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The Platform for Reaching National Consensus

The G 17 PLUS Platform for Reaching National Consensus comprises ten issues of key importance for the reorganization of the state and successful continuation of economic reforms. The Platform contains the description of the present situation with respect to each issue and defines goals and proposes of measures for reaching these goals. The Document has been distributed to all member parties of the original DOS coalition, to trade unions and the Serbian diaspora, together with the G 17 PLUS initiative for a series of discussions on all relevant issues.

The Platform was inspired by the necessity of clearly defining the national interests of Serbia through reaching the widest possible consensus which would replace the growing conflicts on the Serbian political scene. In that respect, the most realistic form of implementation is a series of discussions with various participants on all or some of the open issues.

The fundamental national interest of Serbia is to become part of European integrations. However, a clearly formulated state strategy is a *conditio sine qua non* for getting closer to the family of European states. It should primarily involve two key processes - the continuation of economic reforms and the adoption of the Constitution which guarantees individual freedoms and uncontestable individual rights.

In the process of the continuation of reforms, it is necessary to pay attention to their social sustainability. Balance in this area can be achieved through social agreement between unions and relevant political factors. As far as the new Constitution is concerned, one issue may appear hard to resolve, i.e. territorial organization of power and the consequent constitutional status of Kosovo and Metohija.

The most efficient way for overcoming the deepening political and institutional crisis in Serbia at present is to recognize key state issues, as well as to formulate clear strategies for resolving them without political conflicts which threaten to further disrupt the state. The G 17 PLUS Platform is an initiative for discussions and a broad basis for reaching national consensus, with primary emphasis on the interests of the state and citizens and on necessary political stability.

National Consensus

On the 10 most important issues

Issues	Present situation	Goals	Measures
1. Continuation of economic reforms	•The country is halfway in the transition to a market economy (which corresponds to the process of EU accession) •Social costs and unemployment (underemployment) are major concerns •Public support for reforms is much lower than in 2001	•The second phase of the transition	•Medium-term program of structural reforms •Social dialogue and social security • A three-year social agreement between the government and trade unions

Issues	Present situation	Goals	Measures
2. National issue	•Serbs are living in different states, while homelands of national minorities are in the neighborhood •Strained relations between the Serbian Diaspora and Serbia proper • Integration of minorities (without assimilation) is still under the threat of secession •Everybody is worried about losing identity in the process of Europeanization	•All Serbs and national minorities live in one community without borders	•Unification of Serbs and national minorities with their homelands within the EU integration process •Action plan for cooperation between Serbia proper and the Diaspora •Constitutional guarantees of minority rights and freedoms •A new territorial organization of the state (asymmetrical autonomy of two provinces and creation of regions governing police, education, culture, etc.)
3. Country's international position	•The October 2000 reputation has not been preserved •UNSC's allegations of failure to fulfill the obligations relative to the cooperation with the ICTY	•To re-establish the country's reputation abroad	•Strict implementation of the Law on cooperation with the ICTY • Empower domestic judiciary to process potential new war crime charges • Partnership For Peace

Issues	Present situation	Goals	Measures
4. Relations with Montenegro	•A confederation in practice is an impediment to EU integration and international representation	•The state must be functional	•Set the deadline for harmonization •If harmonization falls short, protect the national interests of Serbia (a new constitution should ensure its independence and separate accession processes to EU and WTO)
5. Kosovo and Metohija	•Inefficient protection of Serbian population, the UNSC 1244 Resolution has hitherto not been in effect •The current process is leading to independence of Kosovo and Metohija	•Protection of Serbian population	•A dialogue between Belgrade and Prishtina •Autonomy for the northern part of Kosovo •Special protection for Serbian monasteries •Collective return of refugees and IDPs to the northern part of Kosovo and Metohija
6. Accession to EU	• A Feasibility study is delayed •The SA process has come to a standstill	Accession road map: •Feasibility study in II quarter of 2003 •SA agreement in IV quarter of 2003 •Status of a candidate	•Action plan for harmonization •Should the Action Plan be late or not in effect, initiate a separate process for entrance to the EU

Issues	Present situation	Goals	Measures
		country in 2007 •Full membership in 2010	•Adopt a new pro-European Serbian constitution
7. Constitution	•The existing constitution is an obstacle to a clean cut with the past •A new Constitution should be adjusted to the Constitutional Charter.	•Constitution in compliance with EU standards	•Constitutional Commission consisting of respectable experts •Adoption of the constitution by July 2003 •Simultaneous elections for parliament and a referendum for the Constitution in the fall 2003
8. Balance of power	•Balance of power between the two pillars of executive power (the government and the president) has been disturbed •The nonexistence of a president is an indicator of the political crisis • International reputation of the country has deteriorated	• Balance of power between executive and judicial branches • Balance within the executive power	•New constitution •Revoke the obligatory 50% turnout for presidential election

Issues	Present situation	Goals	Measures
9. Democracy	•Weak parliamentary control over government • Manipulation of mandates against the voters' will •No stable parliamentary majority needed to bring systematic laws	•Responsible government with the parliament representing the will of voters	•New constitution •New electoral law
10. Rule of law	•State apparatus is bureaucratized, expensive and inefficient •Inherited corruption is still present •Property rights and freedom to make contracts are violated	•The rule of law should be efficient and limited by rights and freedoms of citizens •Private property must be sacred	•Radical reform and capacity building of the state administration •Special judicial and investigating offices for the struggle against corruption •Lustration •Denationalization

G 17 Institute Team

Institutional Review

Central Bank Independence

Central banks can be divided into independent and dependent ones. The wider the freedom in pursuing credit, monetary and foreign exchange policy and supervision of banks, the more independent the central bank. Dependent central banks make decisions under the pressure of the state, i.e. the government, thus becoming an instrument in pursuing government's policy. However, where pursuance of economic policy is concerned, independent central banks also coordinate their activities with other relevant state economic policy-makers (primarily with the ministries of finance and economics). The independence of a central bank in itself is not sufficient for attaining macroeconomic goals. The central bank needs to cooperate with particular line ministries and the government and vice versa, but for the pursuance of its policy, the central bank is accountable to parliament. At the international level, the central bank cooperates with international financial institutions and central banks of other countries. This means that the autonomy of the central bank does not mean absolute freedom, but a coordinated relationship with all relevant subjects in the country and abroad, and accountability for decisions taken. This ensures respect for the principle of limiting of power and assumption of all key instruments for providing macroeconomic stability. All of these have positive impact on pursuing sound economic policy and prevent politically motivated monetary expansion.

Central bank independence is assessed on the basis of analysis of legislation which regulates issues relevant for its autonomous work. Analysis of legislation assesses whether the central bank is a leading institution in the monetary area; whether it has constitutional, i.e. legal obligation to follow established economic policy objectives; whether it is obliged to support the government's policy; whether it is subordinate with respect to general guidelines set by the government; whether it is allowed to oppose to the government's general guidelines; whether it is accountable directly to parliament; whether it is entirely under state ownership, etc.

Why an independent central bank at all? Autonomy of the central bank is directly related to efficient attainment of economic policy objectives. ***Firstly**, independent central banks have more success in combating inflation.* Typical examples of independent central banks are the German and Swiss central banks, which were holding inflation steady at about 3% on the average at an annual level for a long period of time (about 40 years) and were world leaders with regard to the stability of national currencies. One percentage point higher inflation was present in Japan and the USA, whose central banks have a slightly lower degree of autonomy. A list can be made with Sweden, Denmark, France, Finland, the UK, Spain, Italy…where states are listed following the degree of independence of their central banks (from independent to less autonomous) and increasing inflation rates. ***Secondly**, autonomy of the central bank is inversely proportional*

to the unemployment rate. Typical examples are Switzerland and Spain. Switzerland, a state with a very high degree of central bank autonomy registers very low unemployment rates, while Spain, with lower degree of autonomy of its central bank records higher unemployment rates. These examples are based on figures for the period from the late 1950s through the early 1990s. However, since for a long time it made no sense to compare Serbia with developed countries, and as the most successful transition countries made huge steps towards the European Union during the last decade, independence of the central bank in Serbia will primarily be compared with the countries of Central and Eastern Europe.

Arguments for Central Bank Independence in Serbia

An independent central bank provides a stable national currency. In the last two years, despite structural changes in the financial system and liberalization of prices, the stability of the dinar has been successfully maintained. Accordingly, restriction of autonomy of the Serbian central bank could be motivated by short-term goals of some interest groups, but in the long run, it would only result in draining off of real money toward economic subjects incapable of surviving in market conditions.

Central bank independence enables economic growth and development. A ten-year experience (1990-2000) showed that inflation creates an unfavorable investment climate; instability of the national currency prevents long-term planning and directs available money (foreign exchange) towards speculative activities. In 2002, macroeconomic stabilization was established and conditions for realization of credit lines were created, while domestic savings are growing. The violation of central bank autonomy in monetary, credit and foreign exchange activities would result, on the one hand, in the suspension of investment plans of small and medium-size enterprises, and on the other, in speculative gains of all who count on inflationary gains and gains from currency differentials (well known pattern “buy for 6, sell for 30”)

Central bank independence prevents inflationary taxes and financing of quasi-fiscal activities. The reform of the financial system implemented thus far could be replaced with a retrograde method of taxation through inflation, which is a manner used by fiscally incapable states. Moreover, such a taxation model would bring about changes in the dynamics of public revenues, which would be soon followed by a drop in their absolute amounts; public revenues would not be sufficient for implementation of a rational social program and would halt the repayment of state debts owed to citizens (debt on the basis of old foreign currency savings, debt toward pensioners, etc.) and to foreign creditors.

An independent central bank ensures efficient application of available monetary instruments. The discount rate, which was cut down to 9% at the beginning of January 2003, is becoming increasingly important as an instrument of monetary, credit and economic policy. Tight credit control of commercial banks has yielded best results thus far in eliminating high inflation rates which were generated through the primary issue. Open market operations are becoming increasingly

important instruments, especially given the establishment of a treasury with the Ministry of Finance and the possibility of state borrowing outside the central bank. The regulation of reserve requirements is an instrument which ensures confidence in the banking system by preventing possible shocks on the financial market (primarily by protecting citizens' new foreign currency deposits).
An independent central bank makes possible the policy of a fluctuating foreign exchange rate, which prevents intentional fluctuations motivated by financial gains that can be realized through currency differentials and through the export of economically uncompetitive products which seek their opportunity in the change of monetary factors and not in the improvement of their own productivity. Numerous econometric models show that, in the case of Serbia, the foreign exchange rate has no effect on export growth, but what has significant impact is productivity improvement.[1]

Concepts of Central Bank Independence

In this paper, we used four concepts for assessing independence of the central bank:

- ***Institutional concept*** – Independence refers to the central bank's power to formulate a monetary policy independently from political institutions, in particular from executive power (the government);
- ***Functional independence*** stands for free decisions related to monetary policy instruments, and is achieved when the central bank has full discretion to deploy monetary policy in attaining goals;
- ***Organizational independence*** concerns freedom of appointment and dismissal of central bank officials. The longer the term of office of the appointees, the more autonomous the central bank.
- ***Financial independence*** relates to the role which the government and/or Parliament plays in determining the budget of the central bank.

Several authors noted that the new central bank laws in transition countries had their role model in the Bundesbank, believing that they could inherit the good inflation record of Germany. However, except for the successful fight against inflation, the central bank is not the only one in charge of formulating sound economic policy, with this rather being a coordinated action of all economic institutions in one country; consequently, the question arises whether it is possible to import German cultural aversion to inflation as well. If it is not possible simply to transfer (as no cultural pattern can be transferred), the question is what to do to build up, both in public and political spheres, cultural aversion to inflation. Two things are certain: firstly, Serbia has horrible experience with hyperinflation (there is a basis for aversion to inflation), and secondly, the incitement of inflatory expectations and departure from the policy of stable national currency will not result in the creation of this cultural pattern, but in the establishment of a position that inflation is inevitable and that we should just get used to it.

[1] See: e.g. article "Macroeconomic Trends in 2002 and Forecasts For The First Six Months Of 2003" in this issue of the G17 Institute Economic Review.

In this section we will present the GMT method (Grilli, Masciandro and Tabellini) for measuring independence of a central bank. This method tends to incorporate all four previously described concepts of independence (institutional, functional, organizational and financial) with the word of law.

The GMT index divides central bank independence into two components – political and economic. Political independence (PI) is defined as the capacity of the monetary authority to independently choose the final goal of monetary and credit policy within the overall economic policy, and it is subject to three factors: the relationship between the government and the central bank in the formulation of monetary policy, the procedure of appointing the board of directors / governor, and the publicly set formal goal (e.g. inflation rate, stability of national currency). These three factors are operationalized by eight criteria: appointment procedure for high officials of the bank (the governor and the board), length of their term of office, participation of the government representative in the board, government approval of monetary policy, legal provision of strengthening the bank's position against the government in case of conflict and statutory obligations to maintain price stability. The GMT index of political independence is a sum of all these equally weighted factors.

The GMT index of economic independence (EI) is defined as the capacity of the central bank to choose the instruments of monetary policy, and covers legal constraints on the central bank's lending to the government, and the position of the central bank in supervising banks. An independent central bank has limited direct credit facility and borrows at market interest rates.

In calculating political and economic independence of central banks in transition countries it is more precise to use a modified GMT index (Maliszevski – 1997). Modification refers to criteria for evaluation of the governor's appointment procedure (G1 – two extra points if the governor is appointed neither by government nor by parliament). Other differences refer to the provisions for dismissal of high officials of the bank (non-political reasons only – inability to perform duties or participation in criminal activities).

Table 1: Modified GMT Index of Political Independence

	G1	G2	B3	B4	B5	R6	R7	C8	C9	Total
Serbia	•		•		•	•	•	•		6

Rules for giving points

G1 - Governor not appointed by the government • ; not appointed by the government and parliament ••

G2 - Governor appointed for more than 5 years

B3 - None of the Board (vice governor, deputy governors) appointed by the government
B4 - Board appointed for more than 5 years
B5 - Provisions for Governors dismissal non-political only
R6 - No mandatory government representative in the board
R7 - Government/parliament approval of monetary policy is not required
C8 - Statutory responsibility to pursue monetary stability
C9 - Presence of legal provision supporting the Bank in conflicts with the government

Table 2: Modified GMT Index of Economic Independence
+

	D1	D2	D3	D4	D5	M6	M7	Total
Serbia	•		•	•		•		4

D1 - Direct credit facility is not automatic
D2 - Direct credit facility is at market interest rates (or at least at discount rates)
D3 - Direct credit facility is temporary
D4 - Direct credit facility is of a limited amount
D5 - Bank does not participate in the primary market for public debt
M6 - The discount rate is set by the central bank
M7 - Supervision of commercial banks is not entrusted to the central bank

GRAFIKON
Corrected GMT Index of Political and Economic Independence of Central Banks

In 2000, the Serbian Central Bank had the lowest level of political independence of all transition countries, while, with regard to economic independence, it was the second from the bottom among 15 countries under consideration. Today the Serbian Central Bank, compared to other transition countries (1996-end) ranks seventh in terms of both political and economic independence. At the end of 1996, Croatian, Slovenian, Lithuanian, Polish, Georgian and Czech central banks had a higher level of political independence than the Serbian Central Bank has today. In the same period, Slovenian, Czech, Hungarian, Polish, Kyrgyz and Georgian central banks had a higher level of economic independence than the Central Bank of Serbia has today. The previously described situation confirms the opinion that an independent central bank (above all, a politically independent central bank) has more success in maintaining stability of the national currency. In the period before 2000, the central bank was not in a position to pursue the policy of a stable dinar because of high political dependence. In the last two years, one of the key reasons for relatively low inflation is political independence of the central bank.

The observation that the work of the National Bank of Serbia (until recently National Bank of Yugoslavia) has been regulated by the same law until 2000 as today is very interesting. A higher level of independence of the National Bank of Serbia in the two previous years compared with the former period indicates that the personality of the governor and other officials in the National Bank may have significant impact on the level of political and economic independence of the central bank within the same legal framework.

A higher level of political independence of the central bank could be reached through the following changes:

- *Firstly*, it is necessary to establish the institution of the board of directors (the proposal rejected in the Federal Parliament in the late 2002 with the argumentation that the central bank would become more independent that way!!!)
- *Secondly*, the governor's term of office should be extended to last over five years. The governor's term of office in the Central Bank of Switzerland is 6 years, in Netherlands, Austria and Canada, 7 years, in Germany, 8 years, and unlimited in Denmark, Finland, Norway and Italy. In the USA, members of the board of directors are appointed for 14 years (without the possibility of reelection), which means that the president of the USA is elected three times during one term of office of the Central Bank director.
- *Thirdly*, in case of conflict between the central bank and the government (whereas the nature of the relationship between the central bank and the government may be in conflict because short-term and politically suitable solutions from the viewpoint of the government may mean disruption of stability of the national currency or the exchange rate), special legal protection of the central bank is necessary (so that it is able to carry out its activities independently and without disturbance) from the government's pressure. Also, it should be mentioned that the criterion B5 (provisions for Governor's dismissal, non-political only) is entirely fulfilled in view of positive legislation.

The Central Bank of Serbia possesses the necessary level of economic independence. It is not obliged to credit either the state or commercial banks automatically, but in order to pursue more efficient economic policy, it is allowed to finance the overcoming of budgetary imbalances only for a limited period of time (by the end of a fiscal year) and for a limited amount (up to 10% of the projected annual revenues to the state's budget, providing that the total amount must be up to 15% of the increase in the Central Bank's dinar placement). Also, the Central Bank establishes the level of the discount rate. However, for further strengthening of the economic independence of the National Bank of Serbia it is necessary to provide:

- **Firstly**, direct credit facility (Article 34 the NBY Law, exception from Article 32) addressed to the state/republic should not be lower than the discount rate (or even the market interest rate).
- **Secondly**, the Bank should not participate in the primary market for public debt. This item is the hardest to be achieved, given the Central Bank's commitment to repay public debt on the basis of old foreign

currency savings by 2016, and we may expect the purchase of securities issued by the Treasury in the future.

Moreover, besides the board of directors as an institution which guarantees central bank independence, what should also be introduced is the establishment of targeted inflation for the current year and an obligation of maintaining it at the planned level (determined by the central bank). The question of targeted inflation is closely connected with the creditability of the central bank, where credibility is defined as confidence in the bank to carry out what has been announced. However, in attaining this goal the governor also needs support from economic policy makers and takers, i.e. from the government. The third key element that must be defined refers to reasons for the governor's dismissal, which are contained under previously established obligations.

Macroeconomic Topic

Kristian Vukojicic

GRAY ECONOMY IN SERBIA
With Special Emphasis On Banks

At the end of 2002, the G 17 Institute conducted a preliminary survey of the gray economy in Serbia. The aim was not to make a precise and quantitative estimation of the gray economy, but only to start identifying it and to propose concrete actions so as to transform the gray economy into legal economic flows, thus contributing to the fight against the gray economy, which policy-makers in Serbia set as a target for 2003/4.

Since the gray economy and the baking industry are closely connected and because a well-regulated financial system disables most common forms of the gray economy, we made a special overview of the banking system.

The analysis of the gray economy is made on the basis of information which rely on estimations made by the G17 Expert Network Representatives, and we may not make any warranty as to the accuracy of the assessment of the situation in municipalities, but the conclusions concerning the gray economy at a global level, owing to the great number of G17 Expert Network Representatives polled, are in our opinion close to the actual situation. The poll covered 51 municipalities (11 from Vojvodina and 40 from Central Serbia).

The analysis of the banking sector is based on information obtained from the poll and interviews with the highest management of banks, while, in cases where we were not able to obtain direct information, analysis relied on estimations made by the most eminent experts from institutions we contacted. The analysis takes into consideration the following issues: banks' capital, relationship between companies' managements and banks, interest rates – break-even point, "black market", financial transactions on the "black market" and taxes.

Total Economic Activity

The Poll encompassed seven activities: commodity production, agriculture, construction, transportation, trade, hotel and restaurant business and tourism, and crafts. We opted for this classification because it is, in our opinion, most acceptable to respondents and therefore yields the most precise results. As the statistics do not cover the gray economy, we made an estimation of the portion of the above-mentioned activities in the total economic activity of municipalities (total economic activity includes both legal and gray market activities). These portions served as weights for the estimation of the gray economy.

In total economic activity, agriculture (24%), commodity production (21%) and trade (20%) dominate over others.

