and outstanding portfolio | – | 181 |
| of which IFC own account | – | 171 |
| Disbursements for IFC own account | – | 131 |
| Portfolio sales, prepayments and repayments for IFC own account | – | 44 |
| MIGA | | |
| Gross exposure | – | – |
| New guarantees | – | – |

Note: Figures in italics are for years other than those specified. 2006 data are preliminary. 11/5/07
.. indicates data are not available. – indicates observation is not applicable.

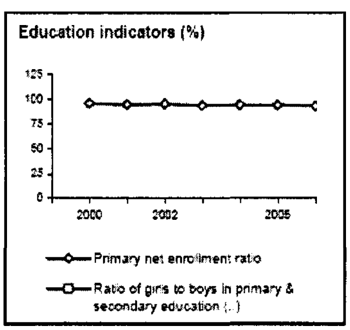
Development Economics, Development Data Group (DECDG).

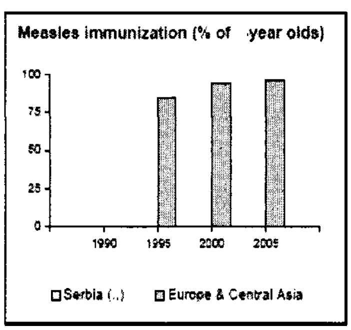
## Millennium Development Goals

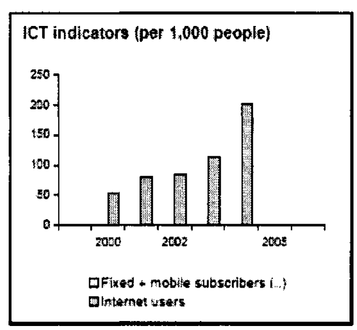
*Serbia*

*With selected targets to achieve between 1990 and 2015*
*(estimate closest to date shown, +/- 2 years)*

| Serbia | 1990 | 1995 | 2000 | 2005 |
|---|---|---|---|---|
| **Goal 1: halve the rates for $1 a day poverty and malnutritior** | | | | |
| Poverty headcount ratio at $1 a day (PPP, % of population) | .. | .. | .. | .. |
| Poverty headcount ratio at national poverty line (% of population) | .. | .. | *10.6* | 9.1 |
| Share of income or consumption to the poorest qunitile (%) | .. | .. | .. | *9.0* |
| Prevalence of malnutrition (% of children under 5) | | | | |
| **Goal 2: ensure that children are able to complete primary schooling** | | | | |
| Primary school enrollment (net, %) | .. | .. | 96 | *94* |
| Primary completion rate (% of relevant age group) | .. | .. | .. | *95* |
| Secondary school enrollment (gross, %) | .. | .. | .. | .. |
| Youth literacy rate (% of people ages 15-24) | .. | .. | .. | *99* |
| **Goal 3: eliminate gender disparity in education and empower women** | | | | |
| Ratio of girls to boys in primary and secondary education (%) | | | | *95* |
| Women employed in the nonagricultural sector (% of nonagricultural employment) | | | | *42* |
| Proportion of seats held by women in national parliament (%) | | | | *11* |
| **Goal 4: reduce under-5 mortality by two-thirds** | | | | |
| Under-5 mortality rate (per 1,000) | .. | .. | .. | *13* |
| Infant mortality rate (per 1,000 live births) | *15* | .. | 11 | 8 |
| Measles immunization (proportion of one-year olds immunized, %) | .. | .. | .. | *96* |
| **Goal 5: reduce maternal mortality by three-fourths** | | | | |
| Maternal mortality ratio (modeled estimate, per 100,000 live births) | .. | .. | *6* | *6* |
| Births attended by skilled health staff (% of total) | | | | *99* |
| **Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases** | | | | |
| Prevalence of HIV (% of population ages 15-49) | | | | |
| Contraceptive prevalence (% of women ages 15-49) | | | | 33 |
| Incidence of tuberculosis (per 100,000 people) | | | | *32* |
| Tuberculosis cases detected under DOTS (%) | | | | |
| **Goal 7: halve the proportion of people without sustainable access to basic needs** | | | | |
| Access to an improved water source (% of population) | .. | .. | *69* | .. |
| Access to improved sanitation facilities (% of population) | .. | .. | .. | .. |
| Forest area (% of total land area) | .. | .. | *26.0* | *25.6* |
| Nationally protected areas (% of total land area) | .. | .. | *4.6* | *4.6* |
| CO2 emissions (metric tons per capita) | .. | .. | .. | *4.4* |
| GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent) | .. | .. | .. | *0.9* |
| **Goal 8: develop a global partnership for development** | | | | |
| Fixed line and mobile phone subscribers (per 1,000 people) | | | | |
| Internet users (per 1,000 people) | | | 53 | *203* |
| Personal computers (per 1,000 people) | | | .. | *220* |
| Youth unemployment (% of total labor force ages 15-24) | | | .. | *47.8* |




