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Serbia w/o Kosovo and Metohija: Basic Economic Indicators

	θ 2002 / θ 2001	IX 2003	X 2003	X 2003 / IX 2003	X 2003 / X 2002	I-X 2003 / I-X 2002
GDP growth rate[1]	4.0%	…	…	…	…	…
Industrial production - total	1.7%	…	…	8.3%	-3.6%	-3.5%
Central Serbia	1.6%	…	…	5.1%	-3.9%	-4.7%
Vojvodina	2.1%	…	…	14.2%	-3.2%	-1.2%
Average nominal net wage, in CSD[2]	51.8%	11,953	12,432	4.0%	23.8%	25.3%
Nominal gross wage, in CSD	…	17,277	17,986	4.1%	24.6%	25.7%
Real growth in average net wage, in %[3]	30.2%	…	…	2.6%	14.8%	13.5%
Ratio consumer basket / average net wage	-31.1%	1.0	1.0	0.0%	-16.7%	-17.8%
Unemployment rate, registered[4]	8.1%	32.2%	…	0.5%	6.7%	12.2%
Current account , in USD million[5]	227.8%	-7	…	-93.4%	-93.5%	0.3%
Trade balance, in USD million[6]	39.3%	-328	...	14.2%	9.1%	31.2%
Exports, USD million	20.6%	210	...	8.2%	8.2%	21.5%
Imports, USD million	31.8%	538	...	11.8%	8.8%	27.6%
Money supply (M_1) CSD billion (end of period)	110.8%	98	98	0.5%	9.9%	28.3%
Cash	122.6%	39	40	2.6%	2.8%	15.0%
Deposit	104.6%	59	58	-0.9%	15.4%	39.8%
Real money supply, in EUR million	107.5%	1488	1481	-0.5%	1.1%	20.3%
NBS for. curr. reserves, USD mil (end of period)	95.0%	3349	3545	5.9%	70.3%	50.5%
Discount rate - annual level	-77.0%	9.0%	9.0%	0.0%	-5.5%	-24.0%
Market interest rate - monthly level	-48.5%	1.2%	1.2%	-2.5%	-26.9%	-43.9%
Retail prices[7]	19.5%	…	…	0.8%	7.9%	12.1%
Costs of living[7]	16.6%	…	…	0.9%	7.2%	10.1%
Industrial producer prices[7]	8.8%	…	…	0.8%	4.4%	4.6%
Medium exchange rate (CSD/EUR) - average	2.1%	65.76	66.43	1.0%	8.7%	6.6%

[1] Estimate

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

[3] Deflator is cost-of-living index

[4] The number of the employed comprises those employed in the socially-owned sector, private sector and small enterprises

[5] The data refer to August

[6] The data refer to September

[7] The data refer to November

Source: SZS, RZS, NBS, RZTR

Prepared by Ivana Radovic

THE GREATEST PROBLEMS OF THE SERBIAN TRANSITION

Press Conference Held on September 25, 2003

Milko Štimac, CEO G17 Institute

INTRODUCTION

From its beginning the G 17 Institute has been monitoring the transition in Serbia and studying the transitional experiences of other countries around the globe. Many comparative studies have been made in order to discover the shortest and least painful road through transition, because there is not such a thing as a painless transition. Besides the scientific experience our researches gained during the last three years, this period also brought us the experience of implementation of reforms. The Institute's associates, who took direct part in the implementation of reforms, bring a new quality to the consideration and comprehension of the Serbian transition, because now, besides foreign experiences, we have our own, both positive and negative experiences relating to the implementation of reforms.

The third year of the transition in Serbia is decisive because reforms have been halted, displaying regressive tendencies in certain areas. The intention of the G 17 Institute is to present the good and the bad sides of reforms in Serbia, through its research and a series of press conferences that will be based on the results of the mentioned research, all of these in order to examine the reasons that brought the reforms to a halt, to examine segments of reforms and the transition which hit Serbian society, the political economy and the system as a whole most severely, as well as what should be done to overcome problems that hinder further development and to apply the best solutions to the Serbian transition.

The greatest problems of the Serbian transition will be presented through eight basic problems: ***macroeconomic stability without economic growth; inadequate tax policy which stifles economic activity and increases the trade deficit; privatization fallen short of initial expectations***, which is reflected in tycoonization that inevitably imperils long-term interests of the Serbian economy (Serbian tycoons recently met with the outgoing Government of Serbia); ***halted reform of the banking sector and the financial market; the unfavorable investment climate; the absence of legal security; institutional and political instability and growing social costs of the transition***. All these topics are equally important, as all of these problems equally obstruct further development of reforms.

Mlađan Dinkić

MACROECONOMIC STABILITY WITHOUT ECONOMIC GROWTH AND INADEQUATE TAX POLICY WHICH STIFLES ECONOMIC ACTIVITY AND INCREASES THE TRADE DEFICIT

Macroeconomic stability which is not accompanied by economic growth has emerged this year, i.e. this problem did not exist in Serbia in the previous two years of the transition. Namely, year 2003 will be the first year of the transition without economic growth. An even more important problem is the fact that institutional and structural reforms have been halted, resulting in an economic recession which continues for two years already. According to all economic indicators, the recession started approximately in autumn 2002. It was not visible at the beginning; but today sufficient time has passed for us to safely say that Serbia is in a serious economic recession.

Three consecutive years of macroeconomic stability have certainly been one of the greatest achievements of the transition thus far. Both according to our estimates and according to indicators in the first eight months, this year's inflation will certainly be below 10% at an annual level, which will be the first one-digit inflation registered in our country since 1969. This is really a great achievement. In the period of January-August 2003, retail price inflation was as low as 5%, and it is realistic to expect that year-end inflation will not exceed 9%. During the period of my being in the position of Governor of the NBY as well as today, I hold to the opinion that monetary policy has been set appropriately. The same people who used to work with me practically still carry out monetary policy, and any fundamental changes are not very likely. What is likely is the strengthening of market instruments for monetary regulation, introduction of repo-operations which was announced for September and the introduction of an interbank money market by the end of the year. I believe monetary policy will be essentially completed in that respect.

However, Serbia is facing another problem: macroeconomic stability exists, but it is not accompanied by economic growth. This problem is not specific just to Serbia; it has been faced by other transition countries, such as Bulgaria and Bosnia and Herzegovina, as well. The problem is that the domestic product may even drop slightly compared to last year. Namely, GDP increased by 5% in 2001 and by 4% in 2002; at the beginning of this year economic policy-makers projected GDP growth at 3.5-4% in 2003. Eight months later, it became obvious that this projection will not come true. The domestic product, i.e. GDP (applying the system of national accounts) will range between -0.8 and +0.5%; in any event, it will be around zero. It is difficult to estimate whether it is going to be slightly positive or slightly negative, as there are four months until the end of the year, but anyhow, year **2003 will be the first year without economic growth**.

Estimation of real GDP growth in Serbia in 2003

	G 17 Institute's estimation				Weighs for GDP calculation[1]
	Realistic		Optimistic		
	index	growth rate %	index	growth rate %	
Industry	96.5	-3.5	97.0	-3.0	28.2
Agriculture[2]	93.0	-7.0	94.0	-6.0	21.1
Construction	100.0	0.0	103.0	3.0	3.9
Transport[3]	103.0	3.0	103.0	3.0	7.1
Trade[4]	103.0	3.0	110.0	10.0	11.9
Other services[5]	104.0	4.0	104.0	4.0	27.8
Real GDP	99.2	-0.8	100.5	0.5	100.0

The Table above shows the structure of GDP formation by sectors, offering two estimations of growth by the end of the year: one is in our opinion realistic, and the other is optimistic. GDP will decrease according to the realistic estimation, while according to the optimistic estimation, it could rise by 0.5% at best. The two most important sectors that constitute 50% of GDP are industry and agriculture.

As far as industrial production is concerned, it is not likely to reach even zero since it dropped by 3.8% during the first eight months year-to-year. Theoretically speaking, to reach its last year's level, i.e. for the industrial production growth rate in 2003 to be zero, the deseasonal index of industrial production will have to increase by as much as 20% by the end of the year. It is not realistic under present conditions. As a matter of fact, such growth had been achieved three times during the last decade, but only after huge crises, when the initial base was very low: it occurred for the first time in the first half of 1994, after the introduction of Avramovic's program, resulting from enormous optimism and macroeconomic stabilization; then, in the second half of 1999, after the NATO bombing, and finally, at the beginning of 2001, when the present Government started economic reforms. Anyhow, such growth had been the result of positive developments coming after big crises. The current situation is different and it is much more likely that industrial production will actually continue to grow by the end of the year, but at a rate no higher than 1% on average per month (we are talking about deseasonal indices). In that case, industrial production would be down by 3.5% year-to-year at the end of 2003. Hence, **according to the realistic scenario, industrial production will drop by 3.5%, while according to the optimistic scenario, the decrease may not exceed 3%.** However, it is highly unlikely that industrial production will reach zero, let alone be positive.

There is general agreement that **agricultural production in 2003 will also be negative**, partly because of the draught, but also because our country does not have, nor has ever had an agricultural policy. Namely, according to available data, wheat crops were very poor, corn production was under the

[1] Share in the GDP structure in 2002
[2] Including forestry, hunting and fishery
[3] Including storage and communications
[4] Including tourism and catering industry (hotels and restaurants)
[5] Including financial mediation, real estate, state administration, education, health care, etc.

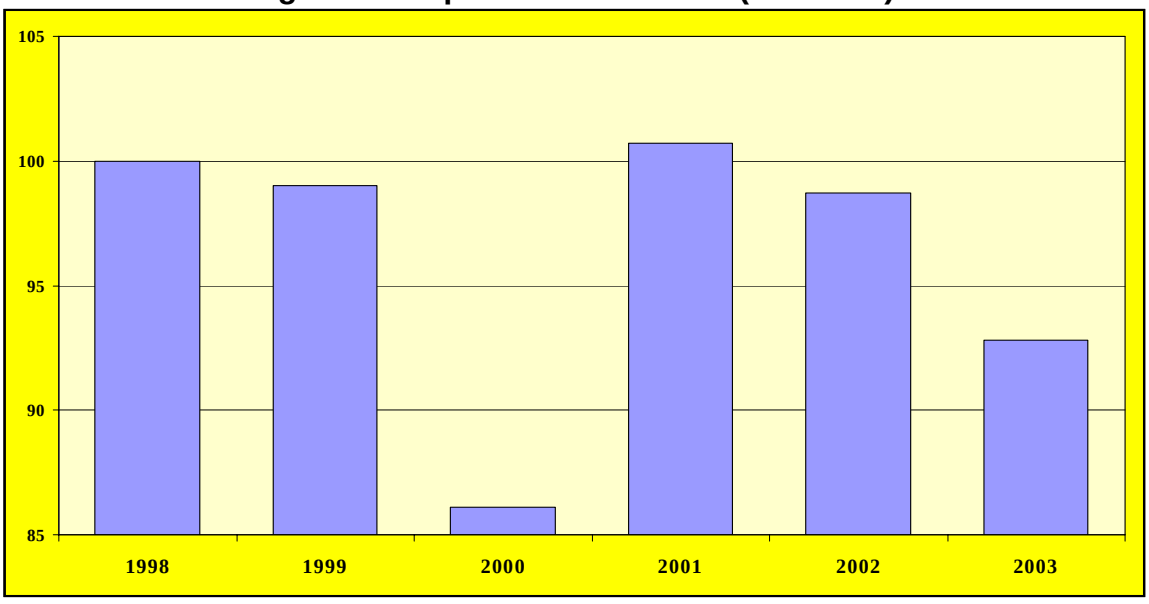
average, while stock breeding is also estimated to be negative. Only the production of industrial crops will be slightly up. In general, total agricultural production is estimated to fall by 6-7% year-to-year; some official forecasts foresee the decrease of 5%, but this discrepancy is entirely irrelevant.

Some other branches, such as construction, will be up at the end of the year. However, it is very difficult to estimate final results in this area since official statistics do not cover all construction-related activities. On the other hand, some indicators of industrial production do not leave room for optimism. The production of construction material, for example, during the first eight months of 2003 was down by 14%, compared to last year, indicating that, because of the serious crisis in the manufacture of construction materials, construction today operates with stocks piled earlier. Since we do not want to sound pessimistic, our estimate of **growth in construction of 0.3%** may be too optimistic.

Transport is also estimated to grow by some 3%.

Trade is also associated with controversial estimates. According to official estimations, trade will increase by 10%, owing to the increase in imports. A more conservative estimation foresees growth of some 3% in trade. Hence, estimates relating to growth in trade are rather elastic, ranging from 3% to 10%. However, even if the optimistic growth of 10% were realized, it would not significantly improve our GDP, i.e. in any case, it would be around zero.

Agricultural production indices (1998-100)



The Chart above shows industrial production in the last three years. It may serve as a basis for analyzing the entire problem of the Serbian economy and the Serbian transition. The first stage of transition started in October 2000, when industrial production recorded mild recovery. This recovery lasted for two whole years, but since October 2002, industrial production shifted downward i.e. started moving toward the level it had before the reforms began. The question arises what induced such a fall or the beginning of a fall in industrial production in the

last twelve months, since it marks the beginning of an overall economic recession in Serbia.

First, it is important to examine the **characteristics of the beginning of the transition process** in Serbia. In October 2000, when the transition started, there was a **political consensus** on the necessity of reforms on the part of the initial DOS and G 17 PLUS.

Furthermore, the transition had **internal professional support**, i.e. the support of a professional and homogenous reform team which worked together and was ready to undertake the hardest political steps.

The third important factor which prompted the beginning of the transition was **social support**. Citizens were patient and this made it possible for some very difficult measures to be taken, e.g. liquidation of the largest state-owned banks.

Finally, the transition in Serbia enjoyed **the support of the international community**, not only absolute **political** support, but also **financial** support, which was of great significance during the first two years.

What are the accomplishments of the first two years of the transition?

Progress was made at the macroeconomic level, and especially in certain sectors, which is a praiseworthy accomplishment. It especially concerns **the following areas:**

- **Citizens' confidence in the national currency was restored; inflation was halted and the dinar gained convertibility**.
- **Public finances were stabilized**.
- **Thorough reform of the banking system was initiated.**
- **The privatization process started.**
- **Liberalization of prices and foreign trade.**
- **The foreign debt was considerably reduced, coupled with regular internal debt financing**, i.e. regular payout of old foreign currency savings.
- **Wages increased in real terms, following permanent economic growth and a mild increase in industrial production**.

What occurred causing Serbia to enter the recession in October 2002?

Serbia went into recession because of the disappearance of all the factors which made the beginning of the transition possible, despite the fact that the transition was relatively successful at the macroeconomic level.

First, internal political consensus crumbled. The conflict between DOS and DSS culminated right after the failure of the presidential election in 2002. At the same time, mutual blackmailing between coalition partners in the Serbian Government, motivated by the struggle for power, pushed economic reforms into the background. Finally, vast energy was wasted on the creation of a quasi-state union between Serbia and Montenegro, while the creation of the Constitutional Charter was used as a smokescreen for certain political clashes and even political purges.

As far as professional support is concerned, unfortunately the reform team fell apart. Because of this, citizens were disappointed and started losing

patience. And this relates to the macroeconomic area as well, since in the last twelve months it was possible to observe certain problems even there.

Moreover, some key reforms have not even started yet, while those that were initiated lost the necessary energy for the second step. In the meantime, those quasi-market and criminal structures which are present in every transition country, arising either at the very beginning of the privatization or at the beginning of the transition, became stronger. These structures make profits owing to the privileges they get from the state, but once they lose such privileges, they are not ready to take part in pure market competition. However, in our country such structures became stronger, being encouraged by the lack of the rule of law and unexpected erosion of morale. They not only got impetus in the last twelve months, but took over entire segments of social life.

Finally, **after the tragic assassination of the Prime Minister**, the Government definitely **went astray and continued to work without any vision**. The final goal of such moves and of actions that are referred to as reforms cannot be seen, as what is taking place over the last several months is obviously far removed from reforms.

Two possibilities lie ahead of Serbia at this moment. It could either tackle problems head on – keep the positive, put right mistakes from the previous period and start the second stage of the transition, **or abandon itself to the current inertness with an uncertain end.**

The G 17 Institute and people gathered around the idea of reforms will certainly propose a new program for the second stage of the transition with the aim of solving observed problems. If the recession, which is becoming increasingly serious, continues, it will compromise macroeconomic stability, an undisputed accomplishment of the first stage of the transition, since macroeconomic stability is not able to survive long if accompanied by an economic recession. For one year already, macroeconomic stability has survived owing to some other factors, such as inflows from foreign countries; but if the recession continues in the long run, macroeconomic stability will certainly be brought into question, not to mention potential long-term problems concerning the servicing of public debt, both internal (old foreign currency savings) and foreign. The public debt servicing is projected on the basis of estimation of permanent GDP growth of 4-5% per year. If the GDP continues not to register growth year after year, increasing public expenditures and a decreasing domestic product certainly will not make it possible to service either the domestic or the foreign debt regularly.

According to our estimations, the debt crisis will not take place before 2007, since, objectively speaking, the level of the Serbian debt today, i.e. its share in the GDP, is much lower than in 2000, and foreign debt servicing is progressive. In that respect, if the GDP grows by 5% per a year on average in the next ten years, Serbia will not have problems in foreign debt servicing. However, if the domestic product were zero or negative, annuities would grow, but problems would not appear before 2007. This means that if the new Government were established in 2004, it would have enough time to avoid a debt crisis.

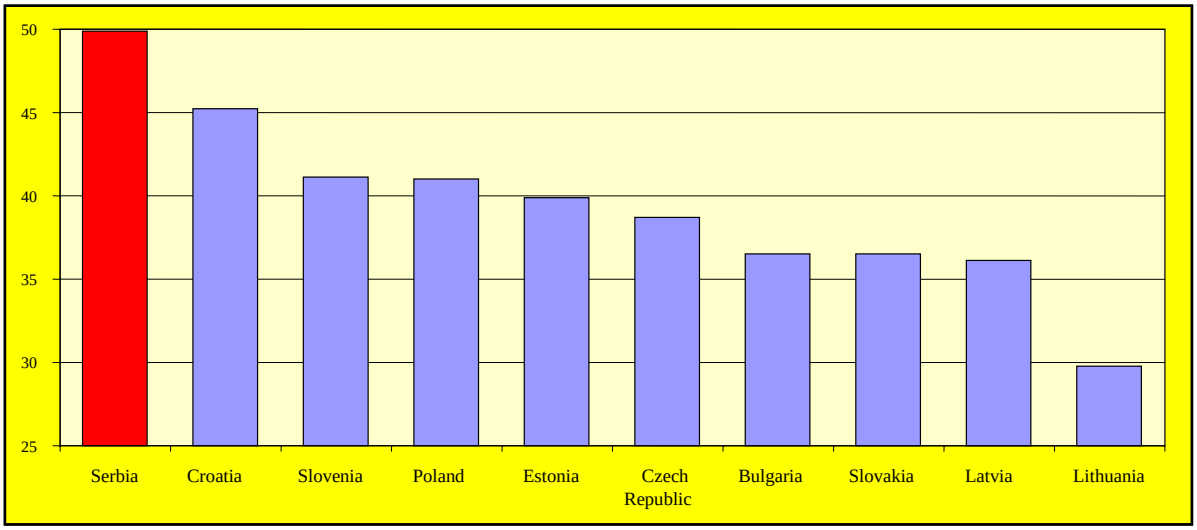
As far as tax policy is concerned, it contributed greatly to macroeconomic stability, but after three years we may say that too much time has elapsed, **while tax policy has not brought expected incentives to the growth of domestic production**. Every tax policy, if well designed, together with monetary policy, is an important factor of macroeconomic stability. Our tax policy was successful in that respect. However, it failed in performing its second function, namely, stimulation of economic growth. Quite the opposite, it even contributed significantly to stifling domestic production and increasing the trade deficit. Namely, the foreign currency exchange rate has been pointed to permanently as an excuse for poor export performance of the Serbian economy. Since I do not hold public office any more, I think I have every right today to say that the exchange rate is a minor factor in export performance, accounting for as little as 10%, especially in the Serbian economy which has not been restructured yet. Other factors, such as fiscal policy, have much broader influence on trade results. In 2003 Serbia is going to register the highest trade deficit ever, and the reason for this is not excess imports. Those who say that our imports are too large are wrong; a developing country must import. The SCG import value is to be CSD 7.9 billion, i.e. it will remain within the projected level. The problem lies in exports. The value of exports for 2003 is projected at US$ 2.9 billion, while US$ 2.6 will be realized by the end of the year. Therefore, exports are going to be lower than projected by US$ 300 million, whereby it must be stressed that even the projected level was too modest. According to our estimation, the trade deficit will reach a record US$ 5.3 billion. This will not compromise macroeconomic stability in the short run, as this discrepancy of US$ 300 million will be compensated by larger privatization proceeds. Owing to the sale of, above all, the tobacco industry, privatization proceeds in 2003 will be higher by some US$ 300 million. However, the trade deficit is a long-term category, while tax revenues from privatization are of a short-term nature, and the question arises as to how the problem of a high trade deficit will be dealt with in the future.

As far as announcements that foreign currency reserves are going to be spent on imports by the end of the year are concerned, a large portion of foreign currency reserves is likely to be spent on imports, as imports traditionally increase in the last quarter. But, again, the problem of an enormous trade deficit is not induced by the exchange rate, but by fiscal policy and the lack of potential mechanisms for it to be resolved. In the short run, macroeconomic stability will not be compromised, but long-term developments are questionable. The question is what is going to happen next year, or after tax proceeds from privatization have been exhausted. The current Government does not think much about future governments, which is not fair. In the National Bank, for example, former management thought of successors, taking care to leave the bank in the best possible condition. If such trends continue, the Serbian economy, as well as the trade deficit, will be in much worse condition than the one inherited from Milosevic, placing a serious burden on any future government.

Serbia still numbers among countries with the highest fiscal burden relative to the GDP. Public revenues constitute 50% of GDP or as much as 60%, if old methodology is applied. Even during the Milosevic regime this share had

not exceeded 55%, and although it might sound unbelievable, the current fiscal burden is larger than during the 1990s.

Public revenue's share in GDP in selected countries



The Table above shows a comparative share of public revenues in the GDP in Serbia and in selected countries in transition. Serbia is convincingly first in terms of its fiscal burden, followed by Croatia with 45%, while in the Lithuanian GDP public revenue constitute as little as 30%. Some developed countries also have lower shares than Serbia.

How does such a huge fiscal burden affect production and the trade deficit? Domestic production is not able to sustain such high tax rates, output is falling, resulting in an increase in imports. Imports grow if there is a demand for goods which our industry is not able to satisfy. Also, because of high costs resulting from an excessive tax burden, export competitiveness of our economy is declining significantly; that, and not the exchange rate, is the main reason for poor export performance of the Serbian economy. Also, if 50% of the GDP is directed to the state sector through the budget, this automatically means that potential resources for investments in the private sector are siphoned off – this effect of siphoning off of capital from the private sector into the state-owned sector is well-known in the theory. To put it simply, we cannot expect investments which generate new jobs in the private sector, because as much as 50% of the GDP goes to the state, which allocates this sum to public functions. Hence, there is a problem concerning the allocation of budgetary resources, bearing in mind that the sources of public revenues are all kinds of fiscal revenues as original revenues, as well as domestic and foreign loans and privatization proceeds. The allocation of these resources turned out to be bad, in particular during the last twelve to eighteen months, because, instead of stimulating exports and domestic production, these tax revenues were used for indirect financing of imports. Hence, domestic tax revenues ended up financing of imports, directly affecting the increase in the trade deficit. Again, on the one side we have very high tax

rates, and because of this, we have a very large gray economy on the other side. Those whose business is registered have to pay very high taxes, while those whose business is not registered pay nothing, which is another problem; and in any event, the entire potential tax base is not being levied. High tax rates increase production costs, thus stifling domestic production, finally resulting in the increase of the trade deficit. The problem in our public finances is that even three years after the beginning of the transition, the process of rationalization of public expenditure has not started yet; such a step is not expected to be made in the first year of the transition, but should have been made after three years. Of course, nobody in the G 17 Institute advocates the expenditures for pensions, social benefits and social functions of the budget to be reduced. However, it is unacceptable that bureaucracy, not only state administration in the Government, but also bureaucracy at all levels, should remain untouched. Instead of downsizing the bureaucracy, some new procedures have been introduced to justify its existence; something similar was experienced in other countries in transition, as well.

So far the transition has hit only production workers. Unemployment rose – one million persons are registered as unemployed today – but this mainly includes workers in factories, while the bureaucracy has not been affected, although DOS in its program promised that bureaucracy will be downsized by one third in the first year of reforms. This has not been done, although such a step would leave room both for the reduction of public expenditures and for strengthening some other functions.

What is the solution?

First, tax rates should be reduced and tax base expanded. This topic has been under discussion for a long time, but it should also be implemented. ***This primarily concerns payroll tax, because this is the tax that burdens production most severely; payroll costs are now too high, causing the gray economy to remain very extensive***.

Secondly, tax on cash transactions should be scrapped, as well as some other fiscal burdens unknown in other market economies.

Finally the introduction of value added tax requires careful consideration. The G 17 Institute does not advise the government to introduce VAT without appropriate preparations, because this is one of the most complex taxes. In any event, it should not be introduced as of January 1, 2004, as projected earlier, since the law has not been passed yet, and it is necessary to have six months of thorough preparations in order to prevent all negative effects which the introduction of the VAT might have on our economy. Also, the question is **whether the VAT rate should be equal to the current sales tax rate**. Simulations could show whether there is room for a slight reduction.

The economy itself will suffer problems once the VAT is introduced, because 40% of the Serbian economy is not sufficiently liquid at the moment, and will not be able to cover the first stage, i.e. to pay the tax in the first stage of production. **Premature introduction of the VAT**, therefore, **would further worsen the recession**, which is a much more important effect than potential impact on inflation. VAT's impact on prices is the aspect most intensively

discussed in the public, but the lack of liquidity in the economy is a more important problem. Since this concerns the most complex tax, it would be necessary first **to educate entrepreneurs** on methods of VAT payment; it is also necessary **to train the tax administration**, and, above all, to ensure that VAT money is refunded in timely fashion. The experience of other transition countries shows that everywhere where the tax administration was not ready, the government was not able to resist keeping the money for itself, causing serious problems with liquidity. Hence, **the government must be capable of refunding VAT in timely fashion**. For all these reasons, the law should provide for **at least a six month preparatory period**. As could be seen in the media, the German advisor to the Government advised the same. Hence, the beginning of enforcement of this law depends on when it is going to be passed in parliament. Furthermore, both experts and entrepreneurs must be involved in the preparation of this law. The dialogue of all stakeholders should precede the passage of the law. The best schedule would be for dialogue to be finished by the end of the year, followed by the creation of a legal text that should come into force in one year, i.e. in 2005. **If the Law came into force before June 1, 2005**, I am sure that **huge problems would occur**.

Hence, my personal opinion is that the rest of the year should be used for public debate with entrepreneurs and experts on specific legislative solutions, because the existing draft law contains some ambiguities: whether the VAT shall have only one or two rates; how to ensure timely refunding; how to solve problems of imported components that are used for export-related production; how to solve VAT-related technicalities concerning relations between Serbia and Montenegro. All of these could be discussed in three months; than the legal text could be prepared and training of entrepreneurs and tax administration carried out. Such a law would come into force as of January 1, 2005. Six months is the period which must definitely pass between the enactment and enforcement of the law. This is confirmed by the experience of NBY (NBS) in the case of transfer of payment operations to banks. The law had been passed one year before it came into effect, while the most intensive preparations took place during the last six months. I support the introduction of VAT, providing that appropriate preparations are made in order to prevent not only a rise in prices, which is not unlikely, but also, much more importantly, potential consequences on further stifling of production, because all liquid assets would be engaged on VAT payment at the beginning. The problem would be much more serious if the state were not to refund VAT forthwith.

How to expand tax base? This is not a difficult task, but requires good organization and logistics which do not exist in the Ministry of Finance today. The tax administration will have to be reformed and modernized completely, as will other inspection offices. It is not just laws that are essential for tax reforms – plenty of good laws have been passed thus far, but what is lacking is a tax administration capable of enforcing those laws. For this reason, Serbia still has a very large gray area. This primarily concerns the Republican Public Revenue Administration, but also all other inspection services: customs, foreign currency inspectorate, etc.

In conclusion, the future Minister of Finance will have to cut tax rates and expand the tax base. Then, the budget should be redesigned and incentives that will foster economic development activated. Hence, on the one hand, numerous duplicated state functions that exist at the moment, from municipalities to the republic, should be canceled, because political decentralization necessitates the decentralization of the budget, that is, cancellation of some functions that are now concentrated in the center. On the other hand, expenditures of the budget of the Republic of Serbia related to financing of the budget of the State Union must be reconsidered. According to all indicators, over 99% of expenditures of the State Union are covered by Serbia. Then, the bureaucracy should be downsized by one third. The budget should be organized so as to finance necessary functions and then, in the next stage, to estimate how many people are necessary to perform these functions. In that sense, logistic reorganization of the state apparatus is necessary. Furthermore, existing incentives should be activated and new ones introduced. For example, the Fund for Insurance of Export Arrangements has existed for a year, but has not insured one dollar of exports. The Fund for Housing Construction Credit Insurance should encourage housing construction - the draft law that is supposed to govern this fund was finished one year ago; it should be passed and applied in practice, with prior engagement of people capable of implementing it. The Fund for the Insurance of Loans for SMEs should be put in operation, since the law governing the work of this fund has been passed, but the Fund itself does not operate. In my opinion, five main areas should be stimulated indirectly through the budget: export, housing construction, SMEs, agriculture and underdeveloped regions. In that respect, another two funds should be established – for agriculture and for underdeveloped regions. Serbia used to have a fund for underdeveloped regions in the past. Today all countries that have unbalanced development have appropriate instruments designed to balance or at least alleviate differences in development levels.

Finally, Serbia needs to have an agricultural budget. Such a budget has never existed in Serbia, although it is a necessary condition for pursuing either agricultural policy or protection policy. The report from the last WTO forum shows that the effective rate of subsidies in European countries amounts to several hundred percent, because agriculture shall not be protected by customs measures, but indirectly, through subsidies and not-tariff measures. Our Minister of Finance will have to deal with the issue of the agricultural budget because this will not only stop the recession, but will also stimulate economic growth.

What should the future Government do to replace the recession with growth? First, it needs to have a clear vision. A new economic program for the second stage of the transition is absolutely necessary. One expert team in the G17 (Vujovic. Jelašic, Dinkic and others) is working on that program which will be very comprehensive, and half of it is already complete. Serbia lacks entire key policies, e.g. industrial policy, trade policy, agricultural policy. Hence, these three policies should be incorporated as integral parts of economic policy, and in that respect ministries should be redesigned to be able to pursue these policies.

HALT IN THE REFORM OF THE FINANCIAL SECTOR

Press conference held on October 2, 2003

Milko Štimac

INTRODUCTION

The banking sector today has been brought to a standstill. The Privatization Adviser in the Bank Rehabilitation Agency has not been appointed yet, the Agency itself is not functioning, the plan for the reconstruction of our largest bank has not been prepared, while activities accompanying privatization are not only in stagnation, but have not even begun.

As far as insurance companies are concerned, after two years, we still do not have the appropriate law governing this area, the supervision over the work of insurance companies de facto does not exist, and this entire area is still in total chaos. No diagnostic analysis of the sector has been performed whatsoever, and finally, the very context of supervision has not been worked out completely.

What is most dangerous in the entire economic part of the transition is that the National Bank of Serbia, previously the leader of reforms, has been reduced to an institution which follows, without questioning, the Government's activities. Since the appointment of the new Governor, practically all statements, made both by NBS officials and by Government itself when referring to the National Bank, have confirmed that the removal of the former management was nothing other than politically motivated and that change was not fundamental, but was intended to halt reforms and to remove a person known for being the leader of reforms in order to prevent him from being an obstacle in the realization of certain interests.

The capital market has always been overshadowed by all these developments. However, it is an equally important segment of economic reforms and the economic transition, and the transition as a whole. As is the case with insurance companies, the capital market has not been institutionally rounded in a two-year period, either. Moreover, at this moment it is subjected to further disintegration and stagnation of its two main institutions – the Securities Commission and the Stock Exchange, meaning that shareholding is left without any effective protection.

Radovan Jelašić

BANKING SECTOR

After having passed through **initial cleansing** in its **first stage** – initial analysis was made, certain banks have been shut down, new licenses have been granted, and the total number of banks has been reduced from 85 to as few as 50, the **banking sector reform** has lost its momentum in the second stage.

The second stage of the banking sector reform – i.e. restructuring – should have been finished by the end of 2003; it projected the carrying out of the debt-equity swap, the beginning of the privatization of banks and full control of majority state-owned banks – there are 16 such banks – by the Bank Rehabilitation Agency.

Furthermore, the enactment of the Law on the National Bank of Serbia was also planned. The Ministry of Finance did a quick and efficient job in that area, and it would be good if this Ministry were as efficient in its original job in terms of the third stage of banking sector reform which foresees **further privatization of banks,** and which is supposed to begin next year, providing that all mentioned problems in the banking sector are solved.

As is already known, the National Bank of Serbia was the leader of reforms in the banking sector. Representatives of the NBS (former NBY) were in charge of the appointment of four out of seven members of the Agency Council, either directly or indirectly, through the Agency.

What has and what has not been done so far in terms of the restructuring of banks? Partial debt - equity swap has been carried out; one portion of the Paris and London Club liabilities was converted into equity, but to date the conversion of all interests rates i.e. of all off-balance liabilities has not been completed, which indicates that additional conversion lies ahead. The Government wants to carry out additional conversion at any price and in any way, not taking into consideration the consequences of such action, in particular in terms of the fact that the state's larger equity in these banks will increase after additional conversion; bearing in mind the manner in which the state managed the banks in which it possesses equity in the last six to nine months, it will find itself in an even more unenviable position than today.

Also, if additional conversion were carried out, the banks in which conversion was made would be in a far worse position in negotiations with other creditors, i.e. creditors not belonging to the Paris and London Clubs. The Government adopted the strategy for bank restructuring in just three weeks, **but took as long as three months to appoint state representatives to the managing and supervisory boards. It appears that strategy is far less important than the actual appointments**. This was the first indication that the entire process is not heading in the right direction, i.e. that the privatization process will not begin in six months.

