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Federal Republic of Yugoslavia Transitional Support Strategy

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ABBREVIATIONS AND ACRONYMS

BRA	Banking Rehabilitation Agency
CAS	Country Assistance Strategy
CDF	Comprehensive Development Framework
DM	Deutsche Mark
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
ERTP	Economic Recovery and Transition Program
EU	European Union
FIAS	Foreign Investment Advisory Service
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
IDA	International Development Agency
IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
I-PRSP	Interim Poverty Reduction Strategy
MIGA	Multilateral Investment Guarantee Agency
NATO	North Atlantic Treaty Organization
NGO	Non-governmental Organization
PRSP	Poverty Reduction Strategy Paper
SAA	Stabilization and Association Agreement
SEE	Southeast Europe
SFRY	Socialist Federal Republic of Yugoslavia
SME	Small- and Medium-Sized Enterprises
TFFRY	Trust Fund for the Federal Republic of Yugoslavia
TSS	Transitional Support Strategy
TTFSE	Trade and Transport Facilitation Program for Southeast Europe
UN	United Nations
UNDP	United Nations Development Program
UNEP	United Nations Environment Program
UNICEF	United Nations Children's Fund
UNMIK	United Nations Mission in Kosovo
WTO	World Trade Organization

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**Memorandum to the Executive Directors of IBRD and IDA
Transitional Support Strategy for the Federal Republic of Yugoslavia**

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**Memorandum to the Executive Directors of IBRD and IDA
Transitional Support Strategy for the Federal Republic of Yugoslavia¹**

I. Introduction

1. ***The government of the Federal Republic of Yugoslavia (FRY) is committed to a reform program centered on transition to a market economy.*** Federal elections in September (and Serbian elections in December) 2000, brought about a dramatic change in government in FRY, with the Yugoslav people demonstrating through this process their strong desire to break with the past. The new Federal government, led by President Vojislav Kostunica's Democratic Opposition of Serbia (DOS) coalition, came to office with a mandate to pursue modernization, market-economy reforms, and international re-integration. As this paper describes, the government is committed to a decisive program of macroeconomic, structural and institutional reforms that will be the necessary first step to recovery. Concessional assistance from donors will also be essential to set FRY on a path toward stability, sustainable growth and re-integration in the international economy.

2. ***Ten lost years have left a daunting economic and human legacy.*** FRY was formed in 1992 out of the Republics of Serbia and Montenegro as the former Socialist Federal Republic of Yugoslavia (SFRY) was breaking up in civil conflict. Nearly ten years of strife, international isolation, and poor economic management, have left in their wake a collapsed economy, fragile institutions and increased vulnerability. GDP today is less than half its level at the start of the decade. The number of poor has doubled. With decapitalized, state- and socially-owned enterprises, loss-making and deeply mistrusted banks, and over-committed, poorly functioning social safety nets, FRY must now catch up with reforms begun a decade ago by its neighbors in Central and Eastern Europe. The process will be made more difficult by large and mounting fiscal pressures, a crippling external debt, weakened governance, and post-conflict challenges that include rebuilding damaged infrastructure. Ten years of conflict and isolation have also cause severe rents in the social fabric of life. Standards of living have plummeted for most Yugoslavs, and large numbers of refugees and internally displaced people have fled to FRY over the decade, from the conflicts in Croatia and Bosnia and Herzegovina, and most recently Kosovo. The physical, institutional and psychological scars of the decade will not heal quickly.

3. ***As it tackles its economic, social and institutional agenda FRY also faces a number of political challenges.*** The FRY government has re-established relations with its neighbors, ruptured over years of conflict. It also now faces the challenge of clarifying relations within the county, in particular with Montenegro and Kosovo (Box 1). An additional challenge is the recent conflict in several Albanian-majority towns in southern Serbia's Presevo valley, near the administrative border with Kosovo. While a cease-fire was recently agreed, the spillover of this conflict to Albanian communities in the neighboring former Yugoslav Republic of Macedonia demonstrates the region's still-fragile inter-relationships. A further challenge for the government will be meeting the high expectations of the Yugoslav population for rapid change and increasing incomes.

¹ The economic challenges and strategy pertain to FRY excluding Kosovo. A separate *Kosovo Transitional Support Strategy – Progress Report* (R2000-130, June 27, 2000), is under implementation (Box 1 and para. 22).

Box 1. Relations with Montenegro and Kosovo

A critical task ahead will be defining the relationship between Serbia (by far the larger republic, with 95 percent of FRY's 10.6 million population and a similar share of GDP) and Montenegro. Montenegro's governing party has for several years increasingly sought greater independence within a looser federation. While the federal government is nominally responsible for monetary policy, foreign affairs, trade and defense, Montenegro has established substantial *de facto* autonomy, including over monetary policy (in November 2000 the DM became sole legal tender), trade policy and customs. Montenegro also began its structural reform process earlier, assisted by donors.

A longer-term challenge is an eventual sustainable settlement for the province of Kosovo, placed in June 1999 under a transitional UN authority (UNMIK), by UN Security Council Resolution 1244 which ended the conflict there. Under this resolution, Kosovo's economic and reform needs have been supported, separate of FRY, since 1999.

4. ***A strong start has been made on the reform agenda and in mobilizing international support.*** Shortly after taking office, the new governments of FRY and Serbia put in place a stabilization and liberalization program that included controlling inflation through cash-balanced budgets and tight monetary policy, unification of the exchange rate and a start to trade liberalization. The program was supported in December 2000 by an IMF Emergency Post-Conflict Facility. Montenegro had begun stabilization and transition reforms earlier, with donor assistance, in 1998. More recently, FRY has committed to an ambitious reform program for 2001 to be backed by an IMF Stand-By Arrangement (para. 13).² The program aims to address macroeconomic imbalances, reform public finances and restructure the enterprise and banking sectors. To mobilize urgently-needed aid, a first Donor Coordination Meeting was organized in December 2000, where over US\$500 million was pledged for energy, food aid and social protection needs for the 2000-2001 winter. To define medium-term needs, the Bank and the European Commission (EC) were asked to develop with the FRY authorities, a medium-term program for international assistance to FRY (para. 14).³ In addition to joining the IMF, FRY has become a member of EBRD, and has initiated discussions with other international creditors toward normalizing financial relations – a key step in re-integration with the world economy.

5. ***World Bank membership and full financial assistance are next steps in FRY's normalization.*** In October, FRY requested the re-opening of discussions on succession to SFRY's membership in the World Bank – which had ceased in 1993 – and on resolution of its \$1.7 billion in arrears to IBRD.⁴ Given its comparative advantage in providing advice and assistance in support of policy reform, its experience with the lessons of transition, and its mandate to coordinate donor assistance in the Southeast Europe (SEE) region, the Bank has a key role to play in a larger, coordinated donor effort in FRY. Following the government's request, the Bank embarked on a two-phase assistance strategy. Recognizing that membership and arrears resolution would take time to complete, this strategy entailed a first phase that would

² Unless otherwise noted, "FRY" and "the government" refer collectively to the governments of FRY, Serbia and Montenegro. Most of the economic, social and institutional issues raised in this TSS apply to a large extent to both Serbia and to Montenegro; however, where there are important differences, they have been noted.

³ The Bank and the EC were tasked in April 1999 with coordinating international assistance and guiding economic development strategies in Southeast Europe, including Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Federal Republic of Yugoslavia (including Kosovo), the former Yugoslav Republic of Macedonia and Romania.

