Ex Post Evaluation of Macro-Financial Assistance to Serbia and Montenegro

Final Report

Client: European Commission, Directorate General for Economic and Financial Affairs

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Abbreviations

BoP	Balance of Payments
BRA	Bank Rehabilitation Agency
CAS	Country Assistance Strategy (World Bank)
CEE	Central and Eastern Europe
CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
DG ECFIN	Directorate General for Economic and Financial Affairs
DPL	Development Policy Loan
EA	Extended Arrangement
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
EU	European Union
FDI	Foreign Direct Investment
FRY	Federal Republic of Yugoslavia
FSSA	Financial System Stability Assessment
GDP	Gross Domestic Product
G&S	Goods and Services
IBRD	International Bank for Reconstruction and Development (World Bank, non-concessional)
ICR	Implementation Completion Report (World Bank)
ICTY	International Criminal Tribunal for the Former Yugoslavia
IDA	International Development Association (World Bank, concessional)
IFI	International Financial Institution
IFS	International Finance Statistics (IMF)
IMF	International Monetary Fund
IPFMA	Integrated Public Finance Management Assessment
LFS	Labour Force Survey
MFA	Macro Financial Assistance (EC)
MNE	Montenegro
MoF	Ministry of Finance
MoU	Memorandum of Understanding (EC)
NBS	National Bank of Serbia
NBY	National Bank of Yugoslavia
NPV	Net Present Value
PA	Privatisation Agency
PFSAC	Private and Financial Sector Structural Adjustment Credit

PRA	Public Revenue Agency
RATEL	Telecommunication Regulatory Agency
RPI	Retail Price Index
RSD	Serbian Dinar
SAA	Stabilisation and Association Agreement (EU)
SAC	Structural Adjustment Credit (WB)
SAL	Structural Adjustment Loan (WB)
SAP	Stabilisation and Association Process
SBA	Stand-By Arrangement (IMF)
SDR	Special Drawing Rights
SFRY	Socialist Federal Republic of Yugoslavia
SME	Small and Medium Enterprises
SMoU	Supplementary Memorandum of Understanding (EC)
SNA	System of National Accounts
SORS	Statistical Office of the Republic of Serbia
SR	Serbia
TA	Technical Assistance
TTC	Travel and Tourism Council
TSS	Transitional Support Strategy
VAT	Value Added Tax
WB	World Bank

Preface

This final report has been prepared by a team from a consortium led by ECORYS Netherlands in association with CASE - Centre for Social and Economic Research (Poland) and Economisti Associati (Italy). The European Commission (EC) contracted the ECORYS consortium to conduct an ex post evaluation of EC Macro Financial Assistance (MFA) provided to Serbia and Montenegro in the period November 2002 to February 2006.

This report includes the results of work undertaken in particular during a mission to the International Financial Institutions (IFIs) in Washington DC, two field missions to Belgrade, and one field mission to Podgorica - conducted in September, October, November and December 2007, respectively. The draft version of the report was discussed during a stakeholders' workshop organised in January 2008 in Belgrade.

We would like to express our special gratitude to all officials in Belgrade and Podgorica and other resource persons in both countries; to staff members of the International Monetary Fund (IMF) and World Bank in Washington and Belgrade; EC officials in Brussels and Belgrade for their cooperation and willingness to contribute to this evaluation by providing us with a good understanding of the facts and events at the time of the MFA operation. We would also like to thank the Steering Committee for its constructive comments and advice throughout the entire period of this evaluation.

Responsibility for the opinions presented in this final report rests exclusively with the authors and should not be attributed to the Governments of Serbia and Montenegro, to the European Commission or to the other IFIs.

Executive Summary

Evaluation objectives and approach

1. This report represents the final report of the ex post evaluation of Macro-Financial Assistance (MFA) to Serbia and Montenegro provided in the period November 2002 to February 2006. The main objectives of this ex post evaluation of MFA were to: (i) assess the effects of the MFA operation, and (ii) learn key lessons that can be applied to future MFA interventions. The evaluation focused on three core areas of effects: (i) macroeconomic stabilisation; (ii) sustainability of the external financial situation; and (iii) structural reforms. This evaluation employed seven main evaluation instruments. The conclusions of this evaluation are based on triangulation of the findings from these different instruments.

Background of the Macro-Financial Assistance

2. The political situation in Serbia and Montenegro has been volatile and fragile. Serbia and Montenegro became the last country/countries to enter into economic transition. Both had to cope simultaneously with the economic consequences of dismantling of the former socialist federation, the collapse of the command economy, as well as with the bad economic situation due to the wars and years of sanctions. International financial institutions and bilateral donors were prepared to support the country, including the EU. On 16 July 2001, the European Council approved macro-financial assistance of up to € 300 million in favour of the Federal Republic of Yugoslavia (FRY). This assistance was provided in the context of a stand-by arrangement with the International Monetary Fund (IMF) covering the period until the end of March 2002. In early November 2002, the Council decided to provide Serbia and Montenegro with further macro-financial assistance of up to € 130 million: comprising a € 75 million grant and a € 55 million loan. It was considered that financial assistance in general would be instrumental in bringing the FRY closer to the Community. It referred to the residual financing gap that remained to be covered after financing from the IMF and the World Bank "*to support the policy objectives attached to the authorities' reform efforts.*" In particular, the Council decision explicitly stated that "*Community macro-financial assistance to the FRY is an appropriate measure to help ease the country's external financial constraints, supporting the balance of payments and strengthening the reserve position*." It also indicated that "*financial assistance from the Community in the form of a combination of a long-term loan and a straight grant is an appropriate measure to support the sustainability of the FRY's external financial position, given its limited borrowing*

capacity." The MFA was closely linked to the three-year IMF Extended Arrangement approved in May 2002.

3. Conditions attached to this second MFA related to measures in the areas of (i) public finance reform and administration, (ii) banking sector reform and (iii) private sector development. It also contained measures that supported harmonisation of economic systems within Serbia and Montenegro, especially with regard to the introduction of common tariffs, value added tax (VAT) and company registries.

4. When the Serbian Prime Minister was assassinated in March 2003, MFA disbursements were front-loaded; and the total amount was increased by € 70 million. The European Union (EU) wanted to back Serbia during this difficult juncture following the assassination.

Impact on macroeconomic stabilisation

5. The main macroeconomic objectives of Serbia and Montenegro, supported by the international community, included the achievement of low inflation with sustainable growth and external viability. In principle, these objectives have been achieved, though some doubts exist on the sustainability in the medium and long term.

Gross impact - Serbia

6. Since 2000, Serbia has achieved sound economic growth; with rates in the range of 4% to 8% (except for 2003) raising the gross domestic product (GDP) in 2007 by over 50% in comparison to 1999. Economic growth has been largely underpinned by domestic demand; and in recent years by consumption of the non-governmental sectors. Economic growth has mainly come from services, in particular transport, the retail trade and financial intermediation.

7. Curbing inflation has been an enormous challenge for the Serbian authorities. In 2001, the inflation rate stood at 99.2%; decreasing to 20.3% in 2002; and to 17% and 12% in 2005 and 2006, respectively. Only in 2007 did it come down to a single digit. This was achieved under the new inflation targeting approach (introduced in 2006) along with strengthening of the dinar, and a mix of negative supply-side shocks. Previous regimes, i.e. monetary targeting and managed float, proved less efficient in controlling inflation.

8. The Current account deficit has worsened gradually since 2000, as imports expanded in line with growing demand. In 2002, the Current account deficit stood at -7.9% of GDP and rose to high levels in 2004 (-11.7%) and 2006 (-11.5%). In the first 11 months of 2007, the deficit was -15.2% of GDP. Against these figures, the importance of the second MFA was non-negligible: total grants and loans disbursed amounted to 2.3%, 5.6%, 0.4% and 2.1% of the Current account deficit in 2002, 2003, 2004 and 2005, respectively.

9. The balances of the capital and financial account have exceeded the Current account deficit since 2000; resulting in a positive net inflow of capital and accumulation of

reserves. Foreign direct investments (FDI) started rising in 2003. Following the further liberalisation of the capital account portfolio, investments have started to register considerable amounts in 2007.

10. Foreign exchange reserves have been on a steady increasing path since 2000; with a particularly marked acceleration in 2006. Total reserves went up from US$3.1 billion at the end of 2002 to US$12.6 billion at the end of 2006.

11. Serbia was also successful in balancing central government revenues and expenditures; switching from a deficit into a surplus in 2005. Tax revenue reforms and improved tax administration led to an increase in revenues; while at the same time also leading to a mitigation of the tax burden on the economy. Recurrent expenditure dominated the expenditure side. Capital expenditure remained low, having only a share in total expenditure of 7% in the period 2002-2006. While MFA disbursement funds have eased current budgetary problems in Serbia, any strong link between the MFA funds and the budget outcome is, however, hard to discern.

Gross impact - Montenegro

12. In 2002, economic growth in Montenegro was only 1.7% of GDP. Since 2003, economic growth accelerated to reach an impressive 8.3% in 2006; and 7.1% in the first three quarters of 2007. Inflation declined considerably from 6.8% in 2003 to 3.0% in 2006. The expansion of Montenegro's economy was mostly in the trade, transport, construction and property sectors. Single-digit inflation was not achieved until 2003.

13. Since 2003, Montenegro's Current account deficit widened considerably from 7 to 10% of GDP in the 2003-2005 period; up to 26% in 2006 and up to as much as -50% in the first half of 2007. This worsening occurred due to rapidly-growing imports triggered by a property and consumption boom along with sluggish export growth. FDI was very low in the 2001-2004 period, but increased afterwards due to one-off transactions related to the sale of state-owned companies; and more recently to the massive inflow of funds for construction investment. FDI financed around 40% of the Current account deficit in 2003-2004; jumping to 250% in 2005, but falling to about 90% in 2006.

14. Montenegro's gross international reserves remained modest in the early part of the decade, and stood at € 60 million (equivalent to US$ 74 million) at the end of 2004. Reserves almost tripled in 2005, reflecting inflows from privatisations; and increased to € 310 million by the end of 2006. They grew by an additional € 114 million in the first half of 2007.

15. As in neighbouring Serbia, public finances improved over the years. Buoyant economic activity and successful tax reforms contributed to marked improvements in the budget balance. The overall budget balance excluding grants rose from -2 to -3% of GDP during 2001-2005 to 1.8% in 2006 and to a remarkable 8.7% in the first three quarters of 2007.

16. While grants covered most of the budget deficit in the first half of the decade; the importance of the MFA was non-negligible in 2003 (when it amounted to roughly half of total grants) and in 2005 (when it accounted for 100% of grants disbursed to Montenegro). On the other hand, high privatisation revenues covered the deficit five-fold, so that the MFA grant did not appear as an indispensable budgetary revenue source.

Net impact- Serbia

17. Estimates of the net impact of MFA to Serbia are calculated by comparing the actual developments with the counterfactual outcomes. In the counterfactual scenario, the IMF would not have increased the assistance in the three-year Extended Arrangement programme. The World Bank would also not have increased its lending programme. Without the perspective of MFA, the quantitative performance criteria in its Stand-By-Agreement would have been set at a more austere level, so as to enable the country to restore macroeconomic stability. The counterfactual therefore represents the situation in which no other official funds would be available to make up for the non-available MFA resources.

18. Lack of MFA assistance would have led to more fiscal austerity and a harder constraint of the balance of payments. Fiscal adjustment would be concentrated on the expenditure side of the budget, as institutional capacities to generate additional revenues would have already been used. On the balance of payment side, the lack of MFA resources would be partly reflected in a lower increase in gross reserves and partly in exchange rate weakening.

19. In the counterfactual scenario, the Current account deficit would be slightly reduced, notwithstanding the direct impact of the absence of the MFA grant. In addition, external debt accumulation would be slightly lower. Expenditure would be reduced by the size of grant element to initially maintain the original deficit, and in addition by the size of loan element; so as to avoid the necessity to find additional deficit financing. As a result, the budget deficit would actually be lower in the counterfactual. The counterfactual would also imply a more restrictive monetary policy; with lower reserve accumulation, lower growth in the monetary base, and less credit to the private sector. This general contraction of macroeconomic policies would slow down economic growth. Impacts on both growth and inflation would remain rather limited - which is consistent with the small overall size of the operation.

20. Therefore, the MFA operation allowed for a slightly more expansionary macroeconomic policy that marginally improved economic growth performance. However, the direct short-term macroeconomic impact of the operation was very small. Potentially, MFA assistance could provide more substantial impact on the medium-term macroeconomic outlook through acceleration of structural reforms.

Impact on structural reforms

21. Most conditionalities were considered relevant to both Serbia and Montenegro. With respect to conditionalities linked to establishing a joint internal market in the Federation, less national ownership existed.

22. The assessment of gross impact distinguishes between ‘formal progress’ and ‘structural progress’. A conditionality has achieved *formal progress* if it has been fulfilled in accordance with the literal formulation of that conditionality. A conditionality has achieved *structural progress* if the reform has become structurally embedded in the Serbian institutional context.

Serbia

23. With respect to Serbia ‘formal progress’ has been fully achieved for most of the conditionalities (11 out of 15). In the areas of insurance privatisation, enterprises privatisation and competition policy, formal progress is assessed as ‘partially’ or ‘sufficiently met’. When the European Council adopted the twin-track approach in October 2004, the conditionalities on tax revenue policy, customs harmonisation, competition policy and business registration became (partly) irrelevant. Waivers were granted for conditionalities on bank and enterprise privatisation.