Note: Figures in italics are for years other than those specified .. indicates data are not available 11/5/07

Development Economics, Development Data Group (DECDG)

## SERBIA: DOING BUSINESS INDICATORS

### Summary of Indicators - Serbia

| | | |
|---|---|---|
| **Starting a Business** | **Procedures (number)** | 11 |
| | **Duration (days)** | 23 |
| | **Cost (% GNI per capita)** | 8.9 |
| | **Paid in Min. Capital (% of GNI per capita** | 8.0 |
| **Dealing with Licenses** | **Procedures (number)** | 20 |
| | **Duration (days)** | 204 |
| | **Cost (% of income per capita)** | 2713.1 |
| **Employing Workers** | **Difficulty of Hiring Index** | 67 |
| | **Rigidity of Hours Index** | 40 |
| | **Difficulty of Firing Index** | 30 |
| | **Rigidity of Employment Index** | 46 |
| | **Nonwage labor cost (% of salary)** | 18 |
| | **Firing costs (weeks of wages)** | 25 |
| **Registering Property** | **Procedures (number)** | 6 |
| | **Duration (days)** | 111 |
| | **Cost (% of property value)** | 5.4 |
| **Getting Credit** | **Legal Rights Index** | 7 |
| | **Credit Information Index** | 5 |
| | **Public registry coverage (% adults)** | 0.1 |
| | **Private bureau coverage (% adults)** | 51.3 |
| **Protecting Investors** | **Disclosure Index** | 7 |
| | **Director Liability Index** | 6 |
| | **Shareholder Suits Index** | 3 |
| | **Investor Protection Index** | 5.3 |
| **Paying Taxes** | **Payments (number)** | 66 |
| | **Time (hours)** | 279 |
| | **Profit tax (%)** | 11.7 |
| | **Labor tax and contributions (%)** | 20.2 |
| | **Other taxes (%)** | 3.9 |
| | **Total tax rate (% profit)** | 35.8 |

| | | |
|---|---|---|
| **Trading Across Borders** | **Documents for export (number)** | 6 |
| | **Time for export (days)** | 12 |
| | **Cost to export (US$ per container)** | 1240 |
| | **Documents for import (number)** | 6 |
| | **Time for import (days)** | 14 |
| | **Cost to import (US$ per container)** | 1440 |
| **Enforcing Contracts** | **Procedures (number)** | 36 |
| | **Duration (days)** | 635 |
| | **Cost (% of claim)** | 28.4 |
| **Closing a Business** | **Cost (% of income per capita)** | 23 |
| | **Time (years)** | 2.7 |
| | **Recovery rate (cents on the dollar)** | 23.1 |