⁴ FRY's membership would be for the whole country, including Kosovo. A plan for resolution of arrears is among conditions for membership.

enable the Bank to provide analytical and advisory services, including development of a medium-term recovery program, and limited financial assistance under a special Trust Fund for FRY (established by the Board of Directors March 13, 2001).⁵ This phase of assistance is well underway (para. 26). Full assistance was intended to follow in a second phase after membership and arrears resolution. FRY has now met most conditions for Bank membership (with the remaining condition expected to be met soon).

6. ***The philosophy of the program is strongly performance-based.*** This Transitional Support Strategy (TSS) sets a framework for full Bank assistance, and outlines the proposed size and content of a first year (FY02) program. The TSS proposes exceptional temporary IDA eligibility for FRY, with an indicative three-year envelope of US\$540 million, in support of a policy reform-focused assistance program. Use of these exceptional IDA resources will be conditional on strong performance against concrete benchmarks, and the dimensions of the IDA program will be determined against performance benchmarks on an annual basis. Specific conditionality for proposed adjustment operations will be in the areas of fiscal sustainability, private and financial sector development and social sector reform – FRY’s most pressing reform challenges, and issues clearly central to IDA priorities of improving public sector transparency and governance, and creating a strong and robust social sector. A TSS – rather than a full Country Assistance Strategy (CAS) – has been prepared in light of, *inter alia*, FRY’s recent emergence from conflict, the poor quality and reliability of statistics, and concern to move quickly in a setting which requires an agile and coordinated international donor response. An updated strategy would be prepared in a year’s time, either as a full CAS if this is feasible, or as a Progress Report on the TSS.

II. Economic, Social and Institutional Context

7. ***FRY’s transition to a market economy is taking place under difficult economic conditions, particularly in the larger Republic of Serbia.*** As of end-2000, recorded GDP had contracted to about 45 percent of its 1989 level, with per capita income falling to about US\$840-990.⁶ Trade volumes had fallen sharply (with exports and imports both down about 60 percent from 1989 levels), and during the period FRY switched from being a net exporter to being a net importer of food and energy. Under-investment and lack of maintenance have been chronic. These steep declines were caused by the combined impact of nearly ten years of periodic regional conflict, international economic sanctions and the accompanying perceptions of political risk on investment, output and established trade links. The recent Kosovo conflict – which disrupted economic activity and trade and destroyed productive assets – caused a sharp 16 percent drop in GDP in 1999 alone. While economic activity picked up in 2000 (real GDP rose by 6 percent), drought curtailed agricultural production and exacerbated energy shortages,

⁵ *Proposed Trust fund for the Federal Republic of Yugoslavia*, R2001-0018, IDA/R2001-0023, February 16, 2001.

⁶ Calculated using the Atlas Methodology. Data problems hinder providing precise estimates. These problems include the difficulties associated with converting national accounts data from the social product system and a multiple exchange rate regime (the upper end estimate reflects use of a weighted average of market and official exchange rates, while the lower end represents market exchange rate). Moreover, population figures are based on outdated 1991 census figures, which do not include 600,000 refugees, many of whom are expected to become citizens of FRY in the near term. Inclusion of this group would increase the population by 5 percent, thereby reducing estimates of GNP per capita in 2000 to between \$800 and \$940.

dampening recovery. In Montenegro, adoption of the DM and donor support made these impacts relatively less severe.

8. ***Fiscal pressures have built up over the last several years and pose a risk to macroeconomic balance.*** While the consolidated government deficit on a cash basis has been kept relatively low, this has been achieved through unsustainable compression of real spending, accumulation of direct budgetary arrears (e.g., to pension and health insurance funds), non-servicing of public debt, and toleration of quasi-fiscal deficits in the enterprise and banking sectors. (The monetary financing of quasi-fiscal deficits was a primary source of inflation, which reached over 100 percent in 2000.) Scarce budgetary resources have been directed at defense and security expenditures, crowding out spending on social services and other priorities. Budget management has weakened, and substantial spending was off-budget. On the revenue side, a complex and distortionary tax system led to evasion, poor collection and a flourishing gray economy. The greatest single risk to FRY's fiscal and balance of payments sustainability, is the legacy of its crushing external, public and enterprise debt. Foreign debt of around US\$12.2 billion (nearly 90 percent in arrears) reaches 136 percent of GDP. The underlying public debt, including liabilities related to citizens' frozen foreign exchange deposits, is even larger.

9. ***The events of the last decade have left enterprises and banks in crisis.*** The bulk of FRY's real sector is organized as socially-owned enterprises. While this unique structure contributed to SFRY's economic development, it is inefficient and non-competitive. FRY's over 7,500 state, socially-owned and "mixed" enterprises are highly indebted, largely loss-making and accustomed to soft budget constraints. Firms have lost markets, lack access to working capital and have been isolated from technological advances. The evolution of modern, market-oriented ownership structures has been delayed, in particular in Serbia (Montenegro recently began implementing a program of privatization.) A tangled web of arrears has built up among state-owned companies, banks and individuals. While a dynamic and profitable small and medium-sized enterprise (SME) sector exists, it has been constrained by repressive regulation – over licensing, permits, inspections, judicial review – and has been pushed into the informal economy. The banking sector, comprised of around 100 predominantly socially-owned banks (with six large banks responsible for 80 percent of the assets) is largely loss-making. Infrastructure has suffered under-investment and delayed maintenance, as well as some conflict-related damage, particularly in the energy and transport networks. State-owned utilities (in particular power) are in poor financial state as a result tariffs that are inadequate to cover operating costs. Deteriorated coastal water and waste management is a key concern in Montenegro, while there are a number of industrial environmental "hot spots," principally in Serbia. Agriculture has been relatively resilient in the crisis (over 20 percent of GDP and exports in 1999), however, production fell with the drought in 2000, and recovery has been held back by poor price and incentive policies and trade restrictions.

10. ***Social service quality has eroded and systems are over-committed, contributing to fiscal pressures.*** FRY's social services were quite well developed, and human development indicators were among the highest in Central and Eastern Europe at the end of the 1980's (primary school coverage 95 percent, low infant mortality rates). While reliable data are unavailable, there does not appear to have been a substantial decline in these indicators over the decade. Rather, service

quality has eroded and accessibility has fallen, indicating there is serious risk that without investment and reform, indicators will begin to worsen. Moreover, there is evidence of the growing burden of social sector services costs on the poor. Among the highest priorities is reform of social sector financing. Spending on social protection and health reaches around 25 percent of GDP (pension spending alone is 12 percent). Social protection systems in both republics provide entitlements that cannot be matched with available revenues and the systems are generating arrears (although donor assistance in Montenegro has helped to offset social protection costs). The health insurance funds are similarly unable to meet commitments. Education's share of budgeted expenditures, on the other hand – at under 4 percent of GDP – is one of the lowest levels in Europe, leading to a steady degradation of the teaching and learning environment. Recorded unemployment is 30 percent (though the ILO-compatible estimate is lower). This, combined with the increase in poverty over the decade (Box 2), has strained social services – which were not designed to cope with a substantial rise in the number of those seeking assistance. With recent changes in legislation, it is expected that a large number of FRY's 600,000 refugees will seek citizenship, placing an additional burden on social systems. As enterprises and banks are restructured and privatized, FRY's rates of unemployment and poverty are likely to increase, placing further stress on social services.

Box 2. Rising Poverty During the 1990s

The social situation of FRY's population worsened substantially over the decade, and more markedly over the last several years. While data are poor, some preliminary conclusions are possible. Prior to the 1990s living standards were relatively high, and inequality fairly low. Now, about one-third of the population lives in near-poverty, and an estimated 1.3 million Yugoslavs (12 percent) live in absolute poverty – about double the 1990 number. Unemployment seems to be of a long-duration nature symptomatic of rigid labor markets. (While employment in the informal sector provides a coping strategy for many, evidence suggests informal employment is not more prevalent than in neighboring countries.) The unemployed, urban dwellers, the elderly and disabled appear to have a higher risk of poverty, as do the 600,000 refugees and 120,000 internally displaced (around 7 percent of the population) who have arrived in the wake of conflict and economic crisis over the last decade. Regional differences are also important, with higher poverty rates in Southern Serbia and Northern Montenegro.