24. ‘Structural progress’ in the areas of privatisation of state-owned enterprises and competition policy was limited. Although privatisation of socially-owned enterprises is due to be finalised at the end of 2008; privatisation of state-owned enterprises is lagging behind. The regulatory framework and institutions strengthening competition have been introduced, but in practice some sectors are still dominated by oligopolies that are hampering competition.

25. All MFA conditionalities in the areas of public finance reform and administration and financial sector reform were covered by IMF and World Bank programmes. Most conditionalities in the area of private sector development that cannot be traced back to the programmes of the international financial institutions (IFI) became irrelevant after adoption of the twin-track approach. The only conditionality that remained valid was part of the Stability and Accession Process (SAP) requirements.

26. Without MFA, most reforms related to the conditionalities would have been implemented. Most structural reform conditionalities were in fact integrated in other IFIs' programmes. Consequently, had MFA not existed, most structural reform conditionalities would have been implemented since they were part of the programmes of other IFIs'. Some reforms would have become an integrated part of the government agenda at any rate. Since many (especially national) interviewees were not familiar with most MFA conditionalities, only a few conditionalities had ‘political reinforcing effects’ (bank privatisation, privatisation of enterprises, treasury system, tax revenue collection and strengthening of the National Bank).

Montenegro

27. Most conditionalities were met in a formal sense. The conditionalities on bankruptcy law and competition policy were partly met. Concerning structural progress,

conditionalities on bankruptcy law, privatisation of state-owned enterprises and competition policy were only incorporated in the Montenegrin institutional context to a limited extent.

28. Due to the synergies between MFA conditionalities and conditionalities attached to IMF and World Bank programmes, in the counterfactual situation, all reforms would have been implemented. The political reinforcing effect of the EU conditionality was considered to be helpful. The added-value of MFA was that it speeded up the implementation of reforms regarding the treasury system, tax revenue collection, strengthening of the National Bank, bank privatisation and privatisation of enterprises.

29. The Ministry of Finance also underlined that the MFA was regarded by the Montenegrin Government as a *credibility-granting* instrument, rather than an instrument to support the balance-of-payments or the budget. Montenegro was eager to display its responsibility and credibility to the international community and the EU in particular; and break with the negative image associated with Yugoslavia. Therefore, meeting the conditionalities was taken seriously as part of the country's international image building. MFA conditionalities were also used by the Government to justify to the public the necessity of some important, difficult and unpopular decisions.

Impact on external sustainability

Gross impact - Serbia

30. The Current account deficit in Serbia worsened gradually since 2000, but this was partly compensated for by increased foreign direct investments in recent years. The Current account deficit reflects fundamental imbalances in the economy; and is the main source of vulnerability in the economy.

31. The combination of (i) a large Current account deficit, (ii) substantial private sector external borrowings, (iii) official IMF and World Bank programme borrowings, (iv) early repayments and (v) Paris and London debt write-offs resulted in a slight decline of total external debt; which declined from 71.4% of GDP in 2003 to around 60% of GDP at present. The structure of the debt changed substantially. The share of public sector debt in total debt shrank from 81% to 59% between 2001 and 2006. Low domestic savings and a high domestic interest rate led to increases in external private sector borrowing reflected in the doubled share of commercial debt.

Gross impact -Montenegro

32. The level of the public external debt of Montenegro was quite stable. It declined from 69.4% of GDP in 2002 to 35.6% in 2003 and has remained stable. Almost 40% of this debt was debt owed to the World Bank, and about one quarter was owed to Paris Club creditors. Private debt has been growing, although from a very low level.

Risk factors

33. A major risk factor constitutes the high current account deficit which has made the country vulnerable to risks. Another risk factor includes the structural weaknesses, which cause the imbalance between investment needs and domestic savings to persist. Without further progress in privatisation, bankruptcy and restructuring, it would be difficult to expect a positive contribution of the corporate sector to the external position today through savings; and tomorrow through gains from increased productive investments into net export-generating activities. A third risk factor is the vulnerability to exchange rate movements. The high level of borrowing remains a serious concern as it creates important foreign currency mismatches. Another risk factor that is closely related to structural reform perspectives is the growth in output and exports. Expected strong growth underpins the external sustainability assessment, but this would change substantially if growth were to slow down permanently to below 5%. Progress in economic integration with the EU is the important factor contributing significantly to any economic projections; and a delay in integration can create contagious consequences, as markets seem to under-price these risks.

34. Further improvement in the external situation would crucially depend on structural reforms, which would lead to a healthier corporate sector and stronger supply responses to increase domestic and external demand; ultimately resulting in sustainable economic growth.

Net impact on external sustainability

35. Based on the macroeconomics, the structural reform and the gross external sustainability impact assessments; the evaluation identified channels through which MFA has influenced the medium to long-term external sustainability. The macroeconomic counterfactual showed that the direct impact of MFA on economic growth in Serbia has been marginally positive in the short term. This was mainly due to the relatively small size of the operation. The impact of MFA on sustainability would be substantial if MFA had accelerated structural reforms in the 2002-2005 period - as these reforms provided the basis for higher GDP growth rates in the medium term. The most important potential impact of MFA on external sustainability could be due to the pressure on accelerated privatisation of banks and enterprises, as well as their restructuring.

36. Overall we conclude that MFA have positively contributed to the medium to long-term external sustainability prospects, albeit that this net impact was likely limited and indirect. The primary channel through which MFA acted in this respect appears to be the enforcement of structural reforms and the improved overall macroeconomic management.

Implications for design and implementation

37. This MFA operation had multiple objectives which were specified in the Council decision. These multiple objectives related to the balance of payments and the international reserve position of the country/countries. The EC had also another -not explicitly formulated- more institution-related objective with this instrument: namely,

relation-building. National authorities in Serbia appeared to have attached value to the explicit reform support objective. In Montenegro, officials emphasised the budget support and the image-building elements.

38. In this MFA operation, the interlinking between the explicit short-term objectives and the objective to support reforms of the government(s) was strong. A number of conditionalities related clearly to ensuring the sustainability of the macroeconomy through relevant structural reforms. This evaluation confirms that the primary channel through which MFA acted was the 'enforcement' of structural reforms. Given the relatively limited size of the operation, this medium-term objective was the most central one.

39. The MFA operation in Serbia and Montenegro has showed 'flexibility' in various respects. It relates to the relatively speedy reaction of the EC after the assassination of the Prime Minister and to the use of a waiver concerning a condition in the area of privatisation.

40. Most conditionalities were similar to the conditions in the IMF Extended Arrangement and in World Bank programmes. This coherence was perceived to be useful. In total, there were 54 MFA conditions. Since most conditionalities were similar to the IFI requirements, national authorities had no specific problems with this large number.

41. The overall size of the disbursements was relatively small. This emphasised again the importance of the structural reform objective.

42. Many officials of other institutions were aware of the conditions, but related them to IMF or World Bank programmes. No press releases of the EC were made in the country to improve the visibility of the MFA instrument.

43. Based on the evaluation findings and conclusions, this final report contains a number of recommendations for the future use of the MFA instrument, based on this specific MFA evaluation of MFA to Serbia and Montenegro. These recommendations refer to the multiplicity of objectives and the selection of conditionalities.

1 Introduction

This is the final report of the ex post evaluation of Macro-Financial Assistance (MFA) provided to Serbia and Montenegro in the period November 2002 to February 2006.

The objective of the final report is to present the evaluation's findings and the conclusions of the evaluation. Additionally, it provides recommendations as input for a meta-evaluation of the MFA instrument. This final report follows closely the evaluation questions, which accord with the *Guidelines for the ex post evaluation of MFA operations* of the Directorate General for Economic and Financial Affairs (DG ECFIN).

The report is structured as follows. Chapter 2 outlines the evaluation objectives, evaluation approach and methods that were used in the ex-post evaluation. Chapter 3 presents a historical overview of relevant MFA events and describes the background of the MFA operation. The succeeding chapters then look at the main evaluation areas: impact on macroeconomic stabilisation, impact on structural reforms and impact on external sustainability. Chapter 4 analyses macroeconomic developments in Serbia and Montenegro. It also discusses the results of a macroeconomic model to understand and determine the effects of the counterfactual scenario, enabling assessment of the net effects of MFA. Chapter 5 discusses the gross and net impact of MFA on structural reforms. Chapter 6 sets out two case studies that provide further analysis of the cause-and-effect relations of structural conditions in the area of bank privatisation and enterprise privatisation. Chapter 7 presents a forward-looking analysis of the gross impact on external and fiscal sustainability. It also draws all the analysis together and puts the findings in a medium to long term perspective by assessing the *net* impact on external sustainability. Chapter 8 considers the implications of the design and implementation of the operation on its efficiency and effectiveness. It contains recommendations for potential future MFA operations in order to increase the instrument's efficiency and effectiveness.

In the Appendix we have documented a detailed description of the macroeconomic model, a description of the Delphi questionnaire, references, and a list of the interviews conducted.

2 Evaluation objectives and approach

2.1 Purpose of the evaluation

Under its Financial Regulation (Article 27.4), the European Commission (EC) is legally obliged to evaluate "all programmes and activities which entail significant spending".[1] This also applies to macro-financial assistance (MFA). Moreover, the Memorandum of Understanding (MoU) between the European Commission and the Federal Republic of Yugoslavia stipulated that an independent ex post evaluation of the assistance may be carried out.[2]

The main objectives of this ex post evaluation of MFA were to: (i) assess the effects of the MFA operation in Serbia and Montenegro from November 2002 to February 2006; and (ii) learn key lessons that can be applied to future MFA interventions, and/or identify the possible need for a reorientation of the present approach. The evaluation was therefore both backward-looking and forward-looking. Any lessons will contribute to the anticipated meta-evaluation of MFA.[3]

2.2 Evaluation approach and methods

The ex post evaluation was based on five broad evaluation questions. Table 2.1 presents these questions, as stated in the terms of reference. They comply with the DG ECFIN *Guidelines for the ex post evaluation of MFA operations*.[4]

Table 2.1 Generic evaluation questions from the Guidelines

No.	Evaluation Question
Q1	To what extent has the MFA been effective in terms of the short-term macroeconomic stabilisation of the country concerned?
Q2	To what extent has the MFA been effective in terms of supporting structural reform?
Q3	What have been the indirect and/or unexpected effects of the MFA?
Q4	To what extent has the MFA contributed to returning the external financial situation of the country

1 Article 27.4 of Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities, OJEC L248 of 16/09/2002.

2 Literally: "An independent ex-post evaluation of the assistance may be carried out by the Commission or duly authorised representatives. The authorities of the Country are committed to supply all necessary information. The evaluation report will be made available to them for comments", Memorandum of Understanding Between The European Community and The Federal Republic of Yugoslavia, p.3, 2002.

3 The lessons will be added to those based on the ex post evaluations of MFA to Romania, the Former Yugoslav Republic of Macedonia, Bosnia & Herzegovina and Tajikistan.

4 European Commission, Directorate General Economic and Financial Affairs, Guidelines for the Ex Post Evaluation of MFA Operation, May 2005.

No.	Evaluation Question
Q5	concerned to a sustainable path over the medium to longer-term? How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?

The evaluation questions broadly focus on three core areas of effects:

1. Macroeconomic stabilisation;
2. Structural reforms;
3. Sustainability of the external financial situation.

These areas focused on the short, medium and long-term effects of the MFA operation, respectively, over specific time horizons. Macroeconomic effects were assessed up to two years after the initial disbursement; structural effects on the economy and institutions up to four years after the initial disbursement; and sustainability of the external financial situation up to three years or more after the initial disbursement

Table 2.2 shows the three core areas of the evaluation, corresponding to Chapters 4-7 of this report. It indicates how they can be traced back to the evaluation component and the sub-evaluation questions from the *Guidelines*.

Table 2.2 Core areas of evaluation, time horizons, evaluation approach and evaluation components

Core areas	Time horizon	Evaluation approach	Evaluation components	Evaluation Questions from Guidelines
Chapter 4: Macroeconomic stabilisation	Short-term - up to 2 years after disbursement	Quantitative analysis, macroeconomic model, structured interviews	• Objectives • Actual development • Counterfactual objectives • Counterfactual outcome • Net effect • Indirect effects • Unexpected effects • Instrument design	Q 1.1 Q 1.2 Q 0.1 Q 0.2 Q 1.3 Q 3.1 Q 3.2 Q 5.1
Chapters 5 and 6: Structural reforms	Short and medium-term - up to 4 years after disbursement	Qualitative analysis, supported by assessment of effect indicators, case studies	• Objectives • Relevance • Actual development • Counterfactual objectives • Counterfactual outcome • Net effect • Unexpected effects • Instrument design	Q 2.1 Q 2.2 Q 2.2 Q 0.1 Q 0.2 Q 2.4 Q 2.5 Q 5.1
Chapter 7: External sustainability	Medium term - 3 or more years after disbursement	Modelling, qualitative assessment of future risks	• Actual development • Main factors • Indirect effects	Q 4.1 Q 4.2 Q 4.3

The findings in of the macroeconomic, structural reform and gross sustainability impact assessment are subsequently consolidated together and put in a medium to longer-term perspective by focussing on the net impact on external sustainability. This is not explicitly addressed in the Guidelines, but can be tackled by including an additional evaluation question: "*What is the MFA contribution to medium and long-term external sustainability prospects?"* The answer is addressed in the final section of Chapter 7.

To attribute effects to the MFA operation in Serbia and Montenegro, we followed a three-step approach in accordance with the *Guidelines for ex post evaluation of MFA*. The *first step* was to identify the types of short-term macroeconomic effects and short and medium-term structural effects on the economy and institutions, as well as plausible cause-and-effect relations between the assistance and its effects. The *second step* was to establish a counterfactual scenario, and the *third step* involved determining the net effect of the operation – i.e. for the macroeconomic and structural impacts, the difference between the observed effects and the possible effects of the counterfactual scenario.