As far as the beginning of the privatization process is concerned, it was agreed with the World Bank, i.e. the International Monetary Fund that the

Privatization Adviser should be appointed by June 2003, i.e. that tender privatization, or the sale of the state's majority equity in Ju banka, Novosadska banka and Kontinental banka should begin by the end of the year at the latest. Not only has privatization not even started, but the Privatization Adviser has not been appointed. It should be borne in mind that the Government approved the program made together with the World Bank and IMF, which means that the Government knows very well what this is all about and what resources the state will be granted if it fulfills prescribed requirements. This concerns PFSAC 2 (Private and Financial Sector Adjustment Credit), a program for the financial, i.e. real sector, agreed with the World Bank in April 2003. Furthermore, **key actions relating to the privatization of banks have not started yet**, e.g. settlement of non-performing debt. **The debtors, in particular big public enterprises, are not at all ready to settle their obligations**. Banks are trying to settle these claims, but debtors are unwilling to negotiate. Reconciliation of debtor-creditor relations in the country has not been carried out to date.

As far as the management of banks in state ownership is concerned, the government proved not to be equal to the task. Since their appointment, members of managing and supervisory boards in the banks in question have been working independently, i.e. **the Agency does not pursue management any longer**. At the beginning, the idea was that the members of managing and supervisory boards would perform their duty without compensation, but it turned out in the meantime that compensations have been paid out after all. Of course, compensations vary depending on membership in the Board of Directors or Supervisory Boards of, for example, Komercijalna banka or Srpska regionalna banka.

The Agency does not have daily information on all aspects of the activities of banks. For example, members of the Council, i.e. the Director of the Agency received information from the World Bank's representatives and Washington that the Novosadska banka signed a strategic agreement with Unicredit, which means that banks are starting to do business independently, despite the state's obligation to pursue management, since the state is responsible for everything going on in these banks.

Finally, **although auditing annual reports** as of 12/31/2002 **were made** for nine out of sixteen banks under major state ownership, at the price of US$ 300 – 400.000, **nothing has been done** yet on the basis of these reports.

Without any doubt, those who became members of managing and supervisory boards of the banks in question have benefited most from this situation. These persons were appointed by the Agency, under the influence of political parties to whom they submit their "reports". Managing directors of these banks are best off. At the beginning they were strongly against conversion, with some of them even bringing charges before the Federal Constitutional Court, but today, they are looking forward to additional conversion, having realized that the state, although a major owner, does nothing in these banks. Unfortunately, **the Agency has been considerably marginalized and decried** both by the Ministry of Finance, which wants to have control over the entire financial system, and by the Ministry for Privatization.

With regard to the privatization of banks, this issue is accompanied by enormous ignorance and lack of understanding. **Discussing the restructuring of banks, government officials are explaining that the decision on whether to shut down one enterprise from the real sector or from the banking sector should be guided by the number of employees.** This means that if one enterprise in the real sector employs more workers than one bank, the bank is the one to be shut down, and this would allegedly solve the problem. No attention is paid whatsoever to the fact that banks have balances and not "disbalances", i.e. if they cannot collect the claims they have, they will not be able to pay out deposits to their own creditors.

The discussion on how to solve the relation between the real and the banking sectors has lasted since March 2003, but nothing has been done so far, with the exception of a public bid being announced three days ago for the creation of a strategy for solving this problem. Unsettled claims still burden the balances of these banks, i.e., balances of enterprises which underwent privatization in the meantime - they are sometimes sold for only US$ 1, but usually without the consent of creditors, i.e. **those who have claims against the enterprises in question take no part in the privatization process. The debtors lobby still rules**.

The lack of human resources is also an important problem. The same group of people is constantly present, circling through institutions – from the Ministry of Finance, through the Bank Rehabilitation Agency to the Council of the National Bank of Serbia.

If the elections were scheduled at the end of this year, and bearing in mind the stage in which the privatization of banks is today, i.e. if the three mentioned banks were not sold until next June, it is not very likely that there would be any privatization of banks in 2004.

As far as the **following steps** are concerned, it would be very important to **finally reach consensus on who is running the privatization of banks**, as this is one of those topics discussed by all – the National Bank of Serbia, the Minister of Finance, and the Banks Rehabilitation Agency. Finally **the appointment of the Privatization Adviser should speed up the privatization process**, although expectations should remain realistic.

The plan for restructuring of our largest bank, i.e. Vojvodjanska banka, which was announced for the end of July has not been finished to date, i.e. if anybody at all is working on that plan, it is people from Vojvodjanska banka itself. The **auditing annual reports**, so dearly paid for by the Agency, **should be used for the creation of a realistic overview of the situation in the nine banks under major state ownership,** since these nine banks constitute the major part of the Serbian banking system.

INSURANCE COMPANIES

Supervision of the functioning of insurance companies *de facto* does not exist.

Supervision over the work of insurance companies used to fall within the competence of the Federal Ministry of Finance, and the entire job was done by four officials. Control over the work of insurance companies was pursued by clerks in the Payment and Settlement Bureau (ZOP); their task was to prepare an analysis and on the basis thereof the Federal Ministry of Finance would make the decision on whether a specific insurance company was solvent or insolvent. However, the ZOP was canceled and the competence for insurance companies was transferred to the Republican Ministry of Finance. People in charge of this actually sit in the Ministry, but have nothing and no one to work with, nor do they have resources at their disposal to build a new organization and to finally restore control over insurance companies.

As with the banking sector**, diagnostic analysis of the sector of insurance has not been made in the last three years, either**. This means that nobody studied international accounting standards on the basis of which the liquidity and solvency of an insurance company can be assessed, which should be the basis for the decision on which insurance companies can continue working and which ones are to be liquidated.

The Law on Insurance Companies has been topical for two years, but **has not entered parliamentary procedure thus far**. Although it is very important **the concept of the supervision of insurance companies is also not known**, i.e. it has not been decided yet whether supervision will be pursued by the Ministry of Finance or by a special agency that should be established for that particular purpose.

The most important future step above all is **the passing of the Law on Insurance Companies in parliament**; then, the **Ministry of Finance** would have to start pursuing supervision and **would need to make the diagnostic analysis of insurance companies operating in Serbia today**. When buying insurance polices, either life insurance, car insurance or any other financial services offered by insurance companies, citizens largely opt for the cheapest one, because they are aware that they will not be able to collect anyway. By supervising the work of insurance companies, the Ministry of Finance is obliged to give citizens the guarantee that insurance companies which possess working license are solvent, i.e. liquid.

Milko Štimac

NATIONAL BANK OF SERBIA

The G 17 Institute left the National Bank of Serbia enough time to consolidate and organize its work. However, at this moment we can say that everything we initially foresaw has come true; namely, **the new Governor of the National Bank of Serbia entered this institution without vision, without a program and without human resources**. The lack of human resources should be especially emphasized, since reforms, as all other processes, are pursued by people. Without professional and capable officers there is no reform. The former management of the NBS should be given credit for being able to gather quality people determined to carry out reforms and to persevere despite all pressures. Since the appointment of the new management, **the National Bank of Serbia has lost its leading role in reforms** and it became obvious how much people matter and how important human resources are for the implementation of reforms and the transition.

The lack of vision, conformation to daily developments, wondering from one daily event to another is best visible in excuses justifying the delay in the appointment of Vice Governors. It is obvious that persons with integrity do not want to enter high state institutions in that manner. It was for this reason difficult to find new Vice Governors, which can only be flattering for the real pro-reform current in the Serbian intelligentsia. Today there is a free fluctuating **group of so-called "independent consultants**" – although there is no sense in talking about independent consultants who work for money, since one cannot be independent while working for money – **who are always willing to do any job**, whether it is in the Banks Rehabilitation Agency, the NBS, the Privatization Agency; wherever there is a vacancy, an independent consultant pops up, ready for sacrifice at the alter of the country, for sacrifice in the name of reforms in Serbia, etc.

According to developments in the National Bank of Serbia, it can be concluded that, on one hand, that freely fluctuating group of "independent consultants" has been exhausted, while, on the other hand, people of integrity do not want to stain the institution they are invited to join. Several basic indicators show that **the conflict between the National Bank of Serbia and the Government of Serbia is for the most part fabricated by the Government**.

First of all, dissonance between the Government and the NBS vanished, or, as one of the Ministers put it, "We got the fairytale National Bank", since we already have the fairytale Government. However, this is hardly the case. Those who worked hard on carrying out reforms, who actively protested any irregularities both in the banking and monetary sectors and in the broader economic environment have been removed, and today there is simply nobody to protest. Instead of insisting on devaluation, since a strong dinar allegedly stifles production and economic growth, as we have been listening to for months, the

Government is suddenly advocating a stable exchange rate for the national currency. Also, instead of deposing proceeds generated from the big privatization sales, and money from the budget, in general, in commercial banks, all revenue is suddenly going into the National Bank of Serbia. It is difficult to understand why this was not the practice earlier, before the appointment of new management. Finally, after loudly campaigning about the high income of employees in the National Bank of Serbia, all **wages, from the Governor downward, doubled or increased several times in some cases**. I am not familiar with anybody from the Government making any comments regarding this.

What should be the following steps? Where is the exit from this blind ally, i.e. how to restore the NBS to the position it deserves and must have?

After the creation of the constitutional framework (once the new Constitution has been adopted), **the new Law on the National Bank of Serbia should be enacted, which would take into consideration suggestions of the IMF, the World Bank and the European Union** regarding four key issues related to independence: **personal, institutional, organizational and financial independence**. The G 17 Institute has already been working on the creation of the new draft law on the NBS. Also, it is necessary **to restore the NBS's leading role** in terms of adoption of a reform agenda in the area of **monetary and foreign exchange policies, supervision of banks, restructuring of the banking system, improvement of payment operations, etc**.

In the weak institutional environment, such as the one we have lived in since Milosevic came into power, control over key currents in political and economic life is often established outside institutions. For example, the Beogradska Banka Group used to control 60% of the total banking potential in Serbia. In such circumstances it is normal for the National Bank to be a mere stage prop. Who plays a more important role in the pursuance of monetary policy in Serbia today – the Governor of the National Bank of Serbia or some private banker? **The central bank in every country**, including Serbia, **must have the leading role, and must be the strongest institution in this sector.** Of course, it is necessary **to modernize the remaining two sectors in the National Bank of Serbia**, i.e. accounting and human resources departments.

CAPITAL MARKET

As far as the capital market is concerned, the main emphasis will be on two key institutions, i.e. the Securities Commission and the Stock Exchange. We will also discuss the institutions which still do not exist in our country.

Serbia still does not have the Law on Investment Funds. Without the law governing open-end investment funds which are able to attract small investors it is not possible to mobilize free capital in its entirety which is sometimes estimated to be EUR 4 billion. One way to attract this money is through savings in banks; another way is by establishing open-end investment funds in which small investors would invest. The meeting of tycoons and the Serbian Government, where they were told to set up an investment fund cannot compensate the absence of the Law; moreover, closed investment funds should

come only at the end. The establishment of closed investment funds at this moment would only foster tycoonization in setting monopolies, oligopolies, etc.

A key institution that should foster, create and conduct the development of the capital market, a match to the role of the National Bank in the banking sector and on the money market, is **the Securities Commission**. Like the Governor of the NBS, the president of the Commission should also be elected by a qualified majority of votes in the National Assembly. The Commission must be accountable to Parliament, report on its work to the Government, and coordinate with it. **The new Law**, unfortunately, gradually **deprives the Commission of its independence,** reducing its competences, stripping it of its powers, **which**, for its part, **leads to further tycoonization**.

What has the Commission done since the beginning of reforms in Serbia until today?

The Commission, in its fifth session, with Mr. Rajkovic in the capacity of president, became **a member of the IOSCO**. The IOSCO is an international association of capital market regulators. Practically, IOCS has the same role in the area of capital market and national capital market regulators, i.e. the Securities Commission in Serbia, as the IMF and the World Bank for the national banks and banking sectors. **The Memorandum of the IOSCA** contains eight groups of rules specifying what should be the role and organization of a national Securities Commission, as well as its competence. Our Commission became a full member of the IOSCA, but nothing has been done since. **Further adjustment to the Memorandum is unfortunately not possible because the Commission's role in the regulation of the capital market is gradually being reduced**.

The sixth session, under the presidency of Professor Bosko Zivkovic, must also be mentioned, as it adopted **binding opinions on the issuance of short-term securities, capital increases and the right to a rubber stamp** - three areas that caused considerable confusion, insecurity and irregularity.

The fifth session was also involved in the fight against embezzlement, in particular in the fight against various forms of company takeovers through capital increases or bankruptcy procedures, against brokerage houses and consultants who helped such takeovers, and against managements of enterprises which abused their positions in financial associations (e.g. the case of Apatinska pivara).

The Commission failed to protect small shareholders. According to the Privatization Law, which is a *lex specialis* compared to the Law on the Securities Market, all issues concerning privatization, including the shares deriving from privatization, are excluded from the competence of the Commission and put under the jurisdiction of the Ministry of Privatization. Since recently the Ministry has been increasingly making direct bargains with buyers. The fact that each case of company takeover is accompanied by the existence of small shareholders who believe that they have been damages, is sufficient evidence to consider whether this privatization method damages small shareholders or not. The Association of Shareholders of Apatinska Pivara, which has existed for some time, is suing the Stock Exchange, the management of the Apatinska Pivara and

brokers who conducted the privatization process. This problem is not being resolved. Hence, the Commission simply was not able to win the battle against the Ministry for Privatization in gaining dominance in this area because it lacked legal foundation for this.

As far as the introduction of corporate governance principles, i.e. the principles of economic democracy is concerned, people in Serbia still do not understand that shareholders are the owners of the company. The share is a document of title. Management is supposed to work for the owner, i.e. shareholder. **Managers**, appointed by Slobodan Milosevic in the past, still rule the roost in the Serbian economy. They **still behave as if they, and not the shareholders, own companies.**

Futures have not been introduced, as well. Serbia is a country in which 50% of the GDP directly or indirectly depends on agriculture. We need futures in order to release inflationary pressures on the budget. We cannot go on otherwise. Without the establishment and introduction of futures to the market, we will not able to have a modern agricultural policy.

Moreover, three brokers have been admitted to the Board of Directors of the Belgrade Stock Exchange. It might sound cynical that I mention this as a positive development, but any further improvements have not be made. The stock exchange is an institution of the market, an institution of intermediaries. If stock exchange intermediaries do not have a dominant influence on the developments on the Stock Exchange, and if the market does not have a dominating influence on developments on the stock exchange, the stock exchange itself should not exist. The Minister of Finance acts as the president of the Board of Directors of the Belgrade Stock Exchange, and two other Ministers are members. Whose word carries more weight – that of the Minister or of a broker? The stock exchange is a market institution. It would be nice if Ministers were to recognize this fact after three years, withdraw form the Stock Exchange's Board of Directors and initiate the process of corporization of the Stock Exchange, i.e. letting brokers take over the stock exchange. Certainly, the Government can always preserve certain influence in the Board of Directors; it may have its representative as a member, but this should not be a Minister, and that person should not act as president. However, the Government should exercise the greatest influence on trading, i.e. the state should trade on the stock exchange through specialized institutions: for example, the Share Fund, which should not only sell, but also trade, i.e. work on maintaining the value of the portfolio it holds; or, the Commodity Reserves, since Serbia is an agricultural country, which should determine the limits of oscillations in the prices of agricultural products.

The Belgrade Stock Exchange has been very active, both under the former and present directors, in the area of regional networking. This market is small and shallow – this applies not only to the Serbian market but to the entire regional market, and the only solution to attracting big and serious investors in the long run is the networking of the capital markets at the regional level. Hence, the Stock Exchange has already made some moves in that direction, and it has done everything it could. Also, there are several initiatives for the establishment of educational centers jointly with other stock exchanges in the region.

Owing both to donations and to efforts of the IT Department of the Belgrade Stock Exchange, stock exchange operations were computerized. The Stock Exchange itself, within its own limitations, took part as much as possible in the battle against embezzlement, but, again, this was not enough, at least not at the required level.

During the regime of Slobodan Milosevic, the state had indirect control over the Belgrade Stock Exchange, as membership in the Board of Directors included half of the banks belonging to the Beogradska Banka Group. Now we have direct state control. Unlike Slovenia, Hungary and Poland, the final listing of the most successful Serbian companies has not been established on the Stock Exchange. 800 most successful companies were privatized under the so-called Beko's Law; on one hand, this resulted in the dispersion of capital, but also in the concentration of capital, on the other. This Law created a large number of small shareholders, but this shareholding is nevertheless concentrated, since shareholders were at the same time employed in companies whose shares they owned. To overcome this it would have been enough to make only one step ahead, i.e. to list those companies on the Belgrade Stock Exchange and allow public trading in these shares in order to attract others to buy shares of companies in question, and thus to stimulate shareholding as such, i.e. as a positive manifestation which enhance responsibility of the entire population and engages it in economic flows. However, this has never been done. Quite the opposite, small shareholders are under permanent pressure to add their shares to the Share Fund in order to sell these companies to a strategic partner. The G 17 Institute conducted a study titled *Investment Map of Serbia*, which suggests what industries should be sold to strategic partners – it mainly refers to huge investment infrastructures. Everything else, e.g. the food industry or retail chains, should be left to shareholding, institutional investors or domestic investment funds which still do note exist. However, the situation in Serbia is completely the opposite. The experience of Hungary and Poland confirmed that strategic partners want to buy the market. Hence, strategic partners are being sold a monopoly, as well, e.g. the sale of the tobacco factory. On the other hand, at least the tobacco factories were sold at a high price, which can not be said for the establishment of a quasi-monopoly for sugar. All these companies should be placed on the Stock Exchange, but unfortunately this has not been done.

The status of the commodity exchange is not regulated. In Novi Sad there is the Product Exchange whose management has been persistently trying for two years to get a license to register as a stock exchange. At this moment, it is under full state ownership. There is a plan for brokers to take over this sock exchange, intensifying trading in basic agricultural products, with introduction of financial derivatives to. Moreover, there is an idea to introduce joint trading simultaneously at the Novi Sad and the Belgrade Stock Exchanges, i.e. to remove obstacles relating to the inflow of capital, money and goods, at lest on the internal market. However, none of this has been realized because the Novi Sad Exchange is state-owned and any strategic decision is subject to the approval of the competent Minister. For this reason futures trading does not exist, resulting in the

decrease of shareholding, reduced interest among investors, decrease of the capital market and, of course, tycoonization.

This is not all. The competences of the Securities Commission are regulated by the law which came into force on October 1, 2003. Nevertheless, the Ministry is already considering further reduction of its competences. An unofficial Draft Law amending this Law foresees the transformation of the Securities Commission into the Agency which would be accountable to the Government of Serbia and not to Parliament. Also, members of this Agency would be selected by the Government, which would be also in charge of supervising the Agency's work. The Agency would not be entitled to make orders and regulations and other general enactments, but only manuals and instructions. The Minister, and not the Agency would be in charge of specifying the forms and contents of the prospectus for the distribution of securities and of the short prospectus, as well as of the request for the approval of the prospectus. The same applies to other activities which are today under the competence of the Commission: specification of the contents of the public invitation for subscription and payment of securities, the contents of the accompanying documentation, etc. There is a danger that the remaining semblance of independence of the Securities Commission will vanish.

PRIVATIZATION FALLEN SHORT OF INITIAL EXPECTATIONS

Press conference held on October 9, 2003

Mlađan Dinkić

The privatization process in all transition countries was the subject of much controversy. Compared to other countries in transition, the citizens of Serbia were not very informed about the problems which our country was facing in the transition process. In the three years of the implementation of privatization, the process was not discussed widely in the public, it ran very quietly, and the first criticism appeared only after six months. Observed independently, it could be said that in the organizational sense the Ministry for Privatization, the Minister for Privatization and the Privatization Agency are currently the best sector in the Serbian Government. Therefore, all problems result from the fact that the goal put in front of the Ministry for Privatization was ill defined, and from the lack of support by other members of the Government who were supposed to help along efforts invested in the privatization process in yielding better results.

Privatization has fallen short of its initial expectations. Firstly, the privatization objective had been ill defined from the very beginning; secondly, the privatization process was abused several times, thus compromising public support.

What does it mean that the privatization objective has been ill defined? **Privatization has been reduced to the selling of state owned property for the sake of ensuring the liquidity of the budget.** However, privatization proceeds should not end up in current spending. The aim of privatization in our country today seems not to be the improvement of efficiency of enterprises and increase in employment, production and export revenues, but rather the elimination of the budget deficit. Hence, **privatization is actually being used as a fiscal and not as a developmental instrument**. Moreover, there are no precise records on how these resources are spent, which compromises both transparency and efficiency of the entire process. For example, 5% of each sale shall be allocated to the restitution fund; however, this fund does not exist and nobody knows in what way these resources are being spent. The budget sometimes borrows that money to the state-owned commercial banks and to other users; neither the Government, let alone Parliament, pursues control over the spending of these resources. All of these are the consequence of an initial problem, namely, **the Government lacks a clear privatization strategy, i.e. it does not know what it wants to privatize, when and how.** The Ministry for Privatization has been given a simple task – to sell as much as possible and to maximize revenue in order to fill the budget. This is the key mistake in this privatization model: **the Government seeks to maximize privatization proceeds in the short term in order to cover the current budgetary deficit, which frequently imperils certain long-term interests of the Serbian economy.** The privatization process should not be run either too quickly or too

slowly. In any event, there must be a strategy determining what enterprises should undergo rapid privatization, and what companies perform well and are estimated to be able to achieve a better price in the future, after having undergone restructuring, if it has been decided to sell them to a strategic partner at all, as this need not always be the best solution.

Hence, the key objection to the **privatization process** in Serbia concerns the fact that **it has not brought desired results in terms of economic development,** i.e. it has not resulted in the growth in production, employment and exports, but only in the change in ownership. Someone could say that it is too early to expect to see positive effects on economic development, but more than three years have passed, and the worrying indicator is that in the third year of privatization, Serbia is registering the lowest employment and exports indicators. However, it is not the fault of the Ministry of Privatization or the Privatization Agency, since the work of this Ministry is not accompanied by other important segments of economic policy, such as fiscal policy. Simply, if there were no permanent pressure to eliminate the budget deficit, Minister Vlahovic would not be required to sell companies, sometimes at the prices that are much lower than what could have been achieved after better preparations; these are often companies which should not be on sale at this moment. Fiscal policy and the tax administration are not engaged sufficiently on taxing the gray economy, and what is more, Serbia has neither an industrial nor a trade policy. Therefore, **privatization itself, without the support of key economic policies, yields poor results.**

Another problem is the absence of an investments-friendly business climate. Enormous red tape, i.e. a very lengthy period necessary for obtaining various licenses and permits for investing in production and employment does not encourage the process of privatization either, because big prospective investors give up even before they start, knowing that they are going to face serious complications.

The final problem concerns development. Namely, the Government abandoned the actual, previously scheduled restructuring of 50 biggest enterprises; as a matter of fact, **the restructuring program was created, 80.000 workers were downsized in the meantime, with restructuring itself not having even started yet**. If someone believes that restructuring only means downsizing, than we are facing a misunderstanding of some economic terms. Restructuring means change in the production program and the production structure and reduction of some other costs not related to the labor force, such as an irrational vehicles fleet or other irrationalities which in practice are rarely reduced. It seems that the Government has left these 50 companies to die out slowly. Objectively speaking, the Government does not have any idea what to do with these companies, consciously leaving this problem to some future government as one of the heaviest burdens. Unfortunately, it might be said that privatization has not been used for the rapid change of the economic structure in Serbia, because we need restructuring as much as we need privatization; all these problems arise from the fact that **the Government of Serbia does not have a ministry which is exclusively in charge of the economy**.

There are two Ministries in the Government of Serbia today formally dealing with the economy – the Ministry of Finance and Economy and the Ministry for Economy and Privatization.

The Minister of Finance largely deals with public finance and this only in terms of macroeconomic stability and not in terms of development. On the other hand, the Minister for Privatization deals exclusively with privatization. I must admit that I have no objections with this, since it is impossible for one man to act as the minister for the economy and as minister for privatization at the same time. However, the problem is that the Government does not have one ministry exclusively in charge of the economy, whose task will be the restructuring of the economy, i.e. implementation of indirect incentives for restructuring.

Another problem in terms of an inappropriately set privatization goal concerns **a partial approach to privatization**. Some authorized buyers have been granted non-standard concessions, again with a view to increasing privatization proceeds, whereby potential damage to the economy as a whole is not taken into account. This practically means that attention is focused only on enterprises that are scheduled for sale, and no attention is paid to the harm which might arise from the application of non-standard methods. I will back up this statement with two examples.

The sale of the company *Sartid* to *US Steel*, which is a success on the one hand, although the manner in which the debt of this company was written off is not something you can read about in economic literature, brought about a serious problem in relations with both German and Italian businessmen who are announcing a halt to any serious economic cooperation with Serbia.

As far as the sale of the Tobacco Industry of Nis and the Tobacco Industry of Vranje is concerned, privatization proceeds are the highest realized in any tender privatization in Serbia, but in return for such high proceeds the market has been closed for potential competition.

Therefore, on one side we have high privatization proceeds which may be considered a success, but this is a partial success because of the negative effect on the economy as a whole due to the promotion of monopolistic behavior. It is not advisable to apply the same privatization method to the petroleum industry; such a method of privatization seemingly brings more benefit, i.e. greater inflow to the budget, but the total effect of such practice on economic development is questionable.

The Government and not the Minister for Privatization should think about total aggregate effects on the economy, as the duty of the latter is to sell at the highest possible price, at least according to the present privatization model.

If privatization is used as a method for filling the budget, and not as a means of stimulating economic development, then what we are witnessing is actual selling off of state property, with the greater portion of public support being lost in the process.

Numerous abuses have compromised public support for the privatization process. The privatization process may be generally divided into three stages. The first stage is the preparation of tenders and auctions. The second stage is the realization of tenders and auctions. The third stage concerns developments

following the completion of the privatization sale. **Control of the preparatory stage and of post-privatization developments does not exist, which left room for various abuses and diminished the actual credibility of the process, although tenders and auctions are run in accordance with the law**. At first glance it looks as if everything is regular, but nothing is actually regular.

What are the forms of abuse in the preparatory stage of privatization?

As in other countries in transition this concerns the problem of **after taking, i.e. the stripping of state assets and their channeling into private pockets even before the privatization sale takes place, either through tender or through auction**. Even the crudest of frauds remain hidden or unpunished. A classic example is the rigging of tenders, especially in auctions which occur outside the Ministry for Privatization with the assistance of some persons close to the Government. I will mention the infamous case of the *Kolesar – Novi Popovac Cement Factory*. Holzim really made the best offer in formal and legal terms, but the tender was rigged before Holzim even applied, and it turned out afterwards that a government official, in this case the Head of the Prime Minister's Cabinet, was the president of the Cement Factory's Board of Directors before the privatization, and continued on as member of the Board of Directors after the foreign partner entered the company. It is incredible that a person who is employed by the Government of Serbia can be allowed to sit on the Board of Directors of a foreign company.

As far as privatization auctions are concerned, the problem is that the preparation of an auction in most cases takes an unnecessarily long period of time, as opposed to tenders, which really do require long periods for preparation. It often happens that an overly extended period for preparation of an auction is used to further devaluate companies which are scheduled for sale. The greatest abuses were made in that area, resulting in the loss of public support because various stakeholders got time to strengthen their positions, i.e. to find legal gaps and in collusion with the corrupt managing directors to fictitiously devaluate the companies they ended up buying.

For example, the managing director of a state-owned or, more often, a socially-owned company in collusion with a potential buyer purposely devaluates the company's assets through reckless borrowing at interest rates highly exceeding those set on the money market. The company records increasing losses and finally goes bankrupt. Then come the commercial courts which are supposed to be a barrier to unlawful behavior, but in effect present the strongest logistic support to these abuses, with a company's assets being sold to the creditor non-transparently or semi-transparently at a much lower price than the actual market price. This was the case with *"Kluz"*. The managing director was consciously borrowing from *Kapital banka* at high interest rates, driving the company into bankruptcy, and consequently, its assets were sold – *Kapital banka* granted some portions to *Zepter* and some portions were sold directly to other interested parties. Anyhow, if a company possesses valuable assets, usually real estate, a public note announcing its sale is published in a daily newspaper with low circulation, and potential serious bidders are not in a position even to see that advertisement. What follows then is the breaking down of the initial price and

selling at half the price; and in the end, although obviously rigged, everything appears to have been carried out legally. After the sale, the managing director of the state-owned or socially-owned company goes to work in one of the private companies owned by a person who bought the company in question. Workers protest, but the director is not there any more. Both the former managing director and the buyer are satisfied. A large number of companies is sold at auctions at low prices because of forced borrowing, all of which is caused by the long period of time which passes from the announcement to the realization of the auction, with control which could prevent the outflow of state-owned capital into private pockets being nonexistent. Of course, the outflow of state-owned capital is not something which happened exclusively after 2000. This happened earlier, as well. Therefore, it is not entirely the fault of the current government, but the current government has done nothing to stop this process, actually allowing it to intensify. Citizens see that and are becoming increasingly disappointed. We must not let the entire process lose public support because of such lapses. **Privatization should be modified and continued**. The experience from the past with private banks such as *Jugoskandik* and *Dafiment,* which robbed their depositors, was later used as an argument against the development of private banking in Serbia; we must not let this happen again. Hence, we must not give up privatization and, instead, all observed anomalies must be removed in order for public support to be restored.

Control is lacking in the post-privatization period, i.e. after the sale of the company, as well. It is often heard that some company was sold for US$ 1, EUR 1 or EUR 3. It is indisputable that a buyer may win a tender because he promised investments amounting to several million euros, along with appropriate social programs, which compensate for a low selling price. However, nobody controls whether the promised investments and social programs are being adequately carried out in practice. The Government loses interest in controlling what is going on after the sale once the selling price flows into the budget, and this is where potential abuses may occur.

Such practice should stop, and **the sole criterion in future tenders should be the price and not promised investments.** Of course, when examining bids, promised investment should be taken into account, as well as the credit rating of a prospective buyer, i.e. it should be checked whether his promises have credibility. However, the tender itself should be based on one single criterion. Any other solution leaves greater room for corruption and casts doubt over the correctness of the decision made by the tender commission. **The tender commission should not be given any leeway in making arbitrary decisions.**

The G 17 Institute is of the opinion that the privatization model should be corrected among other things by introducing adequate control over the process, which is unfortunately lacking today.

To begin with, **the objective of privatization should be changed**. It should be placed in the **service of development and increase in the efficiency of the economy**, while the Ministry of Finance should only be charged with ways on how to fill the budget. These two segments must be separated. Hence,

privatization should in no way have a fiscal role. This means that the future government should invest privatization proceeds exclusively into development projects. **Spending of privatization proceeds should be carried out following a special program which would be presented to Parliament at the beginning of every fiscal year, and at the end of the year a report should be submitted on resource spending**. Such a practice does not exist today and it is not known precisely how these funds are being spent. This would be a way for establishing parliamentary control over the spending of privatization proceeds.

Furthermore, **a portion of privatization proceeds should be used for recapitalization of the state pension fund**. If privatization proceeds were not used for this purpose, we would not have the opportunity to recapitalize the pension fund ever again and to transform it into a real institutional investor like pension funds in other countries. Some other countries in transition used proceeds from the privatization of state-owned flats for the recapitalization of pension funds. We missed that opportunity during the 90s and now we can recapitalize pension funds by using a portion of privatization proceeds that will be generated in the coming two years. A similar method should also be taken into consideration for the recapitalization of the health and education funds in order to transform these institutions into investors, i.e. to enable them to make CSD 1.5-2 out of earmarked CSD 1, and thus to alleviate the servicing of public expenditures. For now one dinar from privatization is spent as one dinar without multiplied effects. There is no other way to recapitalize pension funds and start serious reform of pension insurance, which should also stimulate the development of private pension insurance. Hence, amendments to the Privatization Law should provide for direct allocation of 1% of privatization proceeds for recapitalization of pension funds, and maybe some other funds as well.

It is also necessary **to restore public support for privatization**. This will only be possible if **the broadest possible segments of the population are included in the privatization process**. If the present privatization model, based on the method of direct sale of companies to strategic partners, continues, public support for the continuation of the process will disappear. **The present method should be supplemented with the method of IPO**, which will make possible the selling of shares in open-end investment funds to citizens through banks. It is necessary to create a mechanism through which the equity of companies will be offered to the broadest layers of the population. In this way, Serbia will soon have a large number of small shareholders owning good companies. The point is that special open-end investment funds should be established, which will hold the shares of various companies in their portfolios. In other words, shares held in the portfolio of the Share Fund should be segmented and classified (the Share Fund is estimated to possess shares in the amount of EUR 800 million), and then blocks of shares should be created which contain shares of both good and underperforming companies. Such blocks should be offered to the citizens. In order to carry this out, it is necessary to permit trading in shares through banks and not only through the Stock Exchange. As it is wrong not to offer state securities to citizens thorough banks (something that should be changed in order

for the state's borrowing on the capital market to have full effect, and the state's borrowing on the capital market is the main method of financing deficits in all developed countries), **privatization shares** should not be traded exclusively on the stock exchange, because citizens do not know what the stock exchange is all about and they are not likely to seek brokers. For this reason the entire process should be organized **both through banks and through brokers**. Of course, this would necessitate certain legal amendments. Also, the individual value of share ownership should be limited, for example, to 5% in order to prevent something known in economic theory as a hostile takeover. Therefore, under this privatization method, equity held by each individual in one company must not exceed 5%, which would ensure fairness and popular support necessary for the privatization process to continue.

The pace of tenders should accelerate in order to prevent deliberate devaluation of state-owned capital before privatization takes place. A good example is the "Bambi" company. After an intensive public debate about *"Knjaz Milos"*, and it seems owing to public pressure, the Ministry for Privatization decided to offer "Bambi" to the widest circle of citizens. However, it might happen that the appropriate legal and logistic infrastructure will not be completed until April 2004, for when the sale has been announced, which would allow citizens to get informed about what exactly it is they are buying. Furthermore, such a method of selling should not be applied to one company only. The Law on Investment Funds should provide for the creation of several open-end investment funds, and citizens should have the possibility to get acquainted with what kind of shares they are buying, while one block need not contain shares of only one company, but a mix of shares of several companies in certain proportion, for the sake of the risk spread. Hence, **the task of the future Government in the second stage of the transition will be to educate the population about the capital market**, to develop this market, so that in this area also we can become a country which will one day be compatible with the European Union.

As far as control is concerned, it is necessary to set up an independent state committee outside the Ministry for Privatization. As far as I know, a certain Commission exists at present, but it operates within the Ministry. However, it is not possible for someone from the Ministry for Privatization to control that very same Ministry. An independent commission would monitor the privatization process and would be accountable to Parliament. Finally, for successful control there must be coordination between different institutions, i.e. between the Tax Administration and the Public Payments Administration, i.e. between the Ministry of Finance and the Ministry for Privatization.