11. ***Public institutions are weak and require strengthening and reform.*** While SFRY was highly decentralized – its six republics and two autonomous provinces holding substantial powers and responsibilities – FRY during the 1990s saw a centralization of powers, revenue collection and spending authority, with the government intervening directly in markets (e.g., with price and exchange controls) as a means of managing the crisis of conflict and sanctions. This centralization weakened the civil service and local governments (and also provided opportunities for rent-seeking). The new government has taken substantial measures to reverse the government's role by liberalizing prices and the exchange rate, among other reforms. There are high expectations on the part of local governments for a return to a more decentralized fiscal and political structure, however, local governments will need strengthening to manage increased responsibilities. While the “third sector” in FRY is fairly large (with several thousand local NGOs), over the last decade it has been an “anti-government” force; it now must forge productive partnerships with government.

III. The Government's Economic Program

12. ***The government was elected on a mandate of "breaking with the past."*** The Yugoslav people have expressed a strong desire for a fundamental shift away from this economic, social and institutional legacy. The government is committed to a market-oriented economy strongly linked to Europe, based on the lessons of transition in neighboring countries. The FRY authorities have elaborated a vision of a society where sustained, broad-based increases in living standards are generated by a dynamic private sector that leads growth; one that is re-integrated into the international economy, the SEE region and Europe, with good governance and accountable public institutions:

"Our strategic mid-term goals are clear: We want to create an efficient, open market economy, to eradicate corruption, to protect the neediest and to increase sharply living standards. Such a ... FRY would be an important stabilizing factor in the Balkans. Such a country would strengthen South East Europe and ultimately the entire European continent. Our vision for the country closely mirrors what the members of the European Union have already accomplished: democracy and economic prosperity. In addition to an efficient and open economy, we want to have a vibrant civil society ... freed from fear, corruption and misery.... Ultimately, our vision [is] accession to the European Union..."⁷

13. ***As a first step to achieving this vision, FRY is fully committed to a twelve-month stabilization and reform program.*** The program sets ambitious economic and structural objectives and policies for 2001 within a medium-term framework geared to achieving sustainable growth. Macroeconomic objectives for 2001 include: (a) lowering 12-month inflation to 30-35 percent (5 percent in Montenegro, which has adopted the DM as its legal tender); (b) achieving real GDP growth of 5 percent; and (c) containing the current account deficit (after grants) to 7 percent of GDP. In terms of macroeconomic policies, the FRY government will maintain a managed floating exchange rate regime. The general government cash deficit (after grants) will be consistent with limited recourse to domestic bank financing (0.6 percent of GDP) in 2001. This fiscal objective takes into account that severe demonetization of FRY's economy leaves little room for monetary financing of fiscal deficits (in the case of Montenegro, this outcome is dictated by the use of the DM as sole legal tender). Unified federal and republican budgets for 2001 have been prepared. In Serbia, the budget reflects "core" expenditures and an incremental "budget for recovery and reconstruction" that could be funded provided sufficient donor financing is available in the context of a Donor Conference planned for mid-2001. The government is also committed to a number of structural actions and targets for 2001, identified in the context of development with the Bank, the IMF, the European Commission (EC) and EBRD of a medium-term recovery and transition program (para. 14).

14. ***The Economic Recovery and Transition Program (ERTP) provides a broad framework for reforms and donor support.*** As noted, the Bank and the EC have worked closely with the authorities, and other key donors to elaborate a medium-term ERTP (Box 3). This program lays out near- and medium-term policy reform objectives, and provides a framework to guide donors in developing coordinated assistance strategies. The ERTP has been prepared with a view to

⁷ From "Vision for the FRY: Breaking with the Past, Building a Democratic and Prosperous Country," Position Paper for the Donor Coordination Meeting, Dec. 12, 2000.

providing the initial basis for establishment of a Stabilization and Association Agreement (SAA) – the first step for the countries of SEE toward eventual EU accession. It also provides the foundation on which FRY can prepare a Poverty Reduction Strategy Paper (PRSP). There are four closely inter-related areas where major reforms are underway and planned:

- restoring macroeconomic stability and external balance;
- stimulating growth and creating a basis for a sustainable supply response;
- improving social wellbeing of the most vulnerable and building human capital; and
- investing in improved governance and effective institutions.

Box 3. The Economic Recovery and Transition Program

The Economic Recovery and Transition Program (ERTP) outlines a comprehensive structural and sectoral reform agenda and a priority public investment program. It identifies external financing requirements for a three-year period of around US\$4 billion. Its purpose is to support the design, implementation and financing of a program for transition and rebuilding in FRY. It is also intended as a framework for donor assistance (see Box 4), consistent with the CDF approach of coordinated partnerships based on comparative advantage. The ERTP sets out comprehensive diagnosis, policy, investment and capacity building priorities in fourteen areas of the economy: fiscal adjustment; trade reform; poverty; environment; governance; social protection; health; education; private sector development; financial sector development; energy; transport; water and wastes; telecommunications; and agriculture. It distinguishes three assistance phases: (i) a first urgent needs phase (from October through the end of the 2000-2001 winter); (ii) a medium-term 18-24 month recovery phase; and (iii) a longer term (3-4 year horizon) transition phase. The ERTP will be completed and available in May, and will be presented to a Donor Pledging Conference in mid-year.

Restoring macroeconomic stability and external balance

15. *The government is committed to decisive measures to improve public expenditure management, reform tax policy and reduce quasi-fiscal deficits.* The challenges of an ambitious structural reform program, the need to begin servicing external debt and to deal with accumulated arrears are factors that will put strain on the budget. To address these issues, the government has launched a number of measures to enhance transparency and strengthen expenditure management. Budgets for 2001 incorporate all extra-budgetary funds. Cash management and expenditure controls are being strengthened (in the context of technical assistance from the IMF), and a medium-term strategy for expenditure management is under preparation. Power prices in Serbia were raised by 60 percent in April, and further tariff increases (40 percent each in June and October) are planned, which will help control one of the key structural sources of quasi-fiscal deficits. The Serbian government has also begun a bold tax reform, involving a reduction in the number of taxes, a lowering of some tax rates, and widening of the tax base through elimination of exemptions. The sales tax was unified in April from multiple taxes with multiple rates to an individual tax with one rate. Excises taxes were similarly streamlined. In Montenegro, a tax Action Plan to improve revenue mobilization is under preparation. In terms of external debt, discussions with official creditors have begun. Reaching agreement on appropriately concessional debt rescheduling will be essential to fiscal sustainability. Establishment of a supreme audit institution and improved parliamentary

oversight, development of modern treasuries, introduction of further tax policy reform (including a value-added tax), and improved debt management, are also priorities for the government.