To quantify the net effects of the MFA intervention, both quantitative and qualitative and methods were employed. Two case studies were analysed in detail to understand cause-and-effect relationships between structural conditions and the observed structural developments. This approach would contribute to a better understanding of structural reform progress in Serbia and Montenegro.

This evaluation employed seven *main evaluation instruments*:
- Data collection and analysis;
- Literature and document review;
- A pre-interview questionnaire to prepare for the structured interviews;
- Macroeconomic model;
- Structured interviews with key informants in the field;
- Delphi questionnaire;
- Case study.

To measure the macroeconomic effects of the counterfactual scenario of the MFA intervention, we refined an existing basic macroeconomic model. By comparing the effects of the counterfactual scenarios with the actual outcomes, the net macroeconomic effects of the MFA intervention were established. To understand net structural effects, besides document analysis and structured interviews we also used the 'Delphi' method. Using these evaluation methods, we were able to identify and establish qualitatively possible counterfactual scenarios and related possible structural effects as perceived by interviewees. In the case of impact on external sustainability, we did not elaborate a separate counterfactual scenario but examined channels of potential and actual impact. The net impact on external sustainability could not be considered in isolation, since it was determined by the net macroeconomic and structural effects.

Two case studies have been developed to understand the cause-and-effect relations between the structural conditions and the observed structural developments. This approach would contribute to better understanding of progress on structural reform in Serbia.

The modelling approach is described in Appendix A. Appendix B describes the Delphi method.

Eventually the evaluation was based on a triangulation of all the findings that resulted from applying all the evaluation instruments.

2.3 Evaluation difficulties

The main difficulties encountered during the evaluation related to: (i) availability and quality of data; and (ii) political sensitivities due to the recent volatile history in the Western Balkans. These factors complicated this evaluation.

Shortcomings in the existing statistical data made the evaluation difficult. The quality of most macroeconomic indicators in Serbia and Montenegro was moderate to low, although significant progress has been made in recent years. The insufficient data quality was due to a variety of reasons; the most important of these being the wars in the 1990s and the ensuing break-up of the Yugoslav statistical system.

While Serbia benefited from the fact that the central Yugoslav statistical institutions were in Belgrade, building a fully-fledged statistical system in the country requires more time. However, recent improvements have been impressive; with the proper SNA95-based quarterly national accounts implemented at the moment, and the proper Eurostat inflation methodology adopted in 2007 for calculating the Consumer Price Index.

Generally speaking, data pertaining to a more distant past are less reliable than very recent figures, although at the Statistical Office of the Republic of Serbia (SORS) and the National Bank of Serbia (NBS) considerable attention has been paid to extend the availability of indicators calculated according to newly-introduced methodologies as much in the past as possible. However, for a number of indicators (particularly those related to the labour market), finding comparable datasets describing the situation at the beginning and throughout the MFA period proved to be impossible.

The availability and quality of statistical data in Montenegro is worse. The country has not yet introduced proper SNA GDP accounting. No quarterly GDP accounting is carried out at all; and official GDP estimates for the preceding year only become available in the third or fourth quarter.

Finally, we explicitly mention the recent volatile history of Serbia, in particular. Sentiments towards Serbia and Serbian sentiments themselves were a complicating factor during the evaluation. The evaluation team experienced this in some of the interviews during the field missions in Belgrade.

3 Background to the MFA operation in Serbia and Montenegro

3.1 History of the second MFA operation

3.1.1 Recent history of Serbia and Montenegro

The Socialist Federal Republic of Yugoslavia (SFRY) ceased to exist when Slovenia, Croatia and Bosnia gained independence in 1992. Serbia and Montenegro formed the Federal Republic of Yugoslavia (FRY). The subsequent Serbian-Bosnian war came to an end with the signing of the Dayton agreement in 1995. In 2003, the FRY was renamed as the State Union of Serbia and Montenegro after a constitutional change in 2003. The two Republics (Republic of Serbia and the Republic of Montenegro) shared a titular President, and ran joint defence and foreign policies - but little more. The two states had separate economic policies and currencies.[5] In terms of GDP, Serbia represented about 93 percent of the union. Both Republics had the option of declaring independence after an initial three-year period - a provision that Montenegro had insisted be included in the Constitutional Charter that underpinned the common state. After a referendum in Montenegro in May 2006, in which the majority of its inhabitants voted for independence; Montenegro became the independent Republic of Montenegro. Serbia continued to be a state of the former State Union.

The political situation in Serbia and Montenegro has thus been volatile and fragile. In Serbia, uncertainty was exacerbated in 2003 following the assassination of the Serbian Prime Minister. Furthermore, the desire of Kosovo to become an independent state has also contributed to the fragile political situation.

Due to the volatile situation and the wars, Serbia and Montenegro became the last country/countries that entered into economic transition; having to cope simultaneously with the economic consequences of the dismantling of the former socialist federation, the collapse of the command economy, as well as the bad economic situation due to the wars and years of sanctions. International financial institutions, the EU, as well as bilateral donors were prepared to support the country.

The first Donors’ Conference for the Federal Republic of Yugoslavia, held in Brussels in June 2001, followed a Donors’ Coordination Meeting in Brussels in December 2000. This conference was a major milestone, raising € 1.56 billion, ensuring complementarity between donors in meeting the needs of the FRY, as expressed in the Economic Recovery

[5] Montenegro uses the euro, while Serbia uses the Serbian dinar.

and Transition Programme jointly prepared by the World Bank and the European Commission.

A second Donor Coordination Meeting for Serbia and Montenegro was organised by the European Commission and the World Bank in November 2003. The objective of the Donor Coordination Meeting was to assess the progress achieved in stabilising the political and economic situation and the challenges ahead in sustaining a viable reform path. It was announced that during 2004 overall donor commitments in support of Serbia and Montenegro could reach € 1.1 billion.

3.1.2 First MFA operation

On 16 July 2001, the Council approved macro-financial assistance of up to € 300 million in favour of the Federal Republic of Yugoslavia (FRY) comprising a loan facility of up to € 225 million and a grant facility of up to € 75 million. This assistance was provided in the context of an IMF stand-by arrangement approved in June 2001, covering the period until end-March 2002.

Table 3.1 The First MFA operation in Serbia and Montenegro

Package, Tranche	Date of approval	Date of disbursement	Loan/Grant	Linked to
First MFA	July 2001 December 2001		€ 75 m grant € 225 m loan + € 45 m grant	IMF stand-by arrangement approved in June 2001, covering the period until end-March 2002
1st tranche		October 2001	€ 225 m loan € 35 m grant	
2nd tranche		January 2002	€ 40 m loan	
3rd tranche		August 2002	€ 45 m grant	

Following the clearance of all arrears of the FRY towards the European Investment Bank and the Community, the first tranche of € 260 million (comprising € 225 million loan and € 35 million grant) was released in October 2001. A review mission in December 2001 found that the conditions attached to the disbursement of the second tranche (€ 40 million) had been broadly fulfilled in the following areas: public expenditure management and control, tax administration and tax policy reform, private sector development, bank restructuring and management of external debt. Following this satisfactory review the second tranche was disbursed in January 2002. On 10 December 2001, the Council approved a revision of its July decision increasing the grant element of the assistance to up to € 120 million thereby augmenting the overall amount of this first MFA assistance to € 345 million. This additional grant amount (third tranche) was disbursed in August 2002.

3.1.3 Second MFA operation

In early November 2002, the Council decided to provide Serbia and Montenegro with further macro-financial assistance of up to € 130 million, comprising a € 75 million grant and a € 55 million loan.[6] It was considered that financial assistance in general should be instrumental in bringing the FRY closer to the Community. It referred to the residual financing gap that remained to be covered after financing of IMF and the World Bank "*to support the policy objectives attached to the authorities' reform efforts.*" In particular, the Council decision explicitly stated that "*Community macro-financial assistance to the FRY is an appropriate measure to help ease the country's external financial constraints, supporting the balance of payments and strengthening the reserve position.*" It also indicated that "*financial assistance from the Community in the form of a combination of a long-term loan and a straight grant is an appropriate measure to support the sustainability of the FRY's external financial position, given its limited borrowing capacity.*" The MFA was closely linked to the three-year IMF Extended Arrangement approved in May 2002.

The Memorandum of Understanding (MoU) was negotiated and agreed in December 2002. This MoU specified the macroeconomic and structural adjustment policy conditions for the release of the second and the third tranche of this assistance. In particular it defined measures in the areas of (i) public finance reform and administration, (ii) banking sector reform and (iii) private sector development. It also contained measures that supported harmonisation of economic systems within Serbia and Montenegro, especially with respect to the introduction of common tariffs, VAT and company registries. The conditions were understood to be based on the economic stabilisation and reform programme endorsed by the Country's authorities and were consistent with the IMF agreement.

Table 3.2 The Second MFA operation in Serbia and Montenegro

Package, Tranche	Date of approval	Date of disbursement	Loan/Grant	Condition	Linked to
Second MFA	November 2002 November 2003		€ 75 m grant € 55 m loan + € 45 m grant + € 25 m loan		Three-year IMF Extended Arrangement, approved in May 2002, covering the period till 2005
1st tranche		December 2002 February 2003	€ 30 m grant € 10 m loan	Signature MoU	
2nd tranche		July 2003 September 2003	€ 35 m grant € 30 m loan	Conditions MoU	
3rd tranche		December 2004 April 2005	€ 10 m grant € 15 m loan	Conditions MoU	
4th tranche		December 2005	€ 25 m grant	Conditions SMoU	

[6] Council Decision of 5 November 2002 providing further macro-financial assistance to the Federal Republic of Yugoslavia (2202/882/EC), OJEC L308/25 of 9/11/2002.

Package, Tranche	Date of approval	Date of disbursement	Loan/Grant	Condition	Linked to
		Not disbursed	€ 15 m loan		
5th tranche		Not disbursed Not disbursed	€ 20 m grant € 10 m loan	Conditions SMoU	

Source: EC files

The grant component of the first tranche of this new package of assistance, € 30 million, was released at the end of December 2002, following the signature of the MoU. The loan part of the first tranche of € 10 million followed in February 2003, as the late completion of the ratification procedures of the Loan Agreement between the EC and the country in the Federal Parliament delayed the loan disbursement.[7]

When the Serbian Prime Minister was assassinated in March 2003, the Commission, supported by the Council, proposed to front-load the remaining macro-financial assistance to ease the uncertain external outlook of the country. The relatively large second tranche of € 65 million, comprising a € 35 million grant and a € 30 million loan component was released in respectively July and September 2003 after the Commission had verified that the economic policy conditions in the areas of public finance reform and administration, banking sector reform and private sector development had been fulfilled to a satisfactory degree.

In October 2003, a Commission staff mission was carried out to review the conditionality of the third tranche. This mission found that substantial additional progress was necessary before the third tranche could be released. The third tranche of € 25 million (comprising a grant of € 10 million and a loan component of € 15 million) were disbursed in December 2004 and April 2005, respectively.

In November 2003, the Council decided to replenish the current macro-financial package by € 70 million to up to a total of € 200 million through a revision of the Council Decision of November 2002; in order to help address additional financing needs identified by the IMF in the context of the newly-approved IMF Extended Arrangement. With the topping-up, the EU also wanted to back Serbia during the difficult juncture after the assassination of the Prime Minister. The assistance would be disbursed provided that external financing needs remained, and associated economic reform conditions and performance criteria as laid down in the Supplementary Memorandum of Understanding (SMoU) would be met. The SMoU conditions did not contain anymore conditions supporting harmonisation of the two states' economic systems. The EC no longer insisted on common state institution-building, which caused many difficulties with regard to compliance. The new twin-track approach included separate conditions for Serbia and separate conditions for Montenegro.

[7] The Loan Agreement was ratified by the Federal Parliament in January 2003 and published in the Official Gazette, No. 5 of 25 January 2003.

The front-loading and topping-up decisions were fairly bold steps. After the assassination of the Prime Minister extreme uncertainty existed in the country. The IMF and World Bank programmes were "*on hold*", as significant further reforms slowed down. From a political point of view, the EU reaction to the assassination was considered the "*right*" approach. In the words of one interviewee: "*It was important to put a signal out there*".

The grant component of the fourth tranche, € 25 million, was disbursed in 2005. The loan element of the fourth tranche (€ 15 million) could not be paid in the first half of 2006 as intended, as the authorities had not completed the legal conditions required for the loan disbursement. In July 2006, the authorities were also formally notified by the Commission of its decision not to disburse the fifth and final tranche of this assistance, due to the profound improvements of the external financing situation in Serbia and Montenegro in 2006.[8]

Since the FRY (1992-2003) and the State Union of Serbia and Montenegro (2003-2006) consisted of two entities - Serbia and Montenegro - the allocation of macro-financial assistance between Serbia and Montenegro was agreed as 90% for Serbia and 10% for Montenegro for the first three tranches. This ratio was determined by the authorities without involvement of the EC.

3.2 Relative importance of MFA

Total EC support

Table 3.3 presents an overview of total EU assistance in Serbia and Montenegro for the period from two years prior to the evaluated MFA operation until one year afterwards.

The table illustrates that MFA amounted to almost 50% in the first year of disbursement (including the disbursements under the First Package). MFA disbursements during 2003-2005 amounted to 24%, 4% and 20%, respectively.