These three activities are presented separately according to municipalities on Chart 1. It should be noted that in regions with developed agriculture, commodity

production accounts for 10%, and vice versa. Also, there is a link between trade and commodity production (decrease in the portion of commodity production in the total economic activity of the municipalities under consideration reduces the portion of trade).

Activity	Portion in the total economic activity
Agriculture	
Commodity production	
Trade	
Construction	
Hotel and restaurant business and tourism	
Other	
Crafts	
Transportation	

Chart 1 - Comparative breakdown of the portion of commodity production, agriculture and trade in the total economic activity of the municipality under consideration

- *Commodity production*
- *Agriculture*
- *Trade*

Exceptions which depart from the average to a greater extent:

Crafts are especially developed in Indjija, accounting for 40% (6.5 times more developed than the average), or as much as 70% together with trade. Similar exceptions are observed in Soko Banja (hotel and restaurant business and tourism - 66%) and Sremski Karlovci (construction - 65%).

Ratio of Gray Economy to Total Economic Activity

The greatest portion of the gray economy is associated with trade (36%). The hotel and restaurant business and tourism rank second with 33%, followed by crafts (31.76%). Commodity production is the second from the bottom with little over 20%. On one hand, this may imply stricter discipline in the production sector, but more significantly, this fact may indicate the underdevelopment of this sector, which may be the reason for the lack of greater interest in production in the gray area.

However, regarding the number of municipalities in which over 10% of the total product is produced in the gray area of one out of seven observed activities, trade still ranks first with 31.37% (i.e. in almost one-third of municipalities in Serbia more than 10% of total activities is performed within the gray area of trade). Agriculture is on the second place, as agricultural gray area accounts for more than 10% in the total activity in every fourth municipality in Serbia. Transportation is on the bottom of the list with 0%, meaning that in none of the polled municipalities transportation activity in the gray zone produces over 10% of the municipality's total product.

	Portion of given activity performed in the gray area	Portion of municipalities in which over 10% of the total product is produced in the gray area of the given activity
Commodity production		
Agriculture		
Construction		
Transportation		
Trade		
Hotel and restaurant business and tourism		
Crafts		
Other		

The portion of the gray economy in the total economic activity of municipalities under consideration is presented in Chart 2. The data rely on task knowledge on the participation of the gray economy in the observed activity, and are weighted by the estimated portion of the same activity in the total economic activity of a municipality. The following five municipalities recorded the largest portions of the gray economy: Obrenovac, Pancevo, Krupanj, Ljubovija and Prijepolje.

Chart 2 – The portion of the gray economy in the total economic activity of the observed municipalities

Overview of the Most Common Activities in the Gray Area Within Selected Economic Activities

Commodity production – Population's needs stand for a significant incentive for the gray economy. Table 3.2 shows that more than 60% of the gray economy within commodity production is related to basic living necessities (food and clothing). The manufacture of textile and clothes is the most common activity, accounting for 32% in commodity production. In second place is the manufacture of food products with 29% (65% of gray economy in the manufacture of food products refer to the manufacture of non-alcoholic beverages). The manufacture of wood products ranks third, the manufacture of construction material fourth and the manufacture of chemical products fifth. The manufacture of paper, spare parts for cars, cosmetics, office supplies, and tools and machinery account for less than 5%, and these activities are not included in the Chart for the sake of comprehension.

Agriculture – As far as agriculture is concerned, there are three significant issues. The first one relates to bulk buyers and middlemen for agricultural products. This area accounts for 22% in the gray area of agriculture, and if we put aside the role of production of fruits, vegetables and meat as generators of

the gray economy, the problem of bulk buyers and middlemen would certainly be on the top of the list. The second issue concerns the services of land cultivation, which, according to the poll, accounts for as much as 15% of the total activity in the gray area of agriculture, which means that all services of land cultivation are performed in the gray area. The second from the bottom is (re)sale of fuel (wood and coal), with 6%. Out of the activities which are not presented due to their irrelevance, we must point out the 3.5% portion of the processing of agricultural products, which primarily illustrate underdevelopment of processing structures in the country, but also the opportunity to prevent the expansion of the gray economy in this area. We should not disregard a significant portion of the seasonal workforce, either, but due to the specific method for presentation of this issue, it was not included in Table 3.2.

Construction – The largest portion of the gray economy in construction refers to the construction of buildings and facilities, and activities closely related to construction materials (this category comprises illicit exploitation of lime and sand), which is presented in Table 3.4. Individual construction (including finishing and adaptation) is significantly lower compared to the construction of buildings and facilities for business purposes. A significant portion refers to illicit construction, which is not comprised by the Chart because of the specific methodology for estimation of its impact on the gray economy. As far as actual activities which generate the gray economy are concerned, we should point to masonry, project drafting, ceramic tiles, hardwood floors, sheet metal and aluminum (PVC) windows, floor heating installation and maintenance.

Table 3 – Overview of the most common gray area activities within economic activities		Table 3.4 - Construction	
		Construction of buildings and facilities	
		Timber and construction materials	
Table 3.1. – Commodity production		Individual construction	
Textile and clothes		Services	
Food products		Table 3.5 - Transport	
Products of wood and furniture		Taxi	
Construction materials		Transport services	
Chemicals		Public transportation (passenger)	
Table 3.2 - Agriculture		Forwarding	
Fruits and vegetables		Cable TV	
Bulk buyers and middlemen		Table 3.6 – Catering and tourism	
Meat		Café-bar	

Land cultivation services		Restaurants	
Milk / Diary		Accommodation	
Alcohol		Tourist arrangements	
Fuel (wood and coal)		Table 3.7 – Crafts	
Table 3.3 – Trade		Carpenters/jointers	
Textile		Auto mechanics	
Food		Painters/decorators	
Construction material		Hair dressers	
Cigarettes		Floor heating	
Electronics		Bakeries	
Spare parts for cars and furniture		Tailors/ dressers	
Wood - fuel		Beauticians	

Transportation – The most common activity in the gray area of transport concerns taxi services, with the portion of 35%. Transport services rank second (freight transport only), accounting for 30% in the total gray area of transport. Public (passenger) transport accounts for 26%. We should also draw attention to forwarding and cable TV, which, despite a rather low portion of 6%, may be interesting for their capacity for future generation of the gray economy. The portions of the gray area in transportation are presented in Table 3.5.

Trade – In Chart 1, a relation between trade volume and commodity output (positive correlation, i.e. decreasing portion of commodity production in the total economic activity of the observed municipalities is related to the decrease in the portion of trade) can be observed, while in Table 3.1, which presents the most common activities in the gray area of commodity production, the manufacture of textile and clothes and food production rank first and second (followed by furniture and construction materials). Table 3.3 shows a similar situation. The most common is textile trade (28%), followed by trade in food products (19.5%). Trade in construction material is in third place with 13%, and trade in cigarettes, electronics, spare parts for cars and furniture share the fourth place with 11%.

Tourism and hotel and restaurant business – Over 70% of the gray area in tourism and the hotel and restaurant business is generated in café-bars and restaurants, 22% in the area of accommodation (Table 3.6). Tourism and catering are activities with the most developed techniques for tax evasion (e.g. unregistered rent of rooms, avoidance of visitors' taxes, unregistered workers, unregistered turnover, unregistered hotel/restaurant establishments, unregistered tourist agencies, performance of activities outside registered line of business, organization of concerts, etc.). Café-bars, restaurants, accommodation and package tours are the only reported forms of gray economic activities in tourism and catering.

Crafts - The most active in the gray area are carpenters/jointers (28%), auto-mechanics and painters/decorators (18% each), while hairdressers rank fourth

with 12%. Floor heating installation is in fifth place, accounting for 9% in the generation of the gray economy, as shown in Table 3.7.
Other – Other sources of the gray economy are agencies, real estate agencies,– both sale and renting, betting parlors, health services, intellectual services (private lessons, creation of computer programs), financial services, etc.

Chart 3 – The number and percentage of the population living from the gray economy

- *absolute amount*
- *percentage*

Employment and the Gray Economy

The Poll covered 51 municipalities in 21 regions, with a population of 2.8 million.
By summarizing the estimations of the respondents, we calculated that 670,000 persons, i.e. 25% of the sampled population work in the gray economy. Chart 3 shows the percentage of the population working in the gray economy and the number of persons (in absolute numbers) who live from the gray economy according to municipalities.

Banking Industry

Since the gray economy is closely connected to the financial system of a state, and as the most significant institutions on the financial market in Serbia are banks, this survey processed 17 banks through polls and interviews. Almost all biggest banks which operate on our market are included, together with a significant number of small and medium-sized banks (more precisely, nine big, three medium and five small banks). The survey analyzed bank capital, relationship between the management of particular companies and banks, interest rates, break-even points, reasons for performing some financial operations on the black market, taxes and the most common activities on the black market.
The capital of banks was observed in view of the concentration of capital, and in 53% of surveyed banks, one person (either natural or legal) possesses the block of shares of over 15%, in 6% of banks there are two persons with that proportion of ownership, while 41% of banks has no shareholder who, according to positive regulations, is obliged to declare publicly and to register with the NBY and its Securities Commission.
We asked for two answers to the same question, one concerning the surveyed banks, and another concerning representatives' assessment of the situation in other banks. Further results will be presented in that manner.
The connection between managing structures in the real sector and banks, either on the basis of capital or through managing positions, has been leaving room for the evolution of monopolistic positions in the form of facilitated access to capital, but we must make distinction between two cases – when bank managers own a

company, and when company managers are shareholders or members of managing structures of the bank.
The interconnection between the management of a company which is a depositor in one bank, and managing bodies of the bank would enable capital to drain off into private companies, especially under conditions of significant share of state capital in banks. Therefore, we examined the participation of managements of companies - depositors of certain banks in relevant bodies of that bank. However, we must stress that significant depositors of one bank want to have insight into the bank's business performance and that is the reason for them to request to be present in supervisory, or even managing boards.

Does the manager of a company which is a depositor of a given bank have a seat in any of the bank's boards?	Surveyed bank	Opinion on other banks
a.) yes, it is widespread practice		
b.) yes, in some cases		
c.) never		
d.) I do not know		

The first Table on the right shows the relation between real and financial sectors through the positions in some of the boards of one bank, while the next Table refers to the bank's capital. It should be noted that nearly 75% of respondents gave negative answer to this question (i.e. denied that such relation exists).

Is the manager of a company, which is a depositor (or credit beneficiary) of a given bank at the same time a shareholder of that bank?	Surveyed bank	Opinion on other banks
a.) yes, it is widespread practice		
b.) yes, in some cases		
c.) never		
d.) I do not know		

Similar to the previous one is the question "Are the managers of your bank at the same time shareholders in companies which are depositors (or credit beneficiaries) of the bank?" It is interesting that in as much as over 50% of cases the answer is "never", and there is a much higher percentage of ignorance with regard to this question than in the reverse case (previous table).

Are bank managers shareholders in companies which are depositors (or credit beneficiaries) of that bank?	Surveyed bank	Opinion on other banks
a.) yes, it is widespread practice		

b.) yes, in some cases		
c.) never		
d.) I do not know		

The issue of interest rates cannot be avoided in the financial area, and the situation with "on-sight" deposits (tr. non-interest baring accounts) is pretty interesting in that respect. The bank code prescribes that banks are not obliged to pay out interest on on-sight deposits, but some banks nevertheless approve this interest in order to attract clients, arguing that in this way banks protect the actual value of deposited funds. On the other hand, banks which do not approve such interests argue that this is a policy applied by small banks which need new clients, or that even this concerns banks with (potential) problems with liquidity, and therefore they use this instrument to attract new funds, while their own banks, not approving interest on sight deposits, provide stronger security of the given deposits. However, in the cases of a high and a stable level of on-sight deposits of particular clients, it is to be expected that the negotiating skills of the depositor should be sufficient to persuade the bank to approve an interest rate which, at the very least, exceeds inflation. Why does this not occur in practice? To the question what happens when a big depositor decides to withdraw the deposit from one bank and transfer it to another, one banker answered "you'll offer him a car with 18-inch instead of 15-inch tires". Because of such answers, the question of diversity of interest rates is included in the poll, both from the perspective of on-sight deposits, long-term and short-term deposits, and in terms of range and reason for approving diverse interest rates.
The diversity of interest rates which banks approve to depositors exist in 94% of cases, while only 6% of banks do not approve different interest rates. This discretion is in the range of one percentage point, for two basic reasons: the degree of connection with a bank, and credit rating of a client (risk assessment), and only than the value of the deposit (other mentioned reasons are degree of credit guarantee and credit term).

The range of interest rates on the same category of credits	% of banks
Up to 0.83% p.m.	
1% p.m.	
0.1-0.5% for foreign currency	
1.9% p.m.	
0.9-3.3% p.m.	

The diversity of interest rates on on-sight deposits is present in 30% of banks, 58% of banks do not approve diverse interest rates, while 12% of banks do not approve interest on on-sight deposits at all. In 17% of banks this range is up to 0.5%, 50% of banks have a range between 0.5-0.6% at a monthly level, while the range of 1% p.m. is present in 33% of banks. The main reported reasons are the amount of deposit and arrangement activities, followed by term, while the situation with the bank's liquidity, the possibility and terms for <u>financing and</u>

absence of other bank products participate each with 5% in decision making regarding approval of diverse interest rates. We were given interesting responses to the question whether a similar way of doing business exist in other banks. As many as 41% of respondents who hold management positions in their banks are not familiar with interest rates on on-sight deposits offered by competitors, 47% of them assessed this to be widespread practice, while 12% claim this concerns individual cases only. Comparative examination of diversity of interest rates, ranges and reasons for that diversity, together with the assessment of the situation in other banks are shown in Table 8.

The question which is closely related to interest rates is a bank's break-even point. 46% of banks estimated interests on short-term loans in the range of 2-2.5% at a monthly level to be their break-even point. 38% of banks defined this point at 1-1.5% per month, while 16% of banks did not want to respond to this question (or maybe did not know). As far as long-term loans are concerned, one third of banks estimate break-even points at 9% per year (with forex clauses). One fifth of banks do not approve long-term loans, and another 20% define break-even points at 12% (per year for long-term loans), while for 13.33% of banks break-even points are defined at the interest of 18%. 13.33% of banks did not want to respond to this question.

Reorganization of land registers is in 7.5% cases seen as a significant factor which could contribute to the reduction of interest rates, while 23.5% of banks do not share this opinion – they do not understand interest rates to be a key problem, but ascribe it to the lack of credit potential of banks, hence seeing the growth in domestic savings as the best path towards the reduction in interest rates. They also think that mortgages are not a favorable solution for banks in our circumstances, because in that way banks (under conditions of not being able to collect credits) transfer their credit potential into "concrete and steel". Over 46% of polled banks estimate that the interest rate will be as much as 1% per month after reorganization of land and cadastre registers, while 15.38% of banks anticipate an interest rate at a 2-3% at monthly level. It is interesting that none of the banks opted for interest rates in the range of 1-2%. Almost 40% of bank managers did not want to state their opinion on this issue.

Is there diversity of interest rates?	For on-sight deposits	For time deposits
a.) yes		
b.) no		
c.) do not approve such interests		
If it exists, what is the range?		
0.5-0.8%		
1% p.m. and more		
Up to 0.5% p.m.		
List the reasons for diversity of interest rates		
a.) amount of deposit		
b.) term		

c.) arrangement operations		
d.) liquidity status of the bank		
e.) possibility and terms of financing		
f.) inexistence of other bank products		
g.) bank's policy (whether it invests in safe businesses or not)		
Is this the case with other banks?		
a.) yes, a widespread practice		
b.) yes, individual cases only		
c.) do not know		

56% of bankers see as opportunity that persons who are currently given financial loans on the black market can be included into the banking sector, but a necessary condition for their inclusion is the guarantee of confidentiality of data, which is not enabled under the Law on Money Laundering Prevention (38.46%), then state abolition through the tax on excess profit (30.77%), more active role of banks in attracting that capital (15.38%), lower tax rates (7.69%) and lower fixed costs (7.69%).

The main reason for performing a part of the financial operations on the black market and not over the account is tax evasion. With regard to taxes, 50% of banks put sales tax in first place, and taxes and contributions on wages in second place. Excises are still on a high third place, followed by property tax, financial transaction tax, local community tax, and finally personal income tax.

Respondents assessed trade (56%), production of tobacco, alcohol and coffee (20%), construction (12%) and tourism (8%) to be dominant activities on the black market.

Institutional Topic

Professor Ph.D. Gordana Ilic-Popov

WHAT DOES THE NEW LAW ON TAX PROCEDURE AND TAX ADMINISTRATION BRING TO SERBIA?

Continuing with the implementation of radical reforms of the tax system, the National Assembly of the Republic of Serbia has enacted recently the Law on Tax Procedure and Tax Administration (Official Gazette RS, no. 80/2002), which is to come into effect as of January 1, 2003. By this, Serbia has obtained one comprehensive procedural law which "disburdens" material tax laws which regulate in detail individual taxes included in the tax structure. The provisions of this Law codify the procedure of assessment, collection and control of public revenues.

The Law on Tax Procedure and Tax Administration primarily aims at joining all activities in the process of assessment, collection and control of taxes and other public revenues together in one state office which will be called the Republic's Tax Administration. Namely, the existence of dual tax administration so far, in the form of the Payment and Settlement Bureau (ZOP) and the Republic's Public Revenues Administration (RJUP) to a significant extent hindered efficient administration of the state's finances and provided room and possibility for tax evasion.

The control of taxes and social insurance contributions which are paid after deductions and which was performed by the ZOP was more or less routine, because ZOP only made a comparison between the sum of income paid out (primarily salaries and author's fees) and the data on the total of calculated fiscal obligations. In other words, this meant that the ZOP did not deal with analytical examination, i.e. it did not examine whether the employer, i.e. any other income-payer as a taxpayer, calculated and paid tax for each individual employee, i.e. any other tax payer. On the other hand, the RJUP had the duty to assess and collect only those taxes which are, on the basis of the data on tax returns, established through issuance of a tax statement by the office in charge of taxation (corporate income tax, tax on income from independent activity, annual personal income tax, property tax, etc.). Accordingly, the RJUP did not have at its disposal the data on revenues from taxes which are paid after deductions, and which are, in view of their fiscal significance, much more abundant.

After transferring payment operations from the ZOP to commercial banks, the Tax Administration will have a hard task to provide efficient collection of public revenues (tax on wages, tax on author's fees and other sorts of income which are charged after deductions), which will be subject to the regime of self-taxation. "Self-taxation" is an obligation of an income payer to submit on his/her own a tax return and to do the calculation and payment of particular obligations to a corresponding account. After that, the task of Tax Administration will be to record

all payments and to pursue strict control over the procedure performed by the payer in the calculation of a certain tax.

The new Law will create conditions for Serbia to have a modern, responsible and qualified tax administration, which will be, in organizational terms, a part of the Ministry of Finance and Economy of the Republic of Serbia.

A special novelty brought about by the Law on Tax Procedure and Tax Administration concerns an obligatory introduction of a tax identification number (PIB) both for legal entities and entrepreneurs, as well as for citizens. The significance of the PIB lies in that each payment order submitted to a commercial bank must contain this number, and commercial banks will not be allowed to open an account for any person (neither legal entity and entrepreneur, nor physical person) that does not produce a personal tax number when applying for an account opening, which would make it possible for this person to be identified in all tax operations. The registration of taxpayers will enable Serbia to finally get a comprehensive register of taxpayers.

Aiming at efficient work of the Tax Administration, the Center for Large Taxpayers will be founded for those tax payers which, due to their great fiscal significance for the Republic should be subjected to special tax control. In this way the largest and the most influential, whether economically or politically, will not be overlooked for taxation.

Serbia should get a tax information system which would facilitate introduction of complex types of taxes such as synthesized personal income taxes and value added taxes.