The reform of commercial courts is of crucial importance as well, since commercial courts must be an integral part of the control effort. In that respect, **the system of registration of ownership for companies should be completely removed from courts**. Ownership registration, as it is conducted by commercial courts today, is riddled with abuses. As in other countries, ownership registration in Serbia should be performed by professional notaries. An example that shows how courts can ruin the image of a country without direct fault on the

part of the government is the case of one Norwegian investment. Norway is a country which is not a big investor in Serbia. Nevertheless, they bought a factory for the manufacture of fish tins in Niš. They invested EUR 3 million in equipment and became the owners of 51% of the factory. However, minority shareholders decided at the meeting held in hotel "Maj" to expel the majority owner from the company. It is hard to believe that someone who possess a minority block of shares could even come to an idea of expelling from the factory someone who possesses 51% of ownership and who invested EUR 3 million in increasing production. Nevertheless, Norwegian investors were in shock when they were informed that the Commercial Court in Niš took the side of the minority shareholders and confirmed their decision. **Commercial courts are the most corrupted segment of society at the moment.** Neither intervention with the Mayor of Niš, nor anything else proved of any use. After this experience, Norwegians will never invest in Serbia again. And, what is more, this is not the only case. There are examples of courts taking on matters that are well outside their particular jurisdictions.

In order to remove all shortcomings in the privatization process and to introduce control, it is necessary to enact new regulations, i.e. to amend the Privatization Law and the Accounting Law, to pass the new Company Law, Bankruptcy Law, the Law on Investment Funds and the Law on Insurance Companies. These are some of the key laws which would ensure far better privatization effects.

Milko Štimac

The aim of privatization is not only change of ownership. **Privatization should serve as the backbone of the transition**, as a bridge toward a market economy which will engage as many citizens as possible in the market and ultimately help the creation of a middle class which is the foundation of stability and prosperity in a society. As has already been said, two ministries in our government contain the word economy in their titles, but none of them practically deals with the economy in an appropriate way. This is best seen in the example of shareholding. There were nearly one million so-called small shareholders in Serbia in 2000, owing to earlier privatizations – three privatization waves have occurred in Serbia thus far – and in particular to the privatization carried out under so-called Beko's Law from 1997. This is a significant potential which should be made use of, but there has not been a ministry of economy to deal with this issue, a ministry whose task would be to boost and promote shareholding. Today, unfortunately, **the Ministry for Privatization gives equal treatment to shareholding companies set up during earlier privatizations**, i.e. today's private corporations, **and companies under full social ownership**. The state even forces small shareholders to join their blocks of shares, to sell their shares to particular entities, which is something that must not be done because a share is a document of title, and the owner has full right to dispose of his/her property freely.

What should be done in that respect? In order to make the idea of investment funds and the idea of the placement of shares through public offering possible in an institutional sense, it is necessary to provide the appropriate infrastructure. Hence, **it is necessary to design and promote the stock exchange and to list about fifty of the best Serbian companies on it**. Under so-called Beko's Law, 800 of the best Serbian companies were privatized in the winter 2000/01, and some of these companies have thousands of shareholders. This is more than a solid base for starting the public listing of these companies. Companies list their shares on the stock exchange, which are then subjected to free trading. Whoever seeks to buy shares of certain companies comes to the stock exchange and pays the market price, without direct bargains and negotiations between the management and the state, between the management and the manager's company which was set up in order to takeover the enterprise which has been driven to bankruptcy. **When a share is publicly listed on the stock exchange, whoever wants to take over the company goes to the stock exchange and buys it, provided he has enough money to compete with others who are interested in the same company.** Such practice results in the wider spread of ownership, with citizens being actively engaged in the economy, thus becoming directly interested in what is occurring in the economy of the country.

A stable stock market has a positive impact on the entry of institutional and foreign investors and foreign investment funds, resulting in growing foreign investments. It might be said that such an investor does not exist in Serbia today. Furthermore, a stable stock market mobilizes citizens' savings which today remain stashed in mattresses, and the previously mentioned idea of investment funds and blocks of shares becomes easily feasible.

Finally, a stable stock market ensures efficient control of management. When a share is listed on the stock exchange, it, i.e. business policy of the company in question is on a permanent "referendum". All those who own the company, i.e. shareholders, censure the management by buying or selling shares. If they are not satisfied with business policy carried out by the management, shareholders sell their shares, the price of the company drops, indicating that there is something wrong with the management; then, a shareholders' meeting is called and management is changed. On the other hand, if the company performs well, citizens are increasingly interested in buying its shares, its price grows and management responsible for good results has credibility.

Due to various pressures, shareholding in Serbia has not had opportunity to develop. Small shareholders complained to the Securities Commission, but the Commission does not have legal possibility of protecting them. However, here we could mention a positive example of small shareholders who succeeded in protecting their company. This concerns the case of C market. The story of C Market began as so many others in our country involving corporations. Management tried to gain possession over shares – not to buy shares, as the trading in shares is a legitimate way of takeover. However, it is not legitimate to blackmail workers with their jobs and internal transfers, with an aim of forcing

them to transfer their rights to management. This has been happening in C Market. To protect their ownership, on August 1, 2003 small shareholders formed their association which holds the majority block of shares (nearly 51%). On the basis of these joint shares, the Shareholders' Assembly was held on September 1. The management, i.e. director Radulovic tried to avoid this Assembly and called the minority Shareholders' Assembly a day earlier, giving credibility to himself. Since a minority assembly can in no way be legitimate, a real, i.e. majority Shareholders' Assembly was held on September 1, as planned; the new Managing Board was elected and on September 11, in line with the Company's Statute, dismissed Managing Director Slobodan Radulovic. On September 17 the documentation relevant for the erasure of an authorized person from the Court Register was handed over to the Commercial Court. However, the Commercial Court avoided making the decision for more than 20 days. The Court required new documentation, relevant or irrelevant, to be submitted, and the new Managing Board proceeded accordingly. Another excuse for the delay in decision making was that the judge was too busy, that he did not have time to examine papers, while it was physically impossible to meet him. In the meantime, during the period in which the Court did not erase from the Register a person who cannot represent the company in a legitimate way as he did not have the support of majority owners, the very same person continued to sit in the position of managing director, imposing further pressure on the employed to give up their shareholding rights, above all the right to decision making. He made threats. His people went from store to store, threatening dismissals, transfers from Belgrade to Nis or Novi Sad; in other words, directly violating property rights. The entire situation was followed by various blackmails, dismissals and suspensions.

On October 3, 2003 the employees-shareholders received, under threat of dismissal, an order to sign three documents. The first one was a request for the termination of a contract for the sale of shares with a brokerage house; the second one was a statement that no contract has been signed with a brokerage house in the country or abroad, and the third one is a proxy for Mr. Radulovic's lawyer for representation and for the termination of a contract with a brokerage house. People are being deprived of their right to dispose of their property freely, as if they were minors or mentally retarded. In the meantime, for over 200 days C market has not been paying their suppliers; debts are being cumulated on purpose in order to become bankrupt. Debts toward companies such as BIP, Knjaz Milos, CARNEX, Topola – Backa Palanka, Coca Cola, are piling up. Many of them stopped delivering goods to C Market. Unpaid due liabilities of C Market towards suppliers and banks amount to CSD 2-3 billion. The only liabilities which are regularly fulfilled are those towards a Spanish company owned by Mr. Radulovic's daughter.

What is going on at the moment?

After yesterday's protest (November 8) of workers of C market in front of the Commercial Court and engagement of serious lawyers by majority shareholders, the withdrawal of formerly authorized persons from and registration of new ones into the Court Register cannot last too long. Something that should proceed automatically – owners deciding to change a director – has been

dragged out for 20 days. These twenty days are lost for a company which is becoming increasingly indebted and burdened with the objective of driving it to bankruptcy and causing it to come under the sole competence of the Commercial Court. We hope that the case of C Market will end as the first successful story and that the new Board of Directors and the new director, who are now in the acting status, will be registered in the Register of authorized persons.

INSTITUTIONAL AND POLITICAL UNCERTAINTY

Press conference held on October 16, 2003

Dušan Pavlović

Political and institutional uncertainty can be discussed from two aspects.

One aspect concerns **the impossibility of making decisions in decision-making institutions**, not only in the systemic institutions prescribed by the Constitution, such as the Parliament, the Government, courts, etc. but also in institutions which represent political parties. Political parties, i.e. political coalitions can also have problems in decision making.

The other aspect of the problem is political uncertainty which occurs when institutions or actors for some reason are **prevented from making decisions efficiently.**

As far as institutional instability is concerned, there are certain rules and regulations on the basis of which decisions are supposed to be made efficiently. In effect, decisions are made by violating, circumventing or breaking rules and regulations or by making decisions in an alternative manner, on the basis of rules which are not stipulated by the law, the Constitution or any other enactment which should be observed.

As for political instability, what can be observed is the impossibility of decision making within political coalitions, e.g. the governing coalition. There is a big coalition gathering about 16 parties. The problem is not only the excessive number of parties, but also the participation of parties which have minimal or no support in the electorate. In spite of their minor influence in the electorate, these parties possess leveraging capacity. The political party in power faces problems in making political decisions because it takes time, energy and resources to respond to the leveraging capacity of small parties. Therefore, the number of parties does not actually matters, but what matters is how many small parties there are with no support in the electorate but that, nevertheless, posses a certain number of seats in Parliament (either 2, 3 or 10) owing to a coalition agreement, which puts them in the position of blackmailing the Government and extorting certain concessions in exchange for their support in Parliament.

It has become obvious these days that the coalition is not even capable of making internal decision. The DOS presidency met yesterday, but it is not completely clear what was decided with regard to the future strategy of this coalition, i.e. what it is going to do in and outside the Parliament. This would be the first segment of political instability concerning the non-functioning of the coalition.

The second segment concerns the fact that some external actors interfere in decision making within the coalition. A certain number of members of the Democratic Party, i.e. of the governing coalition, are very influential in decision-making; however, Democrats also have very strong ties with people who are not members, but nevertheless have a certain influence on decision making both in the party and in the coalition. For this reason, smaller parties, which do not have these kinds of relations with people outside the coalition feel neglected and feel that something is wrong, which results in conflicts in the decision making process within the coalition. This concerns political instability and has been present in recent months, especially during past several days.

With regard to institutional instability, its consequences are much more serious than those of the non-functioning of one political party. A party will be punished one way or another in the elections, namely, it will score badly, and either break up (if it concerns a coalition) or disappear from the political scene. It is far more dangerous when institutions do not function, i.e. when rules are not observed. A number of laws, especially laws and by-laws governing the work of the National Assembly, have been enacted after October 5. Nobody can say anymore that it is inappropriate to work according to the laws made by Milosevic, since there are no such laws in force today, as far as the work of the Parliament is concerned. This primarily refers to the House Rule Act of the National Assembly of Serbia. The House Rule Act has been amended several times in the period 2001 – 2003, and it is generally the House Rule Act enacted by the present Parliament. Nevertheless, it has been violated several times not only recently, but also during 2002. Not only was it violated, but there were also some announcements of further violation. The events of Tuesday and the announced striking off from the agenda of the vote of non-confidence against the Government are actually violations of the House Rule Act. This, of course, did not take place, but if parliament is in session and if these issues have not been put on the agenda, or if some other issues have been on the agenda, then Parliament has violated its own House Rule Act.

The House Rule Act, article 199, specifies that if the motion for non confidence against the Government has been submitted in an appropriate form, it shall be put on the agenda, unlike some other issues, e.g. debate on laws, which can be stricken off the agenda. However, Parliament does not have discretionary power to take the motion for non confidence off the agenda. The vote of non confidence is even regulated by the Constitution. Article 93 of the Constitution of the Republic of Serbia stipulates that the motion for non confidence against the Government shall be submitted in an appropriate form by no fewer than 20 deputies; it shall be accompanied with an explanation, i.e. the request shall contain the reasoning for the vote of non confidence. Providing the fulfillment of these conditions, the Speaker shall put the motion on the agenda no sooner than upon the expiry of the three-day deadline and no later than fifteen days after the date when the motion was submitted. The motion shall be debated. If the debate has been held and the Government has been given a vote of confidence by the majority of deputies, the House Rule Act specifies that another motion of non confidence shall not be raised within the following six months. The very fact that

there was intention to begin with an agenda that is different from the one established by Nataša Mićić represents a violation of the House Rule Act. Nataša Mićić as the Speaker of Parliament has a kind of discretionary power to establish and make changes in the agenda, but once the agenda has been proposed, established and proposed to be put to the vote, it shall not be changed any more. Deputies must vote on that agenda.

The attempt from Tuesday to avoid a session of Parliament is in accordance with the House Rule Act, since the Speaker is entitled to postpone a session of Parliament for one day if there is a just reason for doing so. Ms. Mićić, however, did not advise the Assembly of this, but let the deputies wait a whole day. However, since such a situation is not regulated by the House Rule Act, Ms. Mićić cannot be called to account on that basis. The House Rule Act was violated in the point where the Assembly already established the agenda comprising the motion of non-confidence, and such an agenda shall be final. The Democrats proposed that another session of the Assembly be held with a new agenda. Even if it had been said that the first session would be held, but with a new agenda, this would have made sense, but when it was said that a second session would be held, without the first one having been held at all, this really constituted a violation of the House Rule Act, and as such represents one aspect of institutional uncertainty.

Of course, Parliament is not the only institution incapable of efficient decision making, representing a source of institutional insecurity. Whenever we say insecurity, what is at issue is a situation in which one entity, either a political party or a state institution, is not able to make decisions. Parliament is immediately undermined. It is either not capable of making decisions, or when it makes a decision, this is done through the violation of regulations it enacted itself. Numerous other bodies, besides Parliament, are subject to institutional insecurity. A special aspect of institutional insecurity is when institutions are in mutual conflict. The Parliament, for example, is not only in conflict with itself, which is reflected in the fact that it does not observe regulations it had enacted earlier, but is also in conflict with the Constitutional Court of Serbia. The Parliament does not observe rulings of the Constitutional Court which shall be binding for everyone. The Parliament refuses to proceed according to the Constitutional Court's rulings and to return mandates to deputies who were stripped of them in 2002.

A certain number of institutions in Serbia which are of key importance for the functioning of the state are in a similar situation. One example is the Commercial Court, an institution of indisputable importance, but its work is to a great extent influenced by politics. This court sometimes initiates bankruptcy proceedings in some companies prior to the expiration of a statutory deadline, keeps other companies bankrupt for a long period of time and appoints persons possessing direct interest in the bankrupt companies as administrators. Everybody heard of the case of the *JRB*, whose administrator in bankruptcy was Zoran Janjusevic, a person running a private company operating in a similar line of business as *JRB*. It is in his interest for this socially-owned company to be

liquidated and then his own company can take over all activities *JRB* is currently involved in.

What are the consequences of the existence of a large number of institutions which are not able to make decisions (like the Parliament), or decisions that they do make are subject to political influence or the violation of rules they are supposed to follow in their work?

The word insecurity is disturbing in itself. In the case of political insecurity, political actors feel insecure because of the conditions under which the political game is being played. It may make them shift their activities from institutions into the street. Milosevic was overthrown on the street because he did not respect institutions, i.e. the institution of elections and of electoral results. Some parties intensify their activity with street actions: signatures are being collected for bringing down the Government, electoral campaigns are being organized which are in the service of presidential elections.

The representatives of the Radicals said that they were not going to wage only the campaign for the presidential election, but also for bringing down the Government. This greatly unbalances the system as a whole and creates political insecurity, because the rules of the game become unclear. The situation is similar to a football game during which the referee decides to change the rules, and the penalty kick is no longer shot from the distance of 11 meters, but from 66, and it is practically impossible to score a goal from that distance.

This is one of the very important possible implications because it creates a political climate which should have changed after October 5. Many do not want authority to be overthrown and won on the street any longer as this creates a kind of revolutionary spirit among those who come to power. When coming to power occurs through institutions, with the existence of regulations, then power is exercised in a more tolerant manner.

The economic implications of the entire situation are also important. What goes on in the political system affects the entire status of the country, including its economic position, which is of paramount importance for Serbia at the moment. Political uncertainty about when the elections will take place, what the future Government will be like, in what way the future Government will come to power, what its program will be, does not contribute to the country's attractiveness to investors. It is wrong to expect a party which generally advocates economic reforms to continue to advocate the very same reforms after it comes to power in a revolutionary way. Because of the very fact that it came to power in a revolutionary way, it can change and considerably radicalize its program. Such a situation would certainly not attract foreign investors who are interested in investing in this country and whose money is very much needed. The level of foreign investments in this and last year was relatively low, if we do not take into account privatization proceeds which should not be considered as investments because the major portion of these proceeds went into current spending. The level of investments in 2001 and 2002 was very low in terms of greenfield investments, i.e. direct investments in production. The situation is uncertain this year, but a large number of investors is still waiting or has even lost

interest because of political instability. The greater the political instability, the greater the fear among investors.

Moreover, some institutions of relevance for economic life do not function in the way they should.

The most obvious example is the manner in which *Sartid* was sold, a company with an outstanding debt of USD 90 million, in which case the consortium of nine international banks was left empty handed. *Sartid* was sold through a direct bargain to *US Steel* at the price of US$ 23 million without any contract. The entire action was given approval by the Commercial Court. The consortium of nine banks filed to the Public Prosecutor three times, requiring the review of that contract, but this was rejected. The last instance is the Supreme Court and it is yet to be seen what will be its ruling. The implementation of a contract is one of the ultimate principles of the rule of law, one of the most important conditions for economic stability in the country. If someone - a bank, an investment fund or a private entity, lends money, there have to be guarantees that the loan will be repaid. Without such guarantees, the person with money will not come to Serbia, i.e. to a country in which the mechanism for ensuring repayment to a creditor does not exist, but will opt for a country which enforces such mechanisms.

Milko Štimac

Concurrently with this press conference, Mr. Radulovic, who presents himself as the managing director of C Market, is holding his own press conference. The Commercial Court refused to register the new director who was appointed by the majority owners into the Register of Authorized Persons and left Mr. Radulovic, who lost the confidence of the majority owners, to continue running C Market. As a matter of fact, C Market is in a gap at the moment: the real owners cannot realize their rights, for the Commercial Court is not allowing them to do so, while at the same time the person who presents himself as the managing director of C Market derives his legitimacy from nothing short of a referendum!

It might be assumed that after the meeting of the core delegation of the League of Communists, Mr. Radulovic called a meeting of all workers and citizens in C Market where he was given a vote of confidence, and on that basis continues his governance after having appointed the workers' council. This situation very much resembles self-managed socialism, the economic effects of which are obvious today.

Unfortunately, the Commercial Court will place its hands on C Market, a sound company which has its majority owners, but those owners are prevented by the Commercial Court from realizing their property rights.

Fredereic Bastia said once that civilization as a whole is based on three rights – the right to life, the right to freedom and the right to property, private

property. If you deny one of these rights, the other two are compromised, as well. We are witnessing the violation of right to property.

Hemofarm faces a similar situation. This company had an additional issue of shares in the amount of some 60% or less of its present market value. It is not difficult to guess who are those who bought this issue at the price by 60% lower than the market price. Specific names are not known yet, but it will be interesting to see who increases ownership over the state-owned pharmaceutical monopoly in this manner.

What is especially worrisome is the fact that all countries in transition started from an institutional vacuum. They shifted from one system to something completely new. But here we have a specific situation. We have had institutions; we still have institutions, but an institutional vacuum exists anyway. The fact that political parties exist still does not mean that there are institutions through which an individual will be able to group his political interests and to satisfy them through parliament because the majority of our political parties are actually business associations.

It is certain that this Government will not last forever. This institutional vacuum will end one day. Institutions will be established. The question, however, remains whether people who are implementing what it is they think the transition to be in this way are actually thinking of how they are going to behave tomorrow.

LEGAL INSECURITY

Press conference held on October 23, 2000

Radovan Jelašić

The impact of legal insecurity manifests itself in four forms:

a) **High interest rates**, bearing in mind that the inflation rate has been reduced to as little as 8-9% at an annual level. At the same time, last year was characterized by credit expansion, when natural persons and legal entities were granted nearly EUR 1 billion of new loans; competition also increased. Nevertheless, the average weighted interest rate has remained 20% and it is more or less fixed at that level. Hence, nothing changed in the last nine months and one of the basic complaints, at least as far as bankers are concerned, is absence of the rule of law.

b) **The impossibility of using the mechanisms of bankruptcy and liquidation in the process of restructuring**. As is known, one of the planned forms of restructuring of the Serbian economy was restructuring through bankruptcy proceedings. In effect, this was carried out only in exceptional cases, as in *Sartid*. It can be heard these days that Serbia has privatized 1.000 companies in two years, while Hungary privatized as few as 1.800 companies in ten years, which is supposed to prove that our privatization model is far superior compared to the one applied in Hungary. However such results can be explained very simply – Hungary restructured its economy through bankruptcy proceedings, mostly at the beginning of 1995. In Serbia, unfortunately, this mechanism has not been used until today, again because of ineffectual legal mechanisms.

c) **The manner in which *Sartid* was privatized damaged the reputation of Serbia in the international community** and this will certainly have a negative impact on Serbia's rating for a long time.

d) Finally, the significance of **the issue of Kapital banka, i.e. Astra banka** should be stressed again, because the manner in which these proceedings are being conducted, i.e. not conducted (they have lasted for two years already in Astra banka and some 3-4 months in the case of Kapital banka), does not inspire additional confidence among citizens.

Bankruptcy proceedings present a very lucrative job. It can be heard that the most interesting position in Serbia today is that of a bankruptcy administrator

and of a managing director in a company under construction, since both of them have unlimited budgets at their disposal. When bankruptcy or liquidation proceedings are initiated, the bankruptcy court appoints an administrator who is the unquestioned managing director. He is accountable only to the bankruptcy court, which gathers three to five judges, as the exclusive representative of shareholders. They make all decisions concerning the management of a bankrupt company. Moreover, an objection by the Higher Commercial Court, which allegedly pursues control over the work of the Commercial Court, explicitly says that the creditors' committee is often not established at all. This was obvious in the case of *Sartid*. Where the creditors' committee is established after all, this frequently happens only one day before the sale of the bankrupt debtor.

What are the effects of conducting bankruptcy and liquidation proceedings in such manner? A company in bankruptcy, however odd it might sound, makes investments and rents out its real estate for the period of several years instead of cashing it in order to payout the creditors. Such a company is then sold though a direct bargain, without public notice. Judges are sometimes given apartments that belong to the bankrupt companies "for safekeeping", instead of having them sold to cover a company's outstanding liabilities with the money received. Administrators managing bankrupt companies are often, at the same time, both creditors and debtors. Also, it happens often that bankruptcy proceedings are managed by administrators who conduct bankruptcy proceedings in several banks simultaneously, which can represent a serious conflict of interest.

As far as depositing of money in particular banks is concerned, there was a case that one banker protested when the sum of US$ 23 billion paid out by *US Steel* was not deposited to the account in his bank, although he had always been obliging to this company. It is important to underline that the bankruptcy court, i.e. administrator in bankruptcy shall place the money in a central deposit, i.e. at the National Bank of Serbia, and not at an arbitrarily selected bank. Unfortunately, it turned out several times that bankruptcy courts in many banks were very interested in where the money will be placed. During the mandate of the former management of the Bank Rehabilitation Agency, such money was always deposited at the National Bank of Serbia. Although the interest rate in the NBS was lower than in other banks, the issue of security was considered paramount. One foreign diplomat said once that real reforms in Serbia will begin only after the Commercial Court is cleared up.

Every creditor is aware of the fact that the full value of his claim cannot be repaid. However, what matters is not the fact that creditors will be "fleeced", but in what way the "fleecing" will be performed, as it can also be done transparently and according to market rules. Specifically, the case of *Sartid* incited open protests of some countries in the European Union which are threatening, among other things, to suspend bilateral assistance, with consequences on the forthcoming meeting of donors and to coordinate action of EU countries and its institutions because creditors were not even allowed to register their claims (in the amount of US$ 120 million), let alone collect any of them. For all these reasons, it is not a surprise that Serbia ranks 109 among 133 countries on the Transparency International rating list, in league with Bolivia, Ukraine and

Zimbabwe, although we would prefer to compare ourselves with countries which scored far better: Slovenia ranks 29, Hungary 40 and Croatia 60.

Bankruptcy proceedings in Astra banka and Kapital banka have not been carried out yet. The current position is that of a stalemate. The owners of these banks are probably waiting for better days; employees are still receiving their wages, which means that they live at the expense of depositors, while depositors are still waiting for their deposits. Although these banks say that they have all the deposits of their depositors, in effect they are often offering to buy out these deposits at a discount of 30-50% in cash! The rulings of the Commercial Court created an absurd situation, i.e. the National Bank of Serbia is placed at the same level with the findings and opinions of experts from an auditing company. This practically means that the court's ruling is partially based on the opinion of the auditing house. The question arises whether any member of the Supreme Court, with all due respect, knows the difference between a qualified and an unqualified auditor's report. Few people in this country actually know the difference. The existence of a report still does not mean that it is positive, and the court refers to it when making a ruling in favor of the bank and to the detriment of the National Bank of Serbia.

A concrete example of the lack of legal security is the case of *Sartid*. One of the main counterbalances in the entire bankruptcy proceedings is the creditors' committee. However, such a committee in the case of *Sartid* was set up without the participation of all creditors, as the claims of a certain number of creditors were not recognized. One of the creditors whose claim was not recognized is a foreign consortium with a claim in the amount of US$ 120 million. Although this claim has been backed up by over 50 documents, the court did not accept it. Although the creditors' committee was established, it did not hold any meeting during the bankruptcy proceedings. A meeting was not held even when the decision was made to sell the bankrupt debtor to the company *US Steel*. Since form is very important, and the law requires a creditors' committee to be formed, it was set up according to the Document dated March 27, 2003, with the sale of the debtor having been scheduled for the next day, i.e. March 28, 2003.

The bankruptcy court included three judges, two of whom were dismissed in the meantime. This is a violation of the law because the bankruptcy court which initiated the proceedings must be the same as the one making the final decision. This begs the question on what grounds anyone assumed the right to sell the entire company through direct bargain, with written off debts, for US$ 23 million. Furthermore, everybody knew how the proceedings would end even before they were initiated, i.e. it was no secret that *US Steel* was supposed to take over *Sartid*, with it only being necessary to find an adequate takeover mechanism, namely, a way to organize the sale which is legally in order, without accepting the company's overall debt of US$ 1.7 billion.

Bankruptcy proceedings were initiated on July 31, 2002, and *the Agreement on Business and Technical Cooperation* was signed between the administrator and the company *US Steel* already on November 8; this agreement grants *US Steel* the right to manage the company for the period of five years. The Agreement stipulates that if the company were sold to any other party during

this period, *US Steel* would retain the right to the entire income of the company in the following seven years. This agreement excludes the possibility of making an agreement with any other company except *US Steel*. It also stipulates the following:

- The company *US Steel* will not be held responsible for economic losses incurred during its supervision over the accounting and general financial activities.
- The company *US Steel* will not be held responsible for damages or loss of profit arising from the supervision of operative, commercial and administrative activities of *Sartid*.

From the moment *the Agreement on Business and Technical Cooperation* was signed, the possibility of sale to any other buyer was evidently excluded.

So far *Sartid*'s creditors have filed three requests for a judicial review to the Public Prosecutor of Serbia, with no action having been taken on the Prosecutor's part, while all deadlines have expired in the meantime. The fourth request was filed to the Supreme Court of Serbia. The deadline expires at the end of November; afterwards, no legal remedy will be available in this country.

Dušan Pavlović

In contrast with *Sartid*, the Government is not directly involved in the privatization process in *C Market*, which cannot be said for other state institutions, i.e. the Commercial Court.

The major block of shares of *C Market* was privatized under previous privatization laws, i.e. under the 1991 Law. The privatization model introduced by this Law foresaw MEBO, i.e. insider privatization, in which workers, i.e. employees and pensioners of the company in question are privileged in the distribution of shares of that company. They could get shares either free of charge or at a certain discount. Since 1991, when the privatization of *C Market* began, the major block of shares, i.e. over 50%, was distributed to workers. At this moment there is a group of workers – shareholders who are organized in an association and who possess over 50% or, more precisely, 50.2% of shares.

On the other hand, Mr. Radulovic, the general manager of *C Market*, who is the other interested party in the dispute with the worker-shareholders, possesses less than 1% of shares. There are also some 24% of shares currently held by the Share Fund, which are supposed to be sold or distributed among workers in a certain period of time, once the Share Fund decides to do so, as well as one undefined portion of 25% at most, which is registered as social ownership. It is not clear what this is, as these are neither shares from the portfolio of the Share Fund, nor the portion of equity which belongs to workers; but since our Constitution still recognizes the term of social ownership, the existence of these types of shares is lawful.

The dispute broke out at the moment when the majority owners (shareholders who possess over 50% of shares) started pursuing a policy that is different from the policy of director Radulovic, and when they hinted that they were planning to dismiss Mr. Radulovic from the position of managing director at the Meeting of Shareholders scheduled for September 1, 2003. To avoid the entire process and prevent his own dismissal, Mr. Radulovic made several steps which are against the Law.

Firstly, he requested that certain shareholders authorize him to be their representative at the Shareholders' Meeting, but under the Company Law (art. 258 par. 2) Mr. Radulovic, as a member of *C Market's* management, had no right to be given authority by shareholders to represent anyone at the Shareholders Meeting.

Secondly, Mr. Radulovic extorted several authorizations through pressuring and blackmail. Workers-shareholders who gave authorizations or who knew how these authorizations were given said that they were direct telephone threats. In order to avoid the violation of article 258, in certain cases Mr. Radulovic claimed that he transferred authorizations granted by workers-shareholders to third parties. But in the authorizations which Mr. Radulovic transferred to third parties it is explicitly stated that he still retains the right to give an order to the third party on how to vote at the Shareholders' Meeting. Hence, when a worker gives authorization to Mr. Radulovic, he gives up his right to vote, but when Mr. Radulovic does the same, he retains his right to vote and instruct the people he authorized on how to act at the Shareholders' Meeting.

Also, in an attempt to prevent the Shareholders' Assembly from dismissing him, Mr. Radulovic called his own Shareholders' Assembly, which was held one day before the meeting of the Shareholders' Assembly scheduled for September 1. At this meeting it was decided that Mr. Radulovic would continue to be managing director of C Market. His lawyers said that the owners of 76% of the shares attended this meeting. Nobody has ever seen these people; moreover, some shareholders tried to attend the meeting which was held in Surcin on August 30, but the security guards of the Assembly did not let them come in. This information was given by the employees in C Market.

Another abuse involves the Commercial Court. The Shareholders' Assembly (which possesses over 50% of shares) decided to dismiss Mr. Radulovic, to elect a new Managing Board and appoint a new acting director, and filed the request to the Commercial Court to erase the name of Mr. Radulovic as director of C Market from the Court Register. After considering the request filed by organized shareholders, the Commercial Court rejected it on the basis of the following arguments:

- The Assembly had to, but did not dismiss director Radulovic and because of that, there were no legal grounds to proceed according to the shareholders' request.
- The Assembly did not dismiss the former members of the Board of Directors

- The representatives of the socially-owned capital were not represented at the meeting (this refers to those 25% which are still registered as socially-owned capital).

The first objection concerning the dismissal of the former director is not true, because the decision of the Board of Directors stating that the Board of Directors dismissed Mr. Radulovic from the position of director exists. This document was submitted to the court.

As far as the second objection is concern, the Assembly did not dismiss former members of the Board of Directors because their mandates expired and in such a situation the new Board of Directors shall be elected automatically. It is true that the decision on the dismissal of former members of the board of directors does not exist, but it is not necessary to dismiss someone whose mandate has expired. Moreover, it is impossible to dismiss someone who does not hold any position any longer. The Law on the Procedure for Registration in the Court Register stipulates that for the registration of a new director it is only necessary that formal legal conditions be satisfied, and whoever feels that they have suffered damages may take legal action in civil court. The Commercial Court should have established that the request for the erasure of the name of Mr. Radulovic and the registration of the new director was formally satisfied.

Finally, with regard to the representatives of social ownership, it is a travesty that today socially-owned capital is referred to as a legally valid category, since this category is not legally defined; it is not known who the owner of the socially-owned capital is. But, if we accept this objection, again it is not true, as the Assembly was attended by workers–shareholders who represent the working class, a category the Commercial Court still recognizes, together with socially-owned capital.

When we look at the reasoning of the Commercial Court released on October 8, 2003, it can be seen that the Commercial Court either lied deliberately when declaring that the new director was not elected and that the old one was not dismissed, or it used arguments that people from the period before the 80s wanted to hear: the old terminology is used, as is one undefined category, and on that basis people who clearly possess over 50% of shares are deprived of their rights to manage the company.

The current situation is as follows: legal representatives of the majority shareholders submitted an appeal to the Higher Commercial Court, but it is not very likely that this court will issue a ruling in their favor, especially since Mr. Radulovic is a deputy in the National Assembly of the Republic of Serbia and a member of Mr. Mihajlovic's Liberal Party, i.e. a party which sits in the Government; moreover, a few weeks ago, together with 15-16 other businessmen, Mr. Radulovic attended the meeting organized by the Prime Minister. Therefore, there is no doubt that the Government, if not directly, as in the case of *Sartid,* than indirectly, through the Commercial Court will advocate the preservation of the rights of Mr. Radulovic who possesses less than 1% of shares.

Radovan Jelašić

It would be very interesting to make publicly available the analysis of the Higher Commercial Court concerning the work of the Commercial Court. Thus we would be able to see what specific measures the Court has been advised to undertake. A great number of the mentioned problems is included in that report.

It would be good to initiate public debate about the Bankruptcy Law. There is information that this Law has already entered parliamentary procedure. However, some provisions of this Law are worrying. Apart from containing several positive improvements (bankruptcy, i.e. liquidation proceedings are limited in time), it also contains some bad solutions, such as the possibility of the bankruptcy administrator employing additional workers. Generally, it does not seem that the administrator is pressed to end bankruptcy, i.e. liquidation proceedings, in shortest possible period.

Approximately two years ago, at the initiative of the National Bank of Yugoslavia the Law on Rehabilitation, Bankruptcy and Liquidation of Banks was amended. Under that Law, bankruptcy and liquidation proceedings shall be governed by the Bank Rehabilitation Agency instead of the Commercial Court. Although this was an important step forward, the liquidation court still has final word in making any significant decision. This turned out to be a very bad solution during the last two years.

The Law itself will certainly not resolve all the problems. Even if the new Law is enacted, the question arises as to who would enforce it. It would be very important to organize training for courts and professional administrators. Otherwise, we will only cross out one law from the long list of obligations we undertook from the IMF and the World Bank, and nothing will be done in the area of its actual enforcement.