Table 3.3 Total EC assistance to Serbia and Montenegro (excluding Kosovo), 2000 - 2007 (in € millions)

Assistance	2000	2001	2002	2003	2004	2005	2006	2007
Obnova/CARDS	196	207	194	241	229	177	162	182
ECHO***	36	69.3	39.5	….	-	-	-	-
EIDHR**** (state level)		4.6	2.8	2.2				
MFA	-	260*	115**	75	10	40		
Total	**232**	**541**	**351**	**318**	**254**	**202**	**162**	**182**
% MFA of total EC assistance	-	48%	33%	24%	4%	20%	-	-

Source: Website EC Delegation, Serbia and Montenegro, IMF reports

* First MFA.

** of which € 85 million of the first MFA

*** ECHO concluded its operations in Montenegro in 2001 and in Serbia in 2003

**** European Initiative for Democracy and Human Rights

8 This was also not possible, since the conditions were not fulfilled.

IMF support

As mentioned, the MFA operation was strictly related to the IMF arrangements (see Table 3.4).

Table 3.4 IMF arrangements

Facility	Date of Arrangement	Date of expiration	Amount *(in m SDR)*	Disbursements SBA and EA *(in m SDR)*		Comments on completion
Extended Fund Facility	14 May 2002	28 February 2006	650	2001	100	3 reviews completed, 100% utilised
				2002	200	
				2003	200	
Stand-by Arrangement	11 June 2001	31 May 2002	200	2004	162.5	6 reviews completed, 100% utilised
				2005	125	
				2006	62.5	
Total			**850**		**850**	

Source: International Monetary Fund, www.imf.org

In 2000, the FRY became a member of the IMF. In December 2000, the IMF approved a first-credit-tranche purchase, under the policy of post-conflict emergency assistance. This was in support of a short-term program to bring inflation under control, strengthen institutional infrastructure, and pave the way for an upper-tranche arrangement. Serbia and Montenegro successfully completed the 2001 Stand-By-arrangement (SBA) in May 2002, after a two-month extension. In May 2002, the Extended Arrangement (EA) was approved for a total amount of SDR 650 million, to support Serbia and Montenegro's 2002-2005 economic programme. The signing of the three-year arrangement opened the first phase of debt write-off amounting to 51% of the net present value of the original debt to Paris Club creditors. It was extended twice, in May and December 2005, and completed in February 2006. With the completion of the Extended Facility programme, the second phase of the debt write-off by the Paris Club creditors came into effect; reducing the debt by an additional 15% of the net present value of the original external debt amount.

Table 3.5 presents the characteristics of the 2001 Stand-By-Arrangement and the 2002 Extended Arrangement.

Table 3.5 Characteristics IMF arrangements

IMF programmes		
Stand-By Arrangement		
Quantitative performance criteria/indicative targets		***Quantitative performance criteria:*** Floor on the net foreign assets of the NBY Ceiling on net domestic assets of the NBY Ceiling on net credit of the banking system to the consolidated General government Ceiling on contracting or guaranteeing of new non-concessional private sector external debt with original maturity of more than one year ***Indicative targets:*** Ceiling on net domestic assets of the banking system Ceilings on change in the arrears of: • Federal government • consolidated General government in Serbia • consolidated General government in Montenegro Ceiling in the wage bill of the 8 largest public enterprises
Structural benchmarks / performance criteria		Conditions in the sphere of: Fiscal policy Financial sector Private sector development
Approval/Review	**Month**	**Conclusion**
Board approval	June 2001	
1st review	August	The Executive Board completed the first review and granted a waiver for the non-observance of a performance criterion on external debt.
2nd review	November	The Executive Board completed the second review and granted a waiver of applicability of end-December 2001 performance criteria (review would be done under the 3rd review)
3rd review	February 2002	The Executive Board completed the 3rd review.
Extended Facility		
Prior condition		Federation: Submission to Federal Parliament of proposed new Foreign Exchange Law and completion of draft implementing regulations consistent with the key principles described in the MEFP of 26 April 2002.
Quantitative performance criteria/indicative targets		***Quantitative performance criteria:*** Floor on the net foreign assets of the NBY Ceiling on net domestic assets of the NBY Ceiling on net credit of the banking system to the consolidated General government ***Indicative targets:*** Ceiling on net credit of the banking system to: • consolidated General government in Serbia • consolidated General government in Montenegro

IMF programmes		
		Ceiling on net domestic assets of the banking system Ceiling in the wage bill of the 8 largest public enterprises
Structural benchmarks / performance criteria		Conditions in the sphere of: Fiscal policy Financial sector Private sector development
Approval/Review	**Month**	**Conclusion**
Board approval	May 2002	
1st review	April 2003	The Executive Board completed its first review of Serbia and Montenegro's economic performance under the Extended Arrangement. No waivers requested.
2nd review	July 2003	The Executive Board approved waivers for non-observance of the end-June 2003 quantitative performance criteria on net foreign assets and on electricity price increases.
3rd review	June 2004	The Executive Board granted the request for a waiver for the non-observance of the end-December 2003 performance criterion on net bank credit to government, and approved the re-phasing of disbursements.
4th review	December 2004	The Executive Board granted waivers for the non-observance of an end-June 2004 structural performance criterion on adoption of a bankruptcy law and two end-September 2004 quantitative performance criteria on, respectively, contracting or guaranteeing new non-concessional external debt, and on the issuance of new guarantees and the assumption of enterprise debt to banks. The Board also approved a re-phasing of future purchases under the arrangement, added to the arrangement a new quantitative performance criterion on the wage bill of monitored public enterprises, and three new structural performance criteria, as well as modified the ceilings and floors to be applied to certain quantitative performance criteria as of December 31, 2004.
5th review	June 2005	The Executive Board granted waivers for the non-observance of the continuous performance criterion on non-accumulation of new external arrears; the end-March performance criterion on outstanding external arrears; the end-December 2004 structural performance criterion concerning the Yugoslav army and union-level civil employees; and the end-February 2004 structural performance criterion on the legal registration of the new electricity transmission and dispatch company.
6th review	February 2006	As corrective actions compensating for the missed performance criteria (PCs) and benchmarks were implemented, waivers were accepted. Despite delays and setbacks (pension reform), all measures underlying the Fund's structural conditionality were eventually implemented or compensated. The missed end-June and end- September wage bill targets would be compensated by cutting excess bonus payments and by better monitoring of all wages and bonuses in 2006. The missing of the end-June

IMF programmes		
		and end-September net credit to government target, mainly due to expenditure overruns, was expected to be corrected by end-year. Four out of five non-observed PCs were missed with short delays, and the underlying measures were successfully implemented. The fifth non-observed PC, related to pension reform, was compensated by permanent expenditure savings elsewhere in the 2006 budget. Prior actions for the completion of the sixth review were related to ensuring the agreed fiscal targets for 2006.

Post-programme monitoring followed the expiration of the Extended Arrangement in the form of a precautionary Stand-By-Arrangement. The Serbian authorities repaid a part of its outstanding IMF credit faster; so the amount outstanding became less than 100% of their reserve quota. As a consequence, ex post monitoring ended.

World Bank support

In 2001, the FRY became member of the World Bank (succeeding the Former Socialist Federal Republic of Yugoslavia). In 2000, the stock of arrears of the FRY to the World Bank amounted to around US$ 1.7 billion. The World bank Board approved a package of consolidation loans, thereby clearing FRY's arrears.

In the MFA period, the World Bank supported Serbia and Montenegro through a two-phase Transitional Support Strategy (TSS) and a three-year Country Assistant Strategy (CAS) for Serbia and Montenegro covering the period July 2004-June 2007. Table 3.6 presents the structural adjustment related loans and grants.

Table 3.6 World Bank structural adjustment related programmes

Name	Amount *(in m US$)*	Tranches	Board approval date	Closing date
Private and Financial Sector Structural Adjustment Credit (PFSAC)*	85	One tranche; disbursed shortly following approval	23 May 2002	30 Jun 2003
Structural Adjustment Credit (SAC)**	70	One tranche; disbursed upon taking effect in Mar 2002	29 Jan 2002	31 Aug 2002
Social Protection Economic Assistance Grant (SPEAG) - *(Sector) Budget support component*	9.2		29 Aug 2001	30 Apr 2004
Private and Financial Sector Structural Adjustment Credit 2 (PFSAC2)	80	Two tranches, €40 million each, first disbursed upon taking effect in Jun 2003 and second in Oct 2004; with a four-month delay in disbursing 2nd tranche with due to the	10 Jun 2003	31 Dec 2004

Name	Amount (in m US$)	Tranches	Board approval date	Closing date
		assassination of the Prime Minister		
Social Sector Adjustment Credit (SSAC)	80	Two tranches, € 40 m each	22 Apr 2003	31 Dec 2004
Structural Adjustment Credit 2 (SAC2)	45	One tranche, disbursed upon effectiveness in Dec 2004.	16 Dec 2004	30 Jun 2005
Programmatic Private and Financial Development Policy Credit (PPFDPC1)	55	One tranche, disbursed upon effectiveness	6 Dec 2005	31 Mar 2006
Public Sector development Policy Loan (PSDPL)	55	Ongoing	04 Oct 2007	NA
Programmatic Private and Financial Development Policy Credit 2 (PPFDPL2)	NA	Under preparation	18 Apr 2008	NA
Total	**425.84**			

Source: World Bank, extracted from Country lending summaries, Credit Agreements, Project Information Documents and Project Completion Reports (PCR) available on www.worldbank.org

* Complementary activities to PFSAC included: (i) two IDA Technical Assistance Grants for Private and Financial Sector Development of US$ 6 million each (PSD and FSD TA Grants), approved in mid-2001; (ii) two co-financing grants to the Privatization Agency from the governments of the Netherlands and Sweden, totalling nearly $ 3.5 million; and, (iii) the US$ 0.8 million Policy and Human Resources Development (PHRD) Trust Fund Grant from the Government of Japan.

** The Government of Switzerland provided US$6.87 million, as co-financing.

Total financial assistance

Table 3.7 presents the total financial assistance to Serbia and Montenegro in the period 2000 to 2006. MFA assistance (I and II) accounted annually for about 1% to 22% of the total financial flows. MFA II disbursements in 2002-2004 amounted to 1% to 5% of total assistance in that period.

Table 3.7 Total Financial Flows to Serbia and Montenegro (in millions of euro)

	2000	2001	2002	2003	2004	2005	2006
Total support							
• Official transfers	271	591	624	538	583	330****	44****
• Loans*	227	332	421	974	2,119	2,763****	3,755****
EU MFA		**260****	**115*****	**75**	**25**	**25**	
• Loan	-	35	85	40	15	25	-
• Grant	-	225	30	35	10	-	-
EU MFA II as % of total	-	22	10	5	1	1	-

Source: Balance of Payments, IMF Article IV Consultations 2002, 2005, 2006

* Foreign loan disbursements.

** Disbursement of earlier MFA operation.

*** of which € 85 million disbursement of earlier MFA operation

**** Republic of Serbia (2006: proposed).

3.3 Stabilisation and association process

Serbia and Montenegro is participating in the Stabilisation and Association Process (SAP). At the European Summit in Thessaloniki held on 21 June 2003, the European Union offered European Partnership to the Western Balkan countries as one of the key instruments of the EU pre-accession strategy for the potential EU membership candidates.

In April 2005, the EC finalised a feasibility study concerning the commencement of negotiations on a Stabilisation and Association Agreement (SAA). These are conditional on unrestricted cooperation with the International Criminal Tribunal for the Former Yugoslavia (ICTY). In May 2006, negotiations on the SAA were interrupted indefinitely, as Belgrade was not cooperating fully with the ICTY.

In July 2006, the mandate for the SAA negotiations was adapted to the new political situation (Montenegro's independence). This gave the EC the authority to resume the SAA negotiations with Serbia immediately after unrestricted cooperation with the ICTY had been confirmed. In December 2006, the EC began negotiations with Serbia on visa facilitation and readmission agreements. SAA negotiations with Serbia resumed on 13 June 2007. The technical negotiations were completed in October 2007, and the SAA was initialled on 7 November 2007 in Brussels. The signature of the Agreement remains conditional on Serbia achieving full cooperation with the ICTY.

With regard to Montenegro, the negotiations were completed in March 2007; and the SAA was signed on 15 October 2007. The European Parliament gave its formal assent to the SAA with Montenegro in a vote on 13 December 2007.

4 Impact on macroeconomic stabilisation

4.1 Introduction

This chapter analyses the MFA's effects on macroeconomic stabilisation. Table 4.1 shows the related evaluation questions.

Table.4.1 Relevant evaluation questions for analysing the impact of MFA on macroeconomic stabilisation

	Impact on macroeconomic stabilisation
Q1.1	What are the short and medium-term macroeconomic objectives of the assistance?
Q1.2	To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?
Q0.1	What arrangements would have been implemented if the MFA had not been granted?
Q0.2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)?
Q1.3	What has been the contribution of the grants and/or loans provided by the MFA operation to the achievement of MFA objectives?
Q3.1	What, if any, has been the contribution of actions arising as a result of the structural conditionality criteria to the achievement of the short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?
Q3.2	Has the assistance given rise to any unexpected short or medium-term macroeconomic effects? What were these and how did they occur?

The following sections present the main evaluation findings.

4.2 Macroeconomic objectives of the intervention and their relevance

Q1.1: What are the short and medium-term macroeconomic objectives of the assistance?

The Council Decision of November 2002 *explicitly* stated the goal of the assistance: "*Community macro-financial assistance to the FRY is an appropriate measure to help ease the country's external financial constraints, supporting the balance of payments and strengthening the reserve position.*" The objectives linked to this goal were as follows: to ease the country's external financing constraints, to support balance of payments and to secure the foreign exchange reserve position. The MoU stated that assistance was complementary to the resources provided by IFI and bilateral donors in support of the authorities' economic reform programme. Therefore, offering support to the government reform programme was another MFA objective. All these objectives are summarised in Table 4.2.