The Law on Tax Procedure and Tax Administration introduces a completely new measure which concerns cross-assessment of the tax base for two types of taxes, i.e. personal income tax and property tax. The data on property could be of assistance in discovering possible irregularities in filling a personal income tax return, as it will not be easy for a taxpayer who registers low income to explain how he/she got into the possession of property of greater value. In that respect, the Tax Administration will, as of 2004, have the right to compare the growth of taxpayer's property with registered income, which would enable it to establish what portion of income the taxpayer, either physical person or entrepreneur, has not reported to the tax authorities. The tax base for personal income tax can be estimated as the difference between the value of net assets at the end and at the beginning of one calendar year, multiplied by the estimated expenditures for private needs on one hand, and reported income on the other. Taxpayers whose property (flat, house, business premises, garage, land, etc.; shares and stocks in legal entities; equipment for performing business activity as self-employed; motor vehicles, vessels and aircraft; works of art; saving deposits cash money etc.), in the country and abroad, exceeds YuD 20 million will be obliged to submit a special statement to record that property with the Tax Administration by June 30, 2003 at the latest. Otherwise, every difference between the increase in property and reported income, which the taxpayer is not able to support with appropriate documents will be subjected to taxation as "other income", without acknowledgement of standardized costs. The effect of this measure will be to ensure that personal income tax of wealthy citizens cannot be lower than the

amount obtained by applying certain formula, based on indications of taxpayer's wealth and luxurious life style. A similar anti-evasion measure exist in France in cases when the tax office suspects that reported income of the taxpayer does not correspond to his/her actual living standard. The tax official then assesses tax on the basis of presumed income, which is multiplied by the appropriate coefficients which indicate the taxpayer's luxurious life style (house service, private airplane, yacht, luxurious car, horses, membership in a golf club, hunting license, etc.)

The Law on Tax Procedure and Tax Administration brings with it not only a range of obligations put forward with the aim to protect the fiscal interest of the state, but it also introduces certain rights. This primarily concerns the right to obtain free information on tax regulations from the Tax Administration, the right to privacy, the right to access information the Tax Administration holds about a particular taxpayer and the right to revise inaccurate or incomplete data, the right to be present during tax control, the right to a written answer to the question asked about the personal tax situation, etc. It is good that the Law contains certain guarantees for those rights of taxpayers to be actually respected, in the form of prescribing penalties in the amount of YuD 5,000 – 20,000 for offences made by persons in charge and officials in the Tax Administration who violate any of the taxpayer's rights with their actions.

Pursuant with the taxpayer's own written and argued claim that the payment of taxes on the day due poses an inappropriately heavy burden, i.e. creates considerable economic damage, the taxpayer is entitled to special tax relief in the form of a single postponement or payment of taxes in installments (up to 12 months at the longest).

Following the expiration of the transitional regime, i.e. as of December 31, 2003, the Republic of Serbia will be obliged, as any other private creditor, to register its statutory security right to real estate, movable property, financial assets and claims of a taxpayer into the proper register. This will eliminate the possibility for the state as a fiscal taxpayer to be in a privileged position in the collection of tax revenues which used to have priority for collection, relative to other creditors. Such a measure can give significant contribution to stimulating investments in the Serbian economy, because it provides better security to creditors.

Changes are also introduced in the area of tax control, which is regulated so as to correspond to so-called "tax auditing". This process distinguishes office control, field control and uncovering of tax felonies. Office control is a set of actions by which the Tax Administration checks the accuracy, completeness and harmonization with legal regulations of the data recorded in tax returns, tax statements, accounting reports and other records kept by a taxpayer. This form of control, as a rule, is performed by a tax inspector on the premises of the Tax Administration. Tax inspector, however, performs field control on the taxpayer's premises on the basis of an issued control order. With an aim of battling crime with maximum efficiency in the area of public revenues (especially tax evasion, i.e. contraband), a practice observed in the former period, Serbia will get a Tax Police as a special organizational unit within the Tax Administration. The tax police will have authorizations similar to those held by MUP officials who work in uncovering criminal acts, only its work relates exclusively to uncovering tax

felonies and their perpetrators. The following tax felonies are postulated under the Law on tax evasion: not paying tax on income after deductions; creation or submission of forged documents relevant for taxation; jeopardizing tax collection and tax control; illicit sale of excise products.

The tax administration is given the possibility to ask for legal assistance in tax matters from state offices and organizations, organizations of territorial autonomy and local self-governance which are officially obliged to produce facts relevant for assessing tax duties and which they discover by pursuing activities in their competence. Moreover, under the condition of reciprocity, the Tax Administration may ask for legal assistance from foreign tax offices during the taxation procedure, as well as from tax offices from the Republic of Montenegro. International legal assistance will ensure better application of the principle of taxation of resident taxpayers on the basis of their world income, i.e. world assets, and more efficient realization of cross-assessment of the tax base.

The Law on Tax Procedure and Tax Administration should improve financial discipline in Serbia. It is the responsibility of the Tax Administration to provide efficient implementation of tax control, as well as to ensure the rights of taxpayers and to prevent any form of inappropriate behavior or possible abuse by tax inspectors and the inspectors of the tax police.

Institutional Topic II

Ljubica Nikolic, Ph.D.

REFORM OF THE SYSTEM OF FINANCING OF PENSION FUNDS

The Existing System of Financing of Pensions

During the last ten years, the world has encountered an increasingly notable problem of pension system financing, which, as in our country, is organized exclusively as a pay-as-you-go system. Such funds proved to be inefficient since they provide increasingly less security to insured persons. The model of exclusively pay-as-you-go pension funds can be successful only under stable economic activity which generates solid wages. The oscillations in economic growth rates and in the number of employed directly reflect on the operation of such pension funds and on the material status of pensioners. Many countries, both in Western and in Central and East Europe, including our country, have reported constant increase in the ratio of pensioners to the employed. Because of identified problems, the World Bank proposes the reform of pension systems through the introduction of several pillars (sources) of financing.

According to both local and foreign experience, a pension system cannot be stable if it relies only on one pillar, i.e. source of financing. A multipillar pension system provides dispersion of risk and greater stability. Therefore, it is proposed that the pay-as-you-go pension system in which the currently economically active population sets aside means for paying out the pensions of current pensioners, be abandoned in favor of a pension system with several sources of financing (pillars): I pillar – mandatory, pay-as-you-go, defined benefit pension system (based on contributions), II pillar – fully funded, mandatory defined contribution system (based on individually capitalized savings), and III pillar – voluntary pension.

Every pension system is expected to provide old age security. The amount of pension depends on previously paid contributions to the pension fund, which are multiplied by certain index with the passage of time, with a guarantee of a certain minimal pension. Different systems are in force in order to meet these requirements:

- Hungary, Poland, Switzerland, Denmark and the Netherlands have the systems in which contributions are accumulated and invested by one or more pension funds on the securities market. The return of these assets depends on the level of development and trends on financial markets.
- In another system, contributions are deposited to pension accounts, while the pension received depends only on previously paid contributions, multiplied by a certain index which depends on the financial markets. Such a system exists in Sweden and Latvia.
- In Serbia and Montenegro, the amount of pension received depends on the average wage in the last several years of employment, multiplied by a

certain index. Such a system does not stimulate payment of old age pension contributions.

The Necessity of Reform

Previous reform of the pension system in Serbia involved the reduction of the pension insurance contribution rate from 32% to 19.6%, increased retirement age and change in the methodology of calculating pensions so that pensions are now adjusted to trends in both wages and consumer prices. For the time being, there is a commitment to restructure the current system of pension financing of only the I pillar. Changes would concern the establishment of a closer link between pensions received and contributions paid. At the same time, some steps have been taken in order to make possible the financing of the III pillar, i.e. voluntary pension insurance. However, as far as the II pillar is concerned, nothing has started yet for the following reasons: 1) high transition costs; 2) underdevelopment of capital markets; 3) lack of confidence in new funds and savings; and 4) technical problems in implementation. Such a position means postponement of the problem of pension financing and delay of the inevitable, i.e. system reforms.

1.) Expenditures for the reform of the pension system should be considered an investment and not costs. This concerns significant investments with modest short-term and potentially great long-term effects. The example of Poland and Hungary shows that the effects of such investments result in decreased pressure on the budget for these purposes. The pension system itself can generate enough money if it is established properly.
2.) Local securities markets are underdeveloped, especially the capital market, but this is exactly the market that can be stimulated by activating pension funds as institutional investors. At the same time, issuers should be stimulated to offer larger quantities of shares with emphasis on the role of the state as a potential issuer. State securities are likely to be the most attractive for new pension funds, and, on the other hand, by issuing bonds, the state will be able to cover a portion of means for financing pension system reform.
3.) Restoration of confidence in all financial institutions, including new pension funds, is a matter of global economic policy and appropriate normative and institutional solutions. A lot of effort is necessary so as to regain that confidence, and the establishment of new funds requires caution in that respect, but this does not mean the postponing of reform.
4.) The experience of those countries which are halfway into the reform of their pension systems can be of assistance in overcoming numerous problems which accompany every reform.

The fiscal burden in our country is huge, pensions are financed from current revenues, and relative to wages, pensions in Serbia are the highest in the region. Low pensions are high with respect to wages, which are also low. We should also bear in mind the unfavorable ratio of the number of the employed to the number of pensioners – 1:1.5. This problematic ratio could be resolved in part by

proper determination of the retirement age and retirement conditions. On the other hand, any extension of the working age is related to the problem of employment of young, educated, unemployed people. At first glance, the youth, companies, and even the entire economy are at loss. However, numerous researches confirm that shortening of the working age of the employed would result in a range of losses. Employers would lose experienced and reliable workers, the budget would be overburdened and the economy at loss, along with the retired persons themselves. Hence, the problem of unemployment should be resolved by creating new jobs, and not by early retirement of the employed. Unemployed young people should be provided with jobs that correspond to their qualifications.

The problem of financing traditional state pension funds in our country has resulted in the situation that as little as 60% of pensions are paid out of the Republic's budget, while the remainder is paid out of uncertain donations. This inevitably imposes the need for pension system reform. Pensions cannot be paid in the amounts higher than available funds allow, because this threatens other social groups. Because of very high tax and contribution rates, many local companies are evading these payments. Lower tax rates would bring about increased collection, because it is likely that many would not try to evade payment. Lower contribution rates could be applied on a wider base, which would result in greater amounts collected. In the future, pensions should be paid out from pension funds and not from current tax revenues. Pensions cannot rise in real terms without being supported by economic growth.

How much time will reform take? The pension system reform in Hungary and Poland took six years, including two years spent on adopting the concept of reform. It took seven years in Sweden. In our country, the necessary set of reform laws and accompanying bylaws will likely be adopted in a much shorter period because we are in a position to benefit from the experience of others. Reform should begin as soon as possible, without copying ready-made solutions from other countries and uncritical acceptance of the opinions of foreign experts. It should be borne in mind that after the first several years of operation of the new system of pension funds, practical problems will arise and new adjustments will have to be made. While building the concept of pension reform, the needs of other social groups and not only those of pensioners should also be taken into consideration.

Possible Directions of Reform

In keeping with domestic needs, and in line with the experience of transition countries and expectations of international institutions, three local sources of pension financing should be implemented: 1. to maintain the existing mandatory pay-as-you-go defined benefit pension system (I pillar – mandatory basic insurance); 2. to introduce the fully-funded defined contribution system (II pillar – mandatory supplementary insurance), and 3. to introduce the system of voluntary pension insurance (III pillar). Hence, we propose a mixed pension system composed of three pillars: the first pillar is based on solidarity and is legally

binding, the second and third pillars are based on capitalization of savings for old age, whereby the second pillar is mandatory, while the third one is a matter of citizens' free choice. Reformed pension funds should function as a separate form of investment funds.

The reform of the system of pension funds financing could evolve in the following way. At the beginning, a certain percentage (for example 2/3) of the contribution can be used for the first, already existing source of pension financing, while the remainder (1/3) can be used as the second pillar which is capitalized on financial markets. Contributions invested in the second pillar would be funds owned by insured persons themselves. Insured persons should be given the opportunity to choose between several mandatory pension funds. The Fund selected by the insured person would invest one third of the contribution in the appropriate securities. Portfolio managers assess the profitability of investments, disperse the means of their beneficiaries in order to maximize profit with minimal risk. In this way, by fulfilling retirement conditions prescribed by Law, an insured person is provided with two pensions from different sources of financing. The third pillar of pension financing, based on voluntary pension insurance, should be developed concurrently. Development of this pillar is likely to take place in a relatively short time, while the development of the second pillar requires a longer period of time and fulfillment of numerous conditions. This does not mean that its implementation should be halted, but only that visible financial effects should not be expected in the near future.

In the initial stages of reform, until pension funds start working as real institutional investors, they might hire investment managers to manage the investment of funds. Funds may count on the investment sectors of banks, independent investment managers and insurance companies. Of special significance could be insurance companies, which would establish special accounts for pension funds and manage the assets of these funds, keeping the tax relieves which must be allowed to pension funds.

There are possibilities for the introduction of voluntary pension insurance, and this pillar is in gradual expansion[1]. It is expected that voluntary pension funds would be used first by successful companies for their workers, and if this proves to be a good solution, physical persons would also use them. Companies can be stimulated to use supplementary pension sources for their employees if they are offered adequate fiscal benefits. Voluntary insurance is a supplement to mandatory insurance, which will continue to exist. As domestic pensions have been insufficient and uncertain for several years, additional security of income for retirement is a real need for the majority of the population. Funds from the III pillar can be open-ended (for all citizens) or close-ended (for employees employed by a single employer or for groups of persons connected by a certain interest). Voluntary pension funds work in the same way as mandatory funds, whereby access to them is subject to free will, and beneficiaries themselves determine the amount of their monthly contributions to the fund. Such a solution

[1] The first local private pension fund was founded by "Dunav osiguranje" and a Dutch company TBIH which has vast experience in managing private pension funds. The ownership ratio in this joint company is 51:49 in favor of the foreign partner.

would enable domestic pensioners to receive pensions form the I pillar, a portion from the II and from the III pillar, if they have been depositors of voluntary pension funds.
We should be careful with the introduction of private pension funds for voluntary deposits of citizens. The appropriate regulation framework and control should maximally protect potential insurance beneficiaries.

Prerequisites for Efficient Reform

It is necessary to fulfill a range of prerequisites before implementing the reform of the pension system. The success of the new pension pillar (II pillar) is subject to macroeconomic stability, simulative fiscal policy, appropriate legal and institutional infrastructure and political stability. Since these conditions are related to uncertainty, especially regarding the first and the last condition, it is irrational to expect that the new types of pension funds will start further to fulfill these conditions. In our opinion, the second pillar should be set up as soon as possible, at the same time as efforts are made on fulfilling the mentioned condition. Therefore, we should not expect significant results in the first stages of implementation of the new pension system. Reformist activities should start right away, but visible results are likely only after two years.
The main obstacle to the development of the second pillar in our country refers to underdeveloped capital markets. Initial mistrust in new pension funds is also likely, and it will take some time to restore citizens' confidence in savings and to strengthen preferences towards future spending. It is therefore necessary to take coordinated actions in order to strengthen the overall financial market and the stability of the macroeconomic environment.
The legal infrastructure is also needed. The basis for a future concept of the pension system should be the new Law on Pension Insurance, and the Law on Mandatory and Voluntary Pension Funds that should follow, including regulation of the payment of pensions based on a fully funded system. There is greater need for security in pension funds than in any other investment funds because these assets serve as a guarantee of social security of the fund's members and their families. Therefore the regulations on investing of pension funds must be restrictive, with the aim to reduce risk and generate more secure gains.
The main objective of funded funds is to generate means which will be the basis for income in old age. It is therefore necessary to establish the principles of investing (security and diversity of investments, maintenance of a certain liquidity requirement level), limitations with regard to the kind of property in which it is possible to invest the assets of a pension fund, as well as the maximum level (%) of investment in particular kinds of property. To protect investors, the Law should postulate precisely that the assets of a pension fund must be invested in low risk investments, primarily in state bonds. If laws insist that a large portion of a fund's assets must be invested in long-term bonds or other long-term securities issued by the state or the central bank, this would stimulate the development of a capital market, and the funds' assets would be invested in the safest investments. State bonds are considered to be investments with the lowest risk,

while through the sale of bonds to pension funds the state budget would be able to provide a portion of funds to cover transitional costs of pension reform. The investment of assets of pension funds in securities which are not traded on an organized market should be prohibited, as well as in inalienable forward operations activities.

Should investing of the capital of a pension fund in foreign countries be prohibited? The prohibition of such investments boost the feeling of security of those who invest in the funds, but at the same time, it limits the possibility of capital growth of the funds. Therefore, investing in foreign markets should be allowed only for one portion of the fund's assets and in only limited amounts. Such a solution has been accepted in most transition countries.

The accompanying institutional infrastructure. Successful work of modern pension funds cannot be imagined without efficient institutions. One such institution is the central register of insured persons which would keep records of the balances of personal pension accounts of pension funds' beneficiaries. A Control Agency as the main regulatory and supervisory body of the Government would monitor the reform and legality of operations of pension funds and pension associations. Pension insurance companies and specialized insurance companies would take care of the payment of pensions.

Pension Funds as Institutional Investors

The investing of assets of pension funds in securities depends on the situation on financial markets. The experience of transition countries indicates that reformed pension funds started investing carefully in securities. In order to ensure real (market) valuation of a fund, investment of a pension fund's assets in property whose value cannot be determined on the organized market (e.g. shares which are not traded on the market) must be prohibited. To protect the value of assets on personal accounts in case of low return, beneficiaries of mandatory funds should be assured a certain amount of guaranteed return. Guaranteed return is an institution which exists in practice and for this institution mandatory pension funds differ from other funds, where there are no guarantees as a rule. For example, the value of an investment fund comes from the market value of its portfolio and these funds do not have fixed, guaranteed return. For the III pillar, as a rule, guaranteed return is not prescribed, but members of voluntary pension funds are generally entitled to certain state incentives and tax exemptions.

The investment of pension funds' assets can intensify turnover on the market. To what extent this could be achieved in our country depends on the future concept of the domestic pension system and total trends on the financial market. Modern pension systems imply a range of connected institutions, which could be based on institutions that are yet to be mentioned in this article.

The establishment and administration of pension funds is performed by pension associations. They are founded as joint stock companies or limited liability companies. The founders of a pension fund are issued a permit by the Control Agency (or other competent institution) to start up their company and after paying the founding capital and registration in the court registry, the pension association

must obtain permission for work from the Agency. Founding capital must be higher if a pension association manages a mandatory pension fund, or smaller if it manages a voluntary pension fund. A pension association's assets are registered separately from the fund's assets, since ownership over those assets is separated. The insured person may be a member of only one mandatory fund, while membership in voluntary funds is not limited.

A pension fund is owned by its beneficiaries. The fund is founded and administrated by pension associations with the purpose of collecting contributions of fund beneficiaries and investing these means in order to increase their value. Each beneficiary of the fund participates in the ownership of the fund in proportion to the deposits on the personal account. The insurance beneficiaries freely choose the pension fund in which they open their accounts. Beneficiaries of the II pillar opt for one of the available mandatory pension funds by submitting an application to the Central Register of insured persons. Insured persons should be allowed the right to change their fund at any moment, paying compensation to their former fund. An insured person may be a member of only one mandatory fund, with no limitations regarding voluntary funds.

The monitoring and capitalization of paid contributions is insured by initiating personal accounts of insured persons. Employers and other contributors pay a certain percentage of the gross salary to the personal account of insured persons. In the III pillar, insured persons or their employers pay contributions directly to the voluntary pension fund. The introduction of a personal account is in the interest of insured persons and their social security, providing that: 1.) assets in the account are owned by the insured persons; 2.) those assets are protected from bankruptcy and liquidation and can be used only as pensions; 3.) the account is permanent until retirement, not depending on the changes of one's job or temporary interruption in contribution dynamics; 4.) insured persons can check on a regular basis the balance on their account, which stimulates payment of contributions; 5.) there is a possibility of choice of pension fund and negotiability of accounts. Assets from a personal account are being transferred in the case of changing membership, retirement or death of the fund's beneficiary. Then the assets are transferred either to another fund or to a pension insurance company for payment of the pension. If the fund's beneficiary passes away and family members do not have survivor's rights, the assets are subject to inheritance. With the transfer of assets, membership in a given fund ends.

A pension fund's property must be kept in a separate account in a deposit bank which provides higher security and impartiality in its valuation, as well as distinction of that property from the property of the pension association. The deposit bank evaluates a fund's property and provides the pension association with other services for which it charges a certain fee to the fund.