## Serbia - Key Economic Indicators

| Indicator | Actual | | | Estimate | | Projected | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| **National accounts (as % of GDP)** | | | | | | | | | |
| Total Consumption | 96 | 100 | 100 | 98 | 99 | 98 | 98 | 97 | 96 |
| Gross domestic fixed investmen | 16 | 18 | 17 | 18 | 19 | 19 | 20 | 20 | 21 |
| Government investment | 2 | 3 | 3 | 4 | 4 | 5 | 5 | 5 | 5 |
| Private investment | 14 | 15 | 15 | 14 | 14 | 15 | 15 | 15 | 16 |
| Exports (GNFS)[b] | 21 | 23 | 25 | 27 | 28 | 28 | 28 | 28 | 28 |
| Imports (GNFS) | 40 | 46 | 47 | 47 | 49 | 49 | 49 | 49 | 49 |
| Gross domestic savings | 4 | 0 | 0 | 2 | 1 | 2 | 2 | 3 | 4 |
| Gross national savings[c] | 13 | 12 | 11 | 9 | 7 | 7 | 8 | 9 | 10 |
| *Memorandum items* | | | | | | | | | |
| Gross domestic product (US$ million at current prices | 20340 | 24518 | 26232 | 31989 | 40808 | 47197 | 50993 | 55229 | 59943 |
| GNI per capita (US$, Atlas method | 2130 | 2970 | 3560 | 4000 | 4620 | 5540 | 6430 | 7060 | 7610 |
| Real annual growth rates | | | | | | | | | |
| Gross domestic product at market price | 2.5 | 8.4 | 6.2 | 5.7 | 7.0 | 6.0 | 5.5 | 5.5 | 5.5 |
| Gross Domestic Income | 1.2 | 8.6 | 3.8 | 7.0 | 9.0 | 5.8 | 5.1 | 5.0 | 5.0 |
| Real annual per capita growth rates | | | | | | | | | |
| Gross domestic product at market price | 3.0 | 8.7 | 6.1 | 5.5 | 6.6 | 5.7 | 5.2 | 5.2 | 5.2 |
| Total consumption | -3.3 | 11.0 | 0.6 | 5.5 | 11.0 | 6.5 | 5.7 | 5.1 | 4.9 |
| Private consumption | -5.0 | 16.8 | -1.2 | 6.3 | 16.7 | 7.2 | 6.2 | 5.6 | 5.3 |
| **Balance of Payments (US$ millions)** | | | | | | | | | |
| Exports (GNFS)[b] | 4358 | 5559 | 6606 | 8593 | 11523 | 13218 | 14306 | 15446 | 16899 |
| Merchandise FOB | 3319 | 4082 | 4970 | 6486 | 8585 | 9781 | 10550 | 11331 | 12383 |
| Imports (GNFS)[b] | 8177 | 11853 | 11902 | 14886 | 19983 | 23179 | 25121 | 27010 | 29256 |
| Merchandise FOB | 7340 | 10551 | 10260 | 12716 | 17086 | 19828 | 21501 | 23089 | 25000 |
| Resource balance | -3819 | -6294 | -5296 | -6292 | -8460 | -9961 | -10815 | -11564 | -12357 |
| Net current transfers | 2535 | 3641 | 3396 | 3023 | 3089 | 3808 | 4471 | 5119 | 5736 |
| Current account balance | -1420 | -2869 | -2224 | -3664 | -5950 | -7027 | -7391 | -7798 | -8200 |
| Net private foreign direct investmen | 1365 | 966 | 1549 | 4389 | 1530 | 2025 | 2207 | 2620 | 2690 |
| Long-term loans (net) | 1095 | 1619 | 2621 | 4002 | 4694 | 3494 | 4050 | 4168 | 4728 |
| Other capital (net. incl. errors & ommissions) | 230 | 979 | -348 | 1318 | 1538 | 1504 | 1143 | 1002 | 750 |
| Change in reserves[d] | -1270 | -695 | -1598 | -6045 | -1812 | 4 | -8 | 7 | 32 |
| *Memorandum items* | | | | | | | | | |
| Resource balance (% of GDP) | -18.8 | -25.7 | -20.2 | -19.7 | -20.7 | -21.1 | -21.2 | -20.9 | -20.6 |

*(Continued)*

## Serbia - Key Economic Indicators
## (Continued)

| | Actual | | | Estimate | | Projected | | | |
|---|---|---|---|---|---|---|---|---|---|
| Indicator | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| **Public finance (as % of GDP at market prices)**[e] | | | | | | | | | |
| Current revenues | 40.3 | 41.0 | 40.9 | 40.1 | 40.7 | 40.5 | 40.2 | 40.0 | 39 |
| Current expenditures | 40.7 | 38.8 | 37.7 | 37.7 | 38.2 | 38.0 | 37.6 | 37.0 | 36 |
| Current account surplus (+) or deficit (- | -0.4 | 2.3 | 3.2 | 2.4 | 2.5 | 2.5 | 2.6 | 2.9 | 3 |
| Capital expenditure | 3.0 | 2.7 | 2.9 | 4.4 | 4.3 | 4.8 | 4.8 | 4.8 | 4 |
| Foreign financing | 1.1 | 0.9 | 0.7 | 0.5 | 1.5 | 0.1 | 0.0 | -0.1 | -( |
| **Monetary indicators** | | | | | | | | | |
| M2/GDP | 20.9 | 22.6 | 26.2 | 29.8 | 30.3 | 31.2 | 32.3 | 33.3 | 33 |
| Growth of M2 (%) | 27.8 | 31.9 | 42.1 | 39.1 | 14.8 | 18.5 | 15.5 | 15.0 | 10 |
| **Price indices** | | | | | | | | | |
| Consumer price index (% change) | 11.7 | 10.1 | 17.3 | 12.7 | 6.4 | 8.4 | 6.1 | 5.5 | 4 |