Table 4.2 Explicit objectives of MFA assistance

	Objectives	Source
Explicit objectives		EU Council Decision of 5 November 2002 providing further macro-financial assistance to the Federal Republic of Yugoslavia (2202/882/EC)
1	To ease the country's external financing constraints	
2	To support the balance of payments	
3	To secure the foreign exchange reserve position	
4	To support the government reform programme	

From the EC files we noticed a communication from the Ministry of Finance thanking the EC for the MFA assistance; as it helped the country to overcome budgetary problems. A number of interviewees in Belgrade thought that MFA assistance was meant to finance budgetary expenditures.[9]

One international interviewee saw MFA also as a "*relationship-building instrument*". MFA and other EC support were important elements in re-establishing relations between the EC and Serbia. The MFA operation assisted in having an economic rationale in the economic relations between the EC and Serbia.

In addition to these goals and objectives, other objectives can be determined which can be related to the structural MFA conditions. These 'structural' types of objectives were implicitly formulated in the MoU, but explicitly formulated in the SMoU.

4.3 Gross impact – actual macroeconomic outcomes

4.3.1 Introduction

Q1.2: To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?

To answer this question, actual macroeconomic developments are analysed. In order to do this, we have selected macroeconomic indicators which are capable of indicating progress in fulfilment of the objectives.

The MoU stated that the release of the MFA tranches was conditional upon the satisfactory implementation of any arrangements reached with the IMF. Therefore, the MFA corresponded with the objectives of the IMF Stand-By-Arrangement in terms of macroeconomic stabilisation. The main economic objectives included the achievement of low inflation with sustainable growth and external viability. The quantitative performance criteria and indicative targets in the Stand-By Agreement would support the realisation of the underlying macroeconomic objectives.

[9] Interviewees from Serbian authorities and international financial institutions

To assess the the accomplishment of MFA objectives in the medium term, however, these performance criteria and benchmarks from the IMF programmes are less useful because they are too specific, short-term-oriented. As a result, they do not provide an overall picture of the macroeconomic developments over time.

The following variables have been examined: economic growth, inflation, exchange rate, monetary and fiscal indicators and balance of payments indicators.

Table 4.3 presents the macroeconomic indicators which we have used to assess progress in achieving macroeconomic stabilisation.

Table 4.3 Macroeconomic indicators

Macroeconomic stabilisation	Effect indicators
Macro economy	Growth rates in GDP and components Inflation Interest rate Exchange rate
Public finance	Level of government revenue Level of government expenditure Deficit Financing of the deficit
Balance of payments	Current account deficit Components of current account: exports, imports, current transfers Capital and financial account surplus Inflow of foreign direct, portfolio and other investment International reserves
Financial volatility and BoP sustainability *(in Chapter 5)*	Domestic and foreign debt Debt service payments Foreign-currency debt ratings Liabilities of banks

Selected economic figures are presented in Table 4.4.

Table 4.4 Selected economic indicators for Serbia and Montenegro 2000-2008, excluding Kosovo

		2000	2001	2002	2003	2004	2005	2006	2007	2008
Macroeconomic										
GDP growth (%)	SR[1)]	5.0	5.5	3.8	2.7	7.2	6.2	5.7	7.0	6.0
	MNE[2)]	3.1	-0.2	1.7	2.4	4.2	4.0	8.3	7.1	
RPI growth (annual average)	SR[3)]	67.2	99.2	20.3	11.8	9.9	17.0	12.8	6.8	7.2
	MNE[4)]	36.1	21.8	16.8	6.8	2.4	4.1	3.0	3.9	
Real exchange rate	SR[6)]	60.3	125.7	104.3	100.0	101.5	99.0	89.2	79.3	
Unemployment rate	SR	[7)]	21.7	23.5	26.0	26.0	25.2	26.6	25.6*	
		[8)]	12.2	13.3	14.6	18.5	20.8	20.9		

		2000	2001	2002	2003	2004	2005	2006	2007	2008
	MNE[10)]	20.1	19.5	21.6	22.9	22.3	19.7	15.5	14.5	
Fiscal indicators										
Central Government balance (excluding grants, % GDP)	SR[11)]		-0.2**	-3.9	-1.3	-0.1	1.5	1.4	3.7**	
	MNE[12)]		-3.1	-2.8	-3.1	-2.0	-1.6	1.8	8.7 I-IX	
Public debt, internal and external (% GDP)	SR[11)]	169.3	102.2	69.5	64.3	53.3	50.2	34.9	29.0	
	MNE[12)]			88.3	54.3	48.3	41.4	38.0	35.9 IX	
Balance of payments										
Current account balance (% GDP)	SR[5)]			-7.9	-7.0	-11.7	-8.4	-11.5	-15.2	-13.6
	MNE[9)]		-14.8	-12.1	-7.3	-7.2	-8.6	-26.0	-50.3 I-VI	

Note: Projections of Serbian authorities and IMF depicted in grey
1/ Statistical Office of the Republic of Serbia (2000-2006) and Statistical Office of the Republic of Serbia and IMF (2007-2008)
2/ Statistical Office of Montenegro (2000-2005) and Montenegrin Secretariat for Development (2006-2007)
3/ Statistical Office of the Republic of Serbia
4/ Statistical Office of Montenegro
5/ National Bank of Serbia
6/ Own calculation based on data from 3/ and 5/ above, decrease = appreciation
7/ Based on data from the National Employment Office and 3/ above, averages of data from March and September
8/ Based on the Labour Force Survey carried out in September by 3/ above
9/ National Bank of Montenegro
10/ Estimates of the Institute for Strategic Studies and Prognoses based on the data from the Employment Bureau of Montenegro, 4/ and 9/ above
11/ Ministry of Finance of the Republic of Serbia
12/ Ministry of Finance of Montenegro
* Quarterly Monitor of Economic Trends and Policies, FREN, Issue 10, July-September 2007, FREN, 2007
** Third Quarter Inflation Report, National Bank of Serbia, 2007

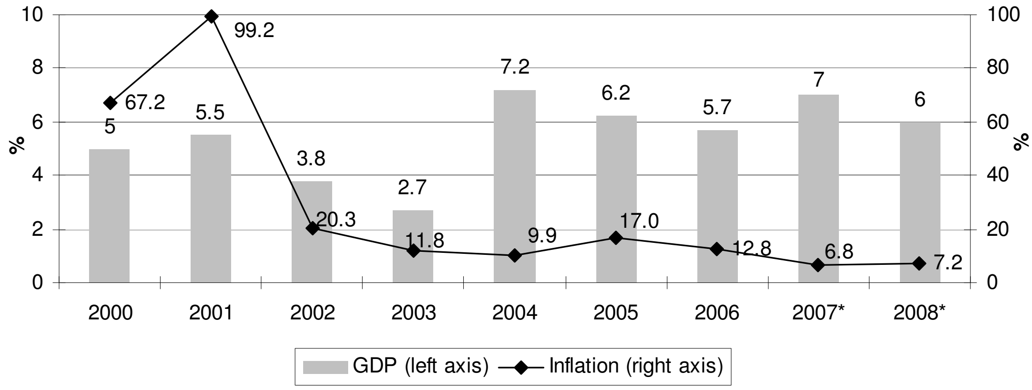
The following sections describe the actual developments in the macro economy in more detail.

4.3.2 Macroeconomic developments in Serbia

Macro economy - Serbia

Figure 4.1 presents real GDP growth and the development of the average Retail Price Index[10] (RPI) for the period 2000-2007.

Figure 4.1 Real GDP growth and inflation in Serbia, 2000-2008



Note: Inflation is measured by the annual average change of the RPI (Retail Price Index)

* Actual figure for 2007 inflation; Serbian Authorities/IMF projections for 2007 GDP and 2008 figures

Source: Statistical Office of the Republic of Serbia and IMF

Table 4.5 present figures on GDP expenditure components.

Table 4.5 Gross Domestic Product: Main expenditure aggregates

	2000	2001	2002	2003	2004	2005	2006	2007*
Real GDP growth (year-on-year, in %)	5.0	5.5	3.8	2.7	7.2	6.2	5.7	7.0
Contribution to real GDP growth, in percentage points								
Domestic demand	4.4	14.7	10.7	2.1	13.6	0.7	5.4	12.7
Consumption	5.4	6.7	8.3	-3.8	10.2	2.5	3.2	11.1
Non-government	*4.4*	*4.6*	*6*	*-4.3*	*12.1*	*3.8*	*3.4*	*10.0*
Government	*1*	*2.1*	*2.4*	*0.5*	*-1.9*	*-1.3*	*-0.2*	*1.1*
Gross fixed capital formation	2.4	-1.7	2.3	4.7	3.4	0.3	1.4	2.0
Net exports of goods and services	0.2	-9.9	-6.5	0.4	-5.2	5.6	0.3	-5.7

* Serbian Authorities/IMF forecast

Source: Statistical Office of the Republic of Serbia and IMF

Over this period, in particular since 2004, Serbia has achieved sound economic growth; with rates in the range of 4% to 7% (except for 2003) raising the GDP in 2007 by over

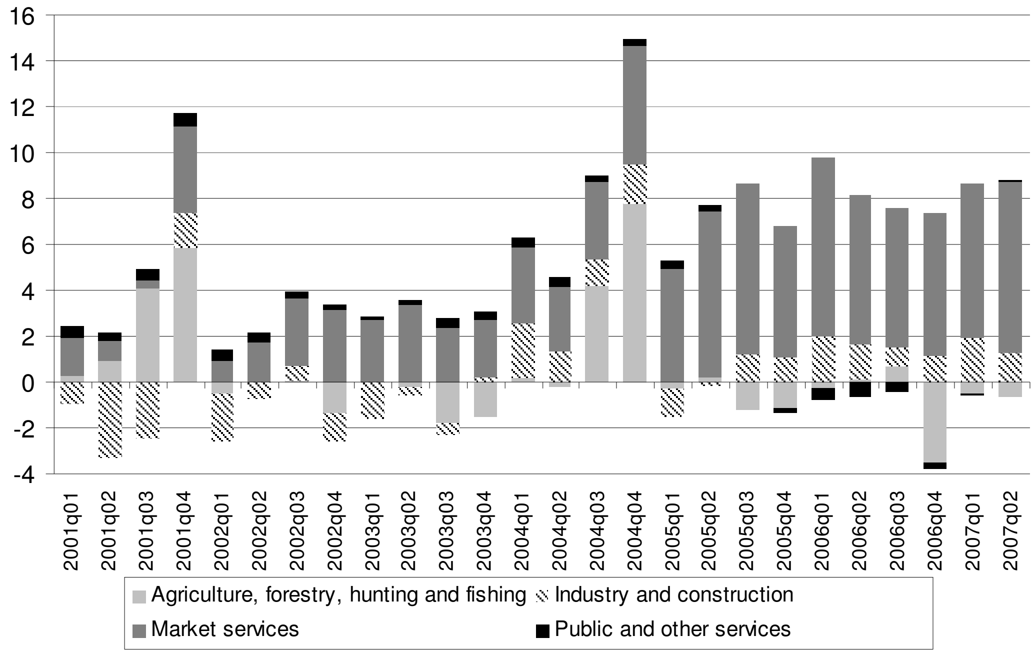
[10] Due to the lack of a proper CPI index (introduced only in 2007), the most common measure of consumer price inflation is the Retail Price Index

50% in comparison to 1999. This is in stark contrast to the previous decade which saw a marked economic decline due to the break-up of Yugoslavia and the ensuing two wars.

Economic growth has been largely underpinned by domestic demand; and predominantly in recent years by consumption of the non-government sectors. Investment and exports have been increasing, but investment rates are still very low - raising the issue of sustainability of high economic growth.

With respect to sectors, economic growth in Serbia has mainly come from service industries; in particular transport, the retail trade, and financial intermediation. Manufacturing industry registered disappointing growth rates (0.3% on average during 2000-2006), while agriculture, construction and mining have been performing only marginally better. Agriculture, traditionally regarded as one of Serbia's strategic sectors, has lost half of its share in GDP; decreasing from 20% in 2000-2001 to just above 10% in 2007.

Figure 4.2 Sectoral structure of the real annual Gross Value Added growth in Serbia, 2001 – 2007 (year-on-year, in %)



Source: Statistical Office of the Republic of Serbia

The relatively high economic growth since 2000 has been the result of increasing total factor productivity accompanied by falling employment.[11] As a consequence unemployment rates have risen gradually over the period to reach 21% in 2006 (based on the Labour Force Survey) amid a very low employment rate (42% in 2005).

11 The result of robust employment growth in non-farm private sector, coupled with sharp declines in the rest of the economy, See IMF, 06/382, 2006.

Inflation and money - Serbia

Curbing inflation has been an enormous challenge for the Serbian authorities. After the hyperinflation experiences of the 1990s, macroeconomic stabilisation and reducing inflation in particular became a primary goal of economic policy. With Montenegro detaching itself from the Dinar currency area in 1999, the Serbian authorities had to adopt policies that would gradually bring inflation down without putting too much strain on the country's real sector and external trade position.

After relaxing the peg to the German mark in December 2000, and devaluing the Dinar by 380%; the National Bank of Serbia (NBS) pursed an eclectic blend of policies - with mixed results. Official NBS documents from 2001-2005 mention the goal of the control of monetary aggregates through limits on the growth of net domestic assets. Excess base money growth (for instance as a result of faster reserve accumulation) would be dealt with through (i) the auction sale of the NBS securities; (ii) changing reserve requirements; and through (iii) open market operations - gradually developing over the years. In practice, monetary policy also had to deal with the aftermath of the banking crisis, and had to gradually rebuild confidence in the banking system.