Stimulating near-term growth and creating the basis for a sustainable supply response

16. *The government is pursuing ambitious reforms to liberalize trade, spur private sector-led growth and restructure its financial sector.* The authorities are committed to developing a transparent and stable trade regime, and promoting healthy private sector development, competition and reduced barriers to new enterprises and banks. Federal trade legislation has been revised to remove most quantitative and licensing import restrictions. In parallel, work is under way to reform customs rules, prepare for a Stabilization and Association Agreement with the EU – the first step towards eventual EU accession – and obtain membership in WTO, all of which are essential to stimulate healthy export growth and private sector development. In the enterprise sector, near-term reforms are underway in both republics to remove the obstacles (barriers to competition, restrictive labor practices, licensing requirements) which most hinder SMEs, and an SME agency has been set up in Serbia. At the same time, preparatory steps are being taken for more difficult reforms: Serbia's existing legal framework for privatization⁸ is being modified so that 70 percent of enterprise equity will be offered to strategic investors, with a view to establishing clearly-defined and dominant owners. A privatization agency has been created, and preparations are underway to sell 34 "early win" firms to strategic investors with the assistance of international investment bankers by mid-2002. It will also be important to strengthen hard budget constraints for enterprises by removing policy and legal barriers to liquidation and transfer of assets from socially-owned to private firms. In Montenegro, privatization (through international tender, and vouchers for smaller firms) is underway and efforts will focus on accelerating the program. Similarly, in the banking sector, reforms are underway to promote entry of new banks and improve prudential regulations and their enforcement. In tandem, development of a fiscally-responsible strategy to restructure insolvent banks in Serbia (including a time-bound plan to intervene in the largest insolvent banks this year) and efforts to strengthen the Bank Rehabilitation Agency (BRA) to manage the resolution/liquidation process are underway. Rehabilitation of aging and damaged infrastructure networks – in particular energy and transport and water/waste management – and re-start of productive activities, especially in agriculture, has already begun. Continued investment, along with structural reforms will also help remove obstacles to growth.

Improving the social wellbeing of the most vulnerable and building human capacity

17. *In parallel with transition, the authorities' reform program aims to strengthen social services by streamlining spending within a tight fiscal envelope.* Both republic governments have committed to carefully designed, fiscally-sustainable policies and programs to improve the security and welfare of the poorest, and to strengthen education systems to build a more productive and flexible labor force that better meets the needs of a modern market economy. The Serbian government has established education, health care, social safety nets and building human capital as fundamental objectives in its 2001 budget. Reforms in both republics will

⁸ Including laws on privatization, on a shares fund, and on the privatization agency, and ordinances on the privatization program, on public tender, on auctions, on out of court settlement, on business valuation, and on appraisers.

include improvements in the structure, coherence and targeting of social welfare programs. In pension reform, the governments are tackling measures to bring immediate fiscal relief (through changes in indexation) and to reduce structural imbalances (by raising retirement ages). In health care, a health strategy and financing plan are under preparation to eliminate chronic inefficiency by identifying new sources of funding (developing a new co-payments system) and reducing and streamlining expenditures. This should be complemented by a health facilities restructuring plan. In education, the emphasis will be on structural and funding reforms as well as improved primary school coverage (where FRY's Roma community is particularly at risk). It will be important to revive the quality of education by re-equipping schools and providing teacher training. Improving the efficiency of resource use through careful decentralization, and restructuring secondary education to improve labor market links are also priorities. The authorities are reviewing labor market legislation to reduce rigidities (and draw SMEs back into the formal sector). They are also reviewing unemployment benefits with a view to bringing them in line with regional comparators and fiscal possibilities as restructuring progresses.

Improving governance and building effective institutions

18. *The government recognizes strengthening institutions is a key to ensuring that the above measures succeed.* The government is committed to efforts to build capacity (at federal, republic and municipal level, and in non-government civil groups), diagnose and address sources of corruption, build public confidence in government, and develop rule-based governance. A Public Administration Council has been established and is tasked with developing a strategy for public administration reform in Serbia. A capacity-building fund has also been set up to help implement recommended reforms. In the context of 2001 budgets, targets for reduced public sector employment have been established. Strengthening rule of law and judiciary reform will be important to successful transition, and a revised legislation on an independent judiciary is under consideration in Serbia. Other needed measures include professionalizing the civil service by reforming its structure and improving recruitment and remuneration, building on a recent new law on government in Serbia that cuts in half the number of ministries. The government, many members of whom were formerly leaders of or affiliated with NGOs, has also substantially broadened the policymaking dialogue by incorporating participation (which ensures policies most closely match preferences of intended beneficiaries). The government intends to build on this through efforts to educate the public on specific aspects of the reform agenda. Accountability of governance should be further increased by external monitoring of public sector performance. Improving corporate governance will also be important to reform.

IV. Medium-term Economic Outlook and External Financing Requirements

19. *Sustainable growth is achievable in the medium term, however it will depend on continued decisive reforms and substantial concessional support.* Real GDP in 2001 is expected to be about 5 percent, driven by recovery of agriculture and electricity production from last year's drought (underlying industrial growth is projected to be near zero, as the effects of sanctions removal and exchange rate devaluation would be offset by those of recession and tightened macroeconomic policy). Projections assume strong macroeconomic management, a sustained reform effort, well-timed and concessional donor financing of the ERTF, as well as

concessional debt rescheduling.⁹ Under these assumptions, growth could average about 4 percent during the period 2002-2010 (Table 1).¹⁰ However, given FRY's daunting starting point, even under these assumptions of strong reform and concessional assistance, full recovery will take time. Per capita income is expected to reach about US\$2,100-2,200, or about 80 percent of the estimated 1990 level, by the end of the decade.¹¹

Table 1. Key Economic Indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2010
National Accounts									
GDP (US\$ millions) 1/	16253	14353	10338	9015	11413	13092	14219	15362	24538
Real GDP growth (%)	..	..	-15.7	6.0	5.0	4.0	4.0	4.0	4.0
Investment (% of GDP)	..	13.0	11.1	14.3	17.5	19.5	21.0	21.3	22.5
Gross Domestic Savings (% of GDP)	..	3.9	-0.4	-3.5	-0.8	1.7	5.2	6.5	14.1
Public Sector Balance									
Expenditures (% of GDP) 2/	..	..	..	40.3	47.4	49.2	48.9	48.7	44.7
o/w public investment	..	1.3	1.5	1.8	2.9	3.2	3.5	4.0	4.0
Revenues (% of GDP)	..	..	..	39.1	41.2	42.2	41.4	41.8	42.0
Deficit (% of GDP)	..	..	..	1.2	6.2	7.0	7.5	6.9	2.7
External Accounts									
Exports of goods and services (% change)	..	..	-35.0	22.2	10.0	13.0	14.5	10.0	8.0
Imports of goods and services (% change)	..	..	-30.5	28.6	20.4	10.7	6.1	6.0	5.1
Current account balance	-1164	-480	-690	-400	-712	-1268	-1297	-1324	-1209
as % of GDP	-7.2	-3.3	-6.7	-4.4	-6.2	-9.7	-9.1	-8.6	-4.9
Indebtedness									
TDO/XGS	..	..	..	333.4	254.2	182.4	179.2	178.1	152.8
TDO/GDP	..	..	..	136.1	88.2	62.9	65.2	66.4	62.6
TDS/XGS 3/	..	..	..	2.3	8.2	14.8	14.3	15.7	14.9
Prices									
Retail price inflation (p.a.)	18.5	29.8	42.4	71.8	80.9	20.0	12.0	7.0	5.0
Real interest rate (e.o.p.) 4/	51.9	25.1	3.3	0.0	28.1	11.3	7.5	4.9	4.0

1/ GDP estimates include Kosovo. The economy of Kosovo is estimated to be about 6 percent of the total FRY economy.

2/ Reported on a commitments basis, but excluding accumulated arrears on external debt.

3/ Exports exclude workers' remittances.

4/ Annualized short-term lending rate. Rate in 2000 is for August.