a. GDP at factor cost
b. "GNFS" denotes "goods and nonfactor services.
c. Includes net unrequited transfers excluding official capital grant
d. Includes use of IMF resources
e. Consolidated central government
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciatio

## Serbia - Key Exposure Indicators

| Indicator | Actual | | | | Estimate | Projected | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| Total debt outstanding and disbursed (TDO) (US$m)[a] | 13575 | 14099 | 15467 | 19606 | 24328 | 27613 | 30984 | 33910 | 36695 |
| Net disbursements (US$m)[a] | 786 | 2002 | 2646 | 4062 | 4691 | 4050 | 3779 | 2908 | 3208 |
| Total debt service (TDS) (US$m)[a] | .. | .. | .. | .. | 1653 | 2431 | 3862 | 5155 | 6011 |
| Debt and debt service indicators (%) | | | | | | | | | |
| TDO/XGS[b] | 190.6 | 147.1 | 145.8 | 149.2 | 150.3 | 148.4 | 152.2 | 153.1 | 151.3 |
| TDO/GDP | 66.7 | 57.5 | 59.0 | 61.3 | 59.6 | 58.5 | 60.8 | 61.4 | 61.2 |
| TDS/XGS | .. | .. | .. | .. | 10.2 | 13.1 | 19.0 | 23.3 | 24.8 |
| Concessional/TDO | .. | .. | .. | .. | 14.0 | 12.6 | 11.3 | 10.3 | 9.5 |
| IBRD exposure indicators (%) | | | | | | | | | |
| IBRD DS/public DS | .. | .. | .. | .. | 32.3 | 11.7 | 7.1 | 4.9 | 3.9 |
| Preferred creditor DS/public DS (%)[c] | .. | .. | .. | .. | 67.8 | 20.9 | 12.5 | 8.5 | 6.5 |
| IBRD DS/XGS | .. | .. | 1.1 | 2.6 | 1.3 | 1.1 | 1.1 | 1.0 | 0.9 |
| IBRD TDO (US$m)[d] | 2270 | 2472 | 2133 | 2129 | 2131 | 2175 | 2220 | 2251 | 2290 |
| Share of IBRD portfolio (%) | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| IDA TDO (US$m)[d] | 273 | 432 | 468 | 550 | 594 | 634 | 669 | 696 | 715 |
| IFC (US$m) | | | | | | | | | |
| Loans | | | | | | | | | |
| Equity and quasi-equity /c | | | | | | | | | |
| MIGA | | | | | | | | | |
| MIGA guarantees (US$m) | | | | | | | | | |

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

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

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

d. Includes present value of guarantees.