The Control Agency carries out control over the operation of a fully funded system of pension insurance. The main task of the Agency is to protect the interests of pension funds' members and beneficiaries of a fully funded mandatory defined contribution pension system. The agency approves and cancels working licenses to pension associations, carries out control over the operations of pension associations, pension funds and the central register of

insured persons, stimulates the development of fully funded pension insurance, prepares bylaws and initiates amendments to legislation in this area.
The Central Register of insured persons as a technical center of a modern pension system should: insure efficient flow of money and data between different subjects in the system, keep records, i.e. databases, in order to ensure reliable and rational operation of the pension system and its control. Employers and other contribution payers inform the Central Register of individual salaries and contributions paid for each insured person according to each payment. The Central Register forwards paid contributions to particular pension funds in which insured persons are members, keep record of data on personal accounts of pension fund's members. Centralized collection of contributions and information systems with the central databases on insured persons and contribution payers ensures the availability of data, more rational and reliable operation of the pension system, at the same time as providing data for more rational performance and control in other systems (tax, health, employment).

The main tasks of the Central Register would be the following:

- Collection of contributions and information on the insured person's salary from the employer and other contribution payers;
- Record keeping necessary for the control of contribution payments;
- Submitting the request to the tax administration to start the procedure of court enforcement of contributions;
- Record keeping on personal accounts of members of mandatory pension funds.
- Reporting to members of mandatory pension funds on contributions paid and the balance of their personal account.
- The transfer of contributions to pension funds and reports to pension associations and pension insurance companies;
- Procedure of transfer of assets from personal accounts in the case of change of membership or retirement.
- Record keeping necessary for efficient work of a fully funded system and for control.

The Central Register should be authorized to carry out, according to contract, other operations on behalf of voluntary pension associations.

Constitutional Charter

Getting Closer to The European Union - One Step Forward Or Three Steps Backwards?

During the process of adoption of the Constitutional Charter of the Union of Serbia and Montenegro, it was often stressed that the Charter will reportedly help and accelerate the integration of our country with the European Union. In line with this, every compromise which in the process of adoption of the Charter seems to be to the detriment of Serbia and to the advantage of Montenegro hides behind requests made by the European Union.

Do these compromises and constitutional solutions really contribute to our swifter integration with the European Union, or do they make it even more distant? What is the real impact of the Constitutional Charter on the future cooperation between Serbia and the world?

Since there is agreement that membership in the EU is our long-term objective and that the entire project of this state union came about because of the EU, then we should certainly begin with the question of the conditions which one country must fulfill to become an EU member. These conditions were defined in 1993 when the following economic and political criteria were set before countries that wished to become EU members (Copenhagen criteria):

1. Stable institutions which guarantee democracy, the rule of law, respect of human and minority rights;
2. Market economy which is able to sustain competition that exists in EU countries;
3. Ability of a country to take on the obligations that come with membership, including the pursuance of the objectives of political, economic and monetary Union.

What is Serbia doing to meet these criteria?

Serbia is adopting the Constitutional Charter which is contrary to the first condition requiring stable institutions. By giving concessions to Montenegro, Serbia is establishing a state union and institutions that are not known in modern history. The concept of a “joint state” with two currencies and two completely separate markets and consensual decision making in a union composed of two member states which are completely asymmetrical, both in terms of size and of interests, guarantees nothing but inefficiency and hindrance of the decision making process. Moreover, Serbia transfers its entire international subjectivity and cooperation to the union with Montenegro, setting up institutions which, by their organization, structure and administration (parity in sharing of power and consensual decision making), fully threaten the realization of Serbia’s interests in international relations. For example, the Ministry for International Economic Relations takes on authority in all areas of international cooperation, except military and home affairs and human rights. Thus, this Ministry should take over the role of a fiscal agent in international financial institutions, and carry out activities related to cooperation with the EU, the World Health Organization, the World Trade Organization and all other organizations that deal with cooperation

in the area of agriculture, economy, transportation, energy, environment, etc. It is obvious that such a Ministry, by its very organization and competences, cannot ensure stable functioning. The Minister who is to be the head of this Ministry will have to possess superhuman knowledge and skills in order, for example, to manage to negotiate the conditions for drawing credit from the World Bank, conditions under which we will export our veal to the EU market and conditions necessary for operating the civil air transportation at the same time. This institutional solution is not sustainable, and if it were, than every country would have only a prime minister and there would not be a need for different ministries.

Another problem that constitution-makers overlooked is the fact that it takes a long period of time to build up institutions, and that human resources educated for specialized areas of international cooperation are scarce. If these people are engaged to work within a inadequate organizational pattern which is already limited in its existence to only three years, and if they are forced to carry out impossible tasks, those few experts we have will abandon the state administration. Instead of strengthening human resources in the country, we will face the reverse process.

The prescribed mechanism of decision making in such institutions, i.e. the principle of consensus – namely the right of the smaller republic (5%) to make decisions on the destiny of the bigger one (95%), certainly does not contribute to the stability of institutions, but, on the contrary, brings about the possibility of total collapse of their work and jeopardizes further development of Serbia, which is the bigger and more developed member state.

The process of adoption of the Belgrade Agreement and the Constitutional Charter showed this mechanism to be a failure, with both sides lacking goodwill for building the joint state. If daily decisions are to be agreed in this way in the future, it may be safely assumed that the future Ministerial Council of the joint state might come to agreement about some key issues once in six months, at best. Maybe the decision-making process could be faster, but only providing that there are permanent concessions of one side. So far this feel to the side of Serbia, for the most part.[1]

Some politicians deceived the public by saying that delay in the adoption of Constitutional Charter puts us further away from the European Union, which, again, jeopardizes the living standard of our citizens. What politicians forget to mention in such statements is that the beginning of negotiations on the stabilization and association agreement do not require only the Constitutional Charter, but much more. Namely, in order to start negotiations, it is necessary to create an Action Plan for harmonization of economic systems of Serbia and Montenegro, which would provide common economic space (customs, trade,

[1] This was especially shown in the adoption of Constitutional Law, when the Serbian side accepted that the activities of the fiscal agent to the IMF be temporarily performed by the Ministry for International Economic Relations, and not by the National Bank of Serbia, only because Montenegro does not allow any institution which has Serbia in its name to be mentioned anywhere in performing joint activities. In this way some members of the Constitutional Commission, with full awareness, jeopardized our cooperation with the IMF, which has been successfully carried out by the National Bank. This shows that even those few institutions that have been reformed in Serbia might be destabilized through the process of creation of the new union of Serbia and Montenegro.

banking, the entire economic environment) and common institutions – to sign the Agreement, it is necessary to implement the Action Plan. Montenegro insists that this process should last three years, while Serbia wishes it to be over as soon as possible, so as to be able to open negotiations on accession to the World Trade Organization and to sign the Association and Stabilization Agreement. This means that, although the Constitutional Charter was adopted, if Montenegro prolongs the harmonization of economic systems, there will be neither the Agreement, nor better living standards.

Experience in negotiations on harmonization held so far after the Belgrade Agreement was signed does not instill optimism, but, on the contrary, indicates that a hard period of harmonization with Montenegro lies ahead for Serbia, as well as concrete losses in the economy[2]. Does this mean that Serbian representatives in full awareness have given up for three years the possibility of signing the Agreement with the EU which prevents Serbia from becoming a WTO member because Montenegro does not want to carry out harmonization prior to the three year term, i.e. until the moment it realizes its independence proclaimed at the highest state level. Montenegro is obviously ready to waste this time, which is not an actual loss for this Republic. With regard to the economic structure of Montenegro, which is based on the export of services and not on commodity exports, membership in the mentioned organizations and integration does not bring any significant benefit to the Montenegrin economy, in the way that it is beneficial for Serbia. The interests of Montenegro are justified, but what is going on with the interests of Serbia, and who represents them?

There is another argument which indicates that the adoption of this Charter will in fact block our attempt to get closer to the EU. Since the entire world knows us as one country with one international subjectivity, all recommendations of the European Commission so far have required common regulations and common institutions on the overall territory. However, in opposition to this requirement, solutions from the Constitutional Charter introduce dual institutions and separate regulations. For example, the EU requires from us a common level of customs protection, common foreign trade regulations and common customs services. The Constitutional Charter, on the other hand, defines the existence of separate regulations and institutions, such as two Customs Administrations, and this is the case in all areas. It was clearly stated that the process would begin only when we achieve mutual economic and institutional unity, and anyone who claims that the Constitutional Charter brings us closer to the European Union deceives the public, either out of ignorance or out of other interests which are certainly not the interests of the development of the Serbian economy. Anomalies in the Constitutional Charter which put us further from the EU should be revised in the Action Plan for harmonization of two economic systems. Is this going to last three years and are we going to spend the entire period in establishing functional

[2] The attempt of accelerated harmonization of customs rates in the area of textiles, aimed at concluding the bilateral Textiles Agreement, which is of great significance for Serbia, is still continuing. The Constitutional Charter has no influence on this process, but Montenegro did not want to meet Serbia halfway, despite the fact that Montenegro will suffer minimal or no damage at all from harmonization in this area, while it would be of great significance to the Serbian textiles industry.

institutions as required by the international community? All of these imply that the union in such form will be more expensive, not only because of the absence of functionality in it, but also because of the missed opportunities from international cooperation. Therefore, the proclaimed will that we should give it a try and see whether this union is able to survive is sensible only if Serbia does not suffer damage during that period, but if damage exists and is already visible from the expert's perspective, than enormous responsibility rests with politicians who accepted such a constitutional solution.

The Belgrade Agreement was supposed to prevent the breakup of the state[3]. It contains forced political compromises with aspirations to put right all the anomalies of the Agreement in the future and goodwill during the creation of the Constitutional Charter, aiming to define a functional state union. However, this aim was not attained. Quite the opposite, what was created was a loose non-functional joint state to which Serbia transfers its entire international subjectivity. Moreover, maintaining its own Minister for foreign affairs, although the Belgrade Agreement stipulates that foreign affairs would be transferred to the level of the union, Montenegro continues to send a clear message that its priority is to gain independence. Therefore, such a model of a state union, accompanied by constant blackmails and irrational demands on the part of Montenegro, not only threatens the functioning of Serbia as a state for itself, but also threatens Serbia as a state which aims at being integrated in the international community.

Finally, in spite of significant efforts and attempts of Serbia and the EU to preserve this union, and despite compromises which were made in order to find models which will not threaten future independence of Montenegro during the existence of the union, costs become much higher and threaten the stability of Serbia. Among other things, the Constitutional Charter prompted sharpening of the conflict in the governing coalition in Serbia and wasted enormous energy on endless meetings with Montenegrin delegations, which were doomed to failure in advance, given their mandate (an independent Montenegro). This significantly slowed down reforms and opened a serious political crisis in Serbia.

Bearing in mind everything advanced so far, and especially the fact that institutional solutions defined in the Charter may jeopardize both international cooperation and further reforms in Serbia, it is becoming increasingly obvious that Serbia will be forced to provide to itself an independent and stable path towards accession to European and international integrations.

[3] Since Montenegro has already completed its economic and legal system, it could rather be said that the Belgrade Agreement should have integrated the two states and not preserved one state.

Tanja Miscevic, Ph.D.

HEADING TOWARD THE FIFTH ENLARGEMENT OF THE EUROPEAN UNION

The Council of the European Union (EU) as an institution responsible for the adoption of primarily general political guidelines and for shaping EU policies, at the Summit held on December 12 and 13 in Copenhagen made another in a series of its historical decisions which has been looked forward to with as much enthusiasm as fear. Namely, on the basis of the proposal of the European Commission (of 09.12.2002.), 15 members of the Union agreed to bring to a conclusion a long lasting process of accession negotiations, and, as of May 1, 2004, the EU will have as many as ten new members. Thus, in less than two years the Union will admit to its membership five CEE countries (Poland, Hungary, the Czech Republic, Slovakia and Slovenia), three Baltic countries (Latvia, Estonia and Lithuania) and two European Mediterranean countries (Malta and Cyprus).

As we are now at the end of the process which has lasted for about fifteen years, during which the EU has also created its new enlargement policy, it would be good to recall its evolution. The reason for this is practical: to see that the path towards the EU is not at all easy and simple, and especially that this process is long and expensive, at the same time as pointing out that the same or similar developments lie ahead of Serbia and Montenegro.

The EU Enlargement Policy

Compared with the existing joint and common policies that the Union has developed over fifty years of its existence, the enlargement policy is by all means the newest and the most specific one. It does not regulate only one area (as is the case with the common agricultural policy or structural policy), nor does it allow for only one form of a political process. This policy is most often considered to be a composit policy, as it comprises at least two dimensions: a macro level (establishment of general objectives and parameters of an enlargement policy) and a mid-level (at which specific details and essence, i.e. contents of this policy are defined). Work on both levels of enlargement policy implies also interference in the elements of other joint or common policies of the Union.

The EU did not have a need to create an enlargement policy earlier, although the membership of this organization has been increased occasionally. The Union has experienced four waves of enlargement so far: accession of the UK, Denmark and Ireland in 1973, Greece in 1981, Spain and Portugal in 1986 and Austria, Finland and Sweden in 1995. The EU also enlarged its territory and population

after the unification of the two Germanys, but this is considered to be an unofficial enlargement. Reasons for the absence of the need to create a common enlargement policy and to define concrete conditions for EU membership are obvious – all new members were Western European countries, bearing similar features and values as the founding countries of the three European communities. The Union was responding individually to individual problems encountered by some of these countries (consolidation of democracy, especially in Greece, as well as significant economic problems in Spain and Portugal).
However, the upcoming, fifth enlargement of membership is without precedent as it implies an increase in the Union's population by 100 million new nationals and a 30% increase of the size of its territory. However, much more important than this obvious enlargement is the fact that new members have different historical, economic, cultural and political experiences, both in relation to each other and to the EU Member States. This is why it is necessary to define relations between new candidates and the Union in a new and different way.

A Basis: The Implementation of Association Agreements

Common characteristics of all countries which accede to the Union are that all of them concluded different forms of Association Agreements with the European Union, and earlier with the EEC, according to Article 310 (ex. 238) of the EC Agreement. The Community signed the first agreements of this type with European Mediterranean countries, first with Greece (1961; Greece became an EC member before the implementation of the Agreement), Turkey (1963), Malta (1970) and Cyprus (1972). These Association Agreements brought about the establishment of a customs union between the EEC and these countries, as well as mutual trade liberalization, and opened the possibility for these countries to become EEC members.
After the end of the cold war and the fall of the Berlin wall (November 1989), Central and East European (CEE) contraries started the process of transition, and one of the main characteristics of this process was the approach of these countries toward European integration. The EU gave support to this process, as it was "…in full compliance with the basic objective of this organization, which is defined as the defense of liberal democracy and the market economy, with the main emphasis being on overcoming the division of the continent" (Summit of the European Council, Rhodes, 1988). However, it was not that clear from the beginning that the Union would have such a dominant role in the process of transition of CEE countries, but it was simply forced to take on that role. The main factors that defined the primary role of the Union are external factors: firstly, the governments of transition countries which have shaped the goals of their foreign policies and internal tasks in compliance with basic values of European integration; of no less importance is the American factor, i.e. the influence of the US administration, which significantly supported such developments.
The first steps were the establishment of diplomatic relations between the EU and these countries, removal of long lasting quotas for imports from CEE countries, and extension of the system of the General Preferential Scheme to

these countries. The European Commission was assigned the widest role in the normalization of relations and in defining necessary assistance. The Commission created and negotiated the Agreement on Trade and Cooperation, under which CEE countries became new trade partners of the EU. The next significant contribution of the Commission was the promotion of the program of technical and financial assistance for reforms (the PHARE program started in 1989 only for Poland and Hungary at first, but later extended to all other countries in transition) and the establishment of the European Bank for Reconstruction and Development (EBRD), which approves public loans to these countries as long as they do not have access to private direct investments.

Attempts to create long range, more comprehensive and closer relations with CEE countries made by the governments of Germany and the United Kingdom were disrupted and halted not only because of the issues that were on the agenda of the European integration itself (negotiations and Inter-governmental Conference for the adoption of the Mastricht Agreement, the creation of the European Monetary Union, etc.), but also because of the impossibility of finding the answer to the question how to include these countries into the integration flows of the EU. Because of this, the concepts of the European Confederation (as presented by President Miterrand) and the European Political Area (proposed by France Andriessen, the Commission member in charge of foreign affairs) did not meet with support in the Union.

A more moderate idea proposed by the Government of the United Kingdom in 1989 was accepted: to create a new type of international contract on accession which is defined as "…a new pattern of relations in Europe" (special meeting of the European Council, April 1990). Thus a new form of Association Agreement was created. Due to great political significance of these agreements and the return of these states to their base, they were titled European Agreements (EA).

These Agreements were concluded between 1991 (the first agreements with Hungary and Poland) and 1996 (the last agreement signed with Slovenia) separately with each of the ten CEE and Baltic countries (with Bulgaria, Romania, the Czech Republic and Slovakia in 1993, and with Estonia, Latvia and Lithuania in 1995). The main goal of the European Agreements was to create a free trade area between the Union and these countries on the basis of reciprocity, asymmetrically and gradually (with a projected period of ten years divided into two stages). Namely, this concerns the economic, social, political and cultural bringing closer of these countries to the Union, which involves areas such as political cooperation, appropriate trade relations, economic activities and cultural cooperation, with necessary harmonization of national legislation of associated states with community law (especially areas relating to internal markets). The European Agreements permitted associated countries access to trade preferentials and benefits otherwise available to EU members only, providing free trade in industrial products (except for agricultural products, textiles and steel), free movement of services, capital and people, and removal of customs and all quantitative restrictions. Special accession institutions were set up for implementing the Agreement: the Association Council (monitors the processes of harmonization with community law), the Association Committee

(regulates implementation of certain areas of the agreement), and the Parliamentary Committee for Association (the center of political dialogue of the EU and applicant countries). The PHARE program remains the main financial instrument in the strategy of preparing CEE countries for membership.
Although the European Agreements are the most comprehensive agreements concluded by the Union so far, the contracting partner, i.e. CEE countries were not very satisfied with them. Namely, the most common objection referred to the economic contents of the agreements, in particular because of slower and limited liberalization in trade with "sensitive" products – agricultural products, textiles, coal and steel, which are the main exporting products of these countries. Another reason is political as the European Agreements do not stipulate clear obligation of the EU to accord these countries membership, since membership is defined as an ultimate goal, while "…association, in the opinion of contracting parties, provides assistance in attaining this goal" (Preamble of the European Agreements).

The Criteria for EU Membership

Taking advantage of imprecise provisions of the Association Agreements, both the European Agreements and agreements concluded with European Mediterranean countries, all associated countries applied for membership in the EU immediately after having ratified agreements. This raised a new problem before the Union, that is, to define what criteria must be fulfilled for one country to become a member. Founding treaties have defined explicitly only the main condition, which is that a country must be located in Europe. Precise criteria were to be defined by heads of states and governments of the EU countries at the Summit held in Copenhagen in 1993. This Summit was a key step both for relations with CEE and for the creation of the EU association policy. Namely, the Union accepted future membership of these states, establishing that associated countries would become EU members as soon as they were able to accept the obligation deriving from membership in relation to economic, legal and political conditions. These conditions (accession criteria) are the following: the stability of institutions which guarantee democracy, the rule of law, human and minorities rights; the establishment of a market economy (competition in particular) and the acceptance of acquis communitaire (according to the classification of the areas of community commercial legislation enlisted in the White Paper which was adopted in 1995). Another condition was added later, which is the existence of efficient administrative structures necessary for the implementation of these agreements.

Agenda 2000

The meeting of the European Council held in Madrid in December 1995 is of great significance for further developments towards the enlargement of the EU and the creation of its enlargement policy. Namely, heads of states and governments for the first time raised the question of fitting in for each candidate

into the general enlargement framework, with cost–benefit analysis of the increase of its membership. Therefore, they asked the Commission to prepare separate reports in response to these questions. In July 1997, the European Commission presented the Agenda 2000, a three-volume report and program of the future actions of the Union, which established a wider perspective for the development of the EU and defined its future financial framework, bearing in mind the challenges of enlargement. This important document covers four major areas: the Commission's assessment of the candidate countries (which at that moment did not meet the criteria set in Copenhagen, while at the same time proposing a different approach to different groups of states); a provisional association strategy (which provides that the enforcement of the acquis must be ensured before the beginning of membership, accession assistance, etc.); the research of the impact of enlargement on the Union (especially the impact on agriculture and structural funds); and establishment of financial prospects of the EU for the period 2000-2006 (which stipulates that the response to financial costs must be redistribution of existing funds, and not the creation of new ones).