20. Export performance will be essential to growth and external balance. The sustainability of FRY's external position depends on a rebounding of exports. Starting from especially low levels, export recovery is expected to take longer than recovery of GDP. Some limited initial growth can be expected to come from existing capacity coupled with the impact of the removal of sanctions and short-term policy improvements. More rapid and sustained export growth will require increasing domestic supply capacity through the upgrading of obsolete machinery and

⁹ For illustrative purposes, projections assume debt relief and rescheduling on highly concessional terms (i.e., 67 percent reduction of the net present value of debt) from official and commercial creditors in 2001/2002.

¹⁰ Table 1 shows historic data for 1997-2000, and projections from 2001-2004, and 2010.

¹¹ It should be noted that a large part of the increase in US dollar growth reflects the impact of real appreciation of the exchange rate from the recent very low levels.

equipment and key repairs to public infrastructure. This is expected to come over time through easier access to capital and inputs, foreign direct investment, and increasing integration into the regional and EU economy (where the SAA process will be important), and the global economy more broadly (through membership in the WTO). The current account deficit is projected to rise from US\$400 million in 2000 to US\$1.3 billion in 2004.

21. ***Medium-term growth will depend on increasing the efficiency of investments.*** In the early years, important support will come from donors through their assistance to the energy, transport, agriculture and financial sectors, and through their provision of credit lines, in association with the ERTF. Reflecting this, public investment is projected to grow in the years ahead, from an unacceptably low 2 percent of GDP in 2000 to a still relatively modest 4 percent in 2004, largely financed from external sources. But in order to ensure sustainable growth, private sector investment will need to increasingly represent a larger share of overall investment. Increased private sector investment is expected to be brought about by the government's program of reforms aimed at improving the enabling environment for domestic and foreign investors, enterprise privatization and bank restructuring. Assuming strong progress on these fundamental reforms, private investment is expected to rise from 12 percent of GDP in 2000 to 17 percent in 2004.

22. ***External financing requirements will remain large in the near term.*** With physical rehabilitation needs and the rising cost of debt service following rescheduling, FRY is expected to have substantial financing requirements in the next few years. Assuming strong reform performance and adequate concessional financing of the ERTF (along with concessional debt rescheduling), the financing gap in 2001 is expected to reach about US\$1.1 billion. Of this total, about US\$550 million has already been committed by donors and will be spent this year on urgent needs, or has been pre-announced by donors. A further US\$550 million remains to be financed. Of this total – subject to the approval of their respective Boards of Executive Directors – some US\$300 million could come from the IMF and the World Bank. The remainder would need to be mobilized by other donors at the mid-2001 Donors' Conference. In terms of Serbia's budget gap, it will be particularly important to ensure that a program of "core" essential needs is fully financed. Adequate donor funding will also be sought for an incremental "recovery and reconstruction budget." Over the following three-year period, the remaining average annual gap (after donor contributions for physical investments and technical assistance) is expected to total about US\$500-600 million per year. This gap is expected to be covered by support from the IFIs, the EU and bilateral donors.

23. ***Low-case scenarios demonstrate the sensitivity of FRY's situation to delays in the reform effort and external assistance.*** There are a number of internal risks that could cause the reform effort to be delayed, for example by the relatively untested implementation capacity of the new government, or resistance to reforms from vested interests. In the case of a delayed or weaker-than-expected reform effort, the policy framework would stagnate, and donor programs could be expected to be less generous and have a smaller impact. Real GDP growth under this scenario is likely to slow to around 1-1.5 percent per year. Private investment would be cut as enterprise restructuring prospects decline, and exports would fall. Debt indicators, in particular, would worsen, due to lower GDP and export growth, and FRY's debt burden could become unsustainable. On the other hand, a low case could also arise from developments exogenous to

FRY, such as a substantial global economic slow-down, particularly in Europe. This would be likely to lead, despite the government's best reform efforts, to reduced demand for FRY's exports and reduced foreign investment. In such a scenario it would be doubly important to ensure donor support is provided. If not, imports would fall, reflecting the smaller amount of external financing. Real GDP growth could be expected to slow to around 1-1.5 percent, as under the previous scenario. As donor funding waned, low capacity to import capital and equipment would lead to reduced investment in industry and infrastructure. Lower overall levels of investment would slow the increase in employment, creating more persistent poverty. Lower donor spending on social programs would exacerbate this effect. These illustrative scenarios indicate the importance of both a sustained reform effort and strong donor support – and the extent to which the effects of both are inter-linked.

V. Proposed World Bank Group Assistance

24. ***External and institutional factors provide the strategic context for Bank assistance.*** This TSS sets out a framework for Bank support to FRY, and makes a specific proposal regarding the size and scope of a first year (FY02) program. Bank support to FRY is shaped by a number of considerations, including the relative importance of FRY in the SEE region, the current circumstances in the country, and constraints on the availability of resources.

- **FRY within an enhanced SEE regional focus.** Over the last decade, international focus on the SEE region as a cross-roads on the European continent has increased – in particular in the context of the Stability Pact which aims to stimulate economic and democratic reforms by spurring closer integration of the countries of the region with Europe. For a decade, FRY has been the “missing link.” The years of conflict and sanctions dampened growth in the whole region, as instability, political risk and disrupted trade and transport routes curtailed investment and trade.¹² A prosperous FRY, on the other hand, will bring benefits not only to the country but also to the broader region. Thus the Bank's efforts in FRY have broader regional implications, linkages and benefits, and should be seen in this context.
- **Coverage of the TSS for FRY.** This TSS addresses all of FRY, with the exception of the province of Kosovo. The reason for this is, as noted, is that the Bank's assistance strategy for Kosovo – consistent with other donor efforts – is handled under a separate Kosovo TSS and a special trust fund implemented by UNMIK, under UN Security Council Resolution 1244. Bank support to Kosovo through FRY cannot now be envisioned for political and practical reasons.¹³ The validity of this approach will be regularly reviewed, including in the full CAS for FRY. At the same time, the present TSS treats Serbia and Montenegro relatively autonomously – reflecting both the *de jure* as well as *de facto* locus of economic decision making. Because of its substantially larger size and greater needs, the Bank's primary focus is on Serbia in this TSS. However, support to the two republics will be provided on an equitable basis (para. 27 and Annex I).

¹² *The Road to Stability and Prosperity in Southeast Europe: A Regional Strategy Paper* (2000), The World Bank.

¹³ In the near term, financing options for continued support to Kosovo would be considered. A change in strategy could be considered provided factors were in place that clarified Kosovo's status, its relationship with FRY, and the intentions of the FRY and Kosovo authorities regarding modes of external assistance.

- **Resource availability.** Given its weakened economic situation and lack of creditworthiness on one hand – but its demonstrated commitment to reform and ability to use resources effectively on the other – it is proposed that FRY be granted exceptional, temporary IDA eligibility following membership and resolution of arrears.¹⁴ In view of the country’s large financing needs in the short to medium term (para. 20), an IDA-financed lending program amounting to US\$540 million over the three-year FY02-04 period is proposed.¹⁵ Given the urgency of the need for support, it is proposed that this assistance be “front-loaded,” with up to US\$200 million as an indicative allocation for FY02, depending on performance. Subsequent IDA allocations (US\$180 million in FY03 and US\$160 million in FY04, in indicative terms) would be determined through an annual review that evaluates progress under the reform program based on performance benchmarks (para. 29 and Annex II). IBRD lending is expected to resume once the country’s creditworthiness improves. FRY could conceivably become eligible for IBRD loans within the next three to five years, if its debt ratios improve, its macroeconomic position stabilizes and sufficient progress is made on structural reform to underpin stability and encourage private investment. As shown in the projections (para. 19-23), successful mobilization of sufficient donor resources, and the conclusion of favorable debt agreements with official and commercial creditors will also be essential.