1000 DAYS OF SERBIAN MINISTRIES

Press Conference, held on November 6, 2003, regarding the Report on 1,000 days of work of the Government of the Republic of Serbia in the field of finance, agriculture and privatization, with a review on international economic relations

Radovan Jelašić

THE REPORT OF THE MINISTRY OF FINANCE AND ECONOMY

It was not easy to get hold of the five-page Report on the work of the Ministry of Finance. Unlike the Report of the Ministry of Trade, it is not posted on the official Internet presentation of the Ministry of Finance and Economy. One of the important positive steps that can be noticed in this report is higher transparency in public finance, with significant simplification of tax rates. Also, a number of products, which include vegetable oil, animal fat and sugar, are exempted from taxes.

It is interesting that the Ministry of Finance had 94 employees up to November 30, 2002, and that this number increased to 11,811 by the end of September, mostly because of the tax administration and because of all the other competences which were in the meantime transferred from the federal level to the level of the Serbian Ministry of Finance.

Budget execution was conducted as planned, while it should be noted that our country did not yet start to finance the following liabilities:

- Liabilities on the basis of the London Club;
- Principal of the debt to Paris Club – only 40% of the interest is financed for now;
- Concerning the World Bank, all liabilities that are currently fulfilled are completely provided for in the form of new credits. It means that by the end of next year we will receive from the World Bank the amount of funds that equals our obligations.

The Report on the work of the Ministry of Finance addresses the restructuring of public enterprises in only three to four sentences. What has been done, according to the Report, in this sector which employs far more employees than all the thousand companies privatized in the previous two years? The following activities are mentioned: monthly follow up of paid wages amounts, supervision over the distribution of subsidies in public enterprises, technical assistance in creating strategic plans and participation of the Ministry in making collective bargaining agreements. It means that, **concerning the restructuring**

of public enterprises, nothing essential was done in the last three years. Concerning subsidies, the surprising fact is that in the next year, the subsidy of almost CSD 5 billion is planned to be allocated just for ŽTP (Railway Transport Company), besides the subsidy in the amount of CSD 14 billion that the Government will provide to public enterprises directly from the budget. This clearly illustrates that a better and more efficient budget can be reached through the restructuring of public enterprises, and that it is not necessary to take only from the pension fund in order to invest in development.

As far as the budget structure is concerned, it is important to emphasize that, although three years have passed (and although the adoption of the development budget was announced every year, and then the following year it was said that actually the development budget was just about to start), **the spending ratio remains unchanged**: 95% of spending and 5% of capital investments. This will be the same next year, and it represents around 2% of our gross domestic product. It is important to note that the funds that were provided for these enterprises were given without any conditions. It could be said that this was actually the buying of social peace, with hope that privatization would provide revenue that would be sufficient for financing the budget. The tax base, i.e. the base for collecting taxes, was not significantly increased. **The gray economy still account for 35-40%.** Also, the **share of public revenues** is alarming, as it still participates with **50%**. In Croatia, this share constitutes 46%, in Slovenia 42%, while in all other countries it is far less. It means that the state still has a very active role in the area of public finance.

A third very important area is **the problem of the gray economy and corruption**. The only law passed in that respect was **the Law on Financing Political Parties** (June 2003). The Report also mentions the Money Laundering Act, but as it is known, that law was prepared by the NBY (National Bank of Yugoslavia) and passed by the Federal Parliament. It is interesting that the Report mentions the Law on Conflict of Interest and the Law on the Agency for Fighting Corruption as items due to be carried out by the end of the year. In **"more normal" countries,** however**, corruption and the gray economy are fought by actions and not by words**. A good example for that are fiscal cash registers. According to the most recent plan, the introduction of fiscal cash registers should be conducted from October 2003 to May 2004. According to the information we have, the Government has not issued a single license for fiscal cash registers until this moment, so nobody can buy such a cash register yet.

The Value Added Tax Law has not been passed yet. If VAT represents a segment of the fight against corruption, the law on its introduction should have been enacted much earlier than October, when it was projected to enter Parliament.

The Report does not mention extra profit tax at all, although it should have an important role in fighting the gray economy and corruption. It is sad that such a tax is still used as a part of political blackmail: first it has been collected, then it has not been collected, and now, supposedly, it is being collected again.

One of the important shortcomings in the Ministry's work concerns the avoidance of a large number of undertaken obligations (towards the IMF and the World Bank). These obligations are part of various financial arrangements with those institutions. The payment thereof does not depend on people, but on the time period in which they will be adopted. The Private and Financial Sector Adjustment Credit (PFSAC 2) depends, among other things, on the following: a) amendment of the Money Laundering Act; b) enactment of the Law on Insurance Companies, that is, analysis of all insurance companies, as was done with the banking sector; c) the beginning of the tender sale of three banks; d) the restructuring plan of the largest bank; e) bankruptcy procedure in the four banks that we have already forgotten, etc.

Finally, it is important to emphasize that according to the Ministry of Finance's Report, with regard to legislative activity, fourteen laws have been waiting for months or years to be adopted. One of the interesting laws is the *Law on Settling Liabilities of the Republic of Serbia based on the Credit for Economic Rehabilitation of Serbia*, which I thought had been passed a long time ago. The Ministry is presently drafting 23 laws, of which 14 are waiting to be accepted as Draft Laws by the Government of the Republic of Serbia by the end of October 2003. It would be interesting to find out how many of them have been adopted. However, with regard to the Law on Conflict of Interest, the Report reads as follows: "…the work on the final version is in progress…" If any law enters the history books as the law that is endlessly discussed, it will be the Law on Conflict of Interest. Also, the date for adopting the Law on the National Corporation for Housing Credit Guarantees has not been specified yet.

These are some key points that, in our opinion, should have been accomplished.

Saša Vitošević

THE REPORT OF THE MINISTRY OF AGRICULTURE AND WATER MANAGEMENT

Serbian agriculture today is characterized by a low level of agricultural production, namely, Serbian agriculture is still semi-extensive, with a very **low level of product competitiveness**, above all on the European market. **20% of gross national income of our county comes from agriculture**, which is, unfortunately, a very bad indicator, because such large participation of agriculture (that is, primary agricultural production) is caused by the fact that other branches of industry from the real sector give small contribution to gross national income. **44% of the population live in rural localities** and directly or indirectly make their income from primary agricultural production. **38% of the population owns agricultural land**, which is a sufficient

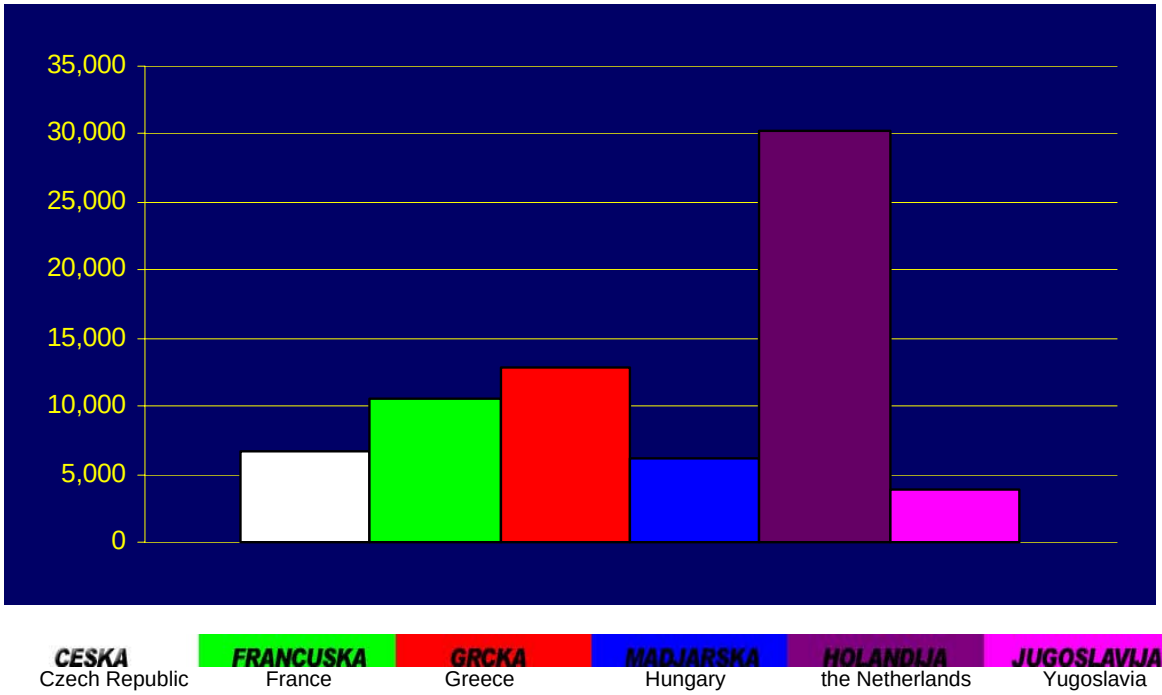
indicator of the **fragmentation of agricultural land**. The size of an average holding ranges from 1.5 to 3 acres per owner.

The existence of a strong monopoly of buyers indicates that institutions which actually exist (such as the anti-monopoly commission) do not function and do not do their job adequately, which results in frequent price disruptions on the agricultural products market.

The exports of primary agricultural products constitute 16-17% in the total export of our country, while around **10% of the labor force** works in the agricultural processing industry or agricultural services, that is, in the **agricultural industrial complex**. The data that can be found in domestic as well as foreign statistics, dealing with this topic, indicates that around 35% of the population directly or indirectly makes its income in agriculture. In developed countries, e.g. the Netherlands, that share ranges between 3-5%.

The indicator of competitiveness of our primary agricultural products on the world market is represented by the data on crops that are realized in our country and in agriculturally developed countries.

Indicators of competitiveness– fruit yield

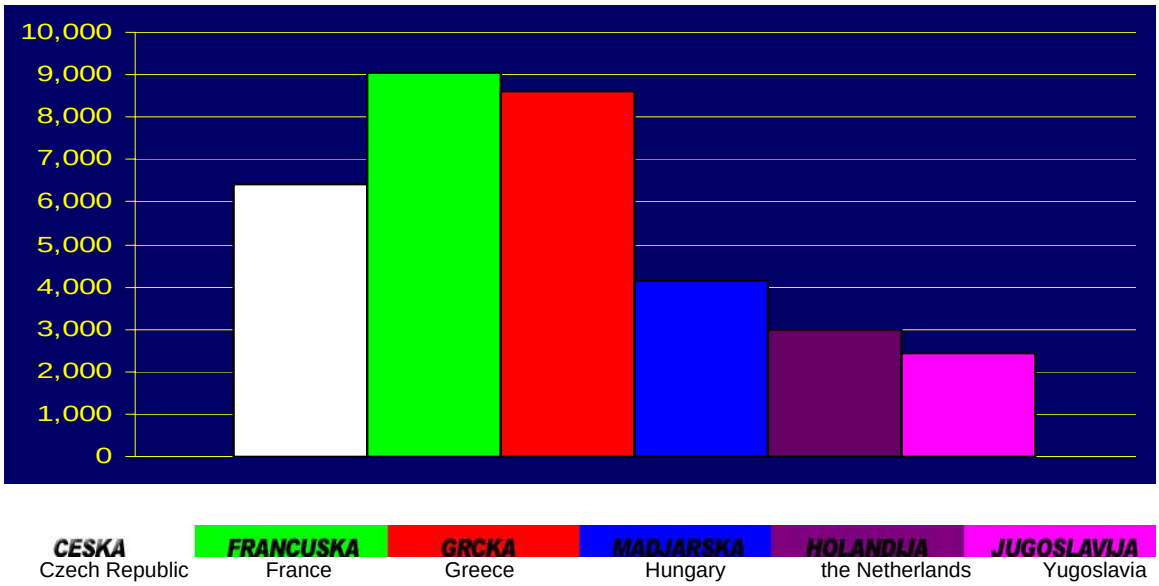


Although maize is considered to be one of the agricultural products of strategic interest for our country, the maize yield is significantly lower than in Greece, a country with rather unfavorable agro-climatic conditions for maize growing, which, owing to adequate consulting services and the use of appropriate agricultural methods, above all irrigation systems, realizes an average maize output of as much as 9 tons per acre.

The situation is similar with vegetables, which fall into the category of the most cumulative agricultural products.

As far as the conduct of reforms after October 5 is concerned, we can say that the Ministry of Agriculture had almost three years to undertake certain steps. Unfortunately, **our country still does not have**, nor has it ever had, any **strategy of agricultural development**, and no country in the world managed to implement reforms in agriculture without a serious strategy. On the Internet presentation of the Government of Republic of Croatia it can be seen how a serious strategy of agricultural development looks like, and not only agricultural, but also some of some other accompanying fields. The creation of a strategy requires participation of all stakeholders on the territory of a country: government, economy, science and other institutions.

Indicators of competitiveness– maize yield



Most experts dealing with these problems are of the opinion that sluggishness in conducting reforms in the field of agriculture, above all, is the result of the lack of political will within governing structure, as well as the lack of capacity for conducting reforms. This primarily refers to the human resources the Ministry of Agriculture had at its disposal in the last three years. The Head of the Ministry was Mr. Veselinov, who was, unfortunately, engaged more in politics, in terms of promoting his political party, than in pursuing agricultural policy.

Legal regulations inherited are inappropriate, and the basic instrument of agricultural policy which the Ministry of Agriculture used during the last two and a half years are decrees and ordinances, which is not good, because decrees do not bring systemic, but short-term solutions of particular problems.

According to the Report of the Ministry for Agriculture, the **agricultural budget** increased nominally between 2000 and 2003. However, the fact which is carefully hidden is that **in percentage terms**, in relation to the total budget of the Republic of Serbia, the agricultural budget was **reduced** from 5.3 to 3.6% during this period. It is positive that monetary incentives are provided for the cultivated

area (per acre) and per yield for particular crops, that is, per head of cattle. Unfortunately, that measure did not have greater effect on the long term establishment of the structure of agricultural production, but only impacted the prices of agricultural products: the citizens of Serbia enjoyed greater benefits from those incentives than the agricultural producers themselves, who cannot manage to improve the quality of their production through monetary incentives.

The organizational structure of the Ministry of Agriculture was not reformed, either; hence, the state administration in this area, in terms of its capacity and finances, is not able to offer adequate services to agricultural producers and other institutions that participate in the agricultural chain. Furthermore, the existing system is inefficient, slow and complex, and unable to respond to changes and demands imposed by international agreements, by the WTO and the EU, as well as by agricultural producers themselves. It is generally known that the most difficult and the most serious negotiations in the process of stabilization and association to the EU are held precisely in the area of agriculture. We all witnessed what happened at the last negotiations concerning agricultural subsidies in the EU – subsidies to agriculture today amount to 50% of the total EU budget and no agreement can be reached on how to reduce these subsidies. Namely, the reform of only one segment cannot solve the problem. Even if there is political will to carry out agricultural reform, without comprehensive reforms at the level of the entire government and the entire real sector, adequate effects are not very likely.

The agricultural reforms should include the following:

- **Building of a sustainable and efficient agricultural sector** which will be competitive on the world market and able to provide both adequate food stability for the population and adequate income to agricultural producers.
- **Building of a public sector in agriculture which possesses capacities, resources and instruments sufficient** to fulfill the needs of all participants in the agricultural chain in agreement with the principles of common agricultural policy of the EU (CAP) which our country has to respect if it aspires to membership in the Union.
- **Creation of long-term stability in planning agricultural production,** which was done neither in the past, nor in the last three years, as our agricultural producers, whether professional or, as we call them, non-commercial agricultural producers, do not have a clear vision and receive no information from the state and particular institutions in which direction they should develop their agricultural production and what support from the state and other institutions they can expect.
- **Creation of appropriate conditions for starting negotiations with the World Trade Organization and the EU**, as Serbia will encounter the greatest problems in this area. All transition countries, in particular Croatia, Slovenia, Bulgaria and Romania, put the greatest effort into preparing their administration for the beginning of negotiations. Unfortunately, no single action has been taken in that respect, and, what is more, there is not a single person employed at the Ministry of Agriculture that is seriously and profoundly engaged in this activity.

What should have been done in the area of agricultural reform three years ago is, above all, **the creation of a strategy of development of agriculture in Serbia**. There was enough time for that, keeping in mind that countries in the region accomplished this in a similar time frame. Also, there is **legislative reform**, **administration reform**, **reform of the system of monetary incentives and compensations in agriculture**, **the promotion of the association of agricultural producers**, since this is the only segment of the economy without a quality association through which agricultural producers can realize their interests, in particular, their economic interests. A clear model and system of conducting and supervising reforms does not exist, either.

As far as legislative reform is concerned, the first and basic law that should have been enacted in the first few months of the Ministry's work is the **Law on Agriculture**. It is the most important law from which all other laws arise in all modern countries, or at least countries that aim to develop agriculture, and Serbia should seek to be among such countries This Law shall define objectives and measures of the agricultural policy, basic institutions, administrative and inspection supervision and all basic instruments which the Ministry of Agriculture can and should use as part of the implementation of agricultural policy or agricultural development strategy.

The Law on Agricultural Land is one of the most important instruments at the Ministry's disposal to influence planning of agricultural production in Serbia. There are old laws, even laws from Tito's times, which are still in effect today. Of course, through the reform of agricultural policy, we can expect more significant enlarging of holdings, better care for agricultural land which is, although a very important natural resource, rather neglected and polluted in certain regions of our country, and even in some parts of Vojvodina.

The Law on Registration of Holdings – we still do not have information on how many agricultural producers there are in Serbia today, how many of them are professional farmers, and how many work in agriculture as a hobby (i.e. if a person cultivates wheat on one acre of land in his possession, every serious agro economist would consider him to be a farmer out of hobby). Unfortunately, the incidence of very small holdings engaged nonetheless in farming is not rare in Serbia. Croatia started the registration of holdings at the beginning of 2001, and according to available information, that process was successfully finished in the period of one year, so that Croatia today has a complete picture of agricultural production on its territory.

The Law on Cooperatives – the system of cooperatives has been completely ruined and compromised, and what is even worse, the new system of cooperatives that functions in developed countries still cannot be implemented in Serbia, as there is neither adequate legislation for that, nor political will on the part of the Ministry of Agriculture to become engaged more in this field in order to encourage agricultural producers to realize their economic interests through cooperatives, but according to completely new rules.

The lack of legislation in the area of veterinary medicine, plant protection and phyto-sanitary protection, seeding and nursery, that is, the enforcement of old regulations causes great problems in the export of agricultural

products that can be competitive on certain markets. The case of the Russian Federation is very interesting in that respect. Namely, many of our agricultural products can be competitive on this market, we even concluded the agreement on free trade with the Russian Federation, and in 2001 it was agreed that Serbia can pay a portion of imported natural gas in certain agricultural products; however, as a result of the absence of the mentioned regulations, Serbian agriculture suffers the consequences.

With regard to the reform of the administration, it should be reorganized and rationalized, which involves the reorganization of the Ministry of Agriculture, the establishment of the Agency for Rural Development, Agency for the Market, the Counseling Agency and the Central Laboratory.

Also, it is necessary to improve the work of the administration through permanent education, so that it is enabled to carry out reforms, especially for the process of stabilization and association to the EU, as well as to introduce the system of responsibility.

The Republican Directorate for Commodity Reserves also needs to be transformed. According to all European standards, such an institution cannot exist in this form and function according to existing legislation. It must be transformed urgently into a serious Agency for Market Interventions, whose basic role is, above all, care for strategic reserves of the country and fast intervention on the market when there is price disruption of primary agricultural products, which was not the case up to the present. Last time, it took the Directorate for Commodity Reserves as long as three months to intervene with larger quantities of pork meat at lower prices, when price disruption occurred on the market.

Scientific institutions in the area of agriculture also desperately need the reform. These institutions are not under the authority of the Ministry of Agriculture, but under the Ministry for Science and Technology, which is contrary to the experiences of some developed countries, since scientific institutes, and above all, the establishment and development of a serious national institute, which should include all segments of agriculture, must be connected somehow to the Ministry of Agriculture.

The reform of the system of monetary incentives and compensations in agriculture represents one of the most important instruments used by developed countries in planning their agricultural production and developing agriculture as a whole. The prerequisite for this reform is registration of agricultural producers. What is used as incentive for certain crops concerns subsidies on prices, and not incentives aimed at increasing productivity of agricultural producers. Those are monetary incentives which are granted for sugar beet, sunflower and several other crops, as well as a milk premium, which has been in effect for three years without any plan or vision. If you enter any dairy factory in Serbia you will find warehouses full of cheese, given that because of hyper production of milk, dairy factories are not able to place their products either on the domestic, or on the foreign market, while milk production is profitable for agricultural producers at this moment.

Most importantly, permanent financial compensations and incentives, with the model of direct payment which should be adopted as soon as possible,

together with adequate legislation, must offer a long term vision to agricultural producers as to the direction in which they shall plan their production. First of all, it is necessary to separate commercial and non-commercial farms, that is, the commercial aspect of agricultural production. In addition to the system of monetary incentives, it is necessary to form accompanying institutions. Two models are possible in practice. One model is the Credit Insurance Agency which insures loans granted to farmers. The other model is that the state subsidizes credits granted to farmers by banks. In our country, neither of the two models are present, but only the Development Fund of the Republic of Serbia, which allocates certain funds to agriculture. Unfortunately, we all know that these projects need bank guarantees, which also cost. None of the banks are ready to grant credits for production improvement to socially owned farms.

It is necessary to pay attention to the **dynamics of reforms**, that is, to the term plan, as was done in the countries in the region. The strategy was usually created in the first year of reforms, all necessary laws were enacted in the first two years and structural reform of the administration was performed as well. The registration of agricultural producers started later, as it was necessary previously to enact reform laws; but in any event, registration was conducted within a period of 1 to 1 ½ years. The reform of the system of monetary incentives and compensations in agriculture is a long-term process, but it always starts already in the first year or reforms. This should be a constant and sustainable process, as is the process of improving the work of the administration through permanent education.

The official Report of the Ministry of Agriculture and Water Management itself is very scant, which is probably the consequence of the results achieved by this Ministry. The Report is written on five pages only, and the present state is presented descriptively, without concrete statistical parameters.

The measures of fiscal, foreign trade and monetary policy are listed as measures taken by the Ministry of Agriculture, although they do not fall into the competence of this Ministry at all. This, above all, relates to the reduction in taxes and contributions, some fiscal allowances etc. The measure of customs levy, which has been recently transferred from the federal to the republican level as an instrument of market protection, is noted as one of the system measures taken by the Ministry. Also, when determining customs levy, the statistical models used by developed countries are not used, and instead they are determined on the basis of wishes and demands of certain agricultural lobbies and groups, whether that be sugar production, soybean production, soybean meal and so on, which is not good for a serious state.

The only measure that was taken but cannot be called systemic is the introduction of monetary incentives for certain agricultural products. The final effect is actually price subvention of agricultural products, and it does not have a reform character that can result in increase in the quality and quantity of agricultural production, because if one agricultural producer is to be given certain monetary incentives, he/she has to be limited by certain parameters, so that he/she is forced to increase the quantity and quality of production.

A very important item that demands attention is the agricultural budget. The Report underlines as a very important and positive measure the increase of the agricultural budget from CSD 5.1 billion in 2000 to CSD 10 billion, as projected for 2004, which was confirmed by the Minister of Finance in the projection of the budget for the next year. However, the proportion of the agricultural budget in the total budget of the Republic of Serbia is reduced from 5.3% in 2000 to 3.6% in 2002. If the planned agricultural budget for 2004 is to amount to CSD10 billion, it should be emphasized that the same amount was allocated as a subsidy for the railway in the last year. This indicates how much the present Government cares for agriculture development in Serbia, as neither agricultural reforms, nor adequate agricultural policy can be implemented without a serious agricultural budget.

As far as legislative activity is concerned, the Report notes that 23 ordinance, 3 regulations and 6 decrees were adopted, but not a single law was enacted.

With regard to water management, the Report stresses that 182,000 acres of land are irrigated in Serbia at present. However, this is not true. Only 30,000 acres of land are really irrigated in Serbia, while the irrigation system is built for 182,000 acres, but it is in poor condition and the Republican Directorate for Water did nothing to improve it.

Also, the Electric Power Industry of Serbia owes the Republic Directorate for Water a total of CSD 1.6 billion, while the Report states that only 20% will be paid off – which was, supposedly, agreed. Who has the right to write off debts to the detriment of water management?

These are only some of the remarks in the Report on 1000 days of the work of the Ministry for Agriculture and Water Management.

Dušan Pavlović

THE REPORT OF THE MINISTRY FOR ECONOMY AND PRIVATIZATION

The Report of the Ministry of Privatization contains more quantitative indicators than qualitative analysis. It includes the results of the up to the present activities of the Ministry, but the results are not put into any context, that is, it is not noted what was planned at the beginning, what the results mean in this context, and what is planned for the future.

The quantitative results of privatization in Serbia show that the total proceeds realized through tenders, auctions and the sale of the minority blocks of shares on the stock exchange up to the day of this Report was presented, that is, up to October 2003, amounts to CSD 1.240 billion. The success of tenders is relatively low: as little as 44% of the total number of offered companies was sold; auctions were much more successful. However, generally speaking, the

companies sold at auctions were sold below their bookkeeping value, while the selling price realized on tenders is almost double the bookkeeping value of the companies privatized in this manner. It is the same situation for sales on the stock exchange.

To get a realistic picture about what these numbers actually mean, it is necessary to compare them with the results of privatization in other countries. When comparing privatization results, it is necessary to take into consideration only those countries that used similar or identical methods of privatization as Serbia, i.e. the model of direct sale. This model was dominant in Hungary, Estonia, Bulgaria and East Germany. I took the example of Bulgaria, as it is a country which will not accede to the EU next year, but in the second round of enlargement, and which is not among the leaders of the reformist East Block.

In the last seven years, Bulgaria realized privatization proceeds in the amount of US$ 7.5 billion, or US$ 3 billion when debts and investments are excluded. If Serbia has realized US$ 1.2 billion of privatization proceeds to date, and privatization is supposed to end next year, whereby privatization revenue is not expected to be higher than US$ 200 million in 2004, that means that for us, at least as far as the first round of privatization of socially owned companies is concerned, total revenue will be approximately half of what was realized in Bulgaria in seven years. With regard to privatization proceeds, the results of our privatization program are not too bad; however, the problem lies in some other aspects of privatization.

A special segment of the privatization concerns public enterprises, which are not discussed yet. The amount of privatization proceeds that could be realized through the sale of these enterprises is still not known, as well as which parts of public enterprises would be offered on sale and which ones would remain in state ownership. Public enterprises would probably be privatized starting from 2005.

The sale of enterprises on tenders and auctions, taking into consideration existing circumstances, could be faster, despite the fact that over 1000 companies were sold and the proceeds of US$ 1 billion were realized during one and a half year. To speed up privatization, it is necessary to do several things. Firstly, the unemployment situation in the country should be examined in terms of whether faster privatization would increase unemployment, as privatization by itself does not create new jobs. Each enterprise that has undergone privatization must lose one portion, most frequently one half, of its labor force.

If we analyze the first three years of transition in the Czech Republic and Bulgaria, with similar tendencies being noted in most of East Europe, there were no great disturbances on the labor market. Even in our country, from the moment when the government was inaugurated to today, no significant disturbances were noted, which means that the current reform process does not cause some dramatic changes on the labor market. Therefore, privatization could be speeded up, especially tender privatization, as that privatization method involves social programs and creates almost no social expenses of privatization.

However, as it is possible that acceleration of privatization with some unpredictable course of events could result in drastic disturbances and significant

increase in unemployment, the solution to that problem should be sought in foreign investments that open new jobs. Minister Vlahovic announced that privatization proceeds in the amount of US$ 200 million are expected in the next year; at the same time, he expects investments in the amount of US$ 1 billion. This means that US$ 800 million must be provided through direct investment in order to realize such expectations. The question is whether this is realistic. I will remind you, privatization proceeds are officially noted as foreign investments; however, the greatest portion of these proceeds goes into the budget, from where they are allocated according to need.

Investments (comparison)

Hungary		Slovakia		Serbia	
1990	$ 311 million	1999	$ 700 million	2001	$ 165 million
1991	$ 1.6 billion	2000	$ 2 billion	2002	$ 300-475 billion
1992	$ 1.6 billion	2001	$ 1.4 billion	2003	$ 1 billion

When we compare the investments in Serbia with the investments that were realized in Hungary and Slovakia in the first three years of the transition, we can see that in the second year of the transition, Hungary had foreign investments amounting to US$ 1.6 billion, including privatization proceeds. Slovakia, which is even more interesting for Serbia, because of similarities of the Milosevic and Mechiar regimes, had US$ 2 billion of foreign investments in the second year of transition, after Mechiar's fall. In the third year of the transition, Serbia realized around US$ 1 billion. I do not know how we will manage to attract 200 million plus 800 million next year, in order that we can successfully compare with Slovakia and Hungary in the fourth year of the transition.

The Bankruptcy Law could contribute to the acceleration of privatization. That Law is in preparation and should be passed at the next session of the parliament, but the question is how it will be enforced in practice.

Also, a completely new judicial authority should be established for carrying out bankruptcy proceedings, similar to the special public prosecutor who has been appointed for prosecuting organized crime and the special court which has been established to try organized crime cases. So far, bankruptcy practice has shown that the Commercial Court is not an institution that can successfully perform this job.

It is also necessary to provide maximum guarantees for the rights of creditors in bankruptcy proceedings. Apart from the infamous case of *Sartid*, where the creditors were duped, there are other cases where the situation is not clear, as is with the sale of sugar factories, which were bought by MK Commerce for EUR 3 or US$ 3. We were told then that the debts were acknowledged, restructured and that they should be paid off. I am inviting Mr. Kostić or somebody from the Ministry to say if the acknowledged debts were really paid off, and if they were not, when will they be. It was said that the price of EUR 3, for which each sugar factory was sold, is so low because Mr. Kostić accepted the

debts of those sugar factories. It is not known until when precisely is he obliged pay off the debts.

To speed up privatization it is necessary to demonopolise the entire process, as well as the work of the Privatization Agency, which has an absolute right to initiate and manage the entire privatization process. The Agency cannot monitor itself, which is what the current Law stipulates. It is necessary to set up a separate body that will monitor its work. The necessary permission of the Agency for initiating the privatization process should also be cancelled, allowing a company that wishes to be privatized, the possibility to start the privatization procedure by itself. In several cases to date, privatization could not begin because of the absence of the permission for privatization. Local governments should be entitled to a higher portion of privatization proceeds than the present 5%, in order to stimulate and encourage them to find buyers for companies on their territories.

Journalist's Question: From which sources exactly should the funds be provided for investments – from foreign currency reserves, some items in the budget or something else?

Investment funds are one of the main sources of foreign investments. If you do not have the Law on Investment Funds, no fund will come here to invest. Foreign investors are also companies that come and start business here, and are not just purchasers of companies which we intend to privatize.

If we exclude privatization proceeds, it can be seen that to date income from direct investments is very small. We should not expect much from domestic investors, as it is generally known that this country is lacking in money. On the other hand, business loans offered by commercial banks also represent a great obstacle, since interest rates are unfavorable: the average interest rate for short-term loans has remained around 14% during the entire year.

One of the basic reasons for high interest rates is that banks are afraid that they will not be able to collect claims if the debtor does not manage to return the money. The basic institution which should guarantee debt payment is the court. It is well known in what state the courts in Serbia are, especially the Commercial Court. We are moving around in a very limited space and I am not sure whether we will manage to reach the projected billion of investments next year, which we realized this year, unless some obstacles concerning institutional conditions for investments are not improved. You need only consider how much time you need to register a company in regular procedure, and every foreigner that comes to do business here must register a company first.

Milko Štimac

MINISTRY FOR INTERNATIONAL ECONOMIC RELATIONS

The Ministry for International Economic Relations has been put in a very uncomfortable situation from the very beginning, as it is difficult to carry out the mission given to this Ministry without the cooperation of other ministries.

Great skill is necessary in order to attract foreign investments to a country whose two former presidents are indicted by The Hague Tribunal, while another president is a witness, to a country in which it is possible for Mr. Radulovic from C Market to call the Meeting of Shareholders which is attended only by him and his bodyguards, but not by the company's shareholders. Even if you attract an investor, he ends up being "hauled in" rather than attracted. FDIs should crown the entire process of reforms. Unless reforms proceed appropriately, normal FDIs will not come. Privatization proceeds are not investments and should not be treated like that. For this reason, the Ministry for International Economic Relations has been, by force of circumstance, set up as a kind of coordinator in making reform laws. However, since other ministries do not work properly, this one cannot be successful in its work either. If we still do not have the Law on Investment Funds, or the entire set of laws mentioned by Mr. Jelašic and Mr. Vitošević, or separate bankruptcy proceedings and separate authorities which conduct them, if land registers and securities depositories are not neatly kept, with managing directors holding registration papers; if companies are not restructured and if nobody knows what corporate governance is all about, Serbia will not see normal FDIs. FDIs will not come until institutional settings have been organized, i.e. until an investment-friendly environment is created. However, the Ministry for International Economic Relations cannot carry out this task all by itself, nor is this its duty after all.

The G17 Institute's suggestion is to finally finish what should have been done three years ago in the area of the reform of the state administration. Among other things, a special Ministry for Economy should be set up, to deal with the economy and maybe commerce, with the Agency for Promotion of Investments in Serbia acting within this Ministry. Such an Agency already exists within the Ministry for International Economic Relations, but its "hands are tied".

As far as the Ministry for International Economic Relations is concerned, the Ministry of Foreign Affairs already has its own economic department and the entire structure dealing with economic relations, and therefore the question arises why double the work. In other words, it would be much more effective, i.e. more FDIs would be attracted to the country if the reform of the state administration were carried out first and if the Ministry of Foreign Affairs were to do its job in the economic area under its competence; at the same time, a separate Ministry of the Economy would be established, possibly together with the Ministry of Trade, and all these ministries would work together on making and enforcing reform laws, above all those relating to the protection of shareholders,

ownership and all rights deriving from the institution of private ownership, in particular, shareholding, but also ownership over real estate, etc. In order to attract normal FDIs, Serbia needs to have the Law on Investment Funds, including pension funds. These two are the main investors. I will take liberty to express my opinion that it seems that the adoption of this law has been deliberately postponed, since this Law would bring quality competition to our market, and then it would probably be impossible to sell factories at EUR 3-5.