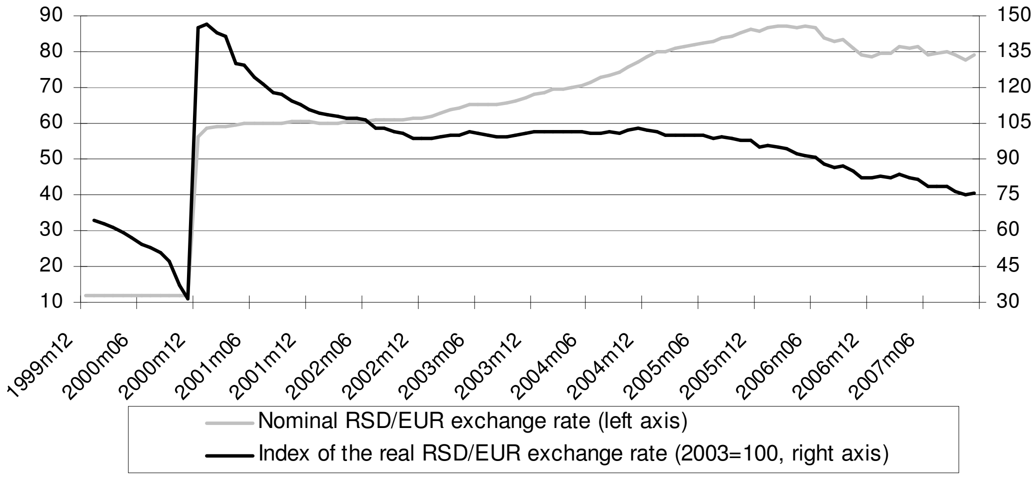
The key element of the monetary regime was the managed "dirty" float of the dinar exchange rate. The NBS reiterated in its annual policy documents that *"the dinar exchange rate shall be determined on the basis of supply and demand on the foreign exchange market. The National Bank of Serbia shall intervene on the foreign exchange market and also apply other instruments on its disposal to adjust the dinar exchange rate in line with the country's sustainable mid-term balance of payments position. Nevertheless, NBS shall at all times take heed of the main monetary policy aim of maintaining the inflation rate within the projected framework."*[12]

In practice, this meant frequent interventions in the foreign exchange market; with the aim of preventing appreciation of the currency - clearly at the expense of higher inflation[13]. As is clear from Figure 4.3, the trend of sharp real appreciation of the dinar vis-à-vis the euro came to a halt in late 2002, and it was followed by a two-year period (2003-2004) of real depreciation and subsequent stabilisation (2005), after which appreciation resumed during 2006 and 2007. Consequently, during the period of managed float (until 2006), indirect inflation targets set in annual monetary policy guidelines were vastly exceeded in most years; and inflation continued to be perceived as not being successfully controlled.

12 See, for instance, NBS, Monetary Policy Programme of the National Bank of Serbia for the Year 2004

13 The de-facto independence of the National Bank of Serbia was rather limited at that time due to frequent changes of governors following the changes of governments.

Figure 4.3 Nominal and real exchange rate developments of the Serbian dinar (RSD/EUR), 2000-2007



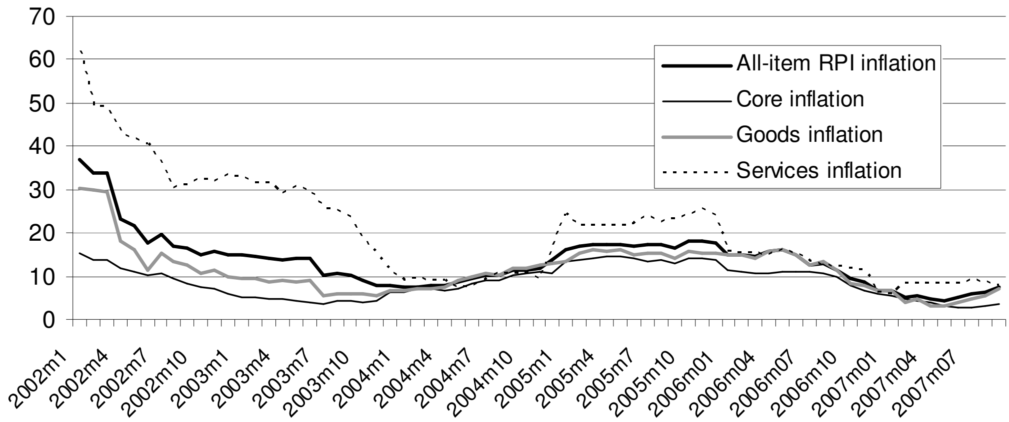
Note: Decrease points to appreciation

Source: National Bank of Serbia

After several years of high double-digit inflation, the National Bank of Serbia formally adopted inflation-targeting in September 2006. The previously pursued regimes, i.e. monetary targeting and managed float, proved less efficient in controlling inflation in the highly euro-based environment, and amid rapidly increasing trade openness and financial flows. Monetary authorities motivated the regime switch through the need to finally achieve and secure low inflation, to strengthen the use of and trust in the domestic currency; as well as to increase the flexibility of adjustment against temporary domestic and external shocks.[14] The two-week REPO interest rate became the main policy instrument, while the nominal exchange rate was free to act as a shock adjustment buffer. The NBS decided to target core inflation defined as the RPI excluding staple foods and items with administratively-controlled prices (amounting to roughly half of the total basket in 2007) to reflect "the retail price inflation under the influence of NBS instruments" [NBS, 2006].

[14] National Bank of Serbia (2006), *Memorandum On the Principles of the New Monetary Policy Framework*, September 2006.

Figure 4.4 Various measures of annual inflation in Serbia 2002-2007 (year-on-year, in %)



Source: Statistical Office of the Republic of Serbia and National Bank of Serbia

The first months of the operation of the new regime proved very successful as inflation declined significantly in late 2006, aided by the strengthening dinar. Inflation declined to a historic low level of 5% (year-on-year, on average) in the first half of 2007; and rebounded somewhat in the second half of the year, mostly due to food and fuel inflation (to 7.4% in July-November, on average). The most recent estimates show core inflation at the end of 2007 stood at just above the lower bound of the targeted range of 4% to 8%[15] while it is projected to be in the middle of the targeted range of 3% to 6% in 2008.

To gain a better insight into inflationary process in Serbia, Figure 4.4, above, presents various measures of annual inflation. As is typical for transition economies, Serbia has consistently registered a large gap between inflation of services and inflation of goods. During extended periods of time, prices of services grew five times faster than prices of goods, on average. While this phenomenon can be partly explained by their non-tradeable character and the ensuing Harrod-Balassa-Samuelson effect; in Serbia it is still largely attributable to administrative price hikes of many services controlled by public monopolies -such as electricity, utilities and public transport. Protracted privatisation and the slow restructuring of ineffective public enterprises with obsolete equipment and excessive employment has been and is likely to remain the major source of inflationary pressure.

On the other hand, goods - most of which have free-market prices - have registered much lower inflation rates. In Serbia, prices in general, and those of goods in particular seem to be very sensitive to exchange rate changes (see Box 4.1, below, on exchange rate pass-through); which make goods inflation very much dependent on nominal exchange rate depreciation or appreciation.

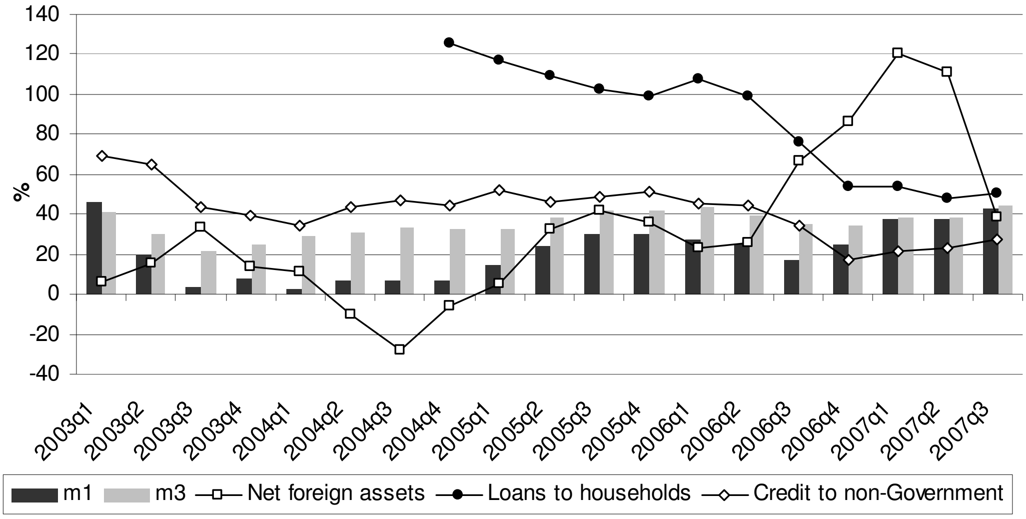
Core inflation calculated without items subject to administrative price changes (and high price volatility, such as agricultural products) has been the lowest of all inflation

15 National Bank of Serbia, Inflation Report 2007Q3

measures during the entire period under review. While the aggregate weight of those items in most EU countries does not exceed 20% to 25%; in Serbia the total weight of excluded items is close to 50%! Since most of the items on the list register inflation rates well above the average, the resulting core inflation is very low. This is regarded as another indicator measuring the size of the public sector and the extent of liberalisation needed.

Figures 4.5 and 4.6 indicate that broad money supply registered very high growth rates close to 40%. This has been due to the credit to non-government, in particular loans to households; and net foreign assets. The latter item has accelerated and gained importance since mid-2003. Recent quarters have seen a particularly sharp rise in the growth rate of this item as a consequence of faster reserve accumulation (see the section on Balance of Payments).

Figure 4.5 Annual growth rates of money supply (M1 and M3), as well as components of M3 (year-on-year, in %)



Source: International Financial Statistics and National Bank of Serbia

Balance of Payments - Serbia

Table 4.5 and Figures 4.7-4.9 present the balance of payments of Serbia for the period 2000-2006; and the first ten months of 2006 and 2007. The Current account deficit worsened gradually after 2000 as imports expanded in line with growing demand that could not be satisfied with the output of the underinvested and predominantly publicly-owned domestic real sector. Both imports and exports have posted double-digit growth in recent years. However, the positive gap of exports dynamics over imports dynamics present since 2005 has recently decreased down to almost zero on the back of expanding domestic demand and real appreciation of the dinar. Interest payments on outstanding foreign debt have become an important component of the Current account deficit in recent years - further widening the negative gap. Current transfers (including remittances) have been consistently positive, and became an important item offsetting the negative balance of goods, services and income (with a ratio ranging from 40% to 70%). Altogether, Current account deficits have been on the rise; reaching 15.2% in the first three quarters of 2007[16]. Against these figures, the importance of the second MFA is non-negligible: total grants and loans disbursed amounted to 2.3%, 5.6%, 0.4% and 2.1% of the Current account deficit in 2002, 2003, 2004 and 2005, respectively.

The balances of the capital and financial account have exceeded the Current account deficit since 2000; resulting in positive net inflows of capital and the accumulation of reserves (see Figures 4.7 and 4.8). Foreign direct investments (FDI) started rising in 2003 (see Figure 4.6), however in the first two years, FDI had been heavily influenced by one-off transactions: the sale of the mobile phone company in 2006 and the FDI outflow in early 2007 due to the purchase of the telecommunications company in Republic of Srpska - i.e. Serbia largest foreign investment. Adjusted to take these effects into account, the upward trend is very noticeable, and is expected to continue into 2008. Still the biggest challenge for Serbia will be the attraction of green-field investments after 2008, in view of less privatisation of enterprises.

Following the further liberalisation of the capital account portfolio, investments have started to register considerable amounts in 2007.