The Process of Enlargement of Membership

Such a comprehensive Report and the Commission's recommendations resulted in the official beginning of a very complex process of the enlargement of membership. This process consists of several elements: a strategy for becoming a member (defined jointly by the EU and each candidate country, taking into account specific conditions in every candidate country), accession negotiations, the process of examining the acquis and the procedure of evaluation of the attained results in this process for each candidate country.

During negotiations for membership for each associated country the conditions for becoming a member are defined, in particular the conditions related to adoption, implementation and enforcement of community legislation. The negotiations with first six candidates (Poland, Hungary, the Czech Republic, Slovenia, Estonia and Cyprus) began in March 1998. The second wave of negotiations with Bulgaria, Romania, Latvia, Lithuania, Malta and Turkey started in February 2000. However, the division of candidate countries into two groups did not imply the order in which these countries would become EU members, but the EU applied a "regatta" approach, meaning that those states which successfully meet the criteria would become members regardless of when the negotiations had started.

The process of analytical research of the community heritage includes the review of 31 areas of community law and procedures, and exposure of the candidate to what has been achieved so far in these areas at the level of the Union, since these are areas in which each candidate country must harmonize its legal system. Analytical research is gradual, so the last of these areas (agriculture, judiciary and home affairs, free movement of people, regional policy, financial control and budget) "open", i.e. start being discussed between the Union and candidate only at the very end of the negotiations.

An important moment in the process of enlargement of the Union is evaluation of successfulness of each candidate country (which begins with the Agenda 2000) in the form of the European Commission's evaluation – with respect to the general framework, but for each country separately. Practically, this means that the European Commission follows the developments in these countries, evaluating the situation on the basis of the defined accession criteria: political, economic and legal. Namely, within this process (which is known as the review process) the European Commission submits regular annual reports to the Council, and these reports serve as a basis which provides direction to the negotiations with each candidate country. The European Commission submitted its first regular reports in November 1998, and every year from then on. On the basis of the Commission's review of the successfulness of candidates, decisions were adopted on concluding negotiations and on enlargement of the EU.

Final Preparations for Membership

What lies in front of both countries which are to become EU members and the Union itself is the creation of a draft and the conclusion of Accession Agreements, which should stand for a final compromise intended to provide easy integration of new members, at the same time as ensuring efficient functioning of the enlarged Union. It has been stipulated that after the creation of the Draft Agreement, the Commission's opinion, consent from the European Parliament and the Council's approval, this Agreement should be concluded in Athens on April 16, 2003. The Union proved that it is not going to leave anything up to chance with it incorporation of protective clauses which were one of the subjects of debate during negotiations on the accession of candidate countries. With these clauses the EU protects itself in cases of unexpected developments during the first three years after enlargement. This concerns protective measures related to economic, budgetary and structural polices in the acceding countries, which may harm the existing coordinated process of economic policy.

As far as Cyprus is concerned, the European Council expressed an earnest wish to admit a united and not a divided Cyprus to the Union. Therefore, in the Presidential Statement from Copenhagen, support was given to the determination of Cypriot Greeks and Turks to continue negotiations aimed at a comprehensive solution of the Cyprus problem, setting February 28, 2003, as a deadline. All conditions of the achieved solution must be incorporated in the Accession Contract, in accordance with the foundations of the Union. However, if a solution is not found, the enforcement of acquis on the northern part of the island would be suspended until the Council decides otherwise. A Commission was assigned to find ways to foster economic development in the northern part of Cyprus in order to bring it closer to the Union.

Another important thing is final (although partial) definition of one of the key issues, i.e. what funds the Union will allocate for its new members. Allocations by the Union for costs resulting from obligations established by certain Union policies that will burden new members are now precisely defined (Annex 1 of the Presidential Statement from the Copenhagen Summit, December 12 – 13, 2002)

– EUR 9.9 billion for 2004, EUR 12.6 billion for 2005, EUR 15 billion 2006. EUR 1.8 billion will be earmarked for agriculture for new members in the period 2004 – 2006, followed by another EUR 3.7 billion and EUR 4.1 billion. For structural activities (projects from structural funds) allocation is defined at EUR 6 billion in the first year, and as much as EUR 8.8 billion in 2006. Allocation for internal affairs and additional costs that may emerge during the transition period is relatively balanced, amounting to EUR 1.4 million for each of the three years under consideration. A total of EUR 1.6 billion for the three-year period will be allocated for administration.

Besides financial issues, of special significance is the incorporation of new members into the institutional system of the Union, with onus on continued efficiency of operation of those institutions. Institutional solutions geared toward enlargement were on the agenda of two inter-governmental Conferences which resulted in the revision of basic documents of the Union, first in Amsterdam (1997) and then in Nice (2000). According to these Agreements, the composition of the European Parliament after enlargement will be the following: Germany – 99, the United Kingdom, France and Italy – 72, Spain and Poland – 50, the Netherlands – 25, Greece, Portugal and Belgium – 22, the Czech Republic and Hungary – 20, Sweden – 18, Austria – 17, Denmark, Finland and Slovakia – 13, Ireland and Lithuania – 12, Latvia – 8, Slovenia – 7, Luxemburg, Estonia and Cyprus – 6, and Malta 5. After the enlargement, ten new Member States will have the following votes in the Council: Poland – 27, the Czech Republic and Hungary – 12, Slovakia and Lithuania – 7, Latvia, Slovenia, Estonia and Cyprus – 4, and Malta – 3. This will amount to a total of 345 votes, while a qualified majority set at 258 votes. As far as the number of members of the Commission is concerned, new members will have one representative in the Commission each, until this institution reaches 27 representatives. After that, once this limit is met, the number of Commission members will start falling and the system of equal rotation between members will be introduced.

Message to Other Candidate Countries

Although the Union has welcomed significant progress in implementation of the Association Agreement and implementation of reforms, the decision on enlargement disappointed Romania and Bulgaria the most, two countries that are left out of the first round of enlargement. It is anticipated that these two countries will join the Union in 2007, providing they continue to make progress in meeting accession criteria and with continuation of accession negotiations. The main requirement regarding these countries is to accelerate preparations, which includes realization and implementation of obligations undertaken during negotiations (first of all, judicial and administrative reforms), while the Union's assistance primarily refers to considerable increase in financial support for these processes.

Another candidate country that will have to wait a little longer for EU membership is Turkey. The European Council praised significant progress made by Turkey toward meeting the Copenhagen criteria, putting special emphasis on the set of

laws and appropriate implementation measures related to key sectors. However, the greatest objections refer to political criteria, not only in terms of the legislative framework, but also in terms of implementation, especially insisting on reaching stability of institutions that guarantee democracy, the rule of law, and human and minorities rights. In case of Turkey, the Union was very precise, as it defined that if the European Council decides that Turkey meets political criteria for membership on the basis of the Commission's report and recommendations during its Summit in December 2004, then negotiations with this country will begin.

As far as the relationship with other interested countries is concerned, in particular the Western Balkan countries, on this occasion these countries were characterized as "neighbors of an enlarged Union". The European Council underlined the significance of meeting the Copenhagen criteria in relation to Croatia, Bosnia and Herzegovina, Serbia and Montenegro, Macedonia and Albania, as well as its own obligation to foster the efforts of these countries in their progress towards the Union. Especially important is the decision for Greece to organizes a special Summit of EU members and countries which are part of the Stabilization and Association Process on June 21, given that it holds the Presidency of the Union in the first half of 2003. It is already clear that this conference will be of great importance for all Western Balkan countries which are expected to show their readiness for mutual regional cooperation during the preparation of this meeting. A proactive approach is especially expected of some of these countries: the Republic of Croatia which applies for membership in February, as well as the state union Serbia and Montenegro, as this conference could be the beginning of negotiations for the conclusion of the Stabilization and Association Agreement with the EU. This will actually be the beginning of a new negotiations process for the next enlargement of membership of the European Union.

Department of European Issues

The EU Review

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Economic News

THE SECOND REPORT BY THE EUROPEAN COMMISSION "THE WESTERN BALKANS IN TRANSITION"

In the late 2002, the European Commission's Directorate-General for Economic and Financial Affairs – Directorate for International Relations, released the second report on the region of the Western Balkans titled "The Western Balkans in Transition"[1].
The Report comprises three units:

- Survey of macroeconomic trends in the region as a whole and of relations with the European Union
- Fiscal consolidation of the region
- Country notes which address economic trends, structural reforms and international relations.

In this brief overview of the Report, we will concentrate on economic trends in the region as a whole (the first part of the Report) and actual assessment of reforms and the economic situation in the Federal Republic of Yugoslavia (the third part of the Report).

Main Economic Trends in the Western Balkans

At the beginning of the Report, it is stressed that the Western Balkan region is composed of relatively small sized economies. While the Federal Republic of Yugoslavia has the largest population (8.6 million), in economic terms Croatia is strongest with a GDP of over € 22 billion. The population of the whole region is almost 25 million people, equivalent to 6.5% of the population of the EU. The GDP of the whole region amounts to € 50 billion, which is equivalent to as little as 0.6% of the EU's GDP, or 40% of Portugal's GDP. The GDP per capita at current nominal exchange rates in the region as a whole averages about € 1.800 with a great difference between particular countries.

[1] The first report "The Western Balkans in Transition" (2001) can be found on http://europa.eu.int/comm/economy_finance/publications/supplement_c_en.htm

The Western Balkans – Macroeconomic Trends, 1998 - 2002[2]

		1998	1999	2000	2001	2002[p]
Real GDP growth[1]	%	3.8	-3.2	4.5	4	3.8
Inflation[1]	%	15.7	16.4	36.4	12	6.1
Exports[2]	Million €	8801	7776	9729	10320	na
Imports[2]	Million €	16690	15036	18423	21461	na
Trade balance with the EU[2]	Million €	-4426	-4205	-5061	-6721	na
FDI	Million €	1138	1618	1713	2542	2111

[p] Projections. [1] Weighted average. [2] Excluding Kosovo and Metohija

Following the recovery in 2000 from the 1999 Kosovo crisis, the Western Balkan region continued to register a rise in real GDP by 4% in 2001, despite the slowdown in the world economy. However, there are significant differences among particular countries in terms of achieved GDP growth rates in 2001, which is indicated in the following table. Stability in the region and reforms in all the states are estimated as contributing to the continuation of positive economic performances of the region as a whole, and to the realization of the real GDP growth rate of nearly 4% in 2002.

Country Summary – Macroeconomic Indicators 2001-2002[3]

Country	Population[1]	GDP p.c.	Real GDP growth		Inflation		Trade balance		Current account[2]		FDI[3]	
	million	In €	%		%		% of GDP		% of GDP		% of GDP	
	2001	**2001**	**2001**	**2002[p]**	**2001**	**2002[p]**	**2001**	**2002[p]**	**2001**	**2002[p]**	**2001**	**2002[p]**
Albania	3.4	1350	6.5	5	3.5	3.9	-25	-22.1	-6.3	-5.9	5	5.8
B&H	4.3	1175	2.3	2.5	3.3	2.3	-36.9	-33.5	-22.3	-20.7	2.9	5
Croatia	4.4	5140	3.8	4	2.6	3	-21	-21.5	-3.1	-3.6	6.5	4.9
FRY	8.6	1412	5.5	4	39	15	-26	-25.8	-5.5	-8.2	1.5	4.4
Kosovo (FRY)	2	941	11	7	11.3	6.5	-47.3	-50.2	9.1	-2	0.3	0.5
Macedonia	2	1885	-4.1	0.5	3.7	3	-11.7	-11.4	-10.6	-9.7	13.2	2
The Western Balkans	*24.7*	*2026*	*4.1*	*3.8*	*12*	*6.1*	*-24.4*	*-24.1*	*-6*	*-7.1*	*5.3*	*4.5*

[p] Projection. [1] Population. [2] Including official transfers. [3] Foreign direct investments.

Significant progress has been made in reducing inflation. Albania, Bosnia and Herzegovina, Croatia and Macedonia have consistently maintained one-digit inflation rates over the past four years, registering an average rate of 2.9% at the end of 2001. A two-digit inflation rate in the region as a whole at the end of 2001 was mainly due to a high inflation rate in Kosovo, and especially the 39% inflation rate in our country (resulting from liberalization of prices in 2001), which is, again, much lower than the 113% inflation rate registered in the late 2000. With a further

[2] Source: "The Western Balkans in Transition", European Commission, Directorate – General for Economic and Financial Affairs, pp. 1, http://euroea.eu.int/comm/economy_finance/publications/westernbalkans_en.htm

[3] Ibidem, pp.2

inflation drop in our country, inflation in the region as a whole should decline, thus reaching for the first time since 1997 a single digit rate.
Western Balkan countries showed large fiscal deficits in 2001, with the exception of Yugoslavia, which recorded, before grants, a fiscal deficit of 1.3% of the GDP, and Kosovo, which showed a surplus of 1.3%, excluding capital expenditures. In other countries of the region, general government deficits as a ratio to GDP averaged more than 6%. Fiscal deficits are expected to improve in 2002 with the exception of FRY, including Kosovo.
In 2001 international trade for the region as a whole was not affected by the global downturn. Although both exports and imports registered upward trends, import growth has outpaced export growth, resulting in the worsening of trade balances in the region. Trade deficits as a ratio to GDP were significantly larger, ranging from almost 12% in Macedonia to 47% in Kosovo. However, increasing trade deficits are not necessarily a negative evolution, especially when they are linked to economic growth and a need for imports in order to satisfy growing investment needs, and/or when they are compensated by surpluses in the balance of services. The introduction by the EU of unilateral trade measures, granting free access to the EU market, represents an important prerequisite for the development of the export sector in the region. In 2001, the share of trade with the European Union in total trade accounted for slightly over 50%, ranging from around 80% in Albania, to more than 40% in our country.
As far as the current account is concerned, it is slightly better than the trade balance, thanks to significant private remittances, positive balances of services and official transfers (especially large in FRY, including Kosovo). The current account is expected to worsen in the two largest economies (Croatia and FRY), leading to an increase in the average current account deficit for the region as a whole.
Foreign direct investments in the region doubled since 1998, reaching € 2.5 billion in 2001, which corresponds to more than 5% of the Western Balkan GDP. This figure is even higher than the same ratio in the eight Central and Eastern European countries (4.8%) which are candidates to EU accession in 2004. This result may be partly explained by the lower level of GDP in the Western Balkans with respect to CEE. In fact, in per capita terms: 2001 FDI inflows in the region were equivalent to € 100, a level that is significantly lower with respect to the benchmark of CEE acceding countries (€ 250). In 2001, the largest inflows of FDI's were directed towards Macedonia and Croatia. The main inflows of FDI's are related to privatization in the countries in the region. FDI flows as a percent of the GDP are expected to stabilize and to increase in Bosnia and Herzegovina and the FRY, and to decrease significantly in Macedonia.
At the end of this part of the Report, an emphasis was put on positive developments realized thus far, and on challenges lying ahead of the Western Balkan countries.
Political and institutional developments are stressed as groundwork for attracting foreign capital in the region. The progressive restoration of peace and stability, and the perspective of integration of the region into the European Union through the Stabilization and Association process have considerably improved the

political outlook in the region. Moreover, Western Balkan countries made progress in reforming their economies, in particular in the area of SME, privatization and trade liberalization (establishment of the Balkans free trade area). The reform of the banking sector has also advanced. Croatia and Macedonia have practically completed privatization of that sector, Bosnia & Herzegovina has privatized major banks, while our country has made considerable improvements in restructuring and cleaning up the banking sector.
These positive steps need to be followed by other reforms, namely the full respect of the rule of law, accompanied by the fight against corruption, transparency of the legal framework, creation of efficient infrastructures and, more generally, establishment of a business-friendly economic environment. Along these necessary reforms, the Western Balkan countries are expected to continue the transition towards functional market economies, through the implementation of important structural reforms, namely the completion of the process of privatization, the creation of efficient financial markets (which in many countries of the region are still at the embryonic stage), and reform of the public sector and establishment of a central treasury system.

The Federal Republic of Yugoslavia

As far as macroeconomic indicators are concerned, economic growth in 2001 was higher than projected, and was mainly driven by the recovery of agricultural output in FRY and increased activity in services. According to the Report, industrial production in the FRY in 2002 is expected to increase by 2-3%, with the economic growth rate reaching 4%, mainly on the basis of estimated increase in services, while agricultural production is expected to remain at the 2001 level.
In the eight months to August 2002, retail prices both in Serbia and Montenegro increased by about 9%, and therefore the estimated annual inflation rate was revised downward from 20% to 15% in Serbia, i.e. from 15% to 10% in Montenegro. The inflation drop in 2001 and 2002 was largely contributed to by a restrictive and a stability-oriented monetary policy of the central bank, and by wage constraints in the public sector.
The FRY general government deficit (including Montenegro's deficit) in 2001 was considerably lower than projected (1.4% of GDP compared to projected 6.1%), amounting to approximately €157 million. This was in part due to a tax policy implemented in the first half of 2001 and the improvement in the collection of tax revenues, but primarily to significant reduction of budgetary expenditures. The deficit was financed through domestic borrowings (0.6% of GDP) and foreign financing (0.8% of GDP as compared to the programmed 4.1%). According to the Report, the budget deficit increase in 2002 is projected at 5.7% of the GDP. This deficit is planned to be financed through domestic borrowings (0.5% of GDP), privatization income (1.3% of GDP) and foreign financing (4% of GDP).

FRY - Main Economic Trends, 1999-2002[4]

	1999	2000	2001	2002[p]

[4] Ibidem, pp. 38.

Real GDP growth	*%*	-18	5	5.5	4
Inflation rate	*% (average)*	42	73	91	20
	% (end of period)	50	113	39	15
Unemployment	*% of labor force*	27	27	28	29
General government balance[1]	*% of GDP*	NA	-0.9	-1.4	-5
Trade balance	*% of GDP*	-15.9	-22.3	-26	-25.8
Current account balance[1]	*% of GDP*	-7.5	-7.6	-10.9	-11.7
External debt	*€ billion*	8.9	12.2	13.5	8.7
Debt-to-export ratio	*%*	NA	453	429	273
FDI	*% of GDP*	0.9	0.3	1.5	4.4
	€ billion	105	27	184	570

[p] Projection. [1] Before foreign donations.

As far as external situation of FRY is concerned, the current account deficit in 2001 was lower than projected (10.9% instead of 14.6% of GDP), although imports grew more than expected and exports were slightly below the projected amount. This improvement was due to higher than expected inflows of remittances from abroad (€ 1,400 million instead of an estimated € 1,000 million). In the first nine months of 2002, the FRY registered a higher than projected trade deficit, in spite of a large 20% increase in exports compared to the same period in 2001. However, imports increased by 25% in that period mainly as a result of strong domestic demand for consumer products and investments. The current account deficit which has been projected at 12.8% in 2002 by the International Monetary Fund program is now projected to reach 11.7% of the GDP as a net inflow from remittances, with money from abroad continuing to exceed the projected level.

In the forthcoming period, debt servicing (interests payments and the need to further strengthening national foreign exchange reserves) will continue to put a heavy strain on the balance of payments in our country. The IMF foresees further slight reduction of the current account deficit in 2003 from 11.7% to 10.9% of GDP, debt amortization payments of around US$ 50 million, further increase in gross foreign exchange reserves by about US$ 600 million, with official financing from abroad in the form of grants and loans expected to amount to US$ 1.3 billion.

The Report praised structural reforms that were implemented throughout 2001 and 2002, especially in the area of expenditure control and tax policy, and the cleaning up of the banking system.

As far as reform in the area of public finance is concerned, important preparatory steps has been taken towards establishing the institution of a Treasury while public expenditures control has been improved considerably. The institution of a Treasury is expected to become fully operational in the spring of 2003.

The process of privatization in Serbia which is carried out through tenders and auctions has gained some momentum since early 2002. Total proceeds from privatization in the first ten months of 2002 exceeded the targeted amount (€ 270 million compared to € 130 million). In order to facilitate the privatization of less profitable companies in Serbia through international tenders, the authorities plan

to amend the Privatization Law, especially the provisions concerning obligatory post-privatization employment protection (from the present five years to one year).

As regards financial sector reform, the achievements of the National Bank of Yugoslavia are praised in strengthening banking supervision. It is also stressed that after the Constitutional Charter goes into force, the NBY will cease to exist and its functions will be taken over by two central banks at the level of the republics.