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

# Serbia Social Indicators

| | Latest single year | | | Same region/income group | |
|---|---|---|---|---|---|
| | 1980-85 | 1990-95 | 1999-05 | Europe & Central Asia | Lower-middle-income |
| **POPULATION** | | | | | |
| Total population, mid-year *(millions)* | 7.7 | 7.6 | 7.5 | 472.9 | 2,474.7 |
| Growth rate *(% annual average for period)* | .. | .. | -0.7 | 0.0 | 1.0 |
| Urban population *(% of population)* | 46.6 | 54.6 | 56.4 | 63.7 | 49.5 |
| Total fertility rate *(births per woman)* | .. | 1.8 | 1.6 | 1.6 | 2.2 |
| **POVERTY** | | | | | |
| *(% of population)* | | | | | |
| National headcount index | .. | .. | 9.1 | .. | .. |
| Urban headcount index | .. | .. | .. | .. | .. |
| Rural headcount index | .. | .. | .. | .. | .. |
| **INCOME** | | | | | |
| GNI per capita *(US$)* | .. | .. | 3,560 | 4,113 | 1,918 |
| Consumer price index *(2000=100)* | 69 | 14 | 331 | 130 | 130 |
| Food price index *(2000=100)* | .. | .. | .. | .. | .. |
| **INCOME/CONSUMPTION DISTRIBUTION** | | | | | |
| Gini index | .. | .. | .. | .. | .. |
| Lowest quintile *(% of income or consumption)* | .. | .. | .. | .. | .. |
| Highest quintile *(% of income or consumption)* | .. | .. | .. | .. | .. |
| **SOCIAL INDICATORS** | | | | | |
| **Public expenditure** | | | | | |
| Health *(% of GDP)* | .. | .. | 6.9 | .. | .. |
| Education *(% of GNI)* | .. | .. | .. | 4.4 | 4.3 |
| **Net primary school enrollment rate** | | | | | |
| *(% of age group)* | | | | | |
| Total | .. | .. | 95 | 90 | .. |
| Male | .. | .. | .. | 91 | .. |
| Female | .. | .. | .. | 90 | .. |
| **Access to an improved water source** | | | | | |
| *(% of population)* | | | | | |
| Total | .. | .. | 69 | 92 | 82 |
| Urban | .. | .. | .. | 99 | 94 |
| Rural | .. | .. | . | 80 | 71 |
| **Immunization rate** | | | | | |
| *(% of children ages 12-23 months)* | | | | | |
| Measles | .. | .. | .. | 93 | 85 |
| DPT | .. | .. | .. | 93 | 88 |
| Child malnutrition *(% under 5 years)* | .. | .. | .. | 5 | 12 |
| **Life expectancy at birth** | | | | | |
| *(years)* | | | | | |
| Total | .. | .. | 73 | 69 | 70 |
| Male | .. | 69 | 70 | 64 | 68 |
| Female | .. | 74 | 75 | 73 | 73 |
| **Mortality** | | | | | |
| Infant *(per 1,000 live births)* | .. | 15 | 8 | 28 | 33 |
| Under 5 *(per 1,000)* | .. | .. | .. | 34 | 42 |
| Adult (15-59) | | | | | |
| Male *(per 1,000 population)* | .. | .. | .. | 316 | 184 |
| Female *(per 1,000 population)* | .. | .. | .. | 134 | 117 |
| Maternal *(per 100,000 live births)* | .. | .. | .. | 58 | 163 |
| Births attended by skilled health staff *(%)* | .. | .. | .. | 94 | 86 |

CAS Annex B5. This table was produced from the CMU LDB system. 11/06/07

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

## Selected Indicators* of Bank Portfolio Performance and Management

**As Of Date 10/30/2007**

| Indicator | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| ***Portfolio Assessment*** | | | | |
| Number of Projects Under Implementation [a] | 18 | 19 | 10 | 10 |
| Average Implementation Period (years) [b] | 1.5 | 2.2 | 2.2 | 2.5 |
| Percent of Problem Projects by Number [a, c] | 5.6 | 26.3 | 10.0 | 10.0 |
| Percent of Problem Projects by Amount [a, c] | 7.4 | 14.4 | 6.3 | 6.3 |
| Percent of Projects at Risk by Number [a, d] | 5.6 | 26.3 | 10.0 | 10.0 |
| Percent of Projects at Risk by Amount [a, d] | 7.4 | 14.4 | 6.3 | 6.3 |
| Disbursement Ratio (%) [e] | 10.6 | 18.4 | 20.1 | 6.5 |
| ***Portfolio Management*** | | | | |
| CPPR during the year (yes/no) | | | | |
| Supervision Resources (total US$) | | | | |
| Average Supervision (US$/project) | | | | |

| Memorandum Item | Since FY 80 | Last Five FYs |
|---|---|---|
| Proj Eval by OED by Number | 13 | 11 |
| Proj Eval by OED by Amt (US$ millions) | 404.3 | 245.2 |
| % of OED Projects Rated U or HU by Number | 0.0 | 0.0 |
| % of OED Projects Rated U or HU by Amt | 0.0 | 0.0 |

a. As shown in the Annual Report on Portfolio Performance (except for current FY).
b. Average age of projects in the Bank's country portfolio.
c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
d. As defined under the Portfolio Improvement Program.
e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.
* All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