Table 4.6 Balance of Payments of Serbia, 2002-2007 (in millions of US$)

(in millions of US dollars)	2002	2003	2004	2005	2006	1-10 2006	1-10 2007
I. CURRENT ACCOUNT	**-1,247**	**-1,420**	**-2,869**	**-2 224**	**-3 656**	**-2,543**	**-5,222**
as % of GDP	**-7.9**	**-7.0**	**-11.7**	**-8.4**	**-11.5**	**-10.4***	**-15.2***
1. Goods and services	-3,098	-3,819	-6,294	-5,296	-6,292	-4,961	-6,877
1.1. Export	2,961	4,358	5,559	6,606	8,593	6,867	9,540
1.1. Import	-6,059	-8,177	-11,853	-11,902	-14,885	-11,829	-16,418
2. Income	-73	-136	-216	-324	-395	-330	-520
2.1. Receipts	62	69	80	98	194	151	201
2.2. Payments	-135	-205	-296	-422	-589	-481	-721
3. Current transfers	1,428	2,059	3,166	3,067	2,803	2,570	1,974
3.1. Receipts	1,798	2,499	3,766	3,902	4,355	3,750	3,499
3.2. Payments	-370	-440	-600	-836	-1,552	-1,180	-1,525
4. Official transfers (grants)	496	476	475	329	228	178	201
II. CAPITAL AND FINANCIAL ACCOUNT	**2,048**	**2,518**	**3,089**	**4,720**	**9,361**	**6,880**	**6,598**
A. Capital account	0	0	0	0	843	419	-410
B. Financial account	2,048	2,518	3,089	4,720	8,518	6,461	7,009
1. Foreign direct investment, net	475	1,365	966	1,550	4,387	2,925	1,301
2. Portfolio investment, net						6	848
3. Medium and long-term loans, net	680	997	1,560	2,198	2,844	2,985	3,094
3.1. Withdrawals	*756*	*1,189*	*2,171*	*2,959*	*5,411*	*4,298*	*5,568*
3.2. Repayments	*-76*	*-192*	*-611*	*-761*	*-2,567*	*-1,313*	*-2,474*
4. Loans to abroad, net			0	-16	41	10	-5
5. Short-term credits and deposits, net	158	66	449	439	93	-75	362

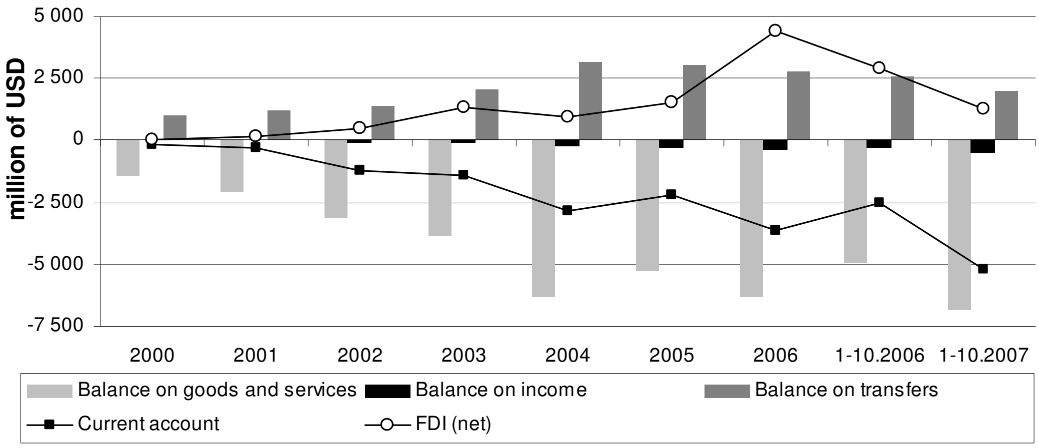
16 Based on estimates of the National Bank of Serbia, see Inflation Report, 2007Q3

(in millions of US dollars)	2002	2003	2004	2005	2006	1-10 2006	1-10 2007
6. Other, net	801	95	68	423	1,158	802	1,230
7. Commercial banks, net	-66	-5	46	126	-5	-192	180
III. ERRORS AND OMISSIONS, NET	**127**	**-177**	**228**	**-469**	**-283**	**-206**	**-236**
IV. OVERALL BALANCE	**928**	**921**	**448**	**2,027**	**5,422**	**4,131**	**1,140**
V. NBS FOREIGN EXCHANGE RESERVES	**-928**	**-921**	**-448**	**-2,027**	**-5,422**	**-4,131**	**-1,140**
Of which: IMF	-255	-277	-7	25	660	416	245

* January-September

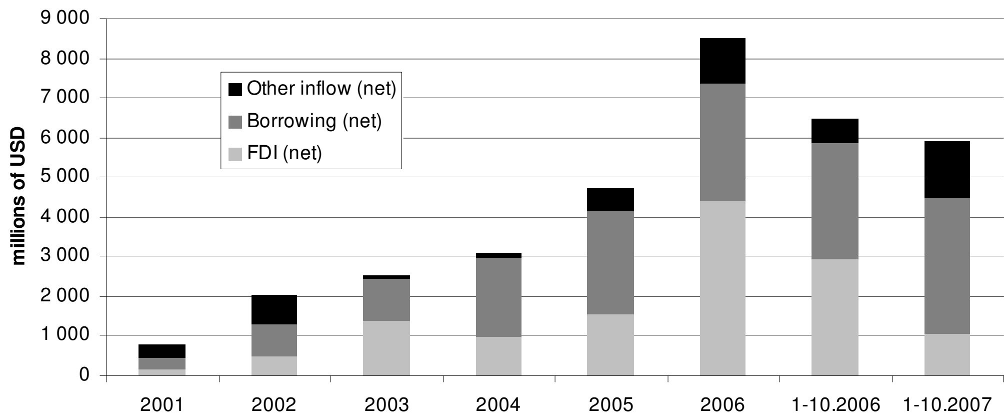
Source: National Bank of Serbia

Figure 4.6 Current account and the FDI, 2000-2007 (in millions of US$ m)



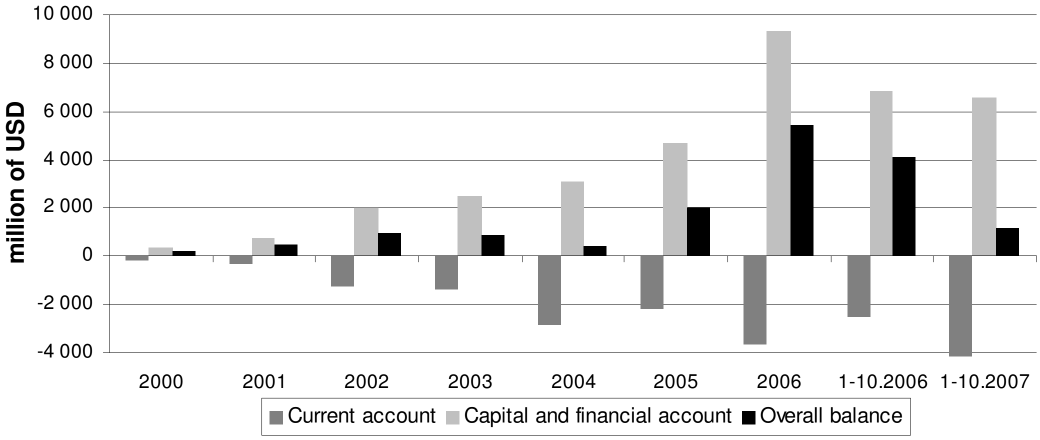
Source: National Bank of Serbia

Figure 4.7 Components of the capital and financial account, 2001-2007 (in billions of US$)



Source: National Bank of Serbia

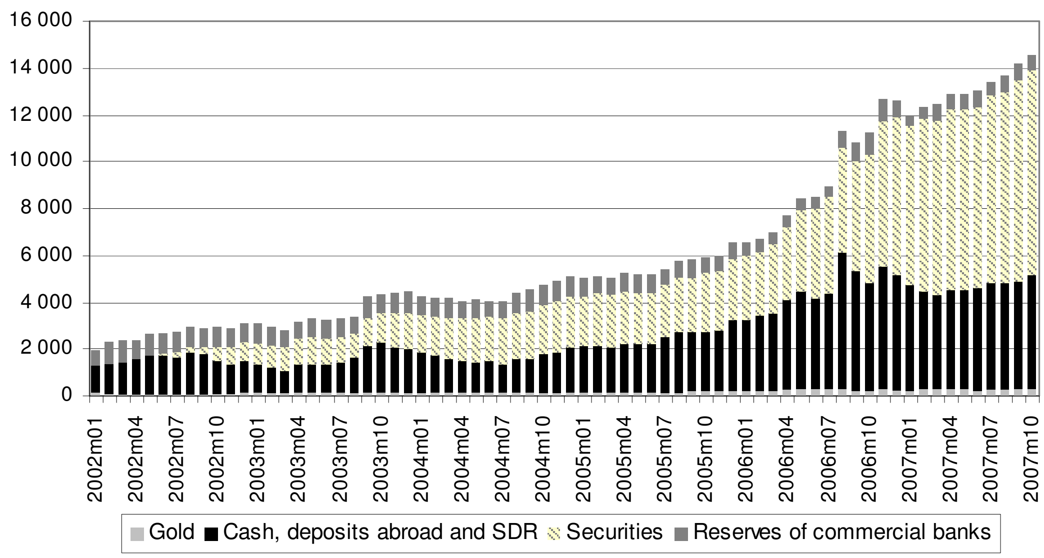
Figure 4.8 Current account, capital and financial account and the overall balance, 2000-2007 (in US$ m)



Source: National Bank of Serbia

Figure 4.10 presents the foreign exchange reserves of the NBS and the commercial banks for the period 2000-2007. The figure illustrates that the foreign exchange reserves have been on a steadily increasing path since 2000; with a particularly marked acceleration in 2006, as a result of record-high FDI inflows. Securities held by the Central Bank have been growing in importance as reserve holdings increased. Their share in total reserves went up from 25% at the end of 2002 to 60% in the third quarter of 2007.

Figure 4.9 Monthly reserve position 2002- 2007 (in US$ bn at the end of the month)



Source: National Bank of Serbia

Exchange rate - Serbia

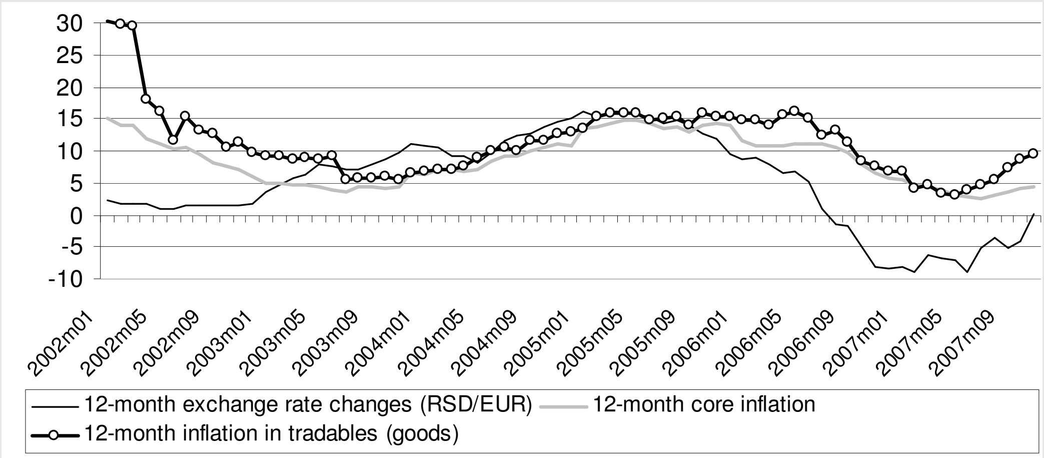
After abandoning the currency fix to the euro in the end of 2000, the Serbian dinar (RSD) has been subject to managed float (see Figure 4.2 above). The National Bank of Serbia has regularly engaged in foreign exchange interventions to contain real appreciation pressures triggered by growing capital inflows. Nevertheless, the real exchange rate of the dinar vis-à-vis the euro (and other major currencies) has appreciated significantly in real terms over the last eight years - and particularly during 2001-2002, 2006 and parts of 2007. It has to be noted that the NBS seems to be phasing out discretionary interventions and puts more emphasis on market-based REPO operations in line with the new monetary policy regime of inflation targeting. This policy seems to be bearing fruit; and the repo rate has proved to have a stronger influence on the exchange rate [IMF, 2006].

Box 4.1 Exchange-rate - inflation pass-through

Understanding the nature of exchange rate movements is of particular importance in Serbia; and is one of the preconditions of the success of the inflation targeting regime. The recent IMF report [IMF, 2006] suggests that the pass-through of nominal exchange rate changes to prices (core inflation) has been significant during the period 2003-2006. It also finds that the impact on persistent exchange rate shocks might be higher than for the short-lived ones, and it detects possible asymmetries in the relationship – while currency depreciation triggers rise in inflation; the evidence for disinflationary effects of appreciation is less clear. The authors obtain high pass-through rates of around 40% for month-on-month changes to over 100% for three-month changes.

Simple visual inspection of the extended sample confirms these results. Figure 4.10 presents annual rates of growth of the nominal RSD/EUR exchange rate, core price index, as well as the goods' price index. Periods of rising depreciation, such as 2003-2004, coincide with rising core inflation, as well as goods inflation; while periods of decreasing depreciation (since early 2006) or even nominal appreciation trigger disinflation to a lesser extent.

Figure 4.10 Core inflation and 12-month changes in the nominal exchange rate (RSD/EUR) 2002-2007 (year-on-year, in %)



Source: Statistical Office of the Republic of Serbia and National Bank of Serbia

Labour market

Total employment in Serbia fell by 7% between 2006 and 2001 (see Table 4.7). However, developments differ markedly in the private and non-private sector. As expected, the non-private sector - comprising general government, state-owned and socially-owned enterprises, as well as mixed-ownership enterprises - has registered a gradual decline in employment. Given the actual restructuring needs in this sector, as well as excessive employment in the General government, this process has been slow. Consequently its share in the number of total employed dropped by 15 percentage-points between 2001 and 2006; reaching 40% in 2006.

On the other hand, private sector employment has gone up by 23% over the same period; increasing its share in total employment from 45% in 2001, to 50% in 2003, and 60% in 2006. This has been the result of divergent developments in the non-farming and farming private sector. While the former saw its employment rise by an impressive 70%; the latter registered a 15% decline. As a result, the non-farming private sector almost doubled its share in total employment: from 20% to 37%.

In its Article IV Consultation 2006 report, the IMF has identified the rigid labour market as one of the most problematic areas. The report points to the fact that the inflexible labour law - which protects existing labour and results in highly inefficient wage-setting in the public sector - preserves the loss-making state-owned sector and socially-owned sector. This burden hinders efficient job creation in the private sector which, albeit relatively dynamic, is not able absorb the new unemployed from the public sector and the farming sector. The resulting unemployment rates have been rising steadily: reaching 27% or 21% in 2006, according to data from the National Employment Office and data from LFS, respectively.