Editor	Ph.D. Mirosinka Dinkić
Prices	Kosovka Ognjenović, M.S.
Wages and Pensions	Jelena Momčilović Marija Vukotić
Labor Market	Jelena Momčilović
Production and Services	Marija Vukotić Ružica Savčić
Foreign Trade	Aleksandra Branković
Monetary Policy	Kristian Vukojičić
Fiscal Policy	Kristian Vukojičić

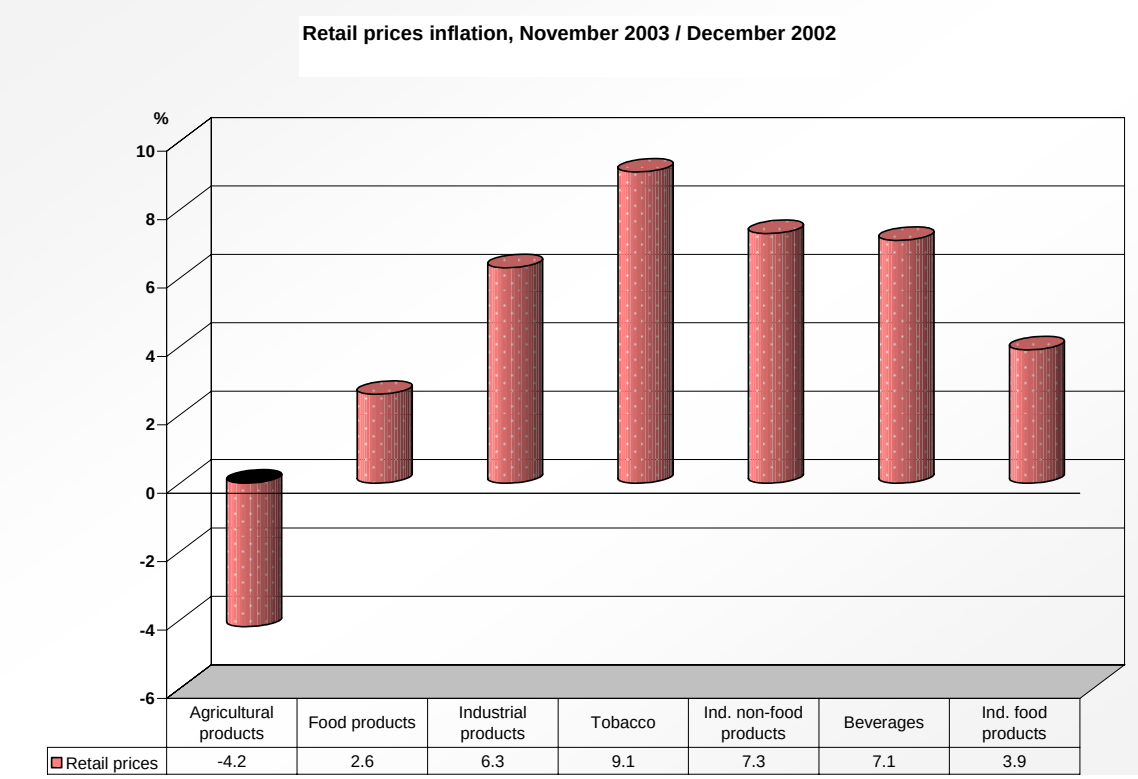
Macroeconomic Review

RISING UNEMPLOYMENT AND DROP IN EXPORT AND INDUSTRIAL OUTPUT

Prices

Average monthly retail price inflation in the last two months was 0.5% and 0.8%, respectively. Cumulative growth in prices in the period January - November 2003 was 7%. Observed on a quarterly basis, trends in retail price inflation were rather steady in 2003; only in the second quarter, the price increase was slightly higher, the cumulative rate being 1.9%, as compared to 1.7% and 1.8% registered in the first and third quarters respectively. The increase in prices recorded in the last two months suggests that a similar growth rate is likely to be achieved in the last quarter, as well. Therefore, retail price inflation in 2003 is likely to reach the forecasted 8%, which is by one percentage point lower than the projected 9%.

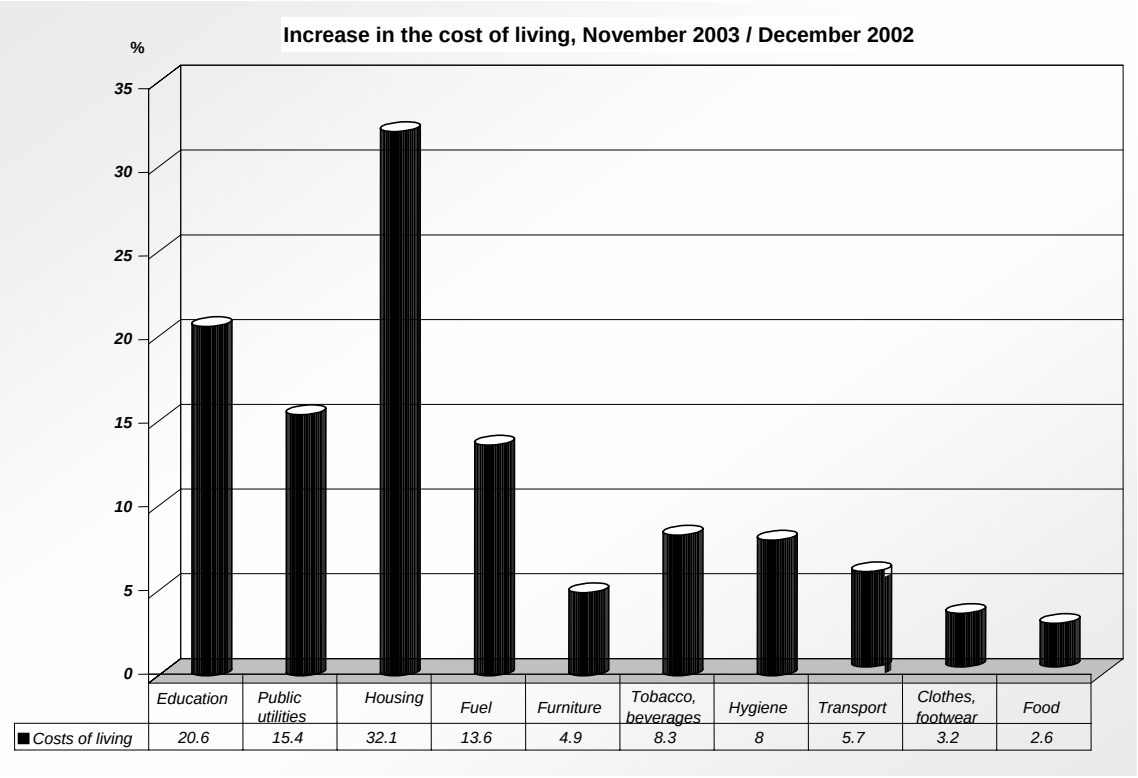
However, with regard to specific groups of products, prices in 2003 grew at different paces (chart 1). Although the prices of the majority of agricultural products increased in November, the cumulative growth thereof was down by 2.4% compared to the end of 2002. On the other hand, the prices of industrial products displayed continuous growth. The highest growth rates were registered with excise goods, tobacco and beverages, and food and non-food industrial products. Several increases in the price of gasoline, together with growth in the



prices of all types of bread and electricity and heating for households partially determined trends in prices in the last eleven months. All mentioned products, except for bread, other than T 850, are under administrative control. To these groups of products we should add domestically produced coal, as the maximum retail price of coal was set up in March 2003 (*Ordinance on the establishment of the maximum retail prices of domestically produced coal*, Official Gazette RS, no. 28/2003). Also, retail price inflation was to a great extent affected by the increase in the price of services. The prices of services grew by as much as 10.5% since the beginning of the year, resulting from gradual liberalization thereof, as opposed to the prices of goods, which registered nearly half the growth (i.e. 5.8%). As far as services are concerned, the prices of transport and postal services and public utilities are still under administrative control.

The cost of living index during the first nine months grew at a slower pace than retail prices. However, its faster dynamics over the last three months resulted in higher cumulative growth measured at the level of the first eleven months of this year (7.2%). With regard to the groups of costs constituting the costs of living (Chart 2), cumulative growth was mainly influenced by the increase in the prices of education and housing. This chart suggests that a large portion of the expenditures of an average household relate to the costs of housing, heating and lighting. A considerable increase in costs was registered also in the following groups: tobacco and beverages, hygiene and health care. The lowest increase in costs, on the other hand, concerned clothes and footwear and food. This is understandable because, being subject to strong competition, textiles and leather manufacturers maintain stable prices, while, on the other hand, demand

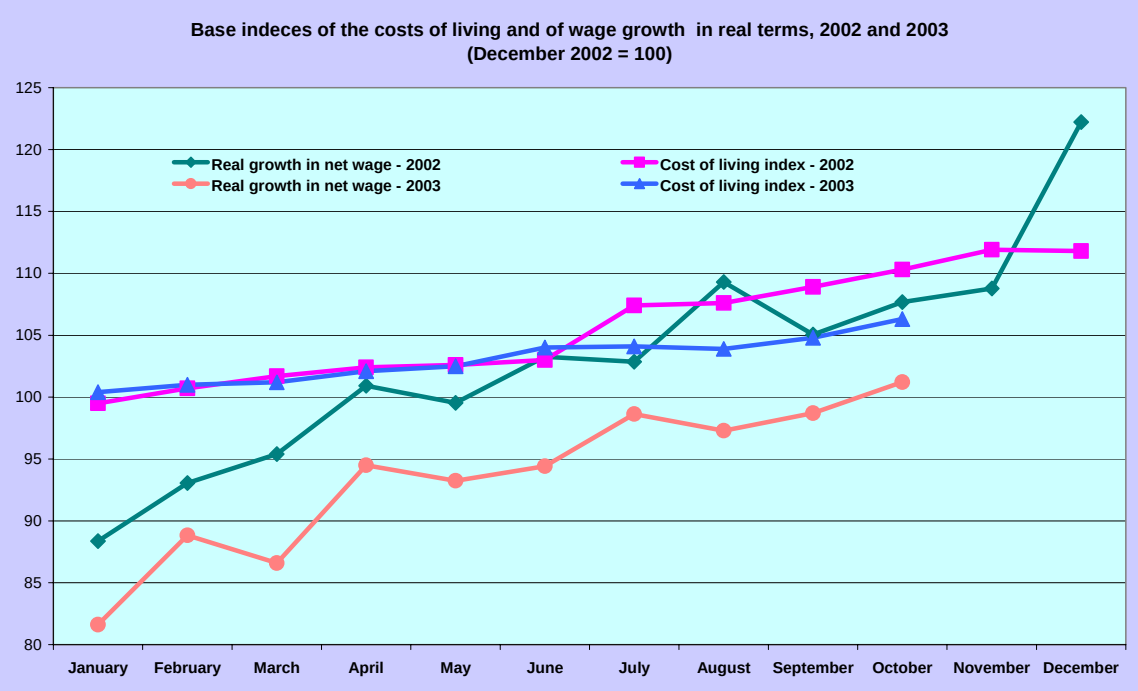
for these goods is not sufficiently elastic to induce significant changes in prices. Food prices have been liberalized and are now set freely, both on small green markets and on the industrial food products market.



Wages and Pensions

The average net wage was up by 7.6% nominally, i.e. by as little as 1.2% in real terms in October 2003 relative to December 2002. At the same time, October was the first month in which the average net wage was higher in real terms, compared to the level achieved in December 2002; from the beginning of this year until October the average net wage was lower in real terms, as compared to December 2002, resulting from considerably slower nominal growth in wages during 2003 (Chart 3).

The average net wage in October 2003 was CSD 12,432, which is up by 4.0% nominally or by 2.6% in real terms, month-on-month. The nominal gross wage in October amounted to CSD 17,986. In the period January - October 2003, the average net wage increased nominally by 25.4% or by 13.6% in real terms, compared to the same period the previous year.



The cost of living index in October 2003, as compared to December 2002, rose by 6.3%, while in the period January - October 2003 year-to-year, it increased by 10.4%.

The ratio of the value of the consumer basket to the nominal net wage in October 2003 was 1.0, remaining stable since July; in October of last year, this ratio was 1.2. The consumer basket for a four-member family was valued at CSD 12,436 in October 2003, a 2.4% increase month-on-month and a 4.4% increase year-to-year.

In October 2003 the nominal net wage in the economy amounted to CSD 11,587, an increase of 5.3% month-on-month in real terms, while the average net wage in the non-economic sector amounted to CSD 14.600, being up by 2.7% in real terms relative to the previous month.

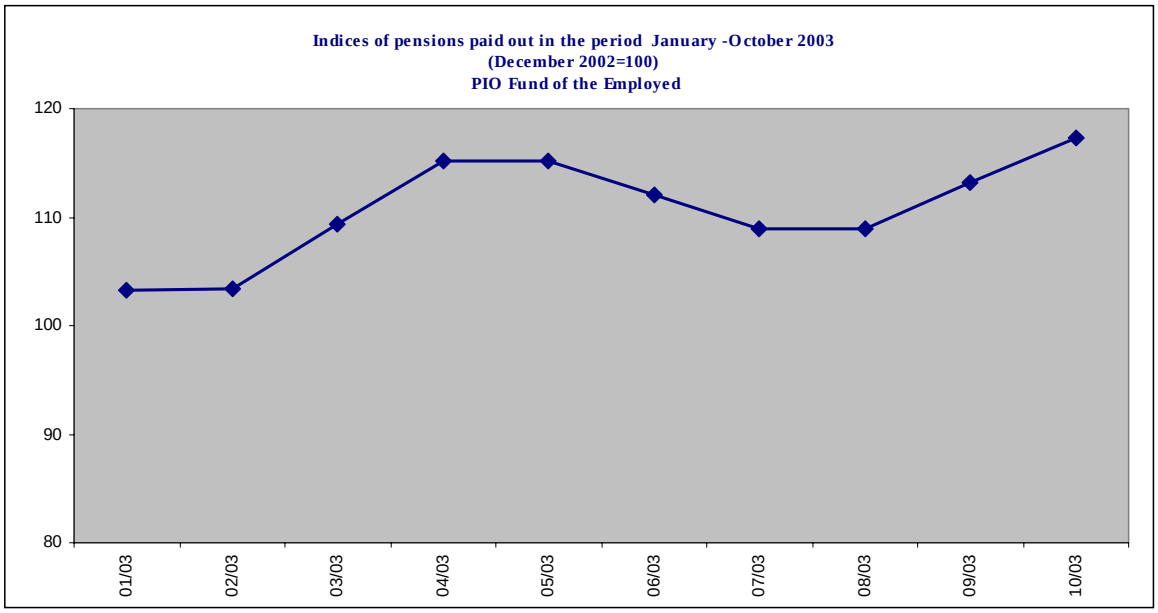
The lowest nominal net wages in October 2003 were registered in the manufacture of wearing apparel and fur (by 78% lower than the average for the Republic), the manufacture of textiles (by 73.7% lower than the average for the Republic), the manufacture of wood and wood products (and cork) (by 66.6% lower than the average for the Republic), the manufacture of leather and leather products, footwear (by 61.7% lower) and machinery and equipment rentals (by 60.75% lower). The highest nominal net wage was paid out in the following industries and activities: real estate operations (by 175% higher then the average for the Republic), the manufacture of tobacco products (by 152.2% higher), insurance (by 115.4% higher), air transport (by 115.3% higher) and financial mediation (by 110.9% higher than the average for the Republic).

The pension paid out by the Old Age Pension and Disability Insurance Fund of the Employed in October 2003 averaged CSD 8,223, comprising the

second portion of the July pension and the first portion of the August pension. It was nominally up by 3.7% or by 2.3% in real terms, month-on-month.

The average pension paid out by the PIO Fund of the Employed in October 2003 increased by 17.4% nominally or by 10.4% in real terms, compared to December 2002.

The average nominal pension in November remained unchanged since pensions are adjusted to the trends in wages and the cost-of-living index on a quarterly basis. The pension paid out in November comprised the second portion of the August pension and the first portion of the September pension. In real terms, the pension paid out in November was down by 0.87% since the cost-of-living index in November increased by 0.9%, relative to the previous month.



The purchasing power of the average pension paid out in October slightly increased (+0.02%) relative to one month earlier. The ratio of the value of the statistical consumer basket per family member to the average pension was 0.383 in September, dropping to 0.378 in October, which implies slight improvement in the living standard of pensioners.

The ratio of the average pension to the average wage in the first five months consistently remained over 70%, but dropped in May. In October this ratio was 66.1%.

The results of our research suggest that the existing mechanism of pension trends adjustment is appropriate. Namely, in the course of 2003, including September, the average paid out pension observed by months, in real terms, was permanently under the level of December 2002. However, the average real pension throughout the year was over the December 2002 level (chart 4). This resulted firstly from the fact that, given its link with 50% of its value to trends in the cost of living, the pension was protected, and secondly,

oscillations in the average wage were overcome through the method of quarterly adjustment.

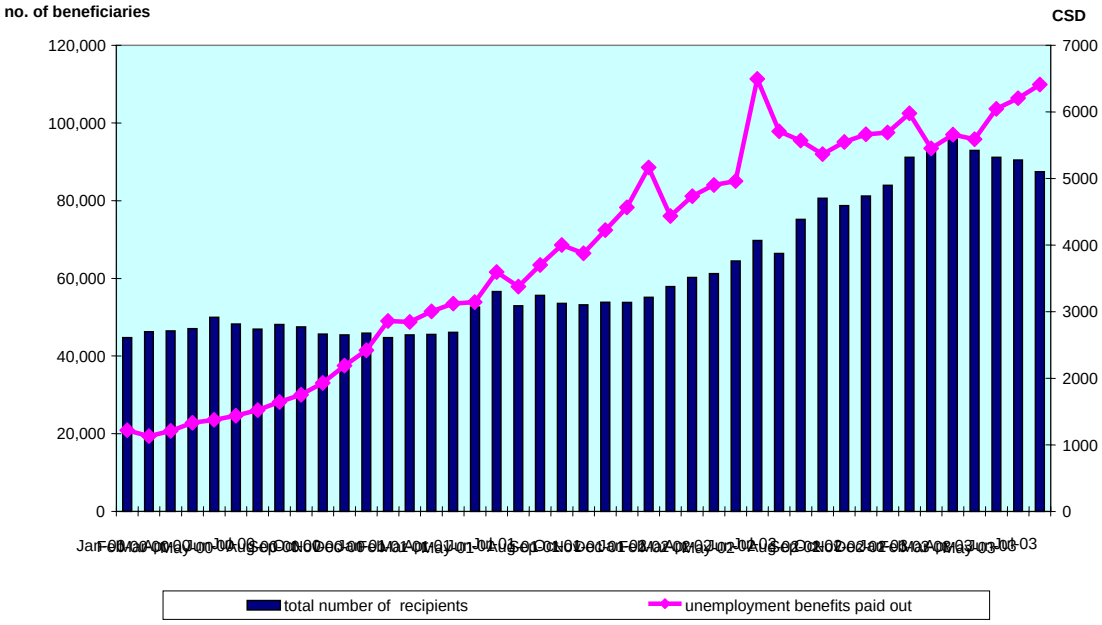
Labor Market

The registered unemployment rate in September was 32.2%, an increase of two percentage points year-to-year.

According to the data of the National Employment Agency, unemployment in October 2003 amounted to 963,000 persons. In the period January – October 2003, the number of the unemployed increased by 14.1% year-to-year. The number of initiated jobs in the same period rose by 13.2%, being 354,186, of which 43.9% concerns fluctuation (change of job), while 56.1% are workers previously registered with the National Employment Agency as unemployed.

The registered demand for labor has also been increasing, although considerably slower than unemployment. In the period January – October 2003, the number of registered new jobs was 429,410, an increase of 9.0% year-to-year. The demand for workers over the same period was fulfilled at 82.5%, indicating an unfavorable structure of labor supply with regard to the structure of labor demand.

The number of unemployment benefit recipients and the amount of benefits per recipient, Serbia, January 2000 - July 2003



The total number of the employed in the first ten months of 2003 year-to-year was down by 2.3%. Employment in the socially-owned sector dropped by 6%; it rose by 10.2% in the private sector and by 1.4% in small companies.

In the period January – August, the average number of unemployment benefit recipients increased by 44.7%, compared to the same period last year.

The number of beneficiaries on the basis of redundant labor rose by 58.2% and on the basis of bankruptcy and liquidation, by 42.3%.

The structure of unemployment benefit recipients is dominated by those who lost their job as redundant workers (55.9% in August 2003); a little under one-quarter (24.2%) refers to those who lost their jobs due to the bankruptcy and liquidation of companies in which they used to work: other categories of beneficiaries constitute 19.9%. According to the latest available data, unemployment benefits per recipient in July 2003 amounted to CSD 6,410, which is 54.0% of the average net wage paid out in the Republic of Serbia in July.

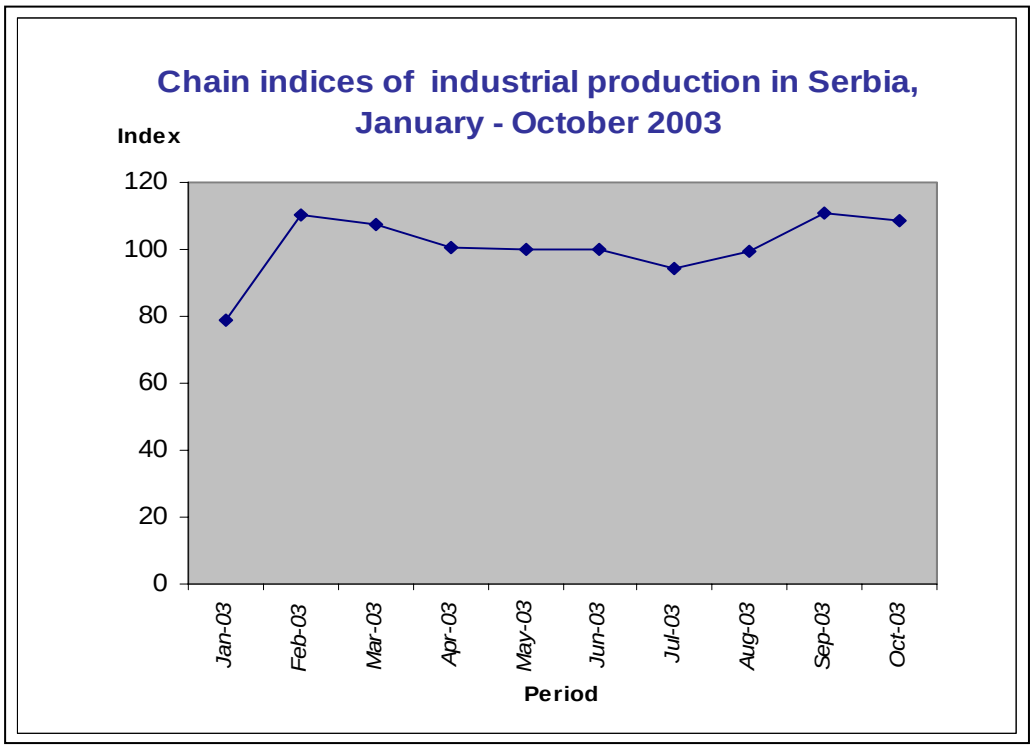
Considerable fluctuation and increase in the number of new jobs suggests that the value of unemployment benefits has a stimulating impact on workers who temporarily lost their jobs to start looking for new jobs.

Production and Services

Industrial production in Serbia w/o Kosovo and Metohija in the period January – October 2003 was down by 3.5% year-to-year. The month-on-month increase of 8.3% in October did not contribute significantly to the reduction of the slump in overall industrial output in the previous months of 2003. In Central Serbia it dropped by 4.7% and in Vojvodina by 1.2%.

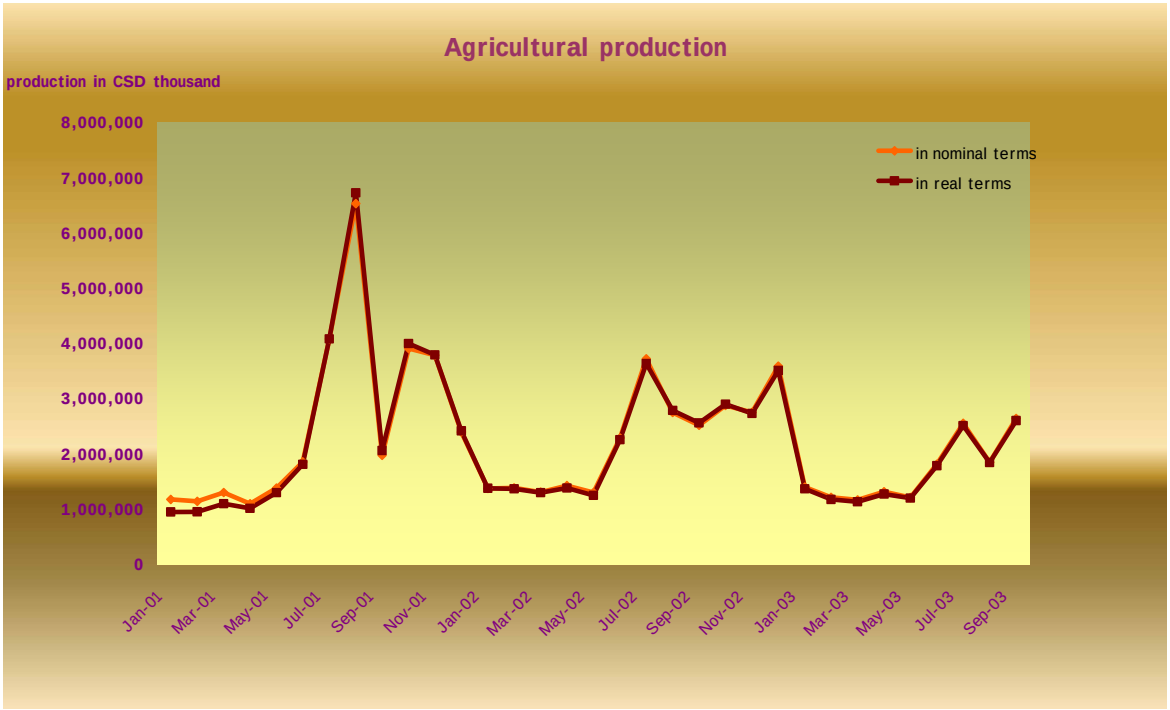
With regard to the sections of industrial production, in the period January – October 2002, mining and quarrying decreased by 1.6% and manufacturing by 5.1%, while electricity, gas and water supply increased by 2.1%, compared to the same period last year.

With regard to the destination of consumption, the production of capital goods dropped by as much as 23.3%, while the production of consumer goods and intermediate goods was lower by 2.9% and 2.3%, respectively, during the same period.



Within the section *mining and quarrying*, the sharpest year-to-year drop in the first ten months of 2003 was registered in *the mining of metal ores* (by 31.5%), while production rose only in *the mining and briquette of coal* (by 5.7%).

As far as *manufacturing* is concerned, only two fields, out of 23, registered growth in production year-to-year: *the manufacture of chemicals and chemical products* (by 31.7%) and *the manufacture of metal products except machinery* (by 7.1%). At the same time *the manufacture of clothes and fur* and *recycling* plummeted (by -42.3% and -40.0% respectively). In the period January – October 2003, compared to the same period last year, production increased in three fields of manufacturing, whereby only in *the manufacture of chemicals and chemical* products it was higher than 10% (15.6%), followed by *the manufacture of basic metals* (2.5%) and *the manufacture of coke and refined petroleum products* (1.8%). *Electricity, gas and water supply* also registered an increase in production over the same period (2.1%). The sharpest drop was registered in *the manufacture of clothes and fur* (-44.1%), followed by *the manufacture of wood and products of wood and cork, except furniture* (-29.5%), *the manufacture of textiles* (-28.9%), *the manufacture of precision and optical instruments* (-28.9%), *the manufacture of radio, TV and communication equipment* (-27.5%) and *the manufacture of leather and leather products, footwear* (-19.7%).



Due to the this year's drought, and according to the available data on the sale and purchase of agricultural products, agricultural production in the first nine months of 2003 reached only 83% of last year's production. Downward trends did not affect only the growing of vegetables and industrial crops and dairy

production, although the latter started recovering at the end of summer, when it registered considerable growth of over 50% (August and September). Unfortunately, the production of cereals and fruits dropped by one-third as compared to the first three quarters of 2002. The Ministry of Agriculture and Water Management provided the producers affected by drought and hail with 50,000 t of seed wheat, 30,000 t NPK fertilizers and 167.8 million liters of the D-2 diesel fuel, i.e. a fuel refund in the value of CSD 1.36 billion, as compensation for damages caused by the natural disaster.

Construction, trade and air transport registered an increase in the first three quarters of 2003 year-to-year. Measured by the value of the construction works completed, construction increased by 17% nominally or nearly 4%, if corrected with consumer price inflation, while the number of effective hours of work in construction increased by over 7%. As far as transportation is concerned, trends from the first quarter continued, and the volume of freight transport rose by nearly 7%, while passenger transport dropped by 15%. Some deviations are present with road and air transport, since road freight transport was down by 5% and road passengers transport by as much as 25%. At the same time, passengers have increasingly opted for air transport, and therefore the volume of air transport increased by 40%, compared to the same period last year. Retail trade turnover was up by 18.5% nominally or by 5% in real terms in the first three quarters, year-to-year. Over the same period, the value of the turnover in the catering industry increased by 5.4% nominally or by 6.7%, after correction for inflation.

According to the officials in the Ministry of Trade, Tourism and Services, foreign exchange inflow from tourism has been permanently increasing since 2000. Unfortunately, this has nothing to do with intensification of activities in domestic tourism. Measured in the number of tourist nights, tourism in Serbia has a downward trend in 2003. The only months during which the number of tourist nights did not drop compared to last year was May, mainly owing to the fact that the number of tourists in mountain resorts and certain spas did not drop. However, bearing in mind that in the first three quarters of 2003 the number of tourists decreased by 5% (e.g. by as much as 10% in October) year-to-year, it can be assumed that domestic tourists, owing to the increase in their purchasing power, more often opt to spend their vacations in exotic destinations rather than local resorts. Of course, this does not contribute to the increase in the revenue of domestic tourism, but quite the opposite, this means a considerable outflow of money from Serbia.

Foreign Trade

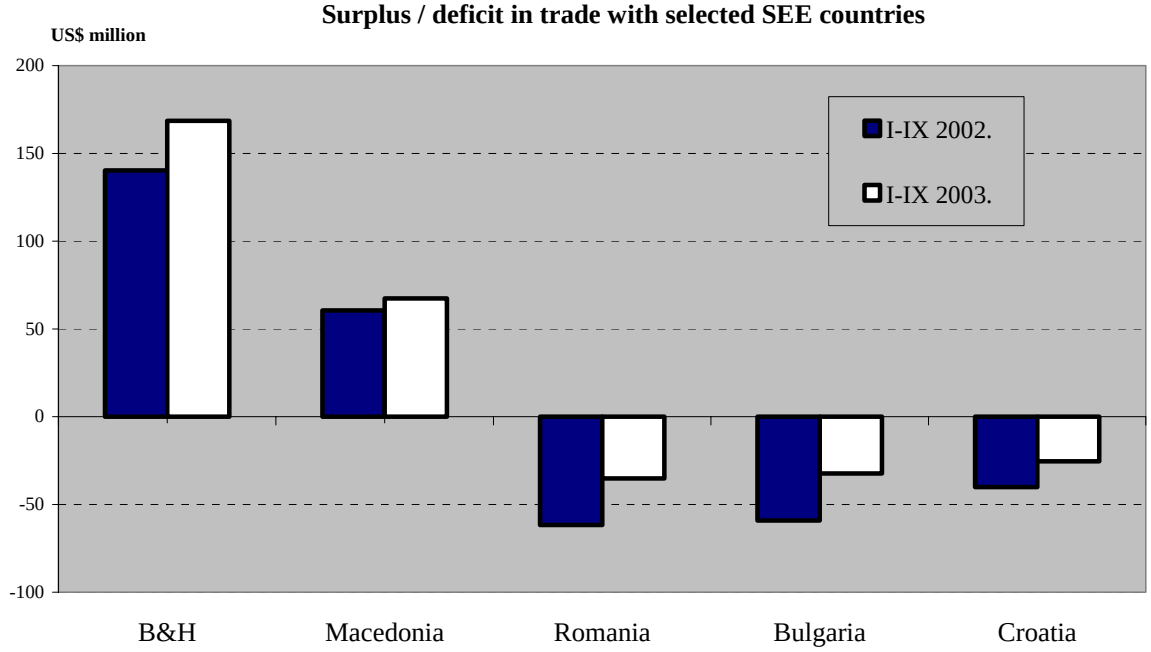
According to preliminary data, commodity exports in September were valued at USD 210 million and commodity imports at US$ 538 million. Measured in nominal US$, the exports value increased by 8% and the imports value by 9%, compared to the same month last year.

Observed in cumulative terms, the value of commodity imports has been growing slightly faster than of commodity exports during this year. As a result, the

trade deficit in the first nine months of 2003 reached US$ 3.2 billion, a nominal increase of nearly one-third, year-to-year.

However, the values of exports and imports, expressed in US$, due to its constant depreciation relative to the EUR, are overestimated compared to the values expressed in EUR as well as relative to quantitative indicators of foreign trade. US Dollar depreciated relative to the Euro by some 12% since the beginning of the year until November, while the depreciation rate in November was 17% year-to-year. Hence, an upward trend in exports and imports growth rates, expressed in EUR, is significantly milder then when expressed in US$. On the other hand, physical volume of commodity exports decreased by nearly 7% during the first six months of 2003, year-to-year, while the physical volume of commodity imports increased by 14%.

Surplus / deficit in trade with selected SEE countries



The free trade area in Southeastern Europe is due to be established at the beginning of next year, encompassing the markets of former SFRY Republics, excluding Slovenia, and of Romania, Albania, Bulgaria and Moldova. These markets constituted about one-third in total commodity exports and 10% of total commodity imports of Serbia in 2002. Similar values were achieved in the first nine months of this year. Commodity trade between these countries is expected to increase following the establishment of a free trade area, as well as FDIs inflow, which is expected to be attracted by the market of some 60 million residents.

In this group of countries, Macedonia and Bosnia and Herzegovina are the most important trade partners of Serbia. They are, at the same time, the only significant trade partners with whom Serbia registers a surplus; owing to this, Serbia has a surplus in trade with the region as a whole. Although trade with other significant partners in the region (Croatia, Bulgaria and Romania) is

associated with a deficit, that deficit has a downward trend relative to the previous year. This resulted for the most part from considerable increase in exports to the mentioned countries, as well as from the reduction of imports from Romania and Bulgaria.