25. **Selectivity, ownership and coordination will guide Bank strategy.** This TSS has been formulated based on: (a) consultation with FRY authorities; (b) the lesson of experience, both with transition in the ECA region and with exceptional financing efforts in other post-conflict countries and territories; (c) the plans of other donor partners; and (d) extensive early analytical work carried out in the context of the E RTP. In light of limited Bank resources, and the larger donor program in which the Bank Group is a partner, our support will be highly selective. The strategy will build on the Bank’s comparative advantage, through its experience and capabilities (for example, in providing lessons of global, or regional policy and project experience). A number of other donors will be more heavily involved in rehabilitation of infrastructure networks, provision of lines of credit and support for local government services (Box 4). Given the interests of other donors in providing this largely investment support, and the Bank’s comparative advantage in policy advice in the key areas of FRY’s reform agenda, the Bank program for FY02-04 will focus on policy reform, with up to 80 percent of commitments in the form of adjustment credits. This level of adjustment lending is in keeping with the government’s commitment to an ambitious macroeconomic and structural reform program agreed with the Bank and the IMF (under which the first steps have already been taken). This level of support will also – in light of large projected fiscal and external financing requirements, even after careful expenditure streamlining, improved budget management, and measures to enhance revenue mobilization (para. 22) – be critical to the success of the reform program. The Bank’s policy advice and assistance will build on lessons learned in providing such support to other

¹⁴ An IDA Eligibility Note presents the case for temporary exceptional IDA eligibility for FRY, noting that it is in keeping with the IDA 12 replenishment report, which permits, on a limited and exceptional basis, IDA eligibility “for countries with a per capita income between the operational and historical cut-offs that are not creditworthy for IBRD borrowing.” Projections suggest that FRY’s GNP per capita will exceed the current historical cut-off of \$1,445 in 2005-06. It is thus proposed that FRY be considered eligible for IDA resources through IDA 13.

¹⁵ This translates into US\$18 per capita per annum (pcpa). This indicative amount represents about 14 percent of the overall three-year Economic Recovery and Transition Program external financing requirements of about US\$4 billion, to which multilateral and bilateral donors will be contributing.

transition countries in the region over the past decade. Reflecting our two-phased strategy, the program of Bank assistance (Annex I) is comprised of two elements: (a) pre-membership assistance; and (b) full support after membership and resolution of arrears.

Box 4. Donor Involvement in FRY

Over 20 multilateral and bilateral donors are providing, or have expressed interest in providing, developmental assistance to FRY. This assistance is largely channeled through bilateral aid agencies, NGOs or other local groups, directly to the government(s), or co-financing with multilateral institutions. Some US\$500 million was pledged for urgent needs at an initial Donor Coordination Meeting in December 2000, and an additional US\$1.3-1.5 billion in funding is expected to be sought at the planned mid-2001 Donor Conference. While a number of donors are providing assistance for physical investments, the number of donors able to provide quick-disbursing funding backing policy reforms is small (the Bank, the IMF, the EU and a few bilateral donors). While the precise assistance levels of donors for 2001 are not known at this stage (and will not be known before the planned mid-2001 Donor Conference), an indicative view of the scope of donor support in various areas can be determined by data on current activities and intentions of multilateral and bilateral donors:¹⁶

- **Multilaterals :** EU: Infrastructure (energy), agriculture, SMEs, health ; **EIB :** Infrastructure ; **EBRD:** Infrastructure, Private/Financial sector development, Microfinance; **UNDP:** Governance/Public Administration; **UNICEF:** Health/Education; **UNEP:** Environment
- **Bilaterals:** **Infrastructure:** Czech Republic, Italy, Greece, Switzerland; **Economic Policy and Management:** Canada, UK; **Governance/Public Administration:** USA; **Private Sector Development:** USA **Financial Sector Development:** Germany, UK, USA; **Energy:** Canada, Germany, Sweden, Switzerland, USA; **Agriculture:** Netherlands, Japan, UK, USA; **Social Protection/Labor markets:** Canada, Denmark, Italy, Greece, Norway, Japan, Switzerland, Sweden, UK, USA; **Health/Education:** Austria, Germany, Greece, UK; **Environment:** Czech Republic, Denmark, Finland, Netherlands, Switzerland.

26. *Pre-membership assistance.* The objective of this early assistance has been to provide timely analysis and advice in the definition of an economic reform agenda – the ERTTP discussed in para. 13 – which will be completed in May. The Bank has also sought to coordinate with donors and raise early urgently-needed funding, and to provide limited financial assistance to prepare the ground for more ambitious reforms. Under the recently-approved TFFRY five projects are under preparation, specifically: (a) technical assistance to build the capacity of the Serbian privatization agency, undertake up to 34 “early win” enterprise sales to strategic investors, and support measures to improve the investment climate; (b) technical assistance to strengthen Serbia’s Bank Rehabilitation Agency and to develop and implement its bank resolution strategy; (c) a social protection grant to meet near terms needs, catalyze donor support, improve the sustainability of social protection systems and begin social protection policy reform; (d) a small power rehabilitation project, complementing a larger EU-funded program, that will help restore badly-needed generation capacity for next winter; and (e) a small coastal water and waste management project in Montenegro to help prepare for tourism development, expected to be a key driver of growth. Preparation of all projects is well advanced and approvals are expected in the period May-July.

¹⁶ This data is intended to be illustrative, not comprehensive or inclusive (and does not include data from Montenegro, although many of the same donors have programs there). Following the mid-2001 Donor Conference, precise data on donor support will be available. Source: Serbian Development and Aid Coordination Unit.

27. **Full assistance program.** Following membership and arrears resolution, the Bank will be able to provide full-scale assistance. As noted, the focus of Bank assistance will be on policy reforms supported by adjustment lending and strong technical assistance, and performance benchmarking. The Bank will undertake highly selective investment lending, where we can maximize policy reform and institution building and where regional aspects, coordination of sectoral policy, client ownership, and transparency are critical. Many development challenges are common to both Montenegro and Serbia. But due to their differing starting points and needs, the programs for the two republics are expected to be fairly separate, e.g., either separate components within the same operation or separate operations (Annex I). Limited resources, and the need for appropriate sequencing, necessitate an intensive focus on a select number of highest priority activities. The program for FY02 under this TSS aims primarily at near-term measures needed in the critical areas of fiscal adjustment, private and financial sector development, and social sector reform (see below). The Bank will also support efforts in the areas of modernizing social services, and improving governance and public sector reform, however, these will largely be preparatory to more substantial reforms to be supported in FY03 and thereafter.