The Report also stresses that further steps which are planned in the reconstruction of the state administration and the real sector seem encouraging.

In the area of international relations, the Report stresses that after political and democratic changes in October 2000, FRY authorities have made considerable progress in establishing links with international organizations, and in particular in normalizing the country's financial relations with multilateral and bilateral creditors. The IMF Extended Agreement for 2002 – 2005 of about US$ 860 million was adopted in May 2002; furthermore, in March 2002, the World Bank disbursed a first Structural Adjustment Credit (SAC).

As far as relations with the European Union are concerned, general Community support was provided under the CARDS program (€ 630 million in 2001 – 2002 to support, among other things, institution building in the public administration and sector reforms in energy and transport); furthermore, the Community supported the process of economic reforms in the FRY through the provision of macrofinancial assistance of € 345 million, of which € 120 million were in the form of grants.

As regards the Stabilization and Association process, considerable progress has been made. The Consultative Working Group of the EC and the FRY met five times, with the next step in the process being the preparation by the Commission of a Feasibility Study on the feasibility of embarking upon negotiations on a Stabilization and Association Agreement. However, timing depends on progress with the implementation of reforms, but also on the finalization and adoption of the new Constitutional Charter and implementation of an Internal Market Action Plan.

Source: "Midday Express", http://europa.eu.int/comm/press_room/index_en.htm

CHARACTERISTICS OF MACROECONOMIC TRENDS IN 2002

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Characteristics of Macroeconomic Trends in 2002
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Forecasts of Macroeconomic Trends in the First Six Months of 2003
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Macroeconomic Trends in 2002 and Forecasts for the First Six Months of 2003

CHARACTERISTICS OF MACROECONOMIC TRENDS IN 2002

General Overview

Gross national income is estimated to have increased by 4% in real terms in 2002, year-to-year, which corresponds to the forecast we made in July last year. The most important factors that affected GDP growth are the following: (1) significant slowdown in inflation, compared with last year; (2) stability of domestic currency; (3) faster inflow of foreign capital from international financial institutions, in the form of credit arrangements and from direct foreign investments in privatization; (4) increase in domestic savings, and (5) imports. The total employment in the formal sector is slightly lower, compared to previous year, which indicates improvement in the quality of development due to improved productivity and efficiency of investments.

The 2002 import growth of 20.6% is considerably above the expected. Coupled with dynamics of exports, which were also beyond expectations, the result is a trade deficit.

The overall standard of living of citizens significantly improved owing to the increase in the population's income in real terms (the average wage in 2002 rose by 30.2% in real terms, year-to-year). High real growth of the average wage implies relatively high growth in the average pension and social benefits.

Realized dynamics of economic growth according to economic activities indicates that a very high level of domestic demand, despite being boosted to a greater extent by foreign donations than by domestic economy, affected a pick-up in construction, retail trade and transport, while industrial production growth was much slower and slightly below expectations.

Reform of the banking sector and the sector of public finance developed according to expectations. The results of these reforms are reflected in much stronger macroeconomic stability than the expected. However, structural reforms in the economy have been lagging behind significantly in terms of the restructuring and privatization of socially-owned enterprises, and the restructuring of public (state-owned) enterprises. Hence, the effects of macroeconomic stabilization are relatively modest in terms of gross national income growth, while they are fully effective in terms of real growth in the citizens' standard of living, and increasingly stimulate domestic savings. Everything put forth thus far indicates that the Government of Serbia will have to accelerate reforms in the real sector so as to permit full positive effect of macroeconomic stabilization on domestic gross income growth, coordination between trends of domestic supply and demand, and on further increase of exports.

Production and Services

Industrial production in Serbia in 2002 registered 1.7% growth, which is slightly under the 2% forecasted by the G 17 Institute in the July Macroeconomic Forecasts. Industrial output rose by 1.6% in Central Serbia and by 2.1% in Vojvodina. With regard to the sectors of industrial production, the highest growth was registered in manufacturing (2.7%); as far as mining and quarrying are concerned, this sector displayed considerably lower growth (by 1%), while water, electricity and gas production and supply dropped by 1.7% year-to-year. By destination of consumptions, the production of capital goods was up by as much as 14.1%, the production of intermediate goods grew by 2.7%, while the production of consumer goods was down by 0.7%.

According to the figures for the first eleven months, the value of realized construction work is estimated to be up by 35.8% in real terms, compared with last year. Very dynamic growth in the real value of realized construction work, which, in our assessment, largely resulted from increase in real domestic demand throughout 2002, has had and will have a manifold effect on other economic activities in 2003. Also, as the real estate demand curve, which in our country primarily relates to flats and commercial space, is subject to interest rates, we expect increase in demand for these goods to follow the announced reduction of interest rates next year, which will have further positive impact on the pick-up in construction activity.

Freight transport recorded strong development in 2003, while passenger transport, except for air transport, dropped off (measured in ton kilometers). Growth of transport volume in 2002 is estimated at about 8%.

Retail trade turnover in 2002 increased by 10.5%, and wholesale turnover dropped by 4.6% in real terms year-to-year. Real growth in overall turnover in trade in 2002 is estimated at 8.5%, compared with the previous year's period.

According to the 10-month performance in tourism and the hotel and restaurant industry, these two activities are estimated to have fallen by 0.6%.

Labor Market

Total employment in Serbia in 2002 dropped by 1.7%, year-to-year, as a result of the significant decrease of 6.1% in the number of employees in the socially-owned sector. Since the data on employment in the private sector and small-sized enterprises is released in March and September every year, the annual average on the basis of these two totals indicates that the number of the employed in the private sector increased by 11.6% and in small-sized enterprises by 10.0%. According to the data of the Serbian Labor Market Bureau, total registered unemployment in Serbia stood at 904,494 in December 2002, a 15.9% year-to-year increase, while the average number of the unemployed in the period January – December 2002 increased by 9.6%. The registered unemployment

rate in 2002 was 28.2%, which is up by 2.2 percentage points compared with the unemployment rate registered in 2001.
The number of job openings decreased by 14.4%, and the number of new jobs dropped by 1.9%. More job openings were filled by permanent employment in 2002 (83.2%), as compared to last year (72.6%). As expected, the share of fluctuation in total employment increased, which is in line with the experience of other countries in transition, with fluctuation in 2002 being 38.6%, compared to 29.3% in 2001.
The number of terminations in 2002 increased by 14.9% year-to-year.
According to the latest data for October 2002, the total number of unemployment benefits recipients amounted to 78,695, out of whom 44,896 are registered as redundancies, and 25,004 on the basis of bankruptcy. The total number of unemployment benefits recipients rose by 32.3% on average in the period January – October 2002, compared with the previous year's period - the number of unemployment benefit recipients on the basis of redundant labor was up by 32.3%, and on the basis of bankruptcy, by 47.7%.

Features of Domestic Demand

On the basis of developments in retail trade, real growth in personal consumption is estimated at 10%, which is twice as high as the development in domestic supply, i.e. GDP. Domestic demand was met to a significant extent through import; the highest rates of growth were recorded in imports of machinery and finished products. A portion of the population's income is estimated to have been put aside for savings.
The average gross wage in December 2002 was YuD 16,643, while the nominal net wage was YuD 11,555, a rise of 12.3% month-on-month, or of 36.6% compared with December 2001. Consumer prices in December 2002 remained at the previous month's level; thus, real growth in the average net wage was equal to nominal growth (12.3%). Real growth in the average wage in December 2002 year-to-year was 22.2%.
The average net wage in Serbia in 2002 was YuD 9,232, an increase of 51.8% in nominal terms, compared with last year. Given consumer price inflation of 16.6% in the period under consideration, the average wage in 2002 increased by 30.2 % in real terms, year-to-year. Such dynamics of growth in wages, coupled with considerable deceleration in the growth of food prices, resulted in the expected balance of the value of the statistical consumer's basket and the average net wage at the end of 2002.
The lowest wages are still paid out in the manufacturing of textile and textile products. Wages in this sector were lower by about 63-73%, compared with the average wage at the level of the Republic. This indicates that the Government needs to reconsider and amend laws and regulations which might be to blame for the unfavorable economic position of this industry.
Bearing in mind the realized dynamics of the average real wage, and given the fact that it participates with 50% in the adjustment of pension trends, we might say that the average pension paid out by the Old Age Pension and Disability Fund of the Employed in 2002 apparently rose in real terms. Since we do not

have comparable data on the nominal pensions paid out in 2001, due to the change in coverage of beneficiaries in 2002 relative to 2001, we are not in a position to present precise and accurate data on real growth in the average pension. However, our estimation of real increase in the average pension is confirmed by the fact that in January 2002 it took 45% of the average pension to cover the value of the statistical consumer's basket for one family member, while, in December 2002, this share dropped to 40%.

Both the Old Age Pension and Disability Fund of Farmers and the Old Age Pension and Disability Fund of the Self-employed were paying out pensions to their beneficiaries on a regular basis throughout 2002. The Old Age Pension and Disability Fund of the Self-employed paid out 12 pensions to December 2002 inclusive, while the Old Age Pension and Disability Fund of Farmers paid out 12.5 out of the planned 15 pensions. This Fund still has significant delay in payments since the pension paid out in December refers to the first half of the September 2001 pension.

Foreign Trade

Import and export growth in Serbia in 2002 went far beyond initial expectations. Commodity exports rose by 20.6% and commodity imports by 31.8%, which is considerably above the projections of both the Federal Government and the IMF, which ranged between 12-14% for exports, and 9-15% for imports. Such a high import growth significantly widened the trade deficit, which, at the level of Serbia, was up by as much as 1 US$ billion, compared with 2001.

According to economic-end use, imports of machinery and finished products, which account for 1/5 in the total imports at present, recorded the highest rates of growth. This trend suggests the process of replacement of obsolete equipment in domestic enterprises, as well as an increased demand for foreign durable consumer goods. Domestic producers of consumer goods are obviously not yet competitive enough on the domestic market, and it is unlikely they will be able to improve markedly their exporting performance before the consolidation of their position in relation to the competition.

The current-account deficit was also wider than projected, reaching US$ 1.7 billion. This is primarily due to unexpectedly high growth of commodity imports, as well as to the fact that the surplus on the part of non-commodity current transactions was slightly lower than last year. The highest surplus was recorded in current transfers (primarily owing to the purchase of foreign currency) and donations, while the surplus on the part of services was lower than projected, being even lower than the surplus recorded in 2001.

Privatization and Restructuring of the Economy

The results of privatization are rather poor. In 2002, only 12 enterprises were sold by tender and about 140 by public auction. This is considerably lower than the number of companies initially scheduled for privatization, i.e. 80 enterprises by tender and 1,000 by auction. Moreover, this is a very modest result considering the total number of enterprises which are due to undergo

privatization (about 4,000). In our assessment, this is the basic reason for the poor performance of the industry in Serbia. The slow pace and poor results of the privatization carried out so far also have a negative impact on the interest of strategic partners in the purchase of large enterprises, and these enterprises to the greatest extent generate negative effects on economic growth and development.

Auction sales are transparent enough, which could not be said for tenders. The present method of selecting the best offer involves as many as four criteria (price, investments, social program and the program of environmental protection), and for each of them there is a certain weight. After a successful tender sale, the data on other offerers is not publicly presented, which raises the question of transparency of tender sale methodology, and whether discretion in selection may appear as a source of corruption. All four criteria are very important and respond to the domestic situation and needs, which makes tender privatization acceptable, both from the position of enterprises and from the overall social position. However, although the issues of social programs and the program of environmental protection are of extreme importance, it must be clearly distinguished which portion of costs of these programs should be borne by the buyer, and which rests with the state given the existing unfavorable situation in both segments.

The process of restructuring large-sized, socially-owned enterprises is also behind schedule, while the restructuring of public enterprise has not even started yet. Continued reduction of inflation could be jeopardized if plans for increase in the prices of electric power, public and other utilities proceed without being accompanied by the restructuring of public enterprises, which are well-known for their irrational performance and huge unnecessary expenditures.

The Government must be ready and determined in resolving these issues, which are, ultimately, of crucial importance for the continuation of overall reforms.

Cooperation with International Financial Organizations

Tardiness in the adoption of the Constitutional Charter resulted in the postponement of the issuance of the third installment of the Extended Fund Facility (EFF), granted by the International Monetary Fund for the purpose of overcoming problems in the balance of payments and stabilization of the dinar. This credit of about US$ 830 million was approved in May 2002, when its first installment was released, while the second installment was drawn in August. Since the Constitutional Charter has been adopted recently, the third installment is scheduled for released during the first quarter of 2003, and it is worthwhile hoping that any new political obstacles will not disturb the expected dynamics of cooperation with the IMF.

Cooperation with the World Bank is primarily directed toward institutional capacity-building and the preparation of a strategy for combating poverty in Serbia. During last year several credits were approved under IDA conditions (twenty-year maturity and ten-year grace period), in the total amount of nearly US$ 200 million. These are the Structural Adjustment Credit (SAC), the Private and Financial Sector Adjustment Credit (PFSAC), credits for improvement of

education and for trade and transport facilitation, aid for financing of export and a credit for technical assistance in the privatization and restructuring of banks and enterprises. In the first six months of 2003 we should expect the release of the Social Sector Adjustment Credit (SOSAC), another PFSAC, credits for promotion of public finance management, for public health investments, as well as Labor Learning and Innovation Credit (LIC).

Free Trade Agreements

The establishment of the Southeast Europe Free Trade Agreement is scheduled for promotion in the middle of this year. So far our country has signed free trade agreements with Bosnia and Herzegovina, Macedonia and Croatia, while during the first quarter of 2003 free trade agreements are to be signed with Albania and Romania.

As far as the countries outside of Southeast Europe are concerned, free trade agreements with Russia and Hungary are effective (ratified last year), while the agreement with Slovenia, which was scheduled for signing by the end of 2002, has been postponed and it is still uncertain when this agreement is going to be signed.

However, due to the inexistence of a common foreign trade regime within the federation, and in particular owing to the announcement that Montenegro is not going to enforce agreements concluded so far, problems in implementation are likely to appear.

Exchange Rate and Foreign Currency Reserves

The result of the adoption of regulations which liberalized operations on the foreign currency exchange market at the beginning of last year is that in May 2002 the International Monetary Fund recognized convertibility of the dinar in current foreign transactions.

Throughout the year, the exchange rate was showing slight nominal depreciation (which started to accelerate slowly by the end of the year) and appreciation in real terms, which was, however, less dynamic than in 2001.

The first six months of 2002 on the foreign exchange market were marked by the conversion of European currencies into the euro. Thus the process of re-monetization of economic activity, initiated in 2001, continued, while the conversion significantly contributed to dynamic increase of the country's foreign exchange reserves. The level of foreign exchange reserves at the National Bank of Yugoslavia at the end of 2002 reached nearly US$ 2.3 billion, which covers five-month imports (the average commodity imports of FRY in 2002), a nearly 100% year-to-year increase. The most important factors contributing to this growth, besides the inflow of foreign exchange through exchange operations, were credits and donations from foreign countries. In this year we may expect reduced inflow on the basis of exchange operations, as well as increased outflows.

Foreign Direct Investments

The level of foreign direct investments in the FRY significantly increased, as compared with 2001, reaching US$ 475 million. The portion of FDIs that entered the country through the privatization process primarily relates to tender privatization (above all, three cement factories sold at the end of the year 2001, but the sale was realized at the beginning of 2002), and to the sale of shares from the Action Fund's portfolio, whereas foreign investors were not very interested in auction sales of enterprises. Greenfield investments have also started, the most important ones being linked to retail trade. Following the removal of political uncertainty associated with the framework of the future federal state, with the further reform of institutions and removal of administrative barriers, completion of a legislative framework, as well as with the speeding up of the privatization process, more dynamic inflow of foreign direct investments can be expected already during this year.

Fiscal and Monetary Policy

Money supply (M1) in December 2002 was YuD 116.4 billion, which is up nominally by 91.3%, or by 66.7%, in real terms, year-to-year. However, if deflationed by the retail prices index, then M1 increased by 66.6%.
The share of cash money supply in M1 had a downward trend, standing at 32.5% in December.
In order to regulate the amount of money in circulation, in 2002 the NBY issued treasury bills in the amount of YuD 74.95 billion. Out of the total value issued, 62.2% of the treasury bills, i.e. YuD 46.62, billion were sold.
A trend of a further cut in interest rates continued in 2002. The weighted average of interest rates on commercial and treasury bills and certificates of deposit at a monthly level in January 2002 was 3.71%, and in the last quarter of the year it did not go beyond the level of 2.50% per month. In December, the average weighted interest rate on short-term securities was 2.40%, at a monthly level. The NBY's discount rate at the beginning of 2002 was 16.43% at an annual level, dropping to 9.50% during the first six months, where it held steady throughout the second half of the year.
The average interest rate on the NBY's treasury bills (for all issuings from April 1 through December 31) is 11.60% at an annual level. Subscription of NBY bills with a 15-day maturity is no longer available as of May, while bills with 90-day maturity were introduced. Treasury bills with 180-day maturity appeared at the Belgrade Stock Exchange in the mid-July 2002.
Year 2002 began with a huge structural change in the banking sector. A ruling on the bankruptcy of the Beogradska banka, Beobanka, Investbanka and Jugobanka was issued on January 3 (the sanation costs of these four banks are estimated at over EUR 4 billion, which is an economically unacceptable amount).
Negotiations with the IMF in March of 2002 resulted in a three-year financial arrangement in the value of US$ 800 million. On May 15, 2002, having fulfilled all obligations under Article VIII of the IMF's Articles of Agreement, the Yugoslav

dinar became convertible for all current foreign transaction for the first time since 1946.

Public confidence in the banking system significantly increased and both dinar and foreign deposits rose considerably. By December 31, 2002, inclusive, total savings in banks reached an equivalent of US$ 851.470 million, of which US$ 791.265 million refer to foreign exchange deposits and US$ 60.205 million to dinar deposits. Leading banks in terms of the level of total savings are Komercijalna banka, Reiffeisen bank Yugoslavia, Vojvodjanska banka, Societe Generale Yugoslavia and Delta banka.

Gross collection of public revenues in 2002 was YuD 435.85 billion, which is nominally up by 61.72% year-to-year. In real terms, fiscal revenues rose by 35.33%, compared with last year. The revenues of budget and other users in the total public revenues of the Republic of Serbia in 2002 account for 56.5%, a 34.25% increase in December 2002, year-to-year. Health insurance revenues also rose by 49.9% over the same period. Fiscal revenues have recorded two years of continuous growth in real terms (deflated by retail prices growth), which may be illustrated with information that public revenues collection in the last six months of 2002 is equivalent in real terms to the amount collected during eleven months of 2000.

Social Insurance

At the beginning of 2002 the new Law on Old-Age Pension and Disability Insurance, adopted at the federal level a year before, went into effect. A new method of indexing of pensions was introduced - instead of the formerly applied indexation in line with trends in wages, as of January, a combined indexation according to trends in wages and the consumer price index (50%:50%) has been applied. This Law extended the retirement age for both men and women: men retire at the age of 63, and women at the age of 58.

The Draft Law on Pension and Disability Insurance in Serbia was adopted at the end of December 2002. This Law introduces a new method for pension calculation according to the formula which adjusts a pension to the value of contributed premiums and the length of pension tenure.

As far as public health is concerned, a strategy for the implementation of reforms in this area is in preparation. Old laws which favor a centralized system of management and administration of healthcare institutions are still in force. The Ministry in charge of public health assigns and releases directors, deputy directors and members of management and supervisory boards of all public health institutions founded by the Republic of Serbia, while in health care institutions dealing with educational activities and scientific research, these officials are assigned and released by the Government of the Republic of Serbia. Decentralization of the management of the healthcare system is necessary and we expect appropriate changes of regulations in that respect.

Social Policy

The Government of the Republic of Serbia prepared a starting framework for the reduction of poverty which is supported by the World Bank. This strategy is to be adopted by mid-2003. The concept of the strategy is based on active measures which would stimulate the development of the domestic economy, thus affecting reduction of poverty, as the poorest families are mostly those with unemployed members. This includes:

- Giving high priority to the restructuring of the economy and the creation of new jobs
- Creating new employment and income opportunities
- Widening the network of SMEs
- Developing new products and services.

Another important law adopted last year is the Law on Family Cash Benefits.