CEE transition countries together constituted 50% of the total Serbian commodity exports during the first nine months of 2003. At the same time, exports to this market rose by over 25%, but a trade deficit also increased by 20%. The deficit growth rate would have been considerably higher had there not been for the already mentioned decrease in deficit and increase in surplus in trade with countries which are to due to form the free trade area in Southeastern Europe.

Monetary Policy

Trends in monetary aggregates suggest gradual and stable growth in the money supply and changes in the structure of M1. Cash money supply reached the amount of CSD 40 billion (during last twelve months, only in December 2002, the cash money supply exceeded this level, amounting to CSD 43 billion). Further increase in the cash money supply is likely by the end of the year, mainly due to seasonal factors and to the fact that New Year and Christmas holidays are linked to larger payments and citizens' wish to have more cash at their disposal. The level of deposits is declining for this reason.

Money supply in October increased by as little as 1.1% in real terms or by 9.9% nominally, year-to-year. The highest growth in the structure of M1 was registered with sight deposits, which increased by 15.4%.

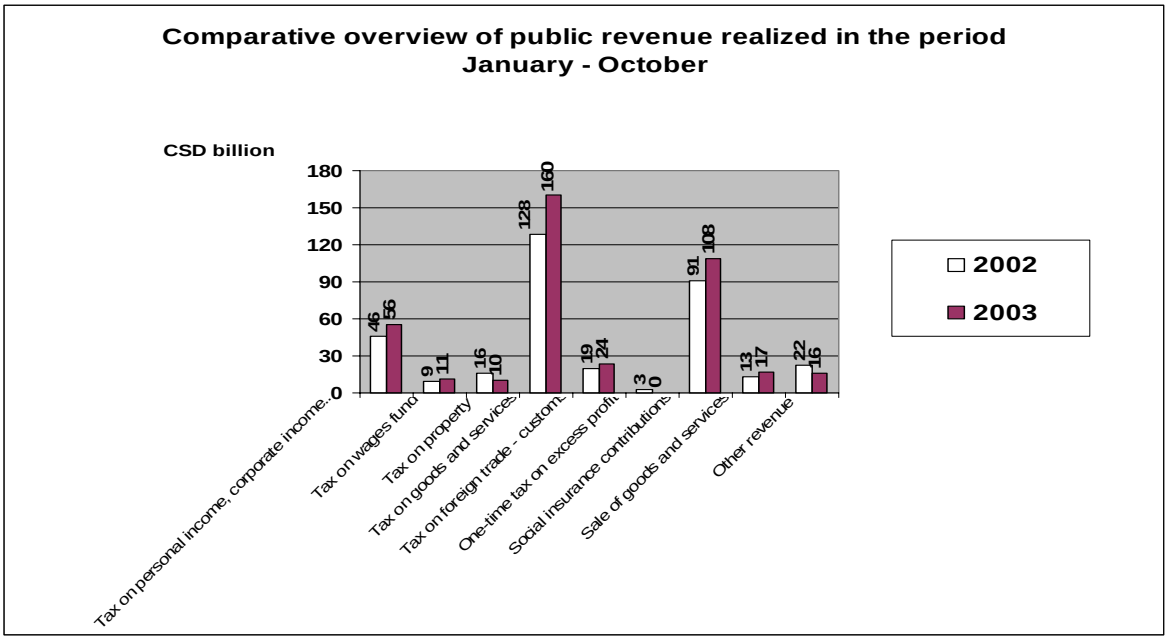
However, if we observe the average for the first ten months of 2003, year-to-year, the increase in the volume of money supply was much more significant (28.3% nominally and 20.3% in real terms increase in M1).

On the money market, interest rates are registering their lowest levels since the beginning of the year. The average weighted active interest rate in banks was 1.19% at a monthly level in October (1.17% is the lowest level of interest rates in 2003, registered in March). However, amounting to 13.9% at an annual level, interest rates are still too high. The interest rate on commercial and treasury bills and deposit certificates at the Belgrade Stock Exchange was for the first time in the last eight years lower than 25% at an annual level (1.88% monthly).

Fiscal Policy

According to data from the Treasury of the Republic of Serbia total gross public revenue was up by 15.4% nominally in the first ten months of 2003 year-to-year. Taxes on goods and services, with 39.8%, constitute the largest share in the structure of public revenues, followed by social insurance contributions (26.9%) and taxes on personal income, corporate income and capital gains (13.8%).

It should be stressed that excess profit tax and property tax collection recorded a considerable drop in 2003. During the first ten months, only CSD 20 million were collected on the basis of excess profit tax, compared to nearly CSD 3 billion during the same period last year. As far as property tax is concerned, in the period January – October 2003, its collection dropped by 42.87% year-to-year. Property tax accounts for as little as 0.7% in the total realized public revenues. On the other hand, this tax is collected from a large number of taxpayers, resulting in high costs of tax administration. For this reason, this kind of tax revenue should be paid special attention to in order to eliminate unfavorable cost effects.



Aleksandra Jovanović, S.J.D.

THE REFORM OF INSTITUTIONS – LAW, POLITICS AND THE ECONOMY IN TRANSITION IN SERBIA AND MONTENEGRO

1. Institutions and the Law are Becoming the Subject of Analysis of Economics

In the media we can see economists on a daily basis referring to legal regulations, the rule of law, courts and other law enforcement institutions. It is no longer odd that economists consider law and institutions to be the basis for upholding the market economy. Economists today advocate the rule of law and the consequently independent judiciary, quality legislation adjusted to international standards and efficient enforcement of laws. Also, it is no longer odd that economists are interested not only in laws and regulations governing economic issues, i.e. business and financial laws directly related to the economy. The amendment of the Constitution, democratization and reform of political institutions and the independent judiciary, which are also the subject of interest of economists, are on the agenda of economic analysis.

2. The Definition of Institutions

Institutions present the rules determining the character of political life in one country and the character of its economic life, and completing the framework of protection of economic and political life – the judiciary, police and army. In the broadest sense, institutions are the rules of conduct, mainly legal rules (but also moral rules and/or customs), and what is more important, the very enforcement of law, as well as the organization which upholds the enforcement of law. In contrast to the general understanding of institutions today, they should not be construed in a narrow organizational sense. Institutional structure defines the allocation of risk and of transaction costs, thus being of decisive importance for the institutional ambiance which investors encounter.

Experience has taught us that the entire institutional structure is responsible for a(n) (un)successful economy, both the structure which directly concerns the economy (property, contracts and contract protection, commercial law, financial regulations concerning banks, stock exchanges, securities) and the structure which does not, such as the judiciary, the police and others.

3. Some Assessments / Indicators of the Institutional and Legal Transition in SCG

Delay in reform and weak economic indicators in Serbia are for the most part considered to be due to the delay in institutional and legal reforms. Numerous polls and research suggest that political and judicial institutions in

Serbia, as well as market institutions, are not completely erected, which is reflected in the enforcement of outdated laws (outdated in terms of not being harmonized with international standards, e.g. bankruptcy law, red tape in starting up companies, problems in real estate registers, accounting standards, etc.); in certain areas, legal regulations do not even exist (investment funds, housing credit insurance), over-regulation and state interference, which increase the costs of economic entities, inconsistency in certain regulations (the absence of horizontal and vertical agreement, e.g. between laws and regulations in the Republic of Serbia and at the level of the state union of SCG), and arbitrary enforcement of laws.

Applying various methodologies international financial institutions monitor and assess the quality of institutional and legal development. Thus, the European Bank for Reconstruction and Development monitors the quality of law and the level of enforcement of law in the area of company/commercial law and finance related regulations. The EBRD's assessments indicate that SCG, compared to other countries, lags in the reform of legal and market institutions. With regard to company law and its enforcement, Serbia and Montenegro scored 3+ in 2001 and 3 in 2002, and with regard to finance-related regulations and their enforcement 3- in 2001 and 2- in 2002. Croatia, Bulgaria, Macedonia and Romania rank better, while Albania and B&H are behind Serbia and Montenegro. Of course, indicators for the Czech Republic, Poland, Hungary and Slovakia are far better. SCG has a considerable delay in the area of finance. Therefore SCG had better indicators of company/commercial law and of finance-related regulations in 2001 than in 2002[1], which, to be honest, applies to the majority of other countries, and not only to SCG. EBRD indicators[2] of legal transition were developed as a measure of quality (extensiveness[3]), i.e. the level to which commercial and financial laws are close to international standards, and as the measures of the extent of enforcement of the law (effectiveness[4]).

For 2003, EBRD developed indicators which measure progress in institutional/legal transition in a new way. Unlike the previously mentioned ones,

[1] Worsening refers to information which legal regulations give to economic entities. This information is more comprehensive after a certain period of time, when the enforcement of legal regulations shows all possible qualitative shortcomings (the contents of the law), as well as shortcomings with regard to enforcement (the relation between normative and actual enforcement).

[2] Besides transitional indicators, transition reports in 1995 have introduced indicators of legal transition. The indicators of legal transition developed by the European Bank for Reconstruction and Development are based on the subjective perceptions of 165 legal and other experts from 27 countries in transition with regard to the quality and efficiency of law. For the methodology for the creation of indicators of legal transition see *Transition Reports, EBRD*, 2002, p 39 and *Law in Transition – Ten Years of Legal Transition.* EBRD 2002, pp 15-17. For the methodology of creating indicators for the business environment and the success of companies, see *Transition Report*, EBRD 2002, pp 24-29.

[3] *Extensiveness* or so-called indicator of quality of law is an approximation of law to international legal standards.

[4] *Effectiveness* specifies the extent of implementation and enforcement of law. The introduction of these indicators made possible the analysis of the impact of legal reforms on investment incentives.

the new indicators are of a sectoral character and measure the level of harmonization of regulations with international standards and the efficiency of law in terms of consequences of its enforcement in specific legal areas. These indicators are focused on the following: security for claims, bankruptcy, capital market and corporative governance, concessions and regulatory framework for telecommunications, while the 2003 report deals with the security for claims. In this area, Serbia and Montenegro, together with B&H, fall within the category of non-reformed countries, although Serbia has enacted new legislation, but it has not been enforced yet. Also a low score goes for the enforcement of law points to those factors and restrictions which obstruct the enforcement of regulations governing the security for claims.

The institutional environment in SCG is assessed in other studies, such as the Index of Economic Freedom of Heritage Foundation, which assesses institutional environment with regard to economic freedom. Namely, economic freedom[5] is assessed on the basis of protection of property rights (functioning of the judiciary, possibilities of expropriations, intellectual property protection), the level of government intervention in the economy (state ownership, state spending), fiscal burden, regulation (administrative procedures, licenses), monetary policy, trade policy, the control of prices and wages, banking and finance, informal market and capital flows and foreign investments. According to these criteria, SCG ranked 149 among 161 states included, with the score 4.25, being behind Slovenia, Croatia, B&H, Albania, Hungary, Bulgaria and Romania. The score 4.25 puts SCG in the group of economically unfree countries, i.e. countries whose institutions do not uphold the market economy.

To the indicators of institutional development we should add so called governance indicators[6], i.e. indicators of the government's efficiency, which assess democracy, political stability, efficiency of state administration, quality of law, the rule of law and control of corruption. For the sake of comparison with CEE countries and with former SFRY Republics, we will mention a few indicators. The score 29.4 given to the quality of law in SCG is twice as low compared to CEE countries (63.2), a conclusion that cannot be drawn from EBRD's report. Such a low score for legal regulations is the result of the high level of government intervention in the economy which has been maintained. The weakest component of governance in SCG, according to this research, is the rule of law, with score 16, which is nearly three times lower compared with Eastern European countries, i.e. five times lower than the index of states - candidates for accession to the EU.

The rule of law is one of the most important prerequisites for a market economy. One segment of the rule of law in Serbia is closely related to constitutional reform, i.e. to the adoption of the new Constitution of Serbia and democratic institutions based thereon. However, this is only one dimension of the rule of law. The quality of law, especially the quality of economy-related law (i.e.

[5] Economic freedoms are assessed on the basis of 50 factors classified in 10 groups of equal relevance.
[6] Kaufmann D, Kraay A and Mastruzu M (2003), Governance Matters III: Governance Indicators, World Bank.

company and financial laws), their enforcement and building of institutions for enforcement thereof is a key point of economic reforms. The rule of law can be basically identified with the enforcement of quality law and presented with different components such as efficiency of the judicial system, level of corruption, the risk of nationalization, probability for a contract not to be protected , etc.

4. Why Institutional Development of Serbia Scores so Badly

The supply and demand for institutions in Serbia are for the most part determined on the political market. This also applies to those institutions (property, contracts, bankruptcy, denationalization) which directly shape the economy and uphold the market. Hence, institutions are not the result of demand of economic subjects for stable and credible rules of the game which shall make their mutual transactions easier and cheaper. The supply of institutions in Serbia is not defined following the criteria of economic efficiency, but is the result of specific political wishes. This means that reformers, in terms of the supply of institutions, pay more attention to how to keep their position of power, and less to how to support those institutions which are decisive for the progress of reforms.

The reform of institutions begins with the change of law, and the change of law changes the cost-benefit ratio for economic entities and the entire population, which causes political tensions, resulting in the postponement or abandonment of institutional reforms. The implementation of institutional reforms in Serbia may be described as a model in which, because of the problems in settling political interests of parties within the governing coalition, attention was exclusively paid to macroeconomic stabilization, while the microeconomic aspect of reform was neglected, except in the banking sector.

5. Why are Institutional Reforms so Slow and what is the Timeline for their Implementation?

Political reasons have determined the models of institutional development not only in SCG, but also in other countries. As a result, we can observe different approaches and the different extent of success of reforms, whereby slowness in carrying out institutional reforms might be rather due to political selection of priority laws and the schedule of their adoption, as well as to slowness in the enforcement of law, which inevitably results from the nature of certain institutions and from the fact that institutional development requires human and material resources.

Thus, some institutional changes, in terms of building the legal framework, organization for enforcement and enforcement itself, can be achieved through short-tem adjustment (e.g. building of institutions which serve to uphold short-term loans by introducing institutions for securing claims). Other institutional reforms may be realized only in the long run (e.g. restructuring of the banking sector, building of financial markets, building and enforcement of bankruptcy procedures).

Sluggishness in the enforcement of law and operation of institutions is sometimes the result of necessity for judicial and other regulatory bodies to have adequate know-how on new material law and procedures for their enforcement. Because of this, it is possible that more rapid legal changes aimed at reforming institutions do not yield efficient results.

6. What are the Models of Implementing Institutional Reforms and what is the Model Characteristic for SCG?

Reports on the transition confirm that institutions are those which go through reform most slowly, and the key problem is the implementation of reforms. Hence, it has been observed that the development of institutions lags behind the process of macroeconomic stabilization and liberalization. The low institutional level in SCG only confirms this conclusion.

Three models of institutional reforms, i.e. of linking liberalization/ privatization and institutional development in countries in transition have been observed so far. Each of these models is predominant in the specific sub-regional groups of countries in transition. The first model is characterized by balanced progress in liberalization/privatization and institutional development, which is the case in Hungary and in the majority of countries of Central and Eastern Europe. The second model is characterized by rapid initial liberalization in the first half of the 1990s, followed by thorough institutional reforms in the second half of the decade, which is the case in Lithuania and the Baltic states. The third model is typical for countries in which quick initial liberalization was not accompanied with rapid and comprehensive institutional reforms, which was the case with the countries lagging behind in the transition. Progress of institutional reforms in SCG suggest that our country has experienced the third model, in which, owing to the problems in settling political interests (within the governing coalition in Serbia), attention was exclusively paid to macroeconomic stability, while the microeconomic component of reform was neglected.

7. Significance of Quality (in Terms of Harmonization with International Standards) of Law and of the Enforcement of Law for the Success of Reforms

Research on the link between economic and legal components of reforms, the majority being related to the area of financial markets and way of financing companies[7], unambiguously indicate that an efficient enforcement of law is a determinant of investments and economic growth.

[7] La Porta R, Lopez-de-Silanes F and Shleifer A (1999) **Corporate Ownership Around the World**, the Journal of Finance, vol. 54, no. 2; La Porta R, Lopez-de-Silanes, F. Shleifer A and Vishny R (1997) **Legal Determinants of External Finance**, the Journal of Finance, vol. 52, no. 3; La Porta R, Lopez-de-Silanes, F. Shleifer A and Vishny R (1998) **Law and Finance**, Journal of Political Economy, vol. 106, no. 6; Beck T, Demirguc-Kunt A and Maksimovic V (2000) **Financing Patterns Around the World – the Role of Institutions**, the World Bank, Policy Research Working Paper, no. 2905, October; Beck T, Demirguc-Kunt A and Levine R (20020 **Law and**

Law is the main instrument of change of institutions and the system, but not the only one, and certainly not sufficient. The quality of law is important for building up efficient institutions, as is the enforcement of law. According to all research, the enforcement of law[8] is much more important for institutional development and efficiency of the economy than the quality of law. An efficient economy necessities the protection of investors' property rights through the improvement of legal protection of investors, in particular through the harmonization of banking standards with international standards, improvement of bankruptcy law and of regulations governing the security for claims, modernization of company law and law regulating securities; however, institutional development which upholds an efficient economy also entails the enforcement of law and not just its enactment.

In conclusion, it has to be emphasized that the quality and enforcement of law and institutional development in Serbia and Montenegro will be to a great extent determined by our participation in the process of association with the EU, as well as by the necessity for Serbia and Montenegro to be able to fulfill obligations deriving from the EU legislation.

Finance – Why Does Legal origin Matter? The World Bank, Policy Research Working Paper, no. 2904, October;

[8] Pistor K, Raiser M and Gelfer S (2000) **Law and Finance in Transition Economies**, The Economics of Transition, vol. 8, no 2.

CEPROB

Institutional Theme

ANALYSIS OF THE SECURITY SECTOR REFORM IN SERBIA AND MONTENEGRO

In view of its topicality, the reform of the security sector stands out among the internal and external priorities of Serbia and Montenegro. This is confirmed by the intensive activities carried out at different levels intended to create conditions for the establishment of a security sector which corresponds to our actual needs, broadly accepted democratic standards and the principles of the organization of the security sector in developed countries.

The reform of the entire security sector, and the introduction of civilian and democratic control over it, as the most important issues in this area, have been in focus of both state authorities and the domestic and international public because of their significance in the democratic transformation of the country. At the same time, together with the request to drop the charges raised against 19 NATO countries before the International Court of Justice, cooperation with ICTY in the Hague and the break of cooperation with Republic of Srpska Army, these two are prerequisites for membership of Serbia and Montenegro in the Euro-Atlantic security integration, which is certainly among the most vital state interests. The progress of democracy in Serbia and Montenegro, its reputation in the international community and integration into modern international institutions depends on the speed and success in resolving these issues.

The G 17 Institute will publish a series of articles that will present an overview of what has been achieved so far, as well as of projected activities in the security sector reform. In this issue, we will give a brief introduction to key elements of the security sector reform in Serbia and Montenegro.

1. Security Sector Reform at the Level of the State Union Serbia and Montenegro

Very important steps have been taken in the area of policy and legislation in terms of the introduction of democratic and civilian control over the security sector in Serbia and Montenegro, the most important ones being as follows:

- *The Constitutional Charter*, the highest legal act of the State Union Serbia and Montenegro, puts forth basic principles of democratic and civilian control over the Army and other subjects of the security sector:

> **Article 41**
> The Minister of Defense shall coordinate and implement the defined defense policy and shall run the armed forces in accordance with the law and the powers vested in the Supreme Defense Council.
> The Minister of Defense shall propose to the Supreme Defense Council candidates for appointment and shall appoint, promote and relieve of duty officers in accordance with

the law.
The Minister of Defense shall be a civilian.
Article 42
After a period of two years, the Minster of Foreign Affairs and the Minister of Defense shall switch posts with their respective deputies.
Article 54
Serbia and Montenegro shall have the Armed Forces under democratic and civilian control.
Article 55
The task of the Armed Forces shall be to defend Serbia and Montenegro in accordance with the Constitutional Charter and the principles of international law governing the use of force.
A defense strategy shall be adopted by the Parliament of Serbia and Montenegro in accordance with the law.
Article 56
The Supreme Defense Council shall be the Commander-in-Chief of the Armed Forces of Serbia and Montenegro deciding on the use of the armed forces.
The Supreme Defense Council shall comprise the President of Serbia and Montenegro and the Presidents of the member states.
The Supreme Defense Council shall take decisions by consensus.
Article 57
Recruits shall do their National Service in the territory of the Member State whose nationals they are, with the possibility of doing their service in the territory of the other member state if they so choose.
Article 58
Recruits shall be guaranteed the right of conscientious objection.

- According to the decision of the Supreme Defense Council of 6 May 2002, the General Staff of the Armed Forces of Serbia and Montenegro became a part of the organizational structure of the Ministry of Defense. It shall be accountable to the Ministry, whereby the Ministry is accountable to the Parliament of the State Union and the Supreme Defense Council, whose members are the President of the State Union and the Presidents of Member States. The implementation of solutions prescribed under the Constitutional Charter concerning civilian and democratic control over the security sector shall be worked out in the Member States' Constitutions, the Law on Defense and Armed Forces, the Law on Security Services, laws on home affairs and security & intelligence agencies in Member States, which will create conditions for the Parliament of Serbia and Montenegro and Member States' parliaments to start pursuing efficiently their central task relating to supervision and control over all segments of the security sector.
- On 20 June 2002, the Parliament of the former FRY passed the Law on Security Services of the FRY which governs civilian control over four security services at the federal level. This Law provides for the control by the Parliament and Federal Government over four existing services: Military Security Service, Military Intelligence Service, the Service for Research and Documentation and the Security Service of the Federal Ministry of Foreign Affairs. The Federal Parliament also established a

Committee in charge of control over the work of the Military Security Service.

- At the session of the Government of the former FRY held on October 31, 2002, it was decided to introduce a stricter procedure for issuing licenses for trade in armaments. This procedure stipulates that the Ministry of Defense shall prepare proposals, while the Council of Ministers of Serbia and Montenegro examines and gives its approval to these proposals, meaning that each application for the license for trade in armaments, military equipment and services must pass internal procedure in the Ministry of Defense first, where it gets expert approval (relating to quality, compliance with regulations, etc.) and then the Ministry of Foreign Affairs has to verify that the prospective export destination is not under sanctions or international isolation. Finally, the proposal must be granted approval by the Council of Ministers of Serbia and Montenegro which examines received proposals once or twice a week. In the meantime, an inter-departmental office has been set up, composed of the representatives of the Ministry of Defense, the Ministry of Foreign Affaires and the Ministry of International Economic Relations of Serbia and Montenegro, of the customs administration and police of both Member States (after the Constitutional Charter was adopted, it was limited to the representatives of the Ministry of Defense and the Ministry of International Economic Relations). This group has prepared a working version of the Law on Trade in Armaments which is waiting to enter into parliamentary procedure. The issue of production of armaments and military equipment is planned to be separated from trade. After the adoption of new legislation governing this area, necessary conditions will be created for pursuing efficient civilian control over the trade in armaments and military equipment in Serbia and Montenegro. The enforcement of this Law will regulate the state's relation toward the manufacturers of armaments and military equipment, at the same time preventing the scandals our country has been involved in concerning illicit exports of armaments to "black markets" such as Iraq and Liberia, from happening again.
- At the session of the Supreme Defense Council held on 15 April 2003, the decision was taken to set up military security services within the Ministry of Defense of Serbia and Montenegro, terminating the jurisdiction of the General Staff of the SCG Armed Forces over Military Intelligence and Military Security Services. The previously mentioned Law on Security Services of FRY was not derogated by this act. The former Military Security Service has been transformed into the Military Security Agency and Military Police Department. The Military Security Agency is directly subordinated to the Ministry of Defense and it has counterintelligence competence, whereby Military Police will stay under the jurisdiction of the General Staff and will be in charge of general security
- On April 22. 2003, the Minister of Defense of Serbia and Montenegro Boris Tadic made a decision concerning financial issues in the area of defense, under which any procurements for Armed Forces exceeding the

amount of YuD 600,000 are prohibited as of April 2003. All procurements exceeding YuD 600,000 shall be carried out through the special Office established within the Ministry of Defense, whereas the procurements valued between YuD 10,000 and 600,000 will be carried out pursuant to the Public Procurement Law. The Public Procurement Office started operating on 11 July 2003. The Public Procurement Office working within the Ministry of Defense shall employ 75 persons; at present there are 20 persons working in the Office who underwent the appropriate training.

- At the session of the Supreme Defense Council held on May 6, 2003, the decision was made that the Council of Ministers of Serbia and Montenegro shall elect military attachés at the proposal of the Minister of Defense.
- According to the decision made by the former Federal Government, the Computer Center was displaced from the General Staff of the Yugoslav Armed Forces and put under the jurisdiction of the Ministry of Defense.
- Pursuant to Article 66 of the Constitutional Charter, the competences of military courts, prosecutors and public attorneys shall be transferred to the bodies of the Member States in accordance with the law. Until the enactment of the Law on the Transfer of Competences, military courts shall continue performing their duties. Pursuant to the Law on Implementation of the Constitutional Charter, the mentioned Law shall be adopted within six months from the date on which the Constitutional Charter came into effect (4 February 2003) at the latest. Although the Law in question has not been passed yet, this is a very positive step in the process of establishing civilian control over the Army.
- The Council of Ministers of Serbia and Montenegro, at the session held on August 27, 2003, adopted the Ordinance concerning civil service that will come into effect as of 15 October 2003. This Ordinance creates legal grounds for civil service or military service without carrying arms. According to the Decision signed by the Minister of Defense Boris Tadic on 17 November 2003, recruits of the Armed Forces of Serbia and Montenegro who opt for civil service will be able to perform their service in one of 370 institutions all over Serbia and Montenegro. Civil service shall last 13 months. The training shall last 14 working days i.e. 84 training hours, and shall be performed through courses, seminars, and other forms of training in classrooms, cabinets and centers. The Instruction for the application of stipulations governing civil service, issued by the Ministry of Defense, emphasizes that a person performing civil service shall be equal in all rights and duties to the soldier in the Armed Forces. If possible, the recruit shall perform civil service in his residence town. Otherwise, he shall perform civil service in the nearest town where there are institutions or organizations planned for the civil service.
- The Council of Ministers of Serbia and Montenegro at the session held on 11 August 2003 approved the participation of units and servicemen of the Ministry of Defense and Armed Forces of Serbia and Montenegro in the United Nation's peace operations and missions. That participation is based on the principles of professionalism and voluntariness. At the

session held on 8 October 2003, the Supreme Defense Council passed the decision allowing the preparations of the Armed Forces of Serbia and Montenegro for participation in International Peacekeeping Missions to begin. By the same decision, Ministry of Defense undertook to prepare legal and other documents necessary for the regulation of the participation of the Armed Forces in these missions, by which the setting for final decision for the launch of the troops by the Federal Parliament should be established.

- The Supreme Defense Council, at the session held on 2 October 2003, sent proposal to the Ministry of Defense to open dossiers of the Military Security Services and to make them available to all interested persons, according to the internal rules and regulations;

Efforts made by the state in this area and activities undertaken shall make possible efficient control over the security sectors in the State Union's Member States, i.e. Serbia and Montenegro. However, although these developments seem encouraging, there are still plenty of unresolved problems, while the enforcement of enacted laws and the enactment of new ones is to a certain extent under question. The most apparent example for such an opinion is the problem which arose concerning approval, provision and control of the budget of the SCG Armed Forces. Namely, the Committee on Defense within the Parliament of Serbia and Montenegro is in charge of control over the SCG Armed Forces, but Member States and their Parliaments are responsible for ensuring approval of the army budget. Given that parliamentary defense committees in Member States have no competences over the Army as a federal institution at present, the approval of the army's budget is in the hands of the Member States' parliamentary committees which are not experts for military issues, in this case the Finance Committees.

2. The Reform of Security Services

Significant progress has been made in the last two years in the area of the reforms of security services.

- We have already mentioned two important events in the process of reforms of security services: the Law on Security Services was passed in federal parliament (on 20 June 2002) and the Military Intelligence Service and the Military Security Service have been placed under the jurisdiction of the Ministry of Defense.
- Significant structural and personnel changes have been made within the military intelligence service and military security service.
- In the Republic of Serbia, the National Security Service has been displaced from the Ministry of Home Affairs, renamed into the Security Information Agency (BIA) and put under the direct jurisdiction and control of the Government. The Law on the Security Information Agency, which governs the scope of activities of this institution, was passed in Parliament on July 18, 2002.

- The Unit for Special Operations, known as the *Red Berets*, which used to operate within the State Security Department of the Ministry of Home Affairs of the Republic of Serbia was dissolved in March 2003 because some of its members took part in the assassination of the Serbian Prime Minister Zoran Djindjic.

Both the State Union and Member States support serious reform of all security services and of the police. The reform of these services is a priority. It will be based on current international standards, e.g. institutional separation of civilian external intelligence and counterintelligence components of the service from the internal component; the establishment of civilian control by the legislative and the executive over the work of these security institutions (intelligence and counterintelligence service); clear definition of the role of the military intelligence and its conformation to the new mission of armed forces; separation of the national security apparatus from public police structures, depoliticization of the work of security services, etc.

To continue the successful process of reforms of security services, it is necessary to fulfill several conditions:

- Adoption of the internal ethical code for security structures. According to available information from the Ministries of Home Affairs of Member States, Serbia and Montenegro will adopt the Code of Police Ethics of the Council of Europe very soon.
- The establishment of parliamentary control over the work of these services through control over the budget and control over the results achieved;
- The enactment of appropriate laws by the Parliaments which shall specify additionally the competence of security services and legally limit the extent of their activities.
- Public confidence building concerning security structures, their efficiency, apoliticality and professionalism.

3. Reform of the Border Security Service

At the session held on December 27, 2002, the Supreme Defense Council made the decision that activities concerning the security of state borders shall be taken over by police following the enactment of the appropriate legislation, and in accordance with set dynamics and material, organizational and personnel possibilities. It was not possible, due to the establishment of the State Union of Serbia and Montenegro, to create these laws earlier. In any event, the transfer of the border security service from the military to the police structure is a very complex process which took nine years in Hungary and eight years in Romania, while in Bulgaria it has not been completed yet even after six years of implementation. At the session held on 10 June 2003, the Supreme Defense Council accepted the position of Montenegro that the security of the administrative border with Kosovo and control over the Land Security Zone shall be transferred to the Ministry of Interior of Montenegro as far as its territory is concerned. The Supreme Defense Council decided that SCG Armed Forces shall

renounce activities and resources and transfer competence of the system of state border security of Montenegro to the Ministry of Interior of Montenegro and proposed to the Ministry Council of Serbia and Montenegro to authorize the Minister of Defense of SCG to conclude the contract in taking charge of activities and resources concerning state border security with the representative of the Montenegrin Government. The Council of Ministers of Serbia and Montenegro made a decision which came into force on August 9, 2003, according to which the SCG Armed Forces shall renounce material resources concerning state border security to the Ministry of Interior of Montenegro, while officers and NCO's of the SCG Armed Forces may, if needed, temporarily be disposed to positions relating to the borders security in the Ministry of Interior of Montenegro. The deadline for the transfer of activities and resources concerning borders security and temporarily outsourcing of personnel to the Ministry of Interior of Montenegro is December 31, 2003. Also, the Ministry of Interior of Serbia announced that it will take over the control over the state border as of the end of 2003. This process is planned to be implemented in stages, by gradual taking over of the state border sector, to end by 2005.

It will be necessary to establish efficient command and communication structures within the trained forces of the Member States' ministries of interior which are to take charge of state border security from the SCG Armed Forces. The profession of a border guard should be defined as a specialized profession which requires special and uniform training for all forces responsible for the control of state borders. In that respect, it will be necessary to accept the recommendations of the European Union and to establish an efficient, well-organized and independent Government's office for state borders security. Also, it is necessary to make a clear division of responsibilities and achieve close cooperation among different institutions for national security (border guards, police, immigration office, contacts with border guards in neighboring countries, etc.) and thus to ensure full security of the state border in line with European standards. The realization of these objectives necessities the assistance of developed countries, in particular in terms of modernization of technical and information systems for state borders security.

4. Reform in the Area of Human Security

The area of human security is a very important segment of the entire security sector since it deals with security issues from the point of view of an individual and with operation of all institutions that have impact on general security (which includes, besides police, armed forces and security services, also hospitals, schools and the aspect of material security). Under the present circumstances it would be more appropriate to say that the sector of human security is yet to be established, not reformed. Little has been done in this area so far. It is certainly worthwhile mentioning the initiative of the Faculty of Civil Defense in Belgrade to set up the Center for Human Security. However, there is still a lack of interest on the part of the state and other institutions involved in

security sector reforms in taking this issue into consideration, although human security enjoys serious attention in the developed world.

Conclusion

The process of reforms in the security sector of Serbia and Montenegro has started with some very important steps which may result in the establishment of really efficient institutions that are subject to democratic and civilian control, separated from the conflicts among political and interest groups, organized in line with modern standards and managed following the principles of professionalism. This process is still in its initial stage in spite of significant progress that has been made. What lies ahead of state structures, political actors, NGOs, media and general public is a range of new legal, institutional, structural, personnel, technical, social and psychological changes which will lead towards the security system that is in every respect able to protect the interest and values of this country, as an integral part of the society, not as a structure which is outside of society.

This is above all our own interest, but also a prerequisite for any participation in modern political and security integrations at the level of Europe and the world.

Of course, the process of reforms in the security sector requires a serious and professional approach which will involve persons who are thoroughly acquainted with ideas and problems from that area. The creation of a wide circle of authorities for the area of defense and security from all the structures previously mentioned as actors of reforms is vital. This *security community* is a safeguard that the process of reforms in the sector of defense and security is progressing in a responsible, well-thought-out way based on broadly accepted theoretical postulates and reliable estimates, without any improvisation and rashness. In a society which does not have a well-developed system of relations between civilian and security structures, this idea is much more significant. Only a deployed security community will be able face the challenges of creating a system of security in Serbia and Montenegro which will provide overall security to the state as a whole, as well as to every individual.

Editors: Aleksandra Jovanovic
Tanja Miščević
Author: Oliver Radosavljević

Institutional Theme

HARMONIZATION OF SERBIA

The G 17 Institute has decided to present a simplified cross-section of the legal framework which is in force mainly in the Republic of Serbia, through a series of articles in the Economic Review within the project ***Monitoring of Institutional and Legal Reforms***. This presentation aims to examine the development and modernization in certain legal areas and the dynamics of adoption and harmonization of the Member Republics' regulations with international standards, in particular those in force in the European Union (EU) and those which fall under the World Trade Organization (WTO). At the same time, the G 17 Institute is planning to provide all interested readers with simplified directions on how to make a harmonogram, and to explain how the harmonization process shall be monitored.