- **Analytical and Advisory Assistance.**¹⁷ After ten years of absence from FRY, there is a critical need for the Bank to develop analytical work – and a demand from FRY for such joint efforts. The multi-sectoral ERTF provides an important baseline. The Bank will focus in FY02 on three core pieces of economic/sector work, all of which build on substantial collaborative work already undertaken through the ERTF. First, we will prepare a **public expenditure review** to assess and determine priorities for public expenditure at the republic level. **Country financial and procurement assessments** would also be undertaken as a part of this exercise. Second, we will prepare, jointly with IFC and EBRD, a **private sector development strategy**. Third, **poverty-focused household survey** work will be launched, preparatory to a planned Interim Poverty Strategy Paper in FY02 (and a full poverty assessment/Poverty Reduction Strategy Paper in FY03). A small legal/judicial diagnostic study is also planned.
- **Adjustment lending.** The FY02 program would focus on two **Structural Adjustment Credits** during the year. Adjustment lending under this TSS would be conditioned on the authorities' macroeconomic and structural program, supported by the IMF (para. 14), remaining on track. Specific conditionality will be developed for each proposed adjustment operation, consistent with this program and building in part on analytical work under preparation (Annex II). In this way, the Bank's response will be commensurate with the actual reform effort. A first adjustment credit will focus on improving **fiscal sustainability and transparency**, including strengthening of public expenditure management, reform of social sectors, and control of quasi-fiscal deficits. Specific measures are likely to include: increased power tariffs in Serbia along with an explicit budgetary subsidy to the power operator (reducing one of the largest sources of quasi-fiscal deficits); agreed federal and republican budgets that integrate off-budget revenue sources and funds; development of a medium-term public expenditure management strategy, including further reforms in budget

¹⁷ In the context of the Stability Pact for SEE, there are also a number of initiatives supported by the Bank, with other partners, on a regional level – including an Anti-Corruption and Transparency Study and a Regional Trade Study – that involve FRY.

monitoring and execution; further progress on tax reform; and reforms in the pension systems and health care financing. A second structural adjustment credit will focus on **transition** reforms, and would support improvements in the investment climate, enterprise privatization, banking reform and labor market reforms. Specific measures would be likely to include: revised FRY trade legislation; a revised framework for privatization in Serbia; privatization of a targeted number of firms in Serbia and Montenegro; preparation for privatization of large holdings (“systems”) and utilities; and continued administrative and legislative measures toward a more conducive investment climate; improved prudential regulation and enforcement; an agreed timetable for implementation of a bank resolution strategy; and labor reform to help bring firms back into the formal economy.

With particular regard to strengthening the fiduciary framework, the FRY authorities have worked closely with the IMF on improving budget management and control measures. Implementation of these measures is an integral part of the reform program supported by the IMF. In the design of specific adjustment operations the Bank will take account of the lessons learned in financial and fiduciary control in transition and post-conflict settings (e.g., Russia and Bosnia and Herzegovina). In addition, as noted, a PER is under preparation and will include a country financial assessment. Finally, a senior Financial Management Specialist will be placed in the Bank office in Belgrade (para. 28) to ensure appropriate fiduciary review and follow up of all lending operations.

- **Technical assistance.** In order for reform measures to be well-prepared and implementable, it will be important to ensure FRY has technical assistance to develop strategies, draft legislation, and build capacity. The **banking and enterprise** technical assistance projects funded under the TFFRY are designed to begin this process. In addition, a similar technical assistance credit for **social sector** reform in the social protection, education and health sectors is planned. The Bank would also seek IDF financing for possible grants to strengthen **statistics and debt management**. Finally, post conflict grant funding to contribute to the government’s **capacity building** fund may be sought, and could support efforts to improve public education and dissemination of the reform effort.
- **Investment Operations.** Based on strong interest from the FRY authorities, the ongoing regional **trade and transport facilitation** (TTFSE) program for SEE would be expanded to FRY (the only country of the region not part of the program), to strengthen customs administration with the goal of reducing smuggling and improving the efficiency of revenue collection. A small **trade facility** would promote trade-related transactions, with an export-support component providing credit insurance, working capital and performance guarantees for exporters, along with technical assistance (which has worked well in other countries in the region). Up to two additional investment (one each in Serbia and Montenegro) operations are planned. These would be selected among projects for which demand on the part of the government is high, Bank experience in the region with similar projects is strong, donor co-financing can be mobilized, and where policy formulation and investment needs come together, matching the Bank’s comparative advantage. These would be defined with the government following the mid-2001 Donor Conference, when greater details on donor programs are available. These are likely to be in the social and/or infrastructure sectors. Limited preparation of possible FY03 operations would also be initiated during FY02.

- **IFC and MIGA.**¹⁸ The Bank Group has developed a PSD strategy in close coordination with EBRD. There is strong partnership between the institutions. IFC, MIGA and the Bank have also developed their respective assistance programs in a synergistic manner. IFC expects to build a substantial investment and advisory program (once FRY becomes a member of IFC and its arrears have been resolved). IFC has commenced initial assessment work, and is focusing on: (i) the financial sector; (ii) SMEs, which can potentially be a leading source of transformation and growth; (iii) certain sectors with high potential, including agro-processing, garments, pharmaceuticals and information technology; (iv) selected large-scale interventions which may include refineries and petrochemicals; (v) advice on model privatization transactions, probably in utilities; and (vi) post privatization finance of enterprises. It has mobilized a US\$1.5 million donor-funded technical assistance facility to support the review of investment prospects. IFC is collaborating closely with the Bank, and expects to complement its policy work in key areas, including the financial sector and enterprise privatization. MIGA expects to be able to support FRY (once membership in MIGA is established) through political risk insurance. A number of applications have already been received. MIGA and FIAS will also assist FRY in establishing an investment promotion agency. FIAS has also provided substantial guidance to FRY on its revised foreign investment legislation, and also plans to conduct a barriers to entry study
- **Aid Coordination.** The Bank will continue to play a strong role in donor coordination. The government places great importance on efficient use of scarce donor resources, preventing gaps and overlaps, and ensuring all donor support fits within the identified priority program. Aid coordination units have been established in both republics, as focal points for donor assistance. The Bank will continue to work closely with these units, including preparing for the mid-2001 Donor Conference. To do this, we will work both through the Bank's resident office (para. 28), and the Joint Office (with the EC) in Brussels. Primary counterparts for aid coordination will be the republic-level aid coordination units. A second Donors Conference, and an update of the ERTP, are tentatively planned around the end of the FY02.

28. **Expanding the Bank's field presence to ensure effective implementation.** Consistent with our pre-membership strategy, in January 2001 the Bank opened a small "mission support unit" that has been the center for coordination of the Bank's activities in FRY. The objective of this office has been: (a) providing support to visiting missions, in particular the early missions associated with the preparation of the ERTP; (b) liaising with government on development of policy reforms and programs; (c) coordinating with donors in the field on program development; and (d) interacting with the domestic media and other stakeholders to gradually re-introduce the Bank to the FRY public. In the context of membership, this presence would be substantially expanded and upgraded to a Bank country office. The role and function of the office will incorporate these core activities, and will expand to include the capacity to manage safeguard functions, including financial management and procurement, as well as project implementation. IFC also expects to establish a field presence in Belgrade, with support from its regional hub in Istanbul, in order to ensure that it stays abreast of FRY's development priorities and that its program is effectively in line with these priorities.

¹⁸ Membership discussions with IFC are underway and are expected to be concluded shortly following membership in the Bank. Membership in MIGA is also expected in the near term.

29. *Performance monitoring will be a key part of the program.* A number of performance benchmarks for this TSS have been developed that will enable FRY to establish a track record on policy reform in each of the four key areas – macroeconomic stability, private sector development, social sustainability and governance (Annex II). Good progress with respect to the benchmarks in the areas of macro stability and private sector development – the primary areas of program focus in FY02 – would be essential to moving forward with continued exceptional IDA. Over the course of the next year, we will develop, working closely with the authorities, a more complete set of country performance indicators. In parallel we will develop a framework for monitoring Bank performance against strategic objectives, as well as the government’s performance against ERTTP objectives. These monitoring tools would be set out in the next strategy document – either a full CAS or a TSS Progress Report – to be prepared in late FY02.

VI. Risk Management

29. There are several risks to a Bank-supported program that are associated with economic developments – stemming from either a delayed or inadequate policy response, or insufficient donor support – that are similar to the risks facing the government and donors in the broader ERTTP (para. 23). The Bank’s strategy has been designed to focus on policy reform, as well as strong donor coordination – and thus seeks explicitly to minimize, to the extent possible, these risks. There are also a number of political risks to the Bank’s program in FRY. Where possible, mitigation measures and strategies have been built in.