**IBRD/IDA Program Summary** **Serbia**

**As Of Date 10/30/2007**

**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)* |
|---|---|---|---|---|
| 2008 | Private Sector DPL | 50.0 | H | M |
| | Railways | 90.0 | H | H |
| | DILS | 40.0 | H | M |
| | Health Improvement Additional Financing | 10.0 | M | M |
| | Result | 190.0 | | |
| 2009 | DPL | 50.0 | H | M |
| | Resavica Regional Development | 40.0 | H | M |
| | Regional Disaster Preparedness | 25.0 | H | M |
| | Energy | 70.0 | | |
| | Result | 185.0 | | |
| Overall Result | | 375.0 | | |

**Operations Portfolio (IBRD/IDA and Grants)**
**As Of Date 10/30/2007**

| | |
|---|---|
| Closed Projects | 17 |
| **IBRD/IDA** * | |
| Total Disbursed (Active) | 77.07 |
| of which has been repaid | 0.00 |
| Total Disbursed (Closed) | 527.59 |
| of which has been repaid | 25.24 |
| Total Disbursed (Active + Closed) | 604.67 |
| of which has been repaid | 25.24 |
| Total Undisbursed (Active) | 317.58 |
| Total Undisbursed (Closed) | 0.00 |
| Total Undisbursed (Active + Closed) | 317.58 |

**Active Projects**

| Project ID | Project Name | Last PSR Supervision Rating: Development Objectives | Last PSR Supervision Rating: Implementation Progress | Fiscal Year | Original Amount in US$ Millions: IBRD | IDA | GRANT | Cancel. | Undisb. | Difference Between Expected and Actual Disbursements a/: Orig. | Frm Rev'd |
|---|---|---|---|---|---|---|---|---|---|---|---|
| P092999 | BOR REGIONAL DEVELOP | # | # | 2007 | 33 | 10 | | | 43.273047 | | |
| P090418 | CNSLTD COLLECT & PENS | U | U | 2005 | | 25 | | | 24.9107916 | 9.07089119 | 6.77946549 |
| P084604 | DANUBE ENTS POLLUT RE | MS | MS | 2005 | | | 9.02 | | 7.72326498 | 3.13659831 | |
| P088867 | ECSEE APL #2 (SERBIA) | S | MS | 2005 | | 21 | | | 21.572573 | 3.84444167 | |
| P075343 | ENERGY EFF (SERBIA) | S | S | 2004 | 18 | 31 | | | 36.8021192 | 4.94999565 | |
| P077675 | HEALTH (SERBIA) | S | S | 2003 | | 20 | | | 4.28496003 | 2.14262595 | 2.14262595 |
| P087964 | IRRIG/DRAINAGE REHAB ( | S | MS | 2006 | 49.37 | 25 | | | 74.425312 | 5.79276088 | |
| P078311 | REAL ESTATE CADASTRE | MS | MS | 2004 | | 30 | | | 20.2265664 | 2.73790823 | |
| P094212 | TRANS AG REFORM | # | # | 2007 | 17 | | | | 17.065625 | | |
| P093545 | TRANS AG REFORM (GEF) | # | # | 2007 | | | 4.5 | | | | |
| P075207 | TRNSPT REHAB (SERBIA) | S | MS | 2004 | 50 | 55 | | | 75.017342 | 8.35672258 | |
| Overall Result | | | | | 167.37 | 217 | 13.52 | | 325.301601 | 40.0319445 | 8.92209144 |