Forecasts of Macroeconomic Trends in the First Six Months of 2003

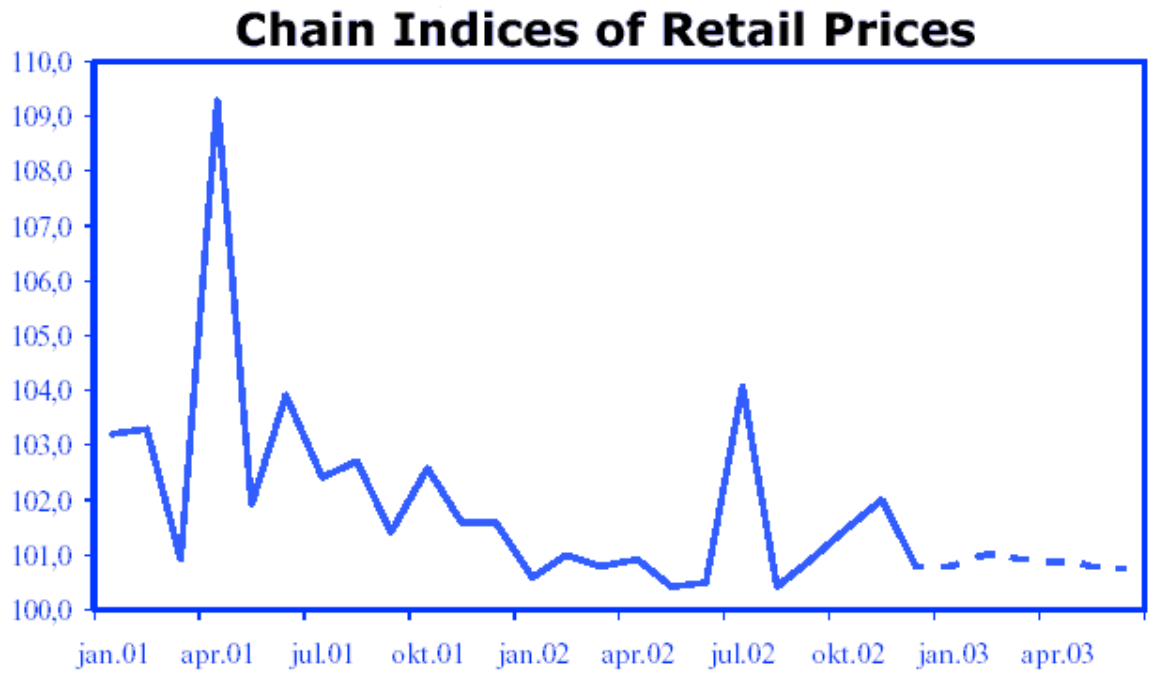
We forecast developments of 17 selected macroeconomic variables for the period of the next six months. In modeling the observed variables we used two groups of models: univariant time series and structural error-correction models. Forecasts are made on the basis of the results of assessment of specified models. Basic links between the observed variables are defined in the G17 Institute Economic Review No. 30. In modeling the subsets of variables we relied on the results of outcomes of appropriate tests. We tested all the analyzed time series for stationarity.

For the majority of time series, the starting point of observation is assigned to July 1999. The latest available data in analyzing nearly all time series relates to December 2002. As the forecast values are obtained by including the dynamics of analyzed time-series, as well as of those measurable variables which are relevant for the explanation of the given time-series, the forecasts will give satisfactory values, unless institutional changes affect developments of analyzed variables.

Prices and Wages

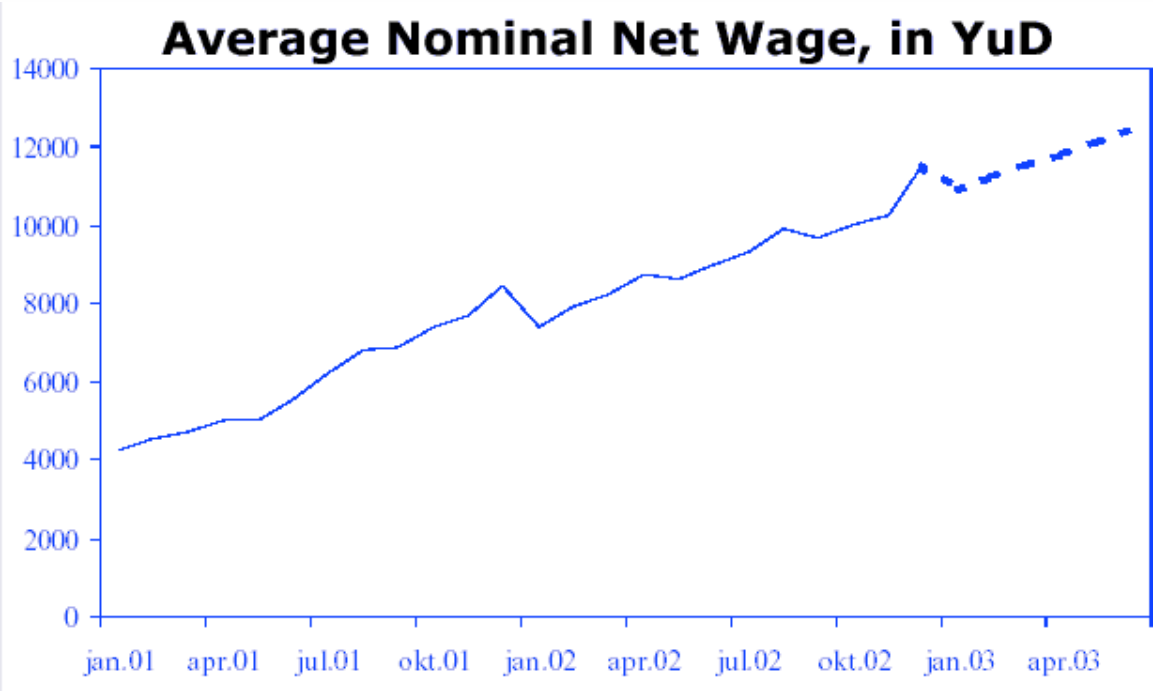
Inflation in June 2003 compared with December 2002 is projected at about 5.1%, while the cumulative rate of retail prices, measured by the ratio of their growth in the first six months to the last year's average, is forecast at about 10.6%. The obtained growth rate of prices does not comprise increase in electricity prices. If increase in the price of electricity announced for April is included, we may expect about a 10% inflation rate already in June (compared to December 2002), which will be higher than the inflation registered in June 2002, and will also exceed the inflation projected for the whole year. This suggests that increase in the electricity price projected for April should be postponed to follow the restructuring of the EPS, which would, in our assessment, result in significant rationalization. In that

context, the issue of the increase of the price of electricity should be reconsidered later. Forecasted values in the chart reflect trends in the retail price index without the impact of electricity price growth.



In the course of the first six months of 2003, we expect the dynamics of growth in the average net wage to slowdown. In June 2003, relative to December 2002, the growth in the average nominal net wage is estimated at 8.4%, while the growth of the real wage is forecast at about 3.1%. The expected real growth of the average wage is based on the projected inflation for the first six months.

Forecasted values of the average nominal net wage are obtained by modeling the average wage, retail prices and the nominal exchange rate. Prices and wages are adjusted to the assessed long-run relationship formed by wages, prices and nominal exchange rate. The inclusion of assessed long-run relationship in the exchange rate equation does not contribute to the explanation of its developments. The assessed value of coefficients suggests further weakening of the impact of the exchange rate on the dynamics of growth in average wages over the forecast period.

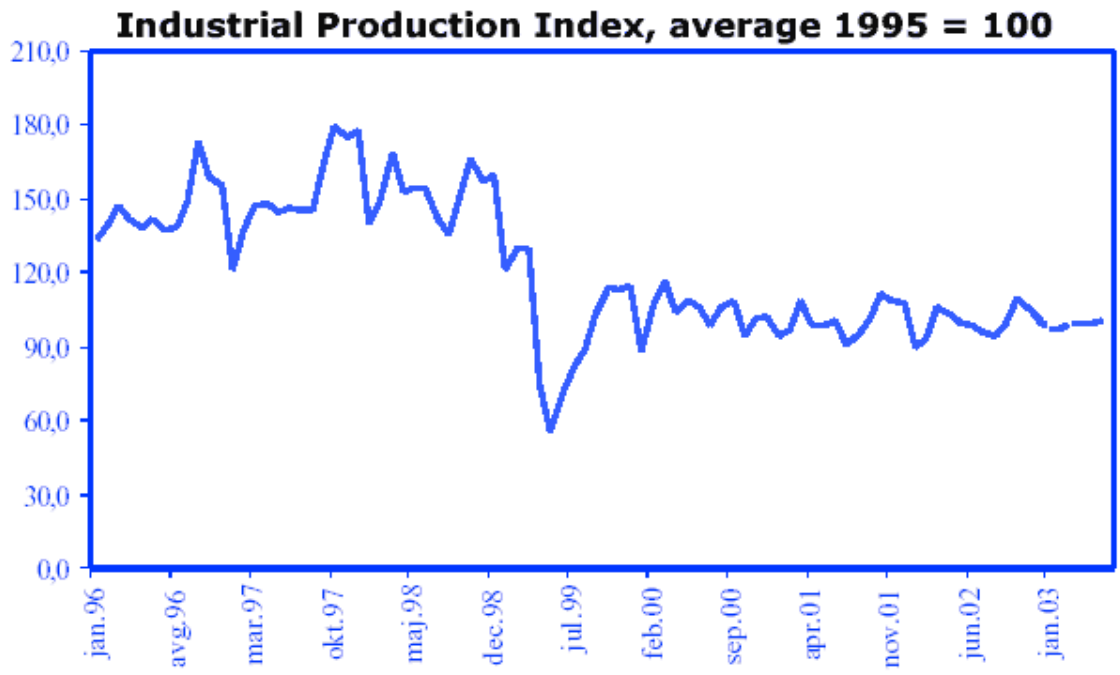


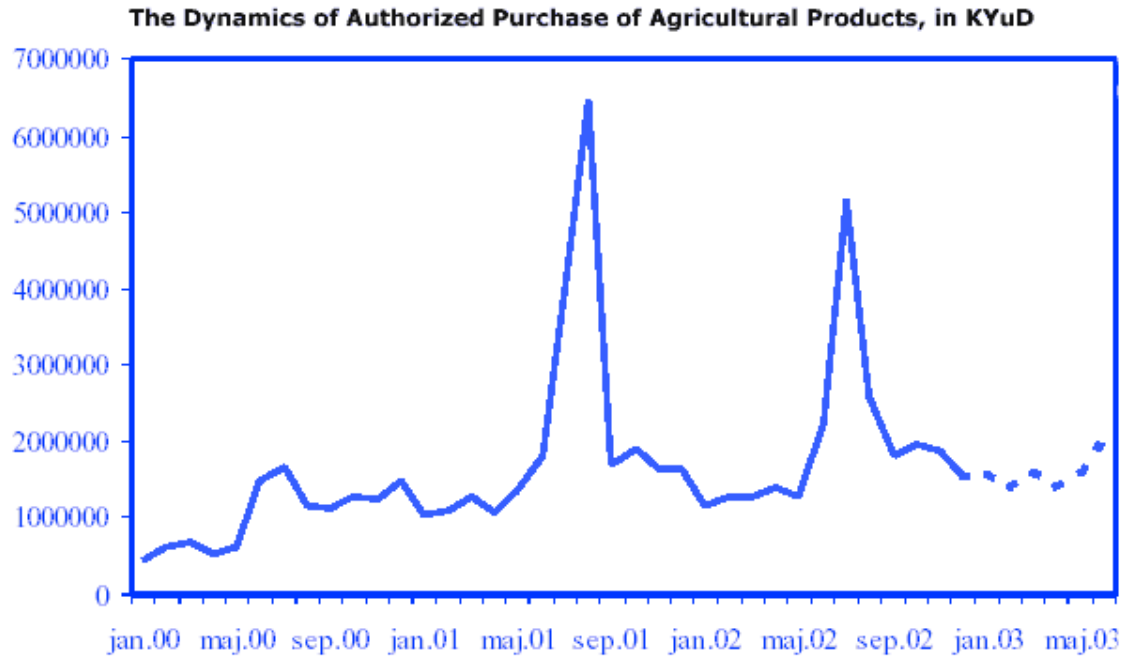
Production and Services

The realized industrial production growth rate of 1.7% at the end of 2002 indicates the beginning of its recovery. Forecasted values of industrial production in the next six months indicate that this process is likely to continue throughout the year, as well. The ratio of the forecasted cumulative growth rate in the first six months of 2003 to cumulative growth rate achieved in the same period last year implies growth of 0.6%.

Forecast values of agricultural production, which are approximated by the time series which reflects the dynamics of authorized purchase of agricultural products, indicates the likeliness of attaining a positive growth rate in the first six months of 2003. Namely, in the course of last year, the value of authorized purchase of agricultural products was down by 6%, compared to 2001, and in the first six months of this year, the value of authorized purchase is estimated to increase by about 11.7%, year-to-year.

In 2002, a significant pick-up was recorded in the value of realized construction work due to the increase in work productivity in the construction industry. Such a dynamics is expected to continue this year. Forecasted values of construction works, expressed as the ratio of cumulative values in the first six months of this year to the values realized in the same period last year, yield a growth of about 44%. In the interpretation of these results it is important to stress that they are exclusively based on available data for the socially-owned sector of the construction industry.

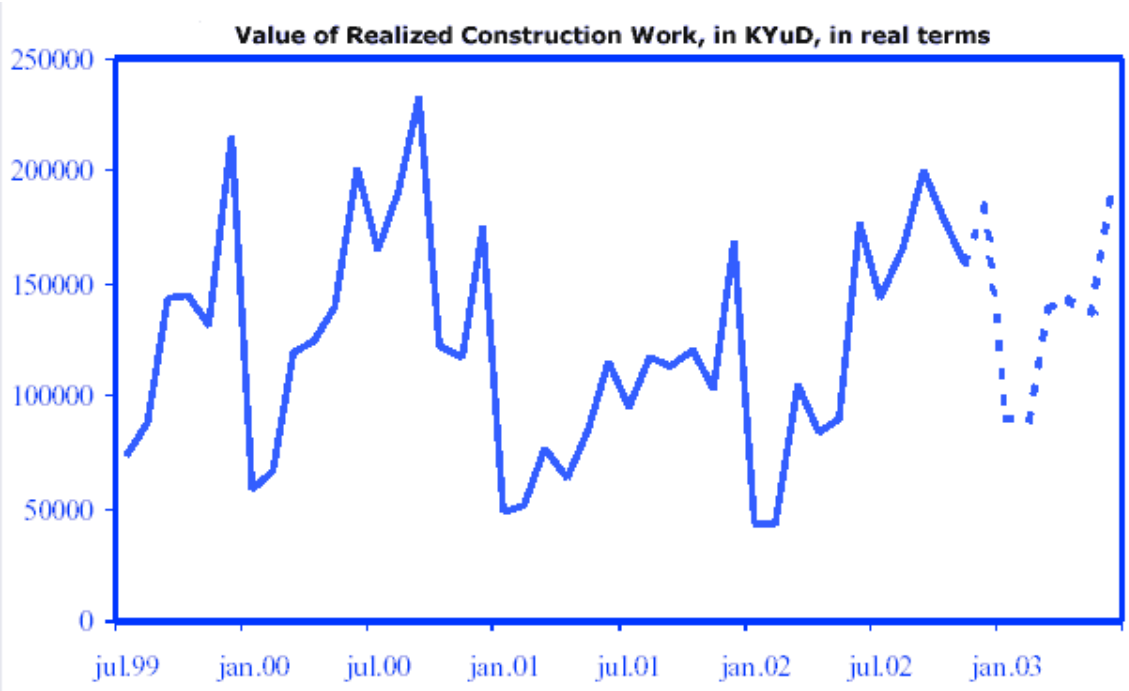




The volume of activities in tourism was assessed by analyzing the series of the number of tourist nights realized in Serbia. While activities in tourism declined in 2002, year-to-year, the total number of tourist nights in the first six months of 2003 is forecast to rise by 0.5%, compared with the performance in the same period last year.

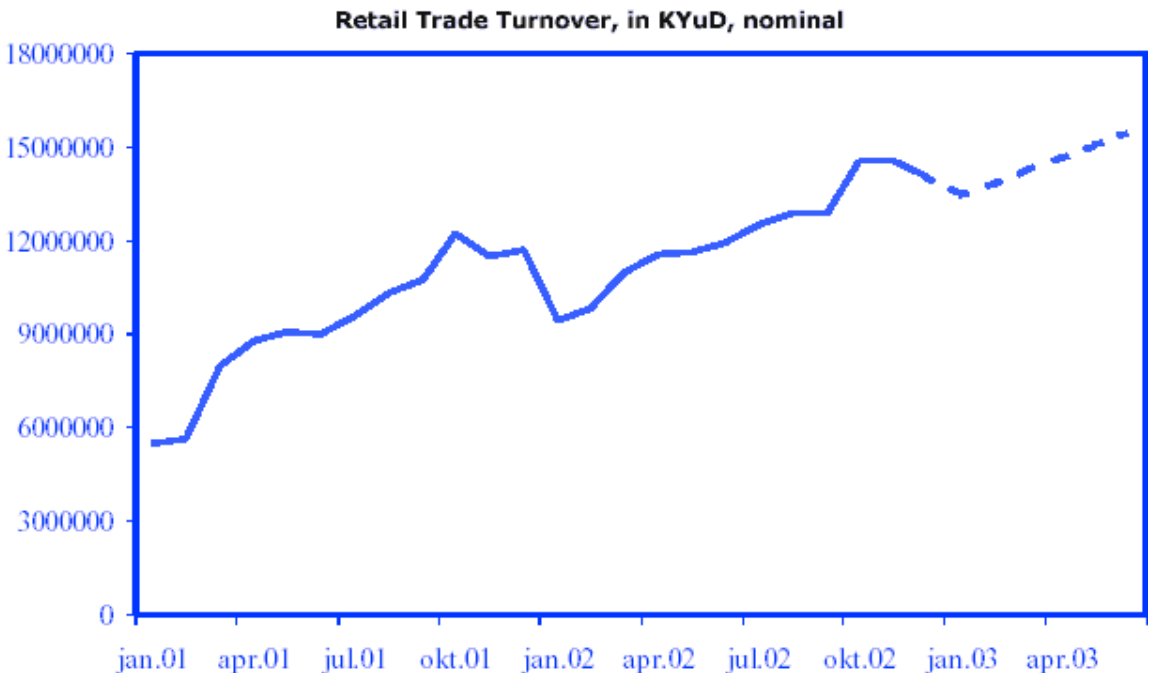
Retail trade recorded a significant increase in turnover during the last two years. The forecast for the following six months is made by assessing the nominal value of realized retail trade turnover in relation to the average nominal net wage and achieved industrial output. The obtained assessment of parameters indicates that

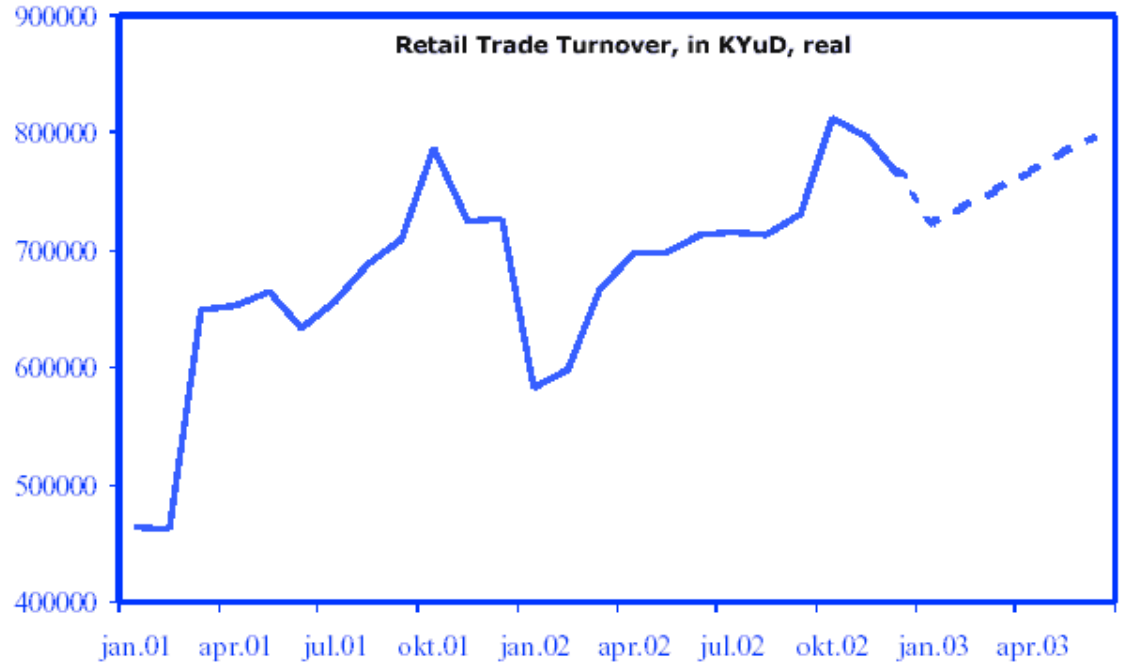
the dynamics of turnover in trade are to a great extent explained by the mentioned factors. Forecasted values for the next six months indicate possible increase in the volume of retail trade turnover by about 18.2% relative to the total value realized in 2002. It is necessary to point to the fact that the available database was not complete. As the original data relates to the socially-owned sector of trade only, forecasted values are relevant only for socially-owned retail trade.