- Compliance of the FRY government with international agreements (notably, with the International Criminal Tribunal for the former Yugoslavia and the Dayton peace accords) is being held by numerous partners as a test of the government’s willingness to abide by international obligations. Failure to live up to expectations could lead some donors to seek a slower donor assistance response, affecting FRY’s economic growth prospects similarly to the impact outlined in the low case scenario. This risk, which is difficult to mitigate, could also slow the pace of approval of Bank-supported operations.
- An internally-driven political risk stems from developments with respect to Montenegro. The governments of FRY, Serbia and Montenegro are in the process of discussing a revised “platform” for greater autonomy for Montenegro within FRY. Montenegrin Parliamentary elections April 22 is likely to lead to clarification over the government’s previously-announced intention to hold a referendum on independence. The design of the strategy and program takes into account the substantial autonomy of the two republics. However, in the event Montenegrins opt for independence, the Bank’s strategy would need to be revisited.
- A regional political risk stems from conflict in southern Serbia, which recently spilled over into Macedonia. The Yugoslav Army, by agreement with NATO, has begun patrolling this portion of the FRY border. If the conflict were to escalate, this could take the FRY government’s attention from the reform agenda, and slow the pace of reform implementation. However, the more serious risk would be that a wider conflict in Macedonia would dampen growth prospects for FRY and for the region as a whole. In either case, the outcome could be similar to the illustrative low-case scenario. This risk is difficult to mitigate.

30. On balance, the risks are outweighed by the benefits to be derived from the Bank joining other international partners in assisting FRY's long-awaited economic recovery, and its re-integration into the regional, European and international economy. Recovery will be difficult, and will require a substantial effort both on the part of FRY and its international partners. However, recovery and re-integration will have tremendous benefits. These benefits will be felt not only by the Yugoslav people, who have endured ten lost years, but also by the populations of Southeast Europe, and Europe more broadly, since FRY's economic recovery will enable it to become a factor of stability – rather than instability – in the region. The Bank has a key role to play in this coordinated international effort.

James D. Wolfensohn
President

By Sven Sandström

June 26, 2001
Washington DC

**Federal Republic of Yugoslavia - Transitional Support Strategy (FY02)
Proposed Lending and AAA Program**

Phase I: Pre-Membership – end FY01 through early FY02		
Grants from TFFRY/ (Beneficiary)*	Amt. (US\$ M)	Analytical and Advisory Assistance
PSD TA (S)	6	<ul style="list-style-type: none"> • Multi-sectoral Economic Recovery and Transition Program (and informal sector reports) • Donor coordination meeting (Dec. 2000) • Donor conference (mid-2001) • Membership paper and transitional support strategy
Banking sector TA (S)	6	
Energy rehabilitation (S)	6	
Social protection/TA (S)	10	
Montenegro water (M)	2	
Total	30	
Phase II: Post-Membership and Arrears Resolution – FY02		
IDA Credits/ (Beneficiary)*	Amt. (US\$ M)	Analytical and Advisory Assistance
SAC I – Fiscal (S, M)	Up to \$160 for SAC I & II	<ul style="list-style-type: none"> • Public expenditure review (with country financial and procurement assessments) • PSD strategy (with IFC and EBRD) • Poverty household surveys • Assistance with I-PRSP • IDF grant (statistics) • IDF grant (debt management) • Country assistance strategy (FY03-04) • Donor meeting (mid-2002) • Legal diagnostic survey • Barriers to entry study (FIAS)
SAC II – PSD (S, M)		
Social sector (S)	10	
Trade facilitation (FRY)	10	
TTFSE (FRY)	5	
Up to 2 additional (1 each S and M)**	15	
Total	200	

NOTES:

* Beneficiaries would be either Serbia (S), Montenegro (M), Serbia and Montenegro with separate components for each (S, M), or the federal government (FRY). Projects would benefit FRY in those cases where the project supports federal functions. Otherwise, most projects are expected to benefit one or both republics.

** To be determined with the government, following the mid-2001 Donor Conference, depending on need, Bank comparative advantage, and funding availability.

Federal Republic of Yugoslavia
Transitional Support Strategy (FY02)
Matrix of Development Objectives, Bank Program and Performance Benchmarks

Objective	Bank Program	Performance Benchmarks (to be completed in 2001 unless otherwise noted)
Restoring macroeconomic stability and external balance	<u>Lending</u> : SAC I (fiscal sustainability); <i>AAA</i> : <i>Public Expenditure Review</i> (with CPAA and CFAA); debt management TA; statistics TA; <i>Economic Recovery and Transition Program</i>	<ul style="list-style-type: none"> • <u>Macro</u>. [FRY] Government's macroeconomic program, supported by IMF, on track • <u>Public expenditure management</u>. [FRY and republics] Unified, agreed budgets (A); and improved budget execution monitoring systems; [Serbia] Substantially increased power tariffs; preparation of <i>medium-term expenditure management strategy</i> • <u>Tax reform</u>. [Serbia] Tax (sales tax, excise) unification and simplification (A), elimination of exemptions; [Montenegro] Tax Action Plan, comprehensive tax code • <u>External debt</u>. [FRY] Concessional rescheduling of official (2001) and commercial (2002) • <u>External financing</u>. [FRY] Mobilization of sufficient foreign assistance for ERTTP (annually)
Stimulating near-term growth and creating the basis for a sustainable supply response	<u>Lending</u> : SAC II (transition reforms); PSD TA (TFFRY); banking TA (TFFRY); power rehab (TFFRY); coastal water (TFFRY); TTFSE <i>AAA</i> : <i>PSD strategy, FIAS barriers to entry study</i> <u>IFC, MIGA, FIAS</u> programs	<ul style="list-style-type: none"> • <u>Trade</u>. [FRY] Revised trade legislation (A); government-approved customs reform plan • <u>Private sector development</u>. [Serbia] New foreign investment law; revised privatization legislation; establishment of privatization agency (A); 1 large and 1 pool of 6 medium firms offered for sale; 3 large and 4 pools offered for sale (Jul 2002); [Montenegro] New company law, bankruptcy law • <u>Banking</u>. [Serbia] Preparation of <i>strategy for intervention in insolvent banks</i>; intervention in large insolvent banks; new prudential legislation and enforcement manual • <u>Utilities</u>. [Serbia] New energy policy, new electricity and regulatory laws • <u>Labor</u>. [Serbia] Revised law on labor relations
Improving social wellbeing of the most vulnerable and building human capacity	<u>Lending</u> : SAC I (fiscal sustainability); social sector credit; <i>AAA</i> : <i>Poverty household surveys</i> ; Public Expenditure Review	<ul style="list-style-type: none"> • <u>Social protection</u>. [Serbia] <i>Draft social protection strategy</i>; new social welfare legislation (Mar 2002); revised pension law (Mar 2002) • <u>Education</u>. [Serbia] <i>Draft decentralization strategy</i>; increased share of spending on education • <u>Health</u>: <i>Health reform strategy and financing plan</i> (new health insurance law, co-payments system) • <u>Poverty</u>: [FRY] Preparation of Interim Poverty Reduction Strategy
Improving governance and building effective institutions	<u>Lending</u> : Structural Adj. Credit (fiscal sustainability); p-c grant; <i>AAA</i> : Legal diagnostic study	<ul style="list-style-type: none"> • <u>Civil service reform</u>. [Serbia] New law on government (A); <i>public administration reform strategy</i> • <u>Judiciary</u>. [Serbia] New law on independent judiciary

Note: Italics designates key analytical tools, the preparation of which will assist in the further definition of more specific reform targets, including specific conditions for proposed adjustment credits. (A) denotes actions completed.