# SERBIA
## Committed and Disbursed Outstanding Portfolio
As of October 31, 2007
(In USD Millions)

| | | Committed | | | | | Outstanding | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Commitment Fiscal Year** | **Institution Short Name** | **Loan Cmtd-IFC** | **Equity Cmtd-IFC** | **QL+QE Cmtd-IFC** | **All Cmtd-IFC** | **All Cmtd-Part** | **LN Out-IFC** | **ET Out-IFC** | **QL+QE Out-IFC** | **All Out-IFC** | **All Out-Part** |
| 2006 | BANCA INTESA SPA | 0.00 | 52.18 | 86.50 | 138.68 | 0.00 | 0.00 | 46.43 | 86.50 | 132.93 | 0.00 |
| 2006 | Continental Bank | 32.20 | 0.00 | 0.00 | 32.20 | 1.10 | 32.20 | 0.00 | 0.00 | 32.20 | 1.10 |
| 1990 | Jugobanka | 0.00 | 0.00 | 0.00 | 0.00 | 1.33 | 0.00 | 0.00 | 0.00 | 0.00 | 1.33 |
| | Panonska | 3.57 | 0.00 | 0.00 | 3.57 | 1.76 | 3.57 | 0.00 | 0.00 | 3.57 | 1.76 |
| | Privredna Banka | 1.11 | 0.00 | 0.00 | 1.11 | 0.54 | 1.11 | 0.00 | 0.00 | 1.11 | 0.54 |
| 2007 | Merkator | 30.00 | 0.00 | 0.00 | 30.00 | 0.00 | 30.00 | 0.00 | 0.00 | 30.00 | 0.00 |
| 03/0702 | ProCredit Serbia | 25.39 | 0.00 | 0.00 | 25.39 | 0.00 | 25.39 | 0.00 | 0.00 | 25.39 | 0.00 |
| 2005 | RIB II | 14.42 | 0.00 | 0.00 | 14.42 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| | RLSerbia | 43.25 | 0.00 | 0.00 | 43.25 | 0.00 | 40.37 | 0.00 | 0.00 | 40.37 | 0.00 |
| 05/06/2002 | Raiffeisen Yug | 13.33 | 0.00 | 0.00 | 13.33 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 2002/05 | Tigar M.H. | 0.00 | 3.92 | 0.00 | 3.92 | 0.00 | 0.00 | 3.92 | 0.00 | 3.92 | 0.00 |
| 2005 | Unicredit Bank | 41.54 | 0.00 | 0.00 | 41.54 | 0.00 | 27.12 | 0.00 | 0.00 | 27.12 | 0.00 |
| 1990 | Vojvodjanska | 5.64 | 0.00 | 0.00 | 5.64 | 2.77 | 5.64 | 0.00 | 0.00 | 5.64 | 2.77 |
| **Total Portfolio:** | | **210.43** | **56.11** | **86.50** | **353.04** | **7.50** | **165.38** | **50.35** | **86.50** | **302.23** | **7.50** |

## SERBIA: IFC Investment Operations Program

| | FY 2005 | FY 2006 | FY 2007 | FY 2008* |
|---|---|---|---|---|
| **Original Committments (US$m)** | 44.5 | 168.9 | 49 | |
| | | | | |
| **Net Committments by Sector (%)** | | | | |
| Financial Sector | 89 | 100 | 39 | |
| General Manufacturing | 11 | | 61 | |
| | | | | |
| **Net Committ by Investment Instruments (%)** | | | | |
| Loans | 96 | 75 | 100 | |
| Equity | 4 | 25 | | |

*As of October 31 2007

## Serbia: MIGA Operations Program

MIGA Outstanding Exposure (Gross Exposure, $ million)

| As of end of fiscal year | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 |
|---|---|---|---|---|---|
| **Sectoral Distribution** | | | | | |
| Finance | 16.9 | 175.0 | 324.1 | 378.3 | 247.9 |
| Agribusiness/Manufacturing/Services | 20.6 | 21.9 | 25.3 | 26.7 | 24.2 |
| Total | 37.6 | 196.9 | 349.4 | 405.1 | 272.1 |
| | | | | | |
| **MIGA's Risk Profile** | | | | | |
| Transfer Restriction | 20.6 | 168.0 | 320.7 | 365.0 | 272.1 |
| Expropriation | 37.6 | 196.9 | 349.4 | 393.0 | 272.1 |
| War & Civil Disturbance | 37.6 | 60.0 | 74.7 | 75.7 | 47.2 |
| Breach of Contract | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | | |
| **MIGA's Gross Exposure in Serbia** | 37.6 | 196.9 | 349.4 | 393.0 | 272.1 |
| **% Share of MIGA's Gross Exposure** | 0.7% | 3.8% | 6.9% | 7.3% | 5.1% |
| **MIGA Net Exposure in Serbia** | 33.8 | 121.8 | 163.8 | 179.5 | 100.5 |
| **% Share of MIGA's Net Exposure** | 1.1% | 3.7% | 5.2% | 5.4% | 3.1% |

MAP SECTION

IBRD 34847


AUGUST 2006