Real growth in retail trade turnover in the socially-owned sector in the next six months is estimated at about 7.5%, year-to-year. The dynamics of real turnover in retail trade is to a great extent explained by trends in the real average net wage. Bearing in mind the expectation of considerably lower growth of the average net wage, the forecasted increase in retail trade turnover indicates that, besides wages and pensions, the development of this variable will be significantly affected by other incomes of the population.

The forecast of trends in passenger and freight transport is made by modeling the variables of the total of realized passenger and ton kilometers, and refers to the period November 2002 - June 2003. Transport, expressed in ton kilometers, rose by 9.5% in the ten months of 2002, compared with the 2001 average, while, when expressed in passenger kilometers, it dropped by 4.6%. We forecast an increase of 2.1% in freight transport, expressed in ton kilometers, by June 2003, and further decrease of about 8.9% in passenger transport, measured in passenger kilometers. Forecasted values for June 2003 are given with respect to last year's average.



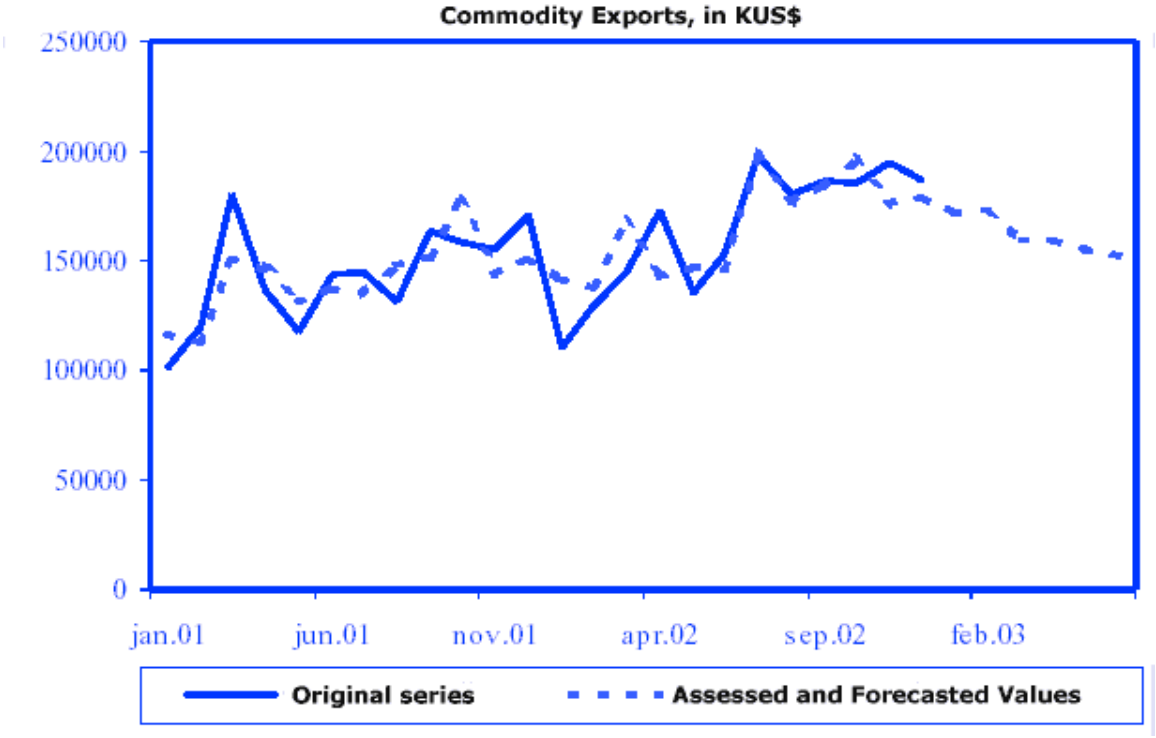


Foreign Trade

The set of variables by which we modeled foreign trade developments over the forecast period, is composed of time series: commodity exports and imports, real exchange rate[1], industrial production and industrial work productivity[2]. In

[1] The real exchange rate was defined as a ratio of the nominal exchange rate to the inflation growth rate in Serbia.

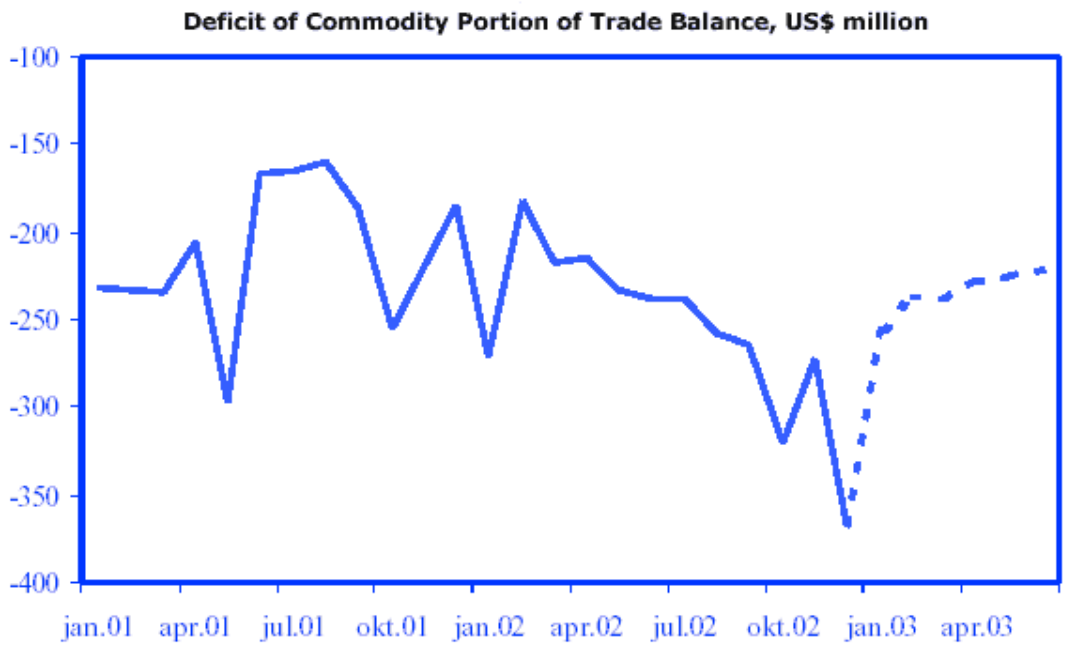
modeling the selected set of variables, we confirmed low exogenousness of the real exchange rate in relation to the parameters of the assessed relationship to which export and import trends adjust in the long run. The long-run relationship is formed by imports, exports and the real exchange rate. In the assessed structural error correction models, by which we modeled variables of commodity exports and commodity imports, we confirmed previously obtained result, which show that the level of the real exchange rate does not explain export trends in the period under consideration. The dynamics of exports are significantly determined by industrial production trends and industrial work productivity, while the dynamics of imports are significantly determined by the level of industrial production from the previous period and the real exchange rate. The assessed models of commodity exports indicate a very high degree of correspondence with original values over the period under observation.



In the first months of 2003, the dynamics of exports were expected to slow down and decrease. However, forecasted values of export trends show that the cumulative value of commodity exports in the first six months of this year will be up by about 14.8%, year-to-year. In the forthcoming months, due to trends in the time series of imports, it is realistic to expect a deceleration and a fall in its dynamics, compared with the end of 2002. The value of imports forecasted in the next six months compared with the real values realized in the same period last year indicate some 7.8% export growth. According to the forecasted dynamics of

[2] The variable *industrial wok productivity* is obtained as a ratio of the industrial production index to the number of employees in industry.

commodity exports and imports, the trade deficit is likely to increase by about 3.5% in the next six months.



In the interpretation of obtained results, we must draw attention to two facts. The data on commodity exports and imports for 2002 on which assessment is based, are only preliminary data. According to the data from July 2002, commodity imports increased considerably, resulting in a significantly larger foreign trade deficit at the year-end.

Exchange Rate, Money Supply and Interest Rates on Short-Term Securities

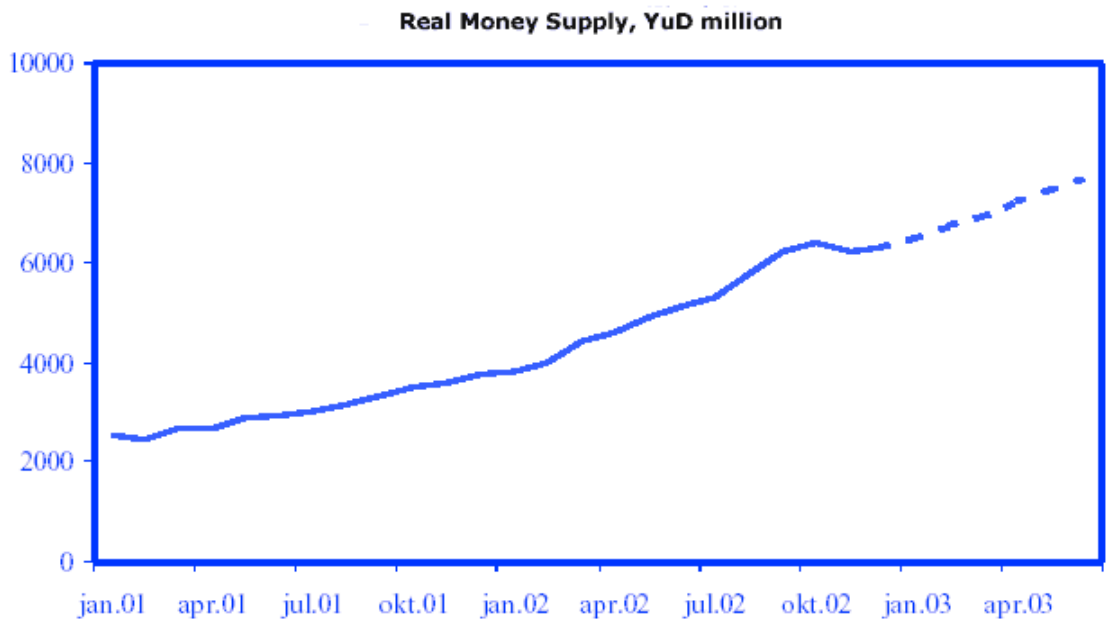
Forecasted values of the real exchange rate are obtained by modeling prices, the real money supply[3] and the real exchange rate. We assessed a long-term adjustment between the three observed variables. The estimated long-run relationship from the previous period to a great extent explains the trends of the real exchange rate in the period under consideration.

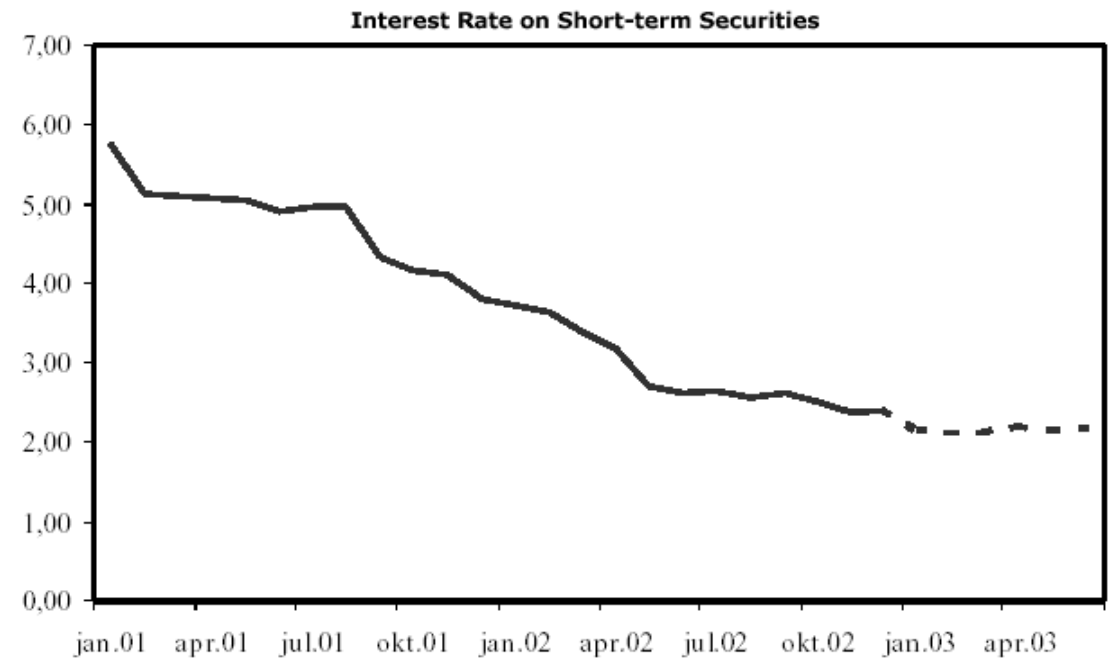
The relation of the forecasted value of the real exchange rate for June 2003 and its actual value in December 2002 indicates the that real exchange rate is likely to appreciate by as little as 1.9%, which practically means that the real value of the domestic currency will be maintained.

In modeling the real money supply we started from a subset composed of three variables – real money supply, real exchange rate and the interest rate on short-term securities. In the analyzed set of variables, the real exchange rate is identified as a weakly exogenous variable, relative to the assessed parameters of the long-run relationship. The dynamics of real money supply are conditioned by

[3] Real money supply is deflationed by the inflation growth rate in Serbia

trends in the real exchange rate. Interest rates on short-term securities become a significant explanatory factor in the trends of real money supply as of the second half of 2002. The dynamics of interest rates are determined by real money supply and the real exchange rate.

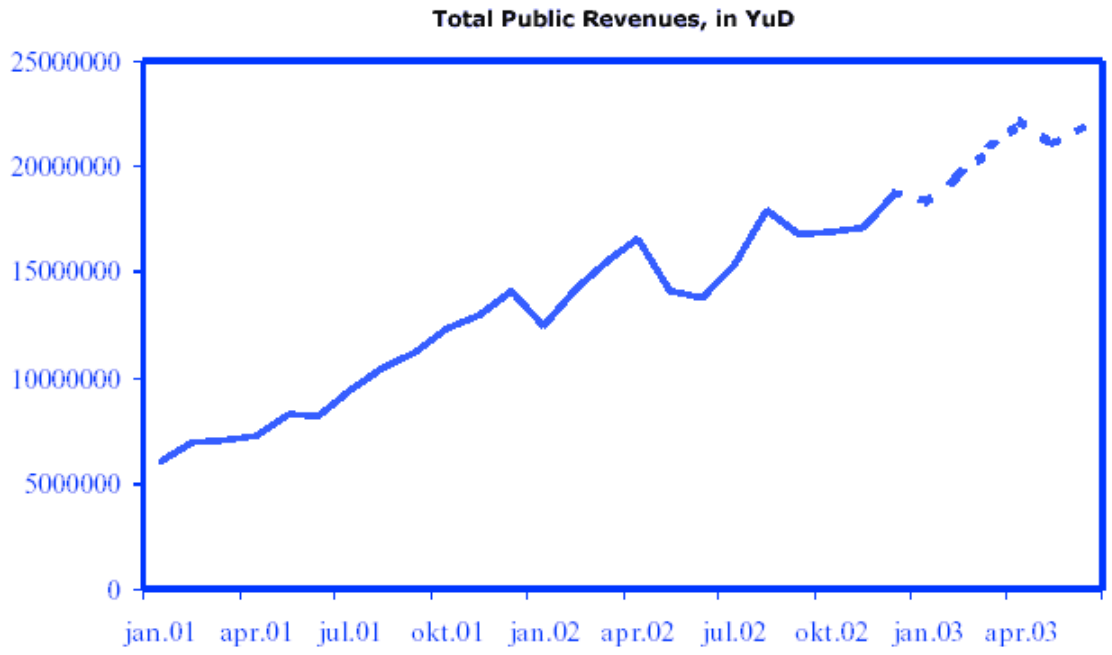




The real money supply had a pronounced dynamics of growth in the course of 2002. It is expected to grow further in the following period. Forecast for the first six months show that the real money supply is likely to increase by about 12.4% in June 2003, compared with December 2002.
In several upcoming months, a slower drop in trends of interest rates on short-term securities may be expected. According to the results of the assessed equation which was used in modeling short-term securities interest rates, the forecasted value of interest rates in June 2003 is lower by about 9.3%, compared to the real value for December last year.

Public Finance

Total public revenues registered significant growth in the last two years. In the first six months of 2003 we expect a further upward trend. Projected nominal growth in the following six months relative to the 2002 average is 30.7%.
The forecasted values of public revenues were obtained by modeling prices, real wages and total public revenues. The assessed values of parameters point to a very high degree of adjustment of public revenues to a long-run relationship with prices and real wages from the previous period. The trends in real wages have a positive and statistically significant impact on the amount of total public revenues.



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Serbia and Montenegro: Basic Economic Indicators

	θ 2002 / θ 2001	XII 2002	XII 2002 / XI 2002	XII 2002 / XII 2001
GDP growth rate*	4.0%	…	…	…
Industrial production	1.7%	…	-4.1%	-0.5%
Montenegro	0.6%	…	3.3%	1.6%
Serbia	1.7%	…	-4.5%	-0.7%
Central Serbia	1.6%	…	2.0%	-2.8%
Vojvodina	2.1%	…	-15.2%	3.8%
Average nominal net wage - Serbia, YuD	51.8%	11,555	12.3%	36.7%
Nominal gross wage - Serbia, YuD[1]	…	16,643	12.5%	37.1%
Real growth in average net wage- Serbia, %[2]	30.2%	…	12.3%	22.2%
Ratio consumer basket - average net wage	-32.3%	1.0	-15.9%	-28.1%
Unemployment rate - Serbia, registered[3]	8.1%	30.7%	0.3%	13.0%
Current account, USD million		…	…	…
Trade balance, USD million	-37.9%	-415	-38.8%	-94.0%
Export, USD million	19.5%	210	0.6%	18.2%
Montenegro	9.1%	24	187.6%	262.3%
Serbia	20.6%	186	-7.2%	9.1%
Import, USD million	30.6%	625	10.2%	59.6%
Montenegro	28.7%	70	73.5%	105.6%
Serbia	31.8%	553	5.1%	55.8%
Money supply (M_1), in YuD million (end of period)	110.8%	115.7	-0.4%	80.8%
Cash	122.6%	43.67	17.2%	71.6%
Deposit	104.6%	72.03	-8.7%	86.9%
Real money supply, EUR million	107.5%	1,880.70	-0.3%	75.5%
NBY hard curr.reserves, USD mil (end of period)	95.0%	2280	9.7%	95.0%
Discount rate- monthly level	-77.04%	0.77%	2.67%	-40.8%
Market interest rate - monthly level	-48.48%	1.50%	-2.6%	-38.0%
Retail prices - Serbia	19.5%	…	0.8%	14.8%
Consumer prices- Serbia	16.6%	…	0.0%	11.8%
Producer prices - Serbia	8.8%	…	0.1%	6.1%
Medium exchange rate (YuD/EUR) - average	2.1%	61.45	0.4%	2.6%

*Preliminary figures

[1]By the gross wage methodology applied as of June 1, 2001.

[2]Deflator is consumer price index.

3 these figures include the employed in socially-owned sector, private sector and SMEs