The presented data has been examined on the basis of available documents and the G 17 Institute's reports, in particular those published in the Economic Review, various documents of the Serbian Ministries and reports released by international organizations operating in our country, such as USAID, World Bank, FIC, EBRD, SCEPP, PricewatrhouseCoopers, etc.

Of great assistance were the authors of the AIA reports on legal reforms[1], as well as experts of the Institute for Comparative Jurisprudence, CLDS, etc. In this issue we are going to analyze the harmonization of the legal framework for financial services and for environmental protection.

Financial Services

Financial services comprise the following sectors: banking, securities, investment funds and insurance. The area of financial services in Serbia is generally underdeveloped by comparison with the countries of the EU, relevant international institutions and other countries in transition[2]. Important reform steps have been made in the banking sector, but progress in the sector of insurance and securities has failed to keep up with the momentum in the banking sector. As far as investment funds are concerned, appropriate legislation has not been enacted yet.

[1] SCEPP AIA Reports, www.plac-yu.org

[2] The area of financial services, especially banking, has a long tradition in Serbia, but due to several decades of a command economy, it has been permanently neglected, and even misapprehended.

The Constitutional Charter of the State Union of Serbia and Montenegro and the existing legal framework and actual enforcement in the area of financial services provide for two separate financial systems in Serbia and Montenegro. Consequently, Serbia and Montenegro have their own monetary systems and separate central banks, ministries of finance and securities commissions established at the level of Member Republics.

Reform in the area of financial services entails the adoption of numerous regulations as well as the solution of the problem of internal harmonization between Serbia and Montenegro in order to establish a functional sector of financial services[3].

I Banking

Despite a long tradition, banking in Serbia necessitated reforms in terms of enactment of a number of laws governing this area: the Law on the National Bank of Serbia (Official Gazette RS, no. 72/2003), the Law on Banks and Other Financial Organizations with amendments (Official Journal of FRY, no. 32/93, 61/95, 44/99, 36/2002 and 72/2003), the Money Laundering Act (Official Journal of FRY, no. 32/93, 61/95, 44/99 and 36/2002), the Law on Securities and Other Financial Instruments Markets with amendments (Official Journal of FRY, no. 65/2002 and Official Gazette of RS, no. 57/2003). Also, we should mention here the Law on the Agency for Deposit Insurance and Bank Rehabilitation, Bankruptcy and Liquidation (Official Journal of SFRY no. 84/89, 63/90 and 20/91 and Official Journal of FRY no. 53/2001), the Foreign Exchange Law (Official Journal of FRY, no. 23/2002) and the Law on Bank Rehabilitation, Bankruptcy and Liquidation.

This is not a complete list of relevant legislation, while the Ministry of Finance and Economy has to prepare a number of new laws[4]. What is topical for the banking sector at the moment is further privatization of banks, the problem of deposit insurance, development of the mortgage market and adjustment of the banking sector to an increasingly demanding market. According to the data of the National Bank of Serbia, 39 banks operate in Serbia today[5].

II Securities Market

The Belgrade Stock Exchange was open at the end of the 1980s as the first modern stock exchange in the country. An emerging system is characterized, among other things, by a great number of brokerage houses operating on this market and the absence of investment banks.

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[3] See: CSEPP, Soskic Dejan "The *Development of Financial Services in the State Union of Serbia and Montenegro*", AIA Report no 5, May 2003.

[4] A list of laws and numerous draft laws can be found at the web sites of the National Bank of Serbia (http://www.nbs.yu) and the Ministry of Finance and Economy of the Republic of Serbia (www.mfin.gov.yu)

[5] A list of banks operating in Serbia is available at http://www.nbs.yu/serbian/10.htm"Banke%20u%20Jugoslaviji

The legal framework consists of the new Law on Securities and Other Financial Instruments Markets (Official Journal of FRY, no. 65/2002, Official Gazette of RS, 57/2003). This Law, which came into force ten months after having been enacted, i.e. in September 2003, opened a range of new questions. The former federal Law was in the meantime "transferred" to the level of Serbia, where it was adopted as the new Republican law with the purpose of "providing an open, public, equal, efficient and cost-effective market and protecting investors, other beneficiaries of financial services and other participants in the securities market"[6]. The Law has not been enforced efficiently yet due to the absence of the Central Securities Depositary (this function is presently performed by NBS) and unclearly determined competences of the Securities Commission and/or the just adopted Policy Regulations which have not become operative[7].

III Investment Funds

Basically, investment funds are intermediaries which collect surplus financial resources in exchange for shares or units and through further investing trade in financial instruments. The basic international document governing this area is the so called Undertakings for Collective Investment in Transferable Securities, known as UCITIS. This document has been incorporated into *acquis*[8].

Serbia does not yet have an appropriate legal framework governing investment funds. With regard to the economic significance and potential thereof, a working group within the Ministry of Finance and Economy set up to deal with this issue earlier, has recently resumed its activities.

It is worthwhile mentioning that until May the Law on Investment Companies was being drafted at the Federal level, and it is expected that the text of this draft law will influence the draft law which is in preparation at the level of the Republic. Further development of the securities sector towards publicity and transparency of the entire system will depend on the dynamics of creation of investment funds.

IV Insurance

The sector of insurance is still rather underdeveloped. A lot of insurance companies deal mainly with the insurance of motor vehicles, while life insurance is largely neglected.

The existing legal framework is based on the enforcement of the Law on Insurance of Property and Persons[9], a federal law in force as of 1999.

Together with consulting teams, the Ministry of Finance and Economy has been drafting the Insurance Law, which is in its final stage today and could be

[6] See: article 2, paragraph 2 of the Law

[7] Some of the Policy Regulations / Instructions are as follows: Policy Regulation on Publishing a Notice on Possession of Voting Sares, Policy Regulation on the Content of the Request for the Issuance of a Working License to the Stock Exchange and of Stock Exchange Reports, Instruction on the Contents and Form of the Prospect for the Distribution of Securities, etc.

[8] SCEPP, AIA Report no. 5

[9] The Insurance Law, Official Journal of FRY, no. 30/96, 57/98, 21/99, 44/99, 53/99, 55/99).

adopted very shortly. The Draft law provides for the conditions and methods of rendering insurance services, regulates the supervision of insurance – i.e. insurance, reinsurance and coinsurance and activities directly related to insurance[10]. Legislator is determined to define clearly the application and basic elements of insurance law, such as insurance services (life – non-life insurance), mandatory and voluntary insurance and the establishment of insurance companies.

The Draft Law is harmonized with *acquis*[11], especially with regard to some basic principles governing insurance legislation in the European Union. This concerns the freedom of selling a full set of insurance products, harmonization of the rules of supervision conducted by national institutions, free work of intermediaries or adjustment of different data of insurance companies.

Environmental Protection

Environmental protection evolved into an important strategic, economic and legal, as well as a serious social issue in all transition countries. This area is typically neglected and insufficiently studied, or even misunderstood in the countries in transition, including Serbia. The dynamics of development affect many economic areas, e.g. the possibility of producing ecologically friendly export goods, competitiveness of domestic economic entities on the world market or safety of consumers[12].

Legal Framework

The Former Federal Republic of Yugoslavia had two resolutions relevant for legal regulation of this area: Resolution on Environmental Policy in FRY (Official Journal FRY, no 31/93) and Resolution of Biodiversity Protection Policy in FRY (Official Journal FRY, no. 22/94).

According to the Constitutional Charter of the State Union of Serbia and Montenegro (Official Journal SCG, no 1/03), Member Republics have legislative authority over environmental regulations. The Charter does not determine the legal basis for coordination between the two Republics on the environment or for their cooperation in the area of international agreements and relationships with international organizations. The Charter on Human and Minority Rights and Civic Freedoms (Official Journal SCG, no. 6/03), which followed the Constitutional Charter, has partially compensated for this lack by introducing the *right to a healthy environment* into the catalogue of human and minorities rights and freedoms. Article 46 of the Charter stipulates that everyone, and in particular the State Union, shall be responsible for environmental protection and improvement, and for the right of citizens to be updated and fully informed about its status, which is a novelty.

[10] Draft Law on Insurance is available at www.mfin.gov.yu
[11] Acquis is a collective term denominating EU regulations.
[12] Existing domestic documents by SCEPP, REC and the Ministry used in this paper.

Brief Analysis of Regulations

Legislative activity was set up in general terms, consisting of one basic law and accompanying sectoral laws The Law on the Grounds for Environmental Protection (Official Journal FRY, no. 24/98, 24/99, 44/99) is a basic law stipulating the principles of environmental protection. This Law regulates the following issues: protection measures in planning and construction, air protection, water protection, soil protection, forest protection, natural resources protection, protection from noise pollution, protection from ionizing radiation, protection from hazardous and waste substances, environmental financing and inspection monitoring. Here we should also mention the Law on the Water Regimen, the Law on Protection against Ionizing Radiation, the Law on Transport of Hazardous Substances, the Law on Production and Trade in Poisonous Substances, numerous policy regulations, decisions and ordinances.

Positive development refers to the fact that numerous international conventions, which regulate particular areas in detail, have been signed; e.g. the Law on the Ratification of the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal (Official Journal of FRY no. 2/99).

The Constitution of the Republic of Serbia (Official Gazette RS 1/90) is also relevant as its article 31 stipulates that environmental protection and corresponding measures are based on the right of citizens to a healthy environment and their duty to protect and improve the environment pursuant to the law. Article 72 of the Constitution further explains how different institutions shall ensure the functioning and protection of the environment.

The main environmental law in the Republic of Serbia is the Environmental Protection Law[13]. This Law regulates the system of protection and improvement of the environment, specifies protection measures, the protection procedure and protected natural wealth management, measures and procedures of protection against the harmful influence of activities on the environment, environmental protection financing and organization.

Special sectoral laws govern the management and protection of various segments of environmental protection, encompassing the Law on Waters, the Law on Forests, the Law on Arable Land, the Law on Hunting, the Law on the Fishery, etc. All these laws should be modernized and adjusted to international standards and *acquis communautaire*.

The Ministry for the Protection of Natural Resource and Environmental Protection, established in June 2002, is competent for environmental protection. The Strategy for further development of this area stipulates that this institution will be responsible for carrying out the activities of ecological integration of Serbia into Europe.

[13] Official Gazette RS, no 6/91, 83/92, 53/93, 67/93, 48/94, 53/95.

The Draft Law on the System of Environmental Protection of the Republic of Serbia, aimed at modernization in this area, is currently in parliament. This Law is harmonized with acquis and other international standards. Such an approach enjoys international support, especially by OSCE and the European Union, which to a great extent assisted in the preparation of this Draft Law.

Regulatory Function - the Agency for Environmental Protection

The Draft Law on the System of Environmental Protection foresees the establishment of the Environmental Protection Agency that shall ensure the protection of natural resources and the environment on the territory of the Republic of Serbia.

The Agency shall operate in accordance with the status of public services and will have legal personality. Its headquarters shall be in Belgrade, and local offices in towns which are seats of local self-governance authorities.

Recommendations

Environmental protection development policy was the subject of numerous talks between SCG and EU within the Consultative Task Force (CTF)[14]. In that respect, both parties adopted Joint Recommendations on Environmental Policy at the fifth meeting of CTF held on 9 -10 July 2002. The coordination of laws and policies, which has already begun, should be improved, while the fulfillment of international obligations undertaken by the State Union and Member Republics is in common interest, especially concerning the following:

- Prompt resolution of the further status of federal laws and bylaws, and of provisions governing environmental issues disseminated in numerous federal laws which are due to go out of force.
- The continuation of work and adoption of the framework law, subsequent adoption of necessary sectoral laws and by-laws, as well as harmonization with Montenegrin legislation ("internal harmonization"[15] between Republics).
- Necessary mechanisms for policy coordination at the level of the State Union.
- Strategic issues concerning waste disposal, quality of air and water. The Strategy and Draft Law on Waste Disposal, which is due to be adopted, stand for positive developments.

A number of institutions will continue to play a leading role in the sector of the environment, e.g. the Institute for Protection of Nature, the Hydro-Meteorological Institute, the Institutes of Public Health (Belgrade, Novi Sad) or the Recycling Agency.

Institutions which help in understanding the significance of environmental protection are of importance for the development of this vital area[16].

[14] For details on CTF see http://europa.eu.int/comm/external_relations/see/actions/index.htm
[15] This is evident in the case of the Federal Law on the Basis for Environmental Protection and two mentioned Resolutions, but it is still unclear what the situation is with regard to the laws on waters, radiation, transport of hazardous substances, etc.

It may be concluded that initial steps have been made and sound foundations have been laid for the development of institutions which shall monitor further development, although, unfortunately, only at the level of the Republic for now. According to official statements concerning the need for complete development of the environment, the data advanced so far present the beginning of development of a significant area in domestic legislation.

[16] Such as EAR, SCEPP, REC, OSCE, COWI and other programs with international support.

Economic Review

Milena Anđelić

BUSINESS ETHICS IN SERBIA AND MONTENEGRO

With regard to the fact that companies in modern conditions of doing business are facing numerous problems, both internal and those arising out of relations with external stakeholders, it is understandable why increasing intention is being paid to the influence of ethical corporate governance. Most people see business ethics as abstract preaching on the good and the bad. Such prejudice is generally accompanied with the "argument" that our economy has not reached that level of development yet. However, business ethics with its proactive approach acts as a kind of compass in turbulent settings, helping us solve different dilemmas and stay on the "course" of the established goals.

The importance of business ethics is revealed in times when changing political and economic circumstances distort the value system of a society. The erosion of moral, work and all other social values, coupled with ignorance and abuse of ethical principles, caused epidemic like spreading of immorality and criminality through all segments of society during the last decade. As the ethics of a society and business ethics are often closely related, we must ask ourselves where business ethics in SCG stand today and what legitimate business interests are in an environment where "the end justifies the means"[1], while individuals hold responsible positions without moral qualms.

The change of deeply rooted business practices, which inevitably derive from the mindset, customs, the legal and political tradition, is certainly a process that requires time. The beginning of changes must be marked with an open public dialogue between the Government and the business community, which should above all help the development of a healthy partnership and trust between these two conflicting sides. All participants should be encouraged to accept a new way of understanding business, with an aim of building a clear and comprehensive approach to understanding the main instruments, mechanisms and factors that are decisive for the successful and consequent implementation of ethics and ethical principles. Of great assistance might be familiarization with the experiences of other transition countries in the area of building the ethical infrastructure[2]. Such an initiative would permit a future strategy for the promotion of ethical values to be defined, as well as the sharing of responsibility among participants interested in implementing further actions. On the other hand, basic ethical guidelines would be created, providing foundations to individual enterprises in selecting and implementing ethical standards, in line with their own

[1] According to psychosocial evolution theory, our society is at the third level which is characterized by amorality, demonstration of personal power and giving and / or receiving of bribes, with this developmental level being dominated by egocentricity, while the dominant ethics are based on the attitude that "the end justifies the means".
[2] Slovenia, etc.

needs and possibilities. A code of ethics is not a set of rules that the management of a company puts on the wall in order to fascinate their clients. It must be subject to permanent discussion, not only among all the employees, but also among other stakeholders.

The minimal standards of business conduct are established by relevant laws. If they are based on ethical understanding of the problem and are applicable in practice, which can be significantly contributed to by reasoned suggestions of different business associations, their success will not fail. The link between politics and criminality in our country is one of the most damaging traditions. Money of suspicious origin is used for shaping the environment and creating "black holes" in the law, because of which individuals keep "doing businesses" freely and generate enormous wealth. In the eyes of the domestic and international public such partnerships, with the conflict of interest accompanying public officials, cause irreparable damage to the credibility of implemented reforms and to all the rules of good state governance.

A serious problem we face daily is corruption at all levels of society. To ordinary citizens, all solutions offered so far, and in particular actions taken in cooperation with insufficiently reformed law enforcement and the judiciary, look like a "smoke screen", bringing no essential change to reality. The understanding that bribes and corruption are an unpleasant, but the only efficient way of doing business is deeply rooted in this country. To eliminate this harmful stereotype it is necessary to educate the public seriously, and the main role and responsibility in that respect should rest with the media and NGOs. Governments, governed by economic interests, have to tackle this problem in order to increase the investment rate. This is particularly prominent in countries which have entered the process of transition. Corruption flourishes as a consequence of the collapse of these systems, frequently followed by an exceedingly rapid privatization process. With inefficient institutions, public procurement seems to have become a natural area for abuses. Given the damages corruption inflicts on society, both stakeholders and ordinary citizens are decreasingly tolerant of such corporate behavior. Such phenomena shift investments towards less profitable sectors and slow down development of the market, but also cause decrease in the standard of living of citizens. It should be stressed that the only thing more harmful than corruption is the toleration of corruption[3]. The first and most important step should be speedy adoption of the National Strategy for fighting corruption. Even if laws based on the highest standards are adopted, there is still the problem of their actual enforcement, which is above all associated with the lack of human resources with integrity and expertise for dealing with these issues. For the Anti-corruption Council to work intensively on tackling these negative phenomena, it must work independently of political leaderships and various stakeholders; otherwise it will continue to register poor results. Big companies also bear responsibility, for when entering underdeveloped markets, instead of bringing along good business practice from their mother countries, they often start

[3] On the list of the most corrupt countries made by Transparency International, Serbia and Montenegro rank 106 among 133 countries surveyed, together with Bolivia, Honduras, Sudan, Macedonia and Zimbabwe (www.transparency.org).

behaving according to the rule "When in Rome…". Because of this, respect for the code of ethics is a basis for healthy cooperation and competition, even when appropriate legal regulations do not exist.

One of the basic prerequisites for the successful functioning of the market economy is a stable financial market. Unfortunately, this sector has turned out to be the most convenient area for various frauds and abuses, especially in a country which still does not have strict regulations and protection of rights of small shareholders[4]. Fraud always involves the establishment and abuse of trust, which can only do harm to the existing mindset of "grab what you can" inherited from the past. Full respect for ethics and ethical principles, as well as other instruments which provide public access to and efficiency of information, together with a strong Securities Commission will set the only proper foundations for the financial sector.

Since it is known what factors must combine to produce unethical practice, this knowledge should be used to only one end, i.e. the creation of a strategic approach which will disable or at least confine undesirable behavior to the minimum. Strong, well designed regulations and their enforcement, followed by business ethics are a "win-win" situation both for citizens and for companies which do business according to ethical standards. It is necessary to draw attention of business people and society as a whole to the fact that the development of the ethical infrastructure is one of the basic prerequisites of successful reforms of the entire system, because only collective and comprehensive action can yield results. There will certainly be considerable resistance from certain structures which gained their power owing to the absence of a strict system of values and of the rule of law, but it is fundamental that ethics and good business practice not be ignored any longer. Unless key questions are raised, we are doomed to repeating mistakes from the past.

[4] A starting point in the creation of rules governing responsibility and protection of rights of shareholders and creditors might be the incorporation of the OECD principles of corporate governance into company practices.

Law Review

Branislav Pejčić

WITH THE TOBACCO LAW AGAINST SMUGGLING AND THE GRAY ECONOMY

The enactment of the Tobacco Law means the continuation of the process of adjustment and completion of the legal framework in line with accepted European and world standards, not only of one segment of production and marketing of tobacco and tobacco products as a specific kind of goods in terms of its fiscal significance for the state in particular, but also the organization of a system in the area of market and other economic relations of general interest in the Republic of Serbia. The Tobacco Law (Official Gazette of RS, no. 17/2003) which came into force on March 7, 2003, regulates, in a normative sense, manufacturers of cigarettes and other tobacco products, wholesale and retail traders of tobacco products, and producers and processors of tobacco. Importers, exporters and carriers of tobacco products are categories which should have been regulated at the Federal level in the course of 2002, when the Draft Law on Tobacco was being prepared. Since this was not done at that moment, and since after the enactment of the Constitutional Chapter legal regulation of this area fell under the jurisdiction of the Member Republics, the export, import and transport of tobacco products must be regulated as soon as possible through appropriate amendments to the Tobacco Law.

Modern Legislative Solutions

The Law was proposed and enacted with the aim of contributing to the development and progress of these industries which are of great importance for the economy of Serbia. Namely, the basic idea of the authors of the Tobacco Law was to define precisely the conditions and manner of producing tobacco and tobacco products, i.e. wholesale and retail trade in tobacco products that will ensure that these activities are performed in a legal way, in permanent and direct cooperation of competent authorities and mutual coordination of activates, as well as to pursue strict control in the enforcement of the Law and accompanying bylaws, i.e. permanent and quality inspection work.

Modern legislative solutions contained in this Law which are supposed to affect both further development and improvement of the tobacco and tobacco products market and the projected fiscal inflow into the budget of the Republic of Serbia resulted from numerous contacts with domestic cigarette producers,

traders and importers, as well as with representatives of Ministries other than the Ministry of Finance and Economy which proposed the Law. Because of the fiscal interest, and for the sake of cooperation of competent authorities and organizations in further suppression of illegal trade in tobacco products, the Law stipulated the establishment of the Tobacco Agency as a separate, inter-sectoral institution which is funded from the budget of the Republic of Serbia, without the right to its own income.

The Tobacco Agency

The Tobacco Agency which operates in accordance with the Law on Public Services as a public service of the Republic of Serbia, with legal identity and seat in Belgrade, shall act towards putting the entire production and marketing of tobacco and tobacco products on the domestic market into legal flows, which means the obligation of fulfilling all conditions and ways of performing this activity prescribed by law and accompanying regulations, the control over the production process and over legality of trade in cigarettes and other tobacco products, improvement of the quality of domestic production of tobacco products and protection of consumers in terms of health regulations and provision of conditions for fulfillment of obligations prescribed under the Law with regard to fiscal revenue. The Agency shall also monitor the developments on the tobacco products market, coordinate the activities of authorities and organizations in the area of combating illegal trading in tobacco products, and carry out all the other duties in accordance with the Law and the Statute of the Agency. The Agency, as a public service, however, is not entitled to pursue administrative supervision, and consequently inspection, with this being under the jurisdiction of the Republican Inspector (market, agricultural, and sanitary). The Agency is also not entitled to issue opinions with regard to the application of the provisions of the Tobacco Law, as this is under the jurisdiction of the Ministries and special organizations, which, according to the State Administration Law, issue the so-called interpretations as the acts of state administration authorities. Under this Law, state administration authorities can provide concrete interpretations, that is, only the Ministry of Finance and Economy is entitled to give opinions on the application of particular provisions of the Tobacco Law[1].

Benefits and Current Problems in the Enforcement of the Tobacco Law

However, several problems have emerged in the enforcement of the Law in practice, which should not have been allowed and which, unfortunately, does not relate to unsolvable situations and “traditional” difficulties, but to the lack of professionalism and of desire to help the numerous traders in tobacco products,

[1] Branislav Pejčić, “Commentary on the Tobacco Law and Bylaws”: Official Gazette of RS, 2003.

in particular retailers, but also other entities which are affected by the Law, because the Law shall be applied in its full scope, as was planned by the Proposer and as it was enacted in Parliament.

The Law was enacted in order to protect and improve the areas in question, in terms of, above other things, harmonization of specific legislative solutions with other regulations in force in the Republic of Serbia as well as with WTO rules, and finally, in order to enforce it appropriately in practice. The Ministry did not reply to many questions raised by wholesalers, retailers and importers of cigarettes and other tobacco products because of the absence of accompanying proposal which the Agency should have delivered to the Ministry. For this reason, the question arises whether it would be better to have adopted the solution proposed during the process of creation of the law, which saw the Agency not as a separate public service, but as an administrative organization within this Ministry or the Ministry of Trade, Tourism and Services. If a special department were formed within the Ministry, e.g. “the Tobacco Department”, such a department would be entitled to pursue supervision and to give opinions in the form of so-called interpretations.

On the other hand, a significant irregularity is that procedural discontinuity occurred in terms of the Law on General Administrative Procedure. Instead of issuing certificates in written form for 30,000 retail traders, the Agency sent the names (firms) of retailers to the “Official Gazette of the Republic of Serbia” to be published there. The names of retailers, hence, were published without any other data, since no fundamental decision was made and the certificates as individual legal acts were not issued. Therefore, retailers have not been informed of the contents, types and scope of acquired rights and obligations, the duration of the so-called temporary license and on legal remedies (appeal to the certificate or lawsuit to initiate administrative dispute). The terms before which the so called temporary licenses should have been valid have expired, while the issuance of final licenses which, according to the Tobacco Law, shall be granted for the period of one year to applicants who fulfil all prescribed requirements, is considerably delayed, since all 30,000 retailers should have received a final written permit by November 8, 2003.

Superficial understanding of the problems that emerged, unauthorized interpretation of legal regulations and degradation of the entire issue appears very often in practice in many areas in Serbia. However, this only confirms that the building of state and other institutions in Serbia is yet to begin and that in the forthcoming period, taking into account the announced adoption of the new Constitution and new organization of authorities and organizations, the position, scope of work and especially supervision over the work and acts of authorities, organizations, public and other services, conditions will be created for our country, with a view to joining the club of European countries which have quality laws and proper enforcement and supervision of the enforcement of laws, other regulations and general acts.

Protection and Promotion of Domestic Tobacco Production

The Law does not regulate special conditions for the manufacture of tobacco leaves, i.e. the tobacco which does not serve for final consumption. Providing a rather liberal approach to individual tobacco manufacturers, the Law contains only those provisions which regulate the obligation to grow specified breeds and classes of tobacco and to use tobacco seeds produced in line with special regulations governing seeds. The Law, however, postulates conditions for tobacco processors, and this is the part of the Law in which the so-called cross-sector character of the Tobacco Agency shall be visible. Namely, the Law specified general conditions for companies and entrepreneurs engaged in the purchase and processing of tobacco and marketing of processed tobacco, while the Minister in charge of agriculture and the Minister in charge of health issues regulated these conditions in detail, while the Agency shall confirm that these conditions are fulfilled.

A special chapter of the Law is dedicated to the manufacturers of final tobacco products and merchants. Companies and entrepreneurs who wish to operate in the production of cigarettes and other tobacco products are obliged to participate at a public tender organized and conducted by the Agency. In order to be granted a license for cigarette manufacturing, the candidate must fulfil conditions prescribed under the Law (appropriate equipment, production capacities, qualified personnel, etc.), the most important of which is the obligation to produce or purchase tobacco processed in the Republic of Serbia amounting to at least 50% of their annual output of cigarettes and other tobacco products on the territory of our country, which shall not be less than 2,000 t a year. In situations when more than 14,000 t of cigarettes are produced in Serbia at an annual level, this provision shall contribute to the protection and promotion of domestic production and processing of tobacco. In order to allow further development of this industry in terms of participation in the production of tobacco products by those manufacturers who are able or will be able to compete with quality brands, the Law provides for the possibility that a company or entrepreneur can take part in a tender even if he does not fulfil prescribed conditions at the moment of the announcement of the public invitation to tender, providing that he submits a project which indicates that these conditions will be fulfilled, with proof of sufficient funding for its realization. In this case also the Minister in charge of agriculture and the Minister in charge of health issues prescribe detailed conditions, the Agency shall confirm the fulfilment of conditions, and the Government makes decisions on the licence issuance.

Legal Trade in Cigarettes

By prescribing conditions for performing the activity of wholesale trading in tobacco products, by granting licenses to companies and entrepreneurs who

meet all the requirements, by running the register of wholesalers and the obligation of placing a special deposit in the amount of CSD 30 million, conditions will be created for the development of a legal market of cigarettes and other tobacco products and combating the grey economy in this area. The Law provides for the possibility for licence application to a company and entrepreneur who submit detailed projects foreseeing the prescribed requirements, as well as proof of availability of funds for project realization. This means that the amount of funds should include the amount of the fee for the license which is granted for the period of five years and which is set at CSD 5 million, payable in five annual instalments, the amount of deposit (CSD 30 million) and mandatory conditions concerning infrastructure which allows storage of at least 30t of cigarettes and appropriate vehicles. Even after fulfilling prescribed requirements, the company, i.e. entrepreneur will not be granted a license for the wholesale of tobacco products if the person authorized to represent the company, i.e. entrepreneur was fined or sentenced to prison for the criminal offence of illicit trade in cigarettes and other tobacco products on the territory of the Republic of Serbia during the period of three years before the date of application for the license. The mentioned legal requirements shall be worked out in detail by the Minister in charge of trade, including the Minister in charge of health issues; the Agency examines whether the requirements are fulfilled, and the Government makes the decision on issuing the license, whereby the Government makes decisions concerning the licenses to importers registered in the Registry of Tobacco and Tobacco Products Importers under equal conditions.

A company or an entrepreneur who applies at the Agency for the licence for retail trade in tobacco products must fulfil requirements prescribed by the Law, that is, to have a preliminary supply contract for tobacco products with wholesalers, to have a facility which meets sanitary and hygienic, health and other conditions, in accordance with the Law governing sanitary supervision, to possess a facility which meets conditions established by regulations governing public utilities, and not to have unfulfilled obligations on the basis of public revenue. Even when prescribed requirements are fulfilled, the company, i.e. entrepreneur will not be granted a license for retail trading in tobacco products if the person authorized to represent the company, i.e. the entrepreneur was fined or sentenced to prison for the criminal offence of illicit trade in cigarettes and other tobacco products on the territory of the Republic of Serbia during the period of three years before the date of application for license. Apart from these, the retailer shall pay a fee in the amount of CSD 3,000 per facility per one year. The retailer who has been granted a license shall put a special sign issued by the Agency at a visible place in the retail facility in which tobacco products are sold. This applies to hotels, restaurants and other catering facilities, as well.

Increased Supervision and Fines for Offences

For the sake of determined enforcement of the Tobacco Law, attainment of goals and implementation of legalization of production and marketing of

tobacco products as a whole, the Law stipulates three-level inspectoral supervision over the enforcement of this Law, as well as appropriate petty-offence regulations.

The Inspector for Agriculture of the Republic pursues control over the production of breeds and classes of tobacco; the use of tobacco seed for the production of nurseries; control over the process of production of tobacco nurseries, raw leaf tobacco; assessment of the quality and quantity of raw leaf tobacco and production of processed tobacco; the quantities of raw leaf tobacco by breads and classes of tobacco purchased from tobacco producers; the quantities of processed tobacco by breeds and classes; control and specification of conditions of tobacco processing; conditions for the manufacture of tobacco products and control over the records and reporting in accordance with the Law and control over the use of domestically processed tobacco in the manufacture of cigarettes. The Inspector for Agriculture of the Republic is entitled and obliged to ban the production of a breed of tobacco if it is not on the list of tobacco breeds; to ban the production or order destruction of a crop if it is made with seeds which are not produced according to regulations governing seeds; to ban the processing of tobacco or tobacco products if the prescribed conditions are not fulfilled or if there is no certificates issued by the Ministry in charge of agriculture on the fulfilment of these conditions; to confiscate tobacco and cut tobacco which is produced or put on sale contrary to the provisions of the Law; to destroy nurseries of tobacco and planted tobacco from seedlings which is produced or put on sale contrary to the provisions of the Law, and to order keeping and submission of records and reports in a prescribed way.

The Sanitary Inspector of the Republic has the right and duty to pursue health supervision over the facilities in which tobacco and tobacco products are manufactured and stored, and over plants, tools and equipment used in the manufacture of tobacco and tobacco products; persons employed in the manufacture and marketing who come in touch with tobacco and tobacco products; health requirement for tobacco and tobacco products, transport vehicles and packaging used for putting tobacco and tobacco products on sale. In pursuing supervision, the Sanitary Inspector of the Republic is entitled to undertake all measures prescribed by law governing the health requirements for consumer products and objects of general use and the law governing sanitary supervision.

The Market Inspector of the Republic has the right and duty to examine: tobacco products in order to ascertain that conditions are fulfilled with regard to labelling of establishments in which tobacco and tobacco products are put on sale; accounting books, license for wholesale of tobacco products, permit for retail trade in tobacco products, special labels, records and other documentation on business activity of the company, i.e. entrepreneur, related to trade in tobacco products; to take written or oral statements from persons in charge in the company in question, i.e. entrepreneur, as well as from other persons concerning facts of relevance for doing business of trade in tobacco products. In pursuing supervision, the Market Inspector of the Republic is entitled to undertake all the

measures prescribed by the law governing conditions for commodity trade, rendering of services in trade in tobacco products and inspectoral supervision.

As far as petty offences are concerned, especially important are those relating to unregistered performance of activity, as well as the offence relating to retail trade in tobacco products. Thus for the offence from article 4, item 1, of the Law (ban against sale to minors), if the sale was performed by the company, both the authorized person in the legal entity and the entrepreneur will be punished, as well as the salesman as a physical person (in both cases). The sharpest fines are prescribed for offences relating to the production of tobacco products and offences in wholesale trade in the amount of CSD 200-400,000.

Bearing in mind the comprehensiveness of solutions established by the Tobacco Law, it is realistic to expect projected benefits that should be made possible through this Law, not only in terms of the fiscal role and financial discipline in collecting taxes and other duties relating to this excise product, but also that the entire area, as a very important industry in Serbia, will be legally regulated. Obedience and proper enforcement of the Law is one of the obligations Serbia must fulfil continually and carefully on its path to the European Union.

EU News

Tanja Miščević, Ph.D.

EUROPEAN UNION ON THE VERGE OF YEAR 2004

Year 2004 will certainly bring a lot of novelties to the European Union. This does not refer only to the largest enlargement of its membership thus far with ten new Member States (Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Cyprus and Malta) which are due to become full members as of May 1, 2003. Also, this does not refer only to the new elections for the European Parliament, which are going to be organized simultaneously in all 25 Member States for the first time, nor to the election of the new Commission.

This concerns the much broader processes embodied in the expression *the dialogue on the future of Europe*. This dialogue also encompasses preparations for the adoption of the first constitutional act of the Union, definition of elements of institutional reforms, as well as the determination of EU's place in international economic and political relations and relations with Western Balkan countries.

Considerations on the Future of Europe

As far as the determination of the future of the Union is concerned, the significance of dialogue is stressed with two large gatherings which are taking place almost simultaneously in the Union. First of all, there is the Convention on the Future of Europe whose aim is to prepare the draft of the first Constitution or Constitutional law for the EU; at present, the third draft of this document is under debate. It should cover all the achievements not only of what is known as community legacy of the EU (*acquis communautaire*), but also other elements of the successful project of the European integration and further possibilities for their spreading - the areas and policy of cooperation (these issues are often denominated as *acquis politicue*). Unlike this gathering which is expected to find the answer for the Europe of the future, the Inter-Governmental Conference which started in Rome on 4 October, must provide the answer to a much more vital question, i.e. the functioning of the enlarged Europe, with the need for further integration. As a matter of fact, this Conference of Member States (old and new) should resolve some controversial issues relating to the distribution of votes in the Council, the number of members of the Commission and the need for new weighing of votes. Of course, the Convention and the Inter-Governmental Conference are closely linked as they have a joint objective, i.e. further improvement of European integration.

For this very reason, all activities of the Union's institutions are focused on providing assistance in finding solutions for these key issues. An example of the

contribution to the general climate of consideration of the future of the integration was given by the states which are due to take presidency over the Union in next three years - Ireland, the Netherlands, Luxemburg, the United Kingdom, Austria and Finland. Namely, these six future presidencies, in cooperation with the European Commission, prepared in November the first Multi-Annual Strategic Program for 2004 – 2006. This program aims at enhancing the work of the Council by setting the precise schedule for the implementation of jointly agreed priorities. It also defines individual objectives which should be attained for the sake of economic competition, full employment, social issues, the improvement of environmental protection and internal and external security. The Strategic Program of the Council has three major parts: the first one refers to the constitutional, geographic and financial profile of the Union; the second one defines the priorities of political modernization and development in major areas of home affairs; the third part defines the directions of the Union's engagement at a global level.

Besides political issues and guidelines for various policies, the European Council paid thorough attention to economic issues. Presidential conclusions at the Summit of the European Council held in Brussels on 16 and 17 October 2003, among other tings, addressed the issue of relaunching the European economy. After the period of uncertainty in the European economy and the recession, some positive signs are emerging today, which are mainly due to improvements in the international economic environment, but also to industrial trends in the Union itself. This new economic progress in the European Union results in a low inflation rate, stabilization in oil prices and better conditions on the financial market; similar trends are expected to continue in 2004 as well. Since the situation in some segments of European society is still fragile, it would be necessary for the European Council, as the highest political institution of the Union, to send the message of confidence in the economic potentials of the EU.

The European Council identified the following as key priorities in this area: the maintenance of sound macroeconomic policies, acceleration of structural reforms and promotion of investments in infrastructure and human capital, in order for economic policies to continue to be targeted toward sustainable growth and enhancement of economic and social cohesion as the main objective. As a matter of fact, the direct purpose of this EU Summit was to focus attention on the question how to boost growth and to organize work with a view to taking concrete decisions at the next Summit (scheduled for 12 and 13 December 2003). Also, this Summit sought to emphasize the need for continued action across a broad front in order to create the backdrop of an economic and social environment favorable for sustainable growth. The Council assessed that the entire process of support for economic progress of the European Union must be closely coordinated within the context of the Lisbon Strategy, a strategy promoted in 2002 with an aim of reducing unemployment in the Union.

European Union in International Relations

The strengthening of the single European market and the implementation of common foreign trade as the most successful segment of the functioning of EU economy is also reflected in the Union's relations with its partners within the World Trade Organization. This cooperation is sometimes very successful, but the EU often appears as the party in dispute before the WTO's Dispute Settlement Body. This is the situation with relations between the Union and the USA – namely, the Union very often introduces additional restrictions to the import of goods from the USA, in agreement with WTO, because of lack of adjustment to WTO rules. Thus, the Council of Ministers of Foreign Affairs at the session of EU General Affairs held on December 8, 2003, adopted a resolution on the establishment of additional customs duties on the imports of specific goods from the USA, as a consequence of the WTO ruling regarding the resolution of the issue of adjustment of the US Act on Foreign Trade Corporations. This resolution allows countermeasures to be imposed, applying a gradual approach, both in terms of time and the level of obligations with respect to commodity imports from the USA.

Being successful in international economic relations, the Union is trying to find its place in international political relations, as well. Thus, the question of intensification of the UN presence in Iraq, i.e. involvement of other states in the peace keeping mission in Iraq put in the foreground very interesting relations between the UN as a world organization and the EU as a regional organization, especially since the issue of peace and security is not an original area of the EU's interests established as such in the Founding Treaties, but an area marked by the process of cooperation of Member States. The relations between the Union and the UN started in 1991, when the UN gave the three communities the status of observers in the work of the General Assembly, thus ensuring their permanent presence in the work of the organization. EU Member States are at the same time members of the UN (two of them are permanent members of the Security Council – France and the UK) and act in this organization as a uniform voting block. For this very reason, in the opinion of the Union, the dynamic role of the Union in the work of the UN must be developed further in a constructive way so as to contribute to multilateralism. To be able to contribute to this developed multilateral system in attaining its basic goals, the EU set as its own goal the strengthening of cooperation with the UN in those areas in which such activity of the Union would be a significant contribution to the UN's work. This primarily concerns areas such as human rights, economic and social issues, sustainable growth, with the Union also showing interest for giving its contribution to all mutually connected aspects of the overall approach to peace, security and development: prevention of conflicts, management of crises, establishment and maintenance of peace. The EU believes that better cooperation of the UN and the EU can also be established in the area of disarmament, non-proliferation of armaments and the fight against terrorism, while the instruments of this

cooperation could be joint initiatives and projects and assistance to third countries in fulfilling their obligations toward multilateral instruments and regimes.

Fight against Illegal Immigration

One of the important issues of the future of the integration which has recently become a part of community policy is the issue of illegal immigration. One of the novelties which certainly mean further communitization of the area of immigration is the decision of the Ministerial Council adopted at the end of November 2003 on establishing mechanisms for monitoring and assessment in the fight against illegal immigration. In the center of this need lies the significance of ensuring cooperation of states in common management of migrations and control of borders, for which purpose the Union provides countries with technical and financial assistance. At the same time, the implementation of systematic assessment of relations with third countries which did not show readiness to cooperate in the fight against illegal immigration proved to be necessary. This assessment is one of the criteria for establishing closer contracting cooperation between third countries and the EU. Broad attention was given to this issue during the Summit of the European Council in Thessalonica (May 2003), as well, defining the dialogue and activities with third countries in the area of immigration as a segment of the general approach, while these activities shall be adjusted to specific situations in different regions and in different third countries.

The mechanism that is being created by the Ministerial Council is aimed at monitoring migration developments in third countries, their administrative and institutional capacities to solve the problems of asylum and migrations, as well as the activities undertaken with regard to illegal immigrations. This mechanism, therefore, should prepare all relevant information for systematic assessment and evaluation of cooperation with these countries, as well as the reasons that may compromise efficient cooperation. According to the conclusions of the Thessalonica Summit, the Commission shall prepare annual reports on the results of monitoring and assessment, and give recommendations on that basis. In order to be able to prepare reports, the Commission, in cooperation with Member States, will first prepare the list of indicators that are based on priority questions defined in Thessalonica. This is not a general list to be applied to all third countries, with the idea of an individual approach having been accepted instead. However, some issues appear as general indicators, such as:

- The existence of national legislation aimed at prevention of and fight against illegal immigration, and its successful enforcement;
- Participation of third states in international instruments regulating asylum and migration, such as the Geneva Convention relating to the Status of Refugees and Protocols thereto, the New York Convention relating to the Status of Stateless Persons, the Palermo Convention against Transnational Organized Crime and Protocols thereto, i.e. the Protocol to Prevent, Suppress and Punish Trafficking in Persons, especially Women and Children and the Protocol against the Smuggling of Migrants by Land, Sea and Air;

- Efforts in migration management, border control and interception of illegal immigrants, taking into account migration pressure on the country in question – special attention should be paid to the efforts made by countries in fighting smuggling and trafficking in human beings;
- Cooperation on repatriation and readmission of the citizens of a country in question and the citizens of third countries, with special attention being paid to the readmission of a country's citizens without formalities and with all necessary documents, as well as the conclusion of an agreement on readmission with the EC, its members and third countries;
- Cooperation in visa policy, with special attention being paid to the specification of the list of countries which are required visas for entering the EU and possible adjustment of the system of visa and procedures of these countries for visa issuance and possible forms of consular cooperation with other countries of the same geographical area and with EU Member States;
- The system of asylum: besides the participation in relevant international instruments, it is necessary to create national legislation which will provide efficient protection required by international law, and the appropriate administrative structures for the processing of asylum applications, including the appropriate training of persons engaged in data processing.

This activity of monitoring is carried out in partnership with third countries on the basis of agreed activities and objectives for each state individually. Also, the Union expects assistance from all its Member States and acceding countries in order to complete the assessment of the situation; the network of the International Labor Organization is also used for the collection of all elements which fall under its competence. The implementation of these mechanisms will be applied on all relevant third countries, with the pilot stage at the beginning, which means that in the first year they will be applied to a certain number of third countries in line with the priorities which shall be subsequently determined by the Council in cooperation with the Commission until the end of 2004 at the latest.

Relations with Western Balkan Countries

An important question with regard to the future of the Union is the question of relations with the countries of the Western Balkans. According to the Enhanced European Integration Partnership, the concept promoted in Thessalonica which foresees more intensive cooperation between the Union and the countries of the Stabilization and Association Process, the EU has foreseen some new instruments for assisting these countries. One such instrument is periodical organization of the Political Forum where the principles and directions of the European future of the Western Balkans will be discussed. The first meeting of this Forum in the form of the meeting of the Ministers of Foreign Affairs of the EU Member States, candidate countries and countries of the Western Balkan region (Albania, Macedonia, Croatia, Bosnia and Herzegovina, Serbia and Montenegro), was held on December 9, 2003, in Brussels. The specific position of these countries was reflected also in the fact that this meeting

was attended by EU High Commissioner for Foreign Affairs, the member of the European Commission responsible for external relations, UN Special Representative in Kosovo, Special Representative in Bosnia and Herzegovina, Special Coordinator of the Stability Pact, Special Representative of the EU in FYR Macedonia, i.e. key actors for many aspects of relations of the Union and certain countries of the region.

The meeting confirmed that the Stabilization and Association Process is the framework for integration of the Western Balkan countries into the European Union. The success of each of these countries on their path toward the EU depends on their individual results in fulfilling the Copenhagen criteria and conditions defined under the Stabilization and Association Process. Special emphasis was put on the fact that the Process requires full implementation of relevant international obligations undertaken by the Western Balkan countries – the UN Resolution1244, the Dayton Peace Agreement, the Ohrid and the Belgrade Agreements, and full cooperation with the ICTY in the Hague (in particular with regard to access to witnesses and to documents).

The Ministers of Foreign Affairs gave their assessment of the situation in each country in the region in the SAP, i.e. progress in negotiations between the EU and Albania for the conclusion of SAA, positive assessment by the Commission of the ability of Bosnia and Herzegovina to start these negotiations, the process of ratification of the agreement for Croatia and Macedonia, as well as the examination of Croatia's candidateship for membership in the Union and preparation of the feasibility study for Serbia and Montenegro. Positive assessment was made with regard to the progress in enhancement of the process which followed after the Thessalonica Summit, which is reflected in the proposal to the Council to make a Resolution on European Partnership, an extension of the twinning program and incorporation of Western Balkan countries in the programs and agencies of the Community.

An important conclusion of this meeting of the Political Forum is the consent of Western Balkan countries on considerably enhancing efforts in their own reform processes, in order to accelerate integration with the EU. Amid these efforts stand the priorities defined in annual reports of the Commission on the SAP and Council's conclusions, as well as the obligations undertaken in Thessalonica. This concerns the reform of public administration, the judiciary and the fight against organized crime and corruption as key segments of integration with Europe. Another significant element of these countries' efforts is the undertaking of concrete steps in regional integration, as was the case at the meeting of Trade Ministers held in Rome on November 13, 2003, the signing of the Memorandum on Understanding on the regional energy market and the announcement of the conclusion of the Memorandum on development of the regional transportation network of Southeast Europe. Considerable assistance in establishing this cooperation is also signified by the "…expressions of reconciliation which were expressed at the highest possible levels, which promote trust and the spirit of cooperation among the countries in the region".

In the discussion on the development of the regional political scene at this meeting support for the "standards-before-status" policy on Kosovo was

expressed, which means, among other things, the continuation of direct dialogue between Belgrade and Pristina. A significant role in the implementation of this policy, according to the conclusions of this meeting, is the announcement of the UN Special Representative to define concrete guidelines and to operationalize this policy by setting the schedule for efficient implementation of key elements and the creation of a durable mechanism for the assessment of progress; the first assessment could be expected in mid 2005 or earlier, if considerable progress is made.

These are just a few open issues within the dialogue on the future of the European Union. The new summit of the European Council and final papers at the Inter-Governmental Conference, namely, gatherings that will be held in December, will provide answers to many of them. However, that would also be an opportunity to raise many new issues on the future of European Integration.

Milko Štimac
Jelena Badža

Economic Review

STOCK EXCHANGE AND STOCK EXCHANGE OPERATIONS

1. Stock Exchanges – Existing Legal Solutions

1.1 The Belgrade Stock Exchange

Since it was reestablished in 1989, the Belgrade Stock Exchange has been facing a systemic problem, i.e. the conflict of status (the founder) and of function (the mediator). Unlike the usual way in which a stock exchange is founded, i.e. through the association of brokers, legislation in our country has not allowed brokers to set up the stock exchange. The major founders of the Belgrade Stock Exchange are banks. Until the political changes in 2000, half of its board of directors consisted of the representatives of the largest banking group in the country, which used to cover 60% of the financial market. Here we had a paradoxical combination of a stock exchange and a monopoly.

After the changes, the situation changed in the way that it was replaced by another paradox. Instead of being placed under indirect state control, the stock exchange was directly controlled by the Government, as four Ministers were sitting in its board of directors, one of whom sat in the capacity of president. With the disappearance of Yugoslavia, the number of ministerial seats in the Board of directors was reduced from four to three. The presence of three brokers in this body did not bring fundamental change in the work and business policy of the Belgrade Stock Exchange.

Thus, the Belgrade Stock Exchange, during the better part of its reestablished existence, was reduced to an administrative institution, i.e. the Government's agency. All attempts to change something in this relation have encountered numerous difficulties, which arise from the fact that the existing non-market settings do not support the stock exchange as an institution of the market. This, unfortunately, applies to the Government elected in December 2000, as well. Recent legislative activities clearly imply that the only intention of the Government is concentration of control over financial and monetary flows in the country, instead of encouraging development of the financial market, its institutions, actors and instruments. This especially refers to considerably reduced independence in the work of the Securities Commission, which succeeds reduced independence of the central bank. Persistent refusal to reform the stock exchange also confirms such an impression.

According to the existing rules of trading which are prescribed by the Belgrade Stock Exchange and approved by the Securities and Financial Markets Commission, what we have today is not trading in shares, but trading in companies. It is common that small shareholders sell their shares to the

management or other investors who seek to take over the controlling block of shares of the company. The price of a company's shares is mainly unchangeable, except for cases where there is an investor who seeks to take over the controlling block of shares, and the price of shares of such companies is permanently rising, while in those companies in which the controlling block of shares is already in someone's possession, the price of shares is most often dropping.

Although the Belgrade Stock Exchange changed the Statute on trading in privatization shares in the last two years, the practice that only big investors manage to buy shares of successful companies because large orders are always executed first has not changed, which leaves small shareholders modest opportunity to buy shares. Small shareholders should bring about full development of financial markets, but since the law on investment funds and companies for managing investment funds, so-called management companies, is not on the horizon, the largest portion of the citizens of Serbia will miss the best potential investments.

After acquiring the controlling block of shares of some 40%, investors usually stop buying shares and the price consequently drops by as much as 20% in the following auctions, as there is no obligation on the part of an investor, as is the case on developed markets, that after having acquired 25% of shares, to offer the same price of shares to all other shareholders.

1.2 The Commodity Exchange Novi Sad

Activities producing damaging consequences are even more visible at the Novi Sad Commodity Exchange. This Exchange managed to reform its activity in the last two years, to organize trading in commodities, which is its traditional activity, and to introduce some novelties. Here we should mention elementary futures contracts on soybean.

The obstacle in the development of the Commodity Exchange is the fact that it is under full state ownership. The two-year attempts by the management to talk the Government into selling its share to interested brokers and banks failed to produce results. The competent authority for the Novi Sad Commodity Exchange at the moment is the Direction for Managing Property of the Republic of Serbia.

The issue of the founding of the commodity exchange is very important, since about 50% of our GDP depends on agriculture. Our Commission could set up a special department which would deal with commodity trading on organized markets.

Although the Serbian economy is based on agriculture, there are still no futures and options on agricultural products. These contracts would allow agricultural producers and buyers to be protected from the risk of fluctuation in prices caused by climatic disasters.

1.3 New regulations

New regulations should sort out such a situation and put the stock exchange on sound foundations. The Stock Exchange is composed of an entire network of relations between the stock exchange, stock brokers and the market, and it is necessary for this reason that stock brokers have ensured and undisturbed access to the pursuance of business policy on the stock exchange. During a transitional period, the existing founders can be allowed the possibility to transfer, i.e. sell shares to stock brokers. Only through their network and in direct cooperation with it might the relation between the stock exchange and the market, in which the stock exchange should be one of the basic focal points, be established. This is the only way for resolving the existing situation, in which the stock exchange has technical conditions for organizing trading in securities, where those who are supposed to do the trading do it unwillingly.

Current activities of the Government, however, are not encouraging. Discussions about the new Law which is due to come into force this autumn clearly indicate that the Government will not give up tight control and influence on the organized financial market. Again, this will be carried out by means of two levers:

- Preservation of ownership over stock exchanges;
- Reduction of the independence of the Securities Commission, i.e. transformation of this Commission into a clerical institution by taking away its independent bank account and by mandatory Government approval of decisions made by this Commission.

1.4 Privatization

Special impetus to the degradation of financial markets is the consequence of the institutional organization of privatization under the 2001 Law, according to which the Ministry of Privatization is competent both for the control of the process/the market, and for trading in shares. Moreover, shares deriving from previous privatizations (the Law from 1997) also fall within the competence of the Ministry of Privatization. Thus, a single entity incorporates the capacity of both key trader and regulator. Such a situation does not allow for any serious development of the market, since serious investors are discouraged to appear in such settings. On the other hand, this leaves plenty of room for tycoonization, which will certainly not result in the development of shareholding and of the financial market.

Another risk may lie in the announced establishment of the so called electronic market (so called OTC) of shares for the Share Fund's portfolio, especially in conditions of weak institutions and insufficient regulation of market processes and the protection of private ownership (shareholders). It seems that the market itself will be formed as an institution of the Ministry which will thus become the organizer of trading, besides already being the key player and regulator. Such combination of functions cannot be stimulating for the

development of the financial market, but quite the opposite – it will only boost negative trends. Our privatization model, which initially started from something which should have been based on the experiences of the successful Polish model, will end up like the Czech model, which proved to be a failure. The main negative result of the Czech model seems to have been already adopted, i.e. asset stripping. Such an OTC will only increase its technical capacity.

Owing to the former Law, it is estimated that Serbia has as many as one million small shareholders. In protecting their own interests, both from tycoons and from the state, they are certainly not in a favorable position. Wherever they managed to articulate their interests, they successfully formed shareholders' associations, frequently making use of trade unions in their companies.

In the Czech Republic, the privatization process was abused by middlemen, while the Polish model was assessed as the best model in terms of long-term development of the financial market. The question is how we can at all compare Poland at the beginning of the 1990s and Serbia today, when we know that all companies in Poland then were in state ownership, while there are 800 companies in Serbia today which are majority owned by private shareholders. To insist on trading in shares on the Stock Exchange, without previously having enacted all necessary legislation, will lead us into the situation of the Czech Republic, but presented from a Polish perspective.

10% of the citizens of Serbia at this moment possess shares of some companies, which resembles the voucher privatization in the Czech Republic. However, without new legislation on securities, investment funds, accounting standards and companies, the realization of the Polish scenario will not be possible, since the Czech scenario has already settled in some companies.

Without the enactment of the aforementioned legislation, small shareholders are selling their property, i.e. their shares, often at a very low price, since price increases are controlled by the Statute of the Belgrade Stock exchange.

The best proof for all the above mentioned is the fact that the Share Fund managed to sell its block of shares in many companies at prices nearly ten times higher than the price at which small shareholders sold their blocks of shares, because when someone acquires 40% of the shares of a company, other investors automatically lose their interest in buying, and according to the law of supply and demand, in the absence of demand, prices go down.

The persistent avoidance of adopting the law which would regulate the establishment of investment funds and the work of associations which manage these funds encourages the existing situation. Small investors do not have channels through which they can act, since small transactions are not profitable for brokerage houses.

1.5 Brokers

The network of brokers should to a certain extent adapt to an appropriately organized financial market. The way it is today, the network completely conforms to the existing situation on the financial market. One half of

some one hundred brokerage houses is not active, a large part of those who are active work with only a few companies, acting as internal brokers, while only fifteen companies are trying to fully develop their activities.

In the last three years privatization caused the intensification of brokerage activities, in particular in collecting and placing on the Stock Exchange shares derived from the two previous privatizations. There are two directly favorable effects of privatization in this area of the financial market:

- Increase in the volume and value of trading on the Belgrade Stock Exchange, which contributed to awareness raising of the existence and significance of the stock exchange and shareholding.
- Increase in the number of brokerage houses in general, and especially of Belgrade Stock Exchange members, with extension of their line of business and differentiation thereupon.

During 2000, the Belgrade Stock Exchange had 33 members, in 2001, 52, and in 2002, 69. In September 2003, this figure reached 79 members. At the same time, undesirable activities developed as well, owing to insufficiently precise regulations, e.g. carpetbagging[1]. The process of accelerated concentration is underway, and all brokers want to gain profits from it. It is necessary to introduce some order into brokerage activities, since capital and professional thresholds constitute good principles. The association of brokers must insist on respect for ethical thresholds by all the actors. The fact that one brokerage house is permitted to represent the seller and the buyer at the same time presents a substantial conflict of interest and potential abuse of insider information. Some brokerage houses advise small shareholders at what price to sell their shares, which is the price that suits the buyer, i.e. the investor whose interests the brokerage house represents in the same transaction.

In the entire process, the Stock Exchange checks whether the buyer possesses money necessary for the realization of the transaction, which is not considered that important in developed markets, since this is something the broker should do. The Stock Exchange should be in charge of ensuring efficient functioning of the market and of controlling conscientious behavior and competitiveness of brokerage houses.

The need for adjustment of the network of brokers in order to increase the quality of services on the financial market concerns, first of all, the differentiation between closing a deal and executing it, i.e. creation of two levels of mediation between the stock exchange and the market, which increases the security of operations on the financial market. The responsibility for the security of operations would be transferred to brokers themselves, i.e. the association, which should be organized upon the principle of association of brokers – physical persons, along similar lines as the bar association or the college of physicians. Self-regulation in this area proved to be the most efficient means for maintaining

[1] The practice of visiting shareholders and persuading them to sell their shares. Information on shareholders is most frequently obtained from the company's management, which keeps and runs books of shareholders (sic!). Thus, brokers collaborate with administrations by carrying out perverted MBO, because in this way they limit one of the basic shareholders' rights, i.e. the right to free disposition.

basic professional standards. Business association of brokerage houses as it exists today is not necessary. The business association of brokerage houses should be the stock exchange.

2. Trading

2.1 Commercial Notes

The short-term liability of a company in the form of commercial notes has been the basic object of trading on the Belgrade Stock Exchange for a decade. Since the beginning of reforms, the volume and value of trading in this security has been decreasing. However, their stubborn survival on the market results from rigid requirements for obtaining bank loans, which make commercial notes the substitute for credits.

This market segment spontaneously emerged in reaction to the restrictiveness of the banking system in providing financing for the economy and the insecurity which created hyperinflation. Until 2000 companies were independent in selecting the issuer for the issuance of commercial notes. Issuers bore high risk as companies were not repaying their debts duly and for this reason acceptance orders and bills were introduced as a new protection measure. In cases of delayed payment, the issuer would block the account of the company and all income would be directed toward the coverage of the debt. However, if we bear in mind that some companies had very low income, if any at all, buyers were unprotected. In order to repay their debts, companies would borrow from other companies at higher interest rates, and debts thus accumulated.

Maturity dates which are rarely longer than one month do not make room for the development of secondary trading in these financial instruments. Because of the great risk, interest rates range between 1.8% and 3.2% at a monthly level.

Brokerage houses made huge profits from trading in commercial notes at the end of 2000 and the beginning of 2001, because interest rates on commercial notes were 5% (up to as much as 7.5%), as compared to 2% interest rate on bank deposits at the time, which implies that the approval of loans was very risky, and the management of some companies deliberately avoided borrowing from banks because of the possibility of making personal profits. At the end of year 2000 the monetary sphere stabilized and banks started landing to the economy; the entry of foreign banks in 2000 introduced new competition between banks, while profit-oriented companies saw this way of borrowing as more favorable compared to commercial notes.

Commercial notes and bonds of companies are today traded on the primary market only.

In summer 2003, the sixth convocation of the Commission for Securities and Financial Markets limited the issuance of commercial notes, by linking licenses and the value of issues to the business performance of the issuer. Thus, the common practice of the abuse of notes for deliberate excessive indebtedness of companies and consequent asset stripping was prevented.

2.2 Shares

Before October 2000, trading in shares did not even exist on the Belgrade Stock Exchange in the real sense of the word. Banks were obliged to publicly trade with every new issue of shares, and the Belgrade Stock Exchange was only used as a place for technically carrying out the capital increase of banks by selling shares to already known buyers.

Privatization brought about a significant change with the insistence that all shares which emerged out of privatization must be traded on the stock exchange. In autumn 2003, the Stock Exchange did not yet become a market of shares, but remained a market of companies. Auctions of shares on the Stock Exchange were discontinued, the market was not liquid, while no company has been permanently listed yet. This is so, among other things, because of the fact that the best companies in Serbia (ca. 1,000) underwent privatization in December 2000 under the 1997 Privatization Law, which put them in the hands of insiders, which most frequently resulted in strong influence of management on other shareholders (employees in that company). At the same time, since this concerns important companies, they are usually the target of tycoons, strategic partners and the Government, which, in agreement with the management, wants to take over a company through capital increase. The management itself, seeking the support of the Government, is often trying to take over the company by manipulating the rights of other shareholders[2]. Both these two phenomena prompted the fifth and sixth convocation of the Securities Commission to react. As far as MBO is concerned, it was not very successful, i.e. it almost completely failed, being limited only to public opinion awareness raising of this problem. With regard to capital increases, the effects remain to be seen.

Current market capitalization of 240 companies whose shares were at least once traded on the Belgrade Stock Exchange is EUR 915.8 million, which is 10% of Serbia's GDP (810.3 billion). To put it simply, through the continued process of privatization and economic growth, this figure is likely to increase and even to exceed the level registered in Slovenia. However, in view of the fact that only serious companies remain on the Stock Exchange for good, that on our Stock Exchange we have trading in companies and not trading in shares, and that only 13 companies constitute one half of the mentioned EUR 915.8 billion, we expect that after the end of privatization and consolidation of ownership, this figure will remain at the same level as in Croatia. It is very interesting that banks are not included in the listing of the Stock Exchange in our country, while on local stock exchanges in CEE countries, banks dominate, being characterized by the highest liquidity of all listed companies.

[2] One can frequently hear of pressures imposed on workers to sign authorizations transferring their right to management, followed by watering down of capital which turns away investors and, finally, carpetbagging (see footnote 1).

Market capitalization, EUR 000m	
Apatinska pivara a.d.	120.220
Hemofarm concern a.d.	89.999
Imlek a.d.	74.885
Fabrika cementa a.d.	70.402
IBP Beograd a.d.	48.227
Sintelon a.d.	44.571
Beoturs a.d.	25.049
Tehnogas a.d.	24.173
Henkel Merima a.d.	20.648
Palic THU a.d.	18.269
Energoprojekt holding a.d.	15.341
Bambi a.d.	11.904
Potisje Kanjiza a.d.	10.900

At the Belgrade Stock Exchange there is no liquid market of shares of any company. Shares are traded at periodical auctions which are scheduled in advance, with a usual period of 30 days between two actions. The shares of 240 companies[3] are traded on the Belgrade Stock Exchange, while the Temporary Depositary contains some 1,200 companies. Many companies are postponing their decision to appear on the Stock Exchange, and many good companies are still not there, although they deserve this in terms of their performance. Many managing directors have failed to recognize the moment for the companies they run to appear on the stock exchange. They hope that their companies will be bought by the buyer of their choice, or by themselves or in association with workers, but do not have sufficient funds at their disposal for that transaction. In many companies there is conflict of interest between management and shareholders, which is one of the reasons for the backpedaling of the privatization process. The new Law on Securities should prevent the rule that only managing directors are entitled to sign the prospectus, which puts them in a position of preventing the company from appearing on the stock exchange. The company will be considered listed by the very act of becoming registered in the Temporary Depository. Hence, managing directors will not have to sign the prospectus for the company to appear on the stock exchange, which will considerably speed up the process of privatization and the development of the domestic financial market.

[3] Companies in which trading was carried out.

2.3 Foreign Currency Savings Bonds

Trading in old foreign currency savings[4] bonds started at the end of November 2001. The Republic of Serbia issued bonds for settling obligations on the basis of old foreign currency savings of citizens in the amount of EUR 4,200,000,000. The issue was divided into series from 2002 to 2016, with May 31 as the maturity date for each year (except 2002, when the maturity date fell on August 26). The nominal value of each bond is EUR 1. From September until the end of 2002, on the Belgrade Stock Exchange, old foreign currency savings bonds in the amount of CSD 1,720,908,815 were sold through 17,439 transactions, whereby no greater difficulties were encountered because the Belgrade Stock Exchange and the Central Depository carried out timely preparations for trading in these financial instruments.

Old foreign currency savings bonds are securities of the highest quality on the market, and there were no irregularities with regard to trading in them. This confirms the significance of a comprehensive institutional approach to the development of the market. From the very beginnings, the prerequisite for trading in these bonds was the placing of a *bona fide* deposit at the Central Securities Depositary with the then National Bank of Yugoslavia[5]. Registration of changes in ownership is completely computerized, and, as a process, separated from the process of trading. For this reason, manipulations with property rights are almost impossible.

Increase in the value and volume of trading in these securities is contributed to by a well organized special market on the Belgrade Stock Exchange, as well. In summer 2003, the Stock Exchange, after the discontinuation of individual auctions, provided all technical conditions for continuous trading in old foreign currency savings bonds. Moreover, distance trading in these securities is expected to start in the autumn.

3. Recommendations

Serbia is at the moment lacking the following:

3.1 Reformed Stock Exchange

For the stock exchange to work properly, it is necessary to strengthen its relation with the market, i.e. to allow brokers to be its founders, and consequently, to have dominant representation in its board of directors. The stock exchange is a typical example of an institution which performs a public function on the basis of private interest, and this is the only bases on which this

[4] This concerns savings frozen in Yugoslav and Serbian banks in 1991, which were not paid out for years; in 1997 limited payments started, which are projected to be completed by 2016. By the existing stand-by arrangement with the IMF, the amount that may be paid out on the basis of foreign currency savings is limited to 0.9% of the Serbian domestic product. In the meantime, citizens may trade in their bonds on the Belgrade Stock Exchange.

[5] Central Depository is transformed into Beokliring, see further in the text.

function can be performed. This should be permitted by the new Law. At the same time, it is necessary to confine the state's participation on the stock exchange to two roles: the role of an observer in the board of directors and as trader on the pitch (of course, through specialized agencies and funds, from the Share Fund to the Commodity Reserves). The mechanisms of stock exchange operations thus established would help in distinguishing competent management from management which was made competent by circumstances.

3.2 Stronger Securities Commission

A kind of curiosity is the fact that the Commission in its fifth and sixth convocation, i.e. in the most fluid environment since it was established, did more work than in all the previous convocations together. This concerns, in particular, full membership in the IOSCO, all the more so because the IOSCO is rapidly becoming a counterpart to other international financial organizations, i.e. a global (securities) market regulator. As for internal affairs, of great importance is the adoption of binding documents of the Commission concerning capital increases, issuance of short-terms securities and acquisition of majority ownership in corporations (takeover). All of these speak in favor of independence of the Commission that has been built and that must be preserved.

3.3 Establishment of the Central Securities Depository

In spite of the great importance of the Temporary Securities Depository as part of the Ministry for Privatization and the Belgrade Stock Exchange Clearing and Settlement Department, private ownership cannot be fully protected without an independent central securities depositary. All advantages of such an institution are already visible in old foreign currency savings bonds trading. Its work in the form of Beokliring shall be expanded to other securities, beginning in autumn.

3.4 Investment Funds

The concentration of capital is necessary as the second stage of privatization; but, again, only if it is based on the process within institutions which allow the logic and interest of capital itself to be revealed as much as possible. Concentration which results from lowering the price of "workers'" shares for the sake of perverted management buyout will not result in capital being placed in the hands of those most competent for managing it. On the other hand, widely dispersed capital in the ownership of workers causes problems for management, which in our countries sometime goes as far as to suggest the concept of workers' self-management. The solution lies in the establishment of widely operating investment funds. Thus we would have an institution whose main *raison-d'etre* is management of capital and, consequently, protection of shareholders' interests. Finally, small shareholders through their concentration in funds, give greater specific weight to their small shares. However, the problem is

that we still do not have a law on funds, and therefore, there are no legal grounds for their operations. Therefore, it would be good if Parliament were to adopt one of the existing draft laws governing this issue.

Investment funds do not exist in Serbia because of the restrictive environment, while individuals stash their cash in “mattresses”, and the majority of savings in banks is not invested. Non-activation of that money reflects the lack of possibilities for trading on the stock exchange. As long as there are no liquid securities on the market, one of the essential functions of these institutions cannot be realized i.e. diversification of investments.

There are several reasons for which it is not possible at the moment to have long-term securities denominated in domestic currency. Firstly, actors on the financial market assess the currency risk as very high, and therefore neither banks nor other actors would invest directly in long-term instruments. Secondly, the premium on liquidity which would be required by investors for long-term securities would be so high that it would not be profitable for an issuer to accept such a discount in emission. Finally, private pension funds and insurance companies as actors which generally need such an instrument do not yet exist in Serbia.

Nevertheless, the turnover of this financial instrument constitutes nearly 14% of the total value of the turnover on the Belgrade Stock Exchange.

3.5 Investing in Foreign Countries

The existing Foreign Exchange Law prohibits the outflow of capital to foreign countries, and the citizens of Serbia cannot buy securities of foreign issuers. The freedom of choice of individuals and companies is restricted, and issuers are protected in a monopolistic manner. Banks are allowed to keep their assets in foreign countries only in accounts of foreign affiliated banks. This practically means that domestic investors are not in a position of acquiring low risk assets such as the highest quality shares and securities of corporations and state bonds. Our country seeks to attract foreign multinational companies to invest in our companies, promising them high profits. However, our citizens will not be allowed to buy shares of these multinational companies and to receive due dividends.

The Foreign Exchange Law allows the denomination of securities in foreign currency, as well as trading in these securities in foreign currency. This creates a better environment for the development of long-term debt securities.