Table 4.7 Employment and unemployment in Serbia, 2001-2006

		2001	2002	2003	2004	2005	2006
Total employment*	Persons	2,787,858	2,736,087	2,710,161	2,678,509	2,654,136	2,600,776
	Index 2001=100	100	98	97	96	95	93
Non-private* (including General government, state- and socially-owned enterprises and enterprises with mixed-ownership)	Persons	1,529,650	1,418,750	1,315,617	1,231,843	1,114,579	1,050,151
	Share in total	55%	52%	49%	46%	42%	40%
	Index 2001=100	100	93	86	81	73	69
Private*	Persons	1,258,208	1,317,337	1,394,544	1,446,666	1,539,557	1,550,625
	Share in total	45%	48%	51%	54%	58%	60%
	Index 2001=100	100	105	111	115	122	123
of which is non-farming private	*Persons*	*566,479*	*629,502*	*720,673*	*804,946*	*952,849*	*963,917*
	Share in total	*20%*	*23%*	*27%*	*30%*	*36%*	*37%*
	Index 2001=100	*100*	*111*	*127*	*142*	*168*	*170*
of which is farming private	*Persons*	*691,729*	*687,835*	*673,871*	*641,720*	*586,708*	*586,708*
	Share in total	*25%*	*25%*	*25%*	*24%*	*22%*	*23%*
	Index 2001=100	*100*	*99*	*97*	*93*	*85*	*85*
Registered unemployment rate	%	21.7	23.5	26.0	26.0	25.2	26.6

		2001	2002	2003	2004	2005	2006
(Statistical Office of the Republic of Serbia)							
Unemployment rate* (LFS survey)	%	12.2	13.3	14.6	18.5	20.8	20.9

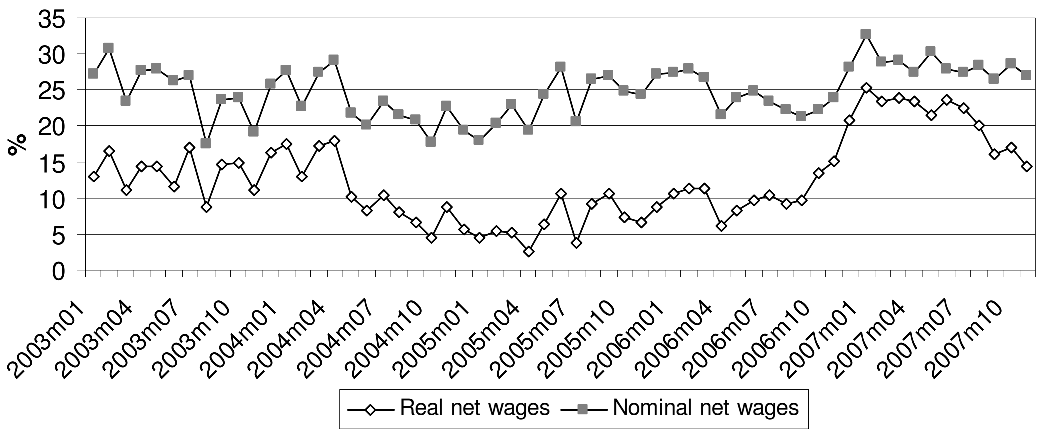
Source: Statistical Office of the Republic of Serbia, National Employment Office

* Data for individual years based on a survey carried out in September (unavailable for 2007)

** Data taken from the Quarterly Monitor of Economic Trends and Policies, FREN, Issue 10, July-September 2007, FREN, 2007

Real wages in Serbia have continued to grow at very high rates for a number of years (see Figure 4.11). Recent acceleration to over 20% in real terms has been underpinned by the large public-sector wage increases that the outgoing government granted in the run-up to the January 2007 parliamentary elections. Such consistently high wage growth lags behind productivity growth; and together with real appreciation of the dinar contributes to the worsening of the competitiveness of the Serbian economy, and the further widening of the Current account deficit. It also casts doubt on the feasibility of sustaining lower inflation in the future.

Figure 4.11 Nominal and real net wage growth (year-on-year), 2003-2007



Source: Statistical Office of the Republic of Serbia

Public Finance - Serbia

Serbia has been successful in balancing central government revenues and expenditures, moving from a deficit into a surplus in 2005. After massive deficits in the 1990s, in 2001, Serbia embarked on a fiscal adjustment process which has resulted in consistent and gradual declines in budget deficits; and yielded small surpluses as early as 2005 (Central government) (see Table 4.8) or even 2004 (General government) (see Table 4.9).

Table 4.8 Public Finance of the Republic of Serbia

		2002	2003	2004	2005	*2006*
Total revenue	**RSD bn**	**174.5**	**262.0**	**334.3**	**418.5**	***499.1***
	% of GDP	17.1	22.4	23.4	23.9	*23.5*
	% of the	100.0	100.0	100.0	100.0	*100.0*
Tax revenue	total	96.0	93.8	92.9	93.2	*87.5*
Personal income tax	revenues	*25.3*	*19.8*	*16.4*	*12.1*	*12.8*
Corporate income tax	(excluding	*2.3*	*2.0*	*2.0*	*2.3*	*3.4*
Sales tax / Value Added Tax	grants)	*39.4*	*39.5*	*40.0*	*51.6*	*45.1*
Excises		*21.6*	*21.5*	*20.7*	*17.0*	*16.4*
Customs		*0.0*	*8.9*	*10.3*	*9.3*	*9.1*
Other tax revenue		*7.4*	*2.2*	*3.7*	*0.9*	*0.9*
Non - tax revenue		4.0	6.2	7.1	6.8	*12.5*
Total expenditures	**RSD bn**	**213.9**	**276.8**	**335.1**	**391.6**	***468.8***
	% of GDP	21.0	23.6	23.4	22.4	*22.1*
	% of the	100.0	100.0	100.0	100.0	*100.0*
Current expenditures	total	96.2	95.8	95.4	96.1	*93.1*
Expenditures on employees	expenditures	*18.9*	*21.0*	*20.9*	*21.5*	*24.6*
Goods and services		*6.5*	*6.1*	*5.0*	*4.6*	*6.5*
Interest payment		*3.4*	*4.0*	*4.0*	*4.3*	*4.1*
Subsidies		*20.9*	*10.7*	*10.3*	*7.3*	*6.5*
Grants and transfers		*32.7*	*41.0*	*44.3*	*46.2*	*39.0*
Social assistance		*12.7*	*11.5*	*9.7*	*11.0*	*11.2*
Other current expenditure		*1.1*	*1.5*	*1.1*	*1.2*	*1.1*
Capital expenditures		3.8	4.2	4.6	3.9	*6.9*
of which NIP expenditures		0.0	0.0	0.0	0.0	*1.9*
Budget deficit / Surplus (MoF)	**RSD bn**	**-39.4**	**-14.8**	**-0.8**	**26.9**	***30.3***
	% of GDP	**-3.9**	**-1.3**	**-0.1**	**1.5**	***1.4***
Privatisation receipts	RSD bn	-	29.9	12.9	19.7	*72.0*

Source: Ministry of Finance

Table 4.9 Consolidated General government revenue and expenditures, in RSD bn (unless otherwise stated)

	2002	2003	2004	2005	2006	1-10-2007
Total revenue	174.5	262.0	334.3	418.5	499.1	525.8
Total expenditures	213.9	276.8	335.1	391.6	468.8	488.3
Budget balance (MoF)	-39.4	-14.8	-0.8	26.9	30.3	37.5
	In % of GDP					
Consolidated fiscal result* (IMF methodology)	-2.8	-4.3	-1.4	-3.2	-4.7	0.3*
Public debt (end-of-the-period)	73.7	67.9	53.7	46.2	38.8	32.3*

* Jan-Sep 2007

Source: National Bank of Serbia[17] for consolidated fiscal result and public debt and Ministry of Finance for the rest

On the revenue side, most prominent reforms included the Law on VAT and the Law on Income Tax. The tax structure has been simplified over the last few years; and the current structure has become more efficient as a result of the shift from taxes on labour towards taxation of consumption, as reflected in the declining share of revenues from direct taxes and rising share in sales tax/VAT. The introduction of the VAT was accompanied by a reduction of the personal income tax rate. In addition, taxation capacity and tax base increased due to more efficient tax collection. All in all, this has led to an increase in revenue; while at the same time also to a mitigation of the tax burden on the economy.

The majority of spending consists of recurrent expenditure (mostly wages, social transfers and donations) which is crowding out public investment. Wages have gradually increased their share in total expenditures from 18.9% in 2002 up to 24.6% in 2006; and even to 27% in the first eleven months of 2007. The IMF has criticised the sharp increase of the wage bill, which grew by 30% (year-on-year) in the first eleven months of 2007 and is projected to increase even more in December.

The share of capital expenditure has been well below 7% for 2002-2006, with no clear trend over this period. This has been vastly insufficient given Serbia's obsolete infrastructure and the need for investment across the country's large public sector. Reacting to these needs, the Government established the National Investment Plan (NIP), a multi-year programme of capital investments (amounting to RSD 44.3 billion). The programme which was initiated in late 2006 has been implemented throughout 2007; producing higher rates of public investments. However, following the critique from the IMF on the lack of focus, the programme underwent a make-over and is now being directed towards large infrastructure projects.

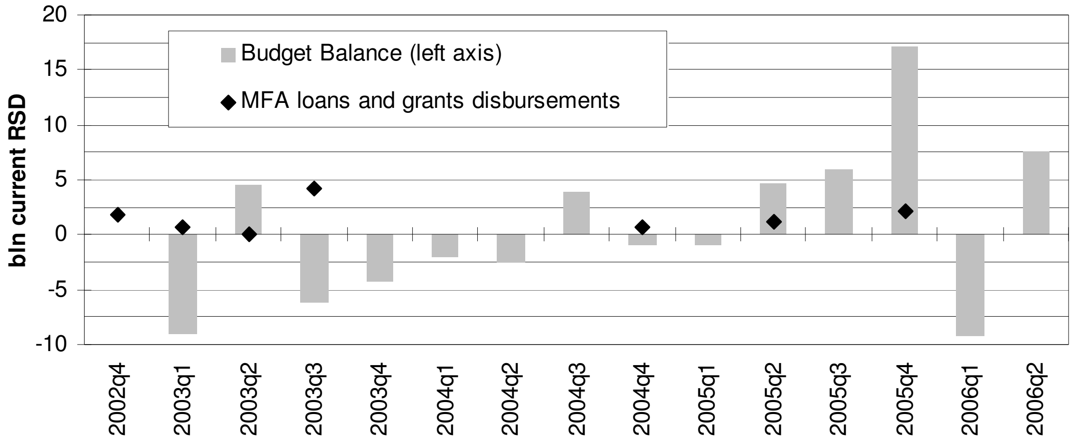
The developments in consolidated finances are in line with those in the central budget, and point to a marked improvement in the fiscal situation in Serbia. However, the

[17] National Bank of Serbia (2007), Third Quarter Inflation Report, 2007

consolidated fiscal results calculated according to the IMF methodology[18] look considerably worse as the data point to a deterioration of the fiscal balance over the 2004-2006 period to -4.7% of GDP in 2006; and an improvement to a mere 0.3% of GDP for the first three quarters of 2007. In view of the accelerating domestic demand (on the back of the credit and wage growth) and rising inflation; the IMF recommends substantial fiscal adjustments of the projected deficits of -0.6% and -0.5% of GDP at the Central government and General government levels[19].

In Figure 4.12, the quarterly values of the budget deficit for the period 2002.Q4-2006.Q2 have been depicted, along with quarterly values of loan and grant disbursements related to the second MFA. While disbursement funds have undoubtedly eased current budgetary problems in Serbia (as indicated by the interviewees from the Ministry of Finances and National Bank of Serbia), it is hard to discern any strong link between the MFA funds and the budget outcome.

Figure 4.12 Quarterly values of the central budget deficit and total loan and grant disbursements related to second MFA (in billion current RDS), 2002-2006



Note: Data for the budget balance in 2002q4 unavailable

Source: International Financial Statistics and National Bank of Serbia

4.3.3 Macroeconomic developments in Montenegro

Macroeconomy - Montenegro

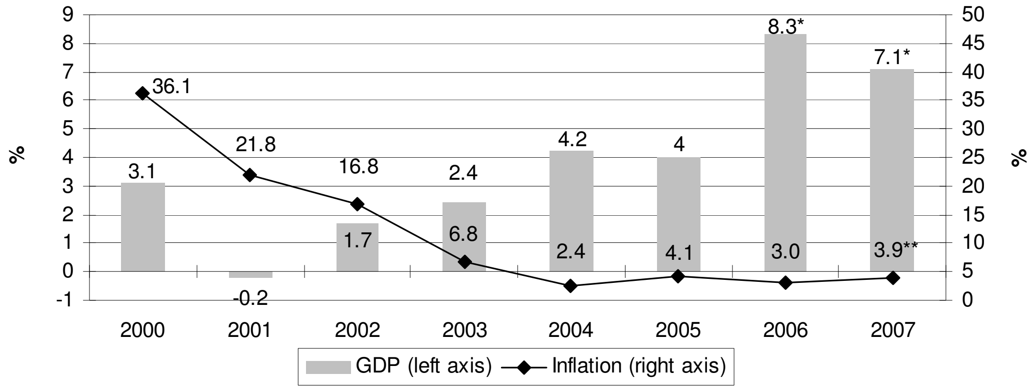
Since the introduction of the German mark as its currency in January 2000, Montenegro has practically detached itself from Yugoslavia, economically. The move was aimed at achieving macroeconomic stabilisation after the prolonged period of economic chaos and hyperinflation prevailing in Yugoslavia in the 1990s. In 2002, the German mark was replaced with the euro which has been the only official currency in Montenegro since then.

18 Including debt repayments and spreading the one-off revenues (e.g. from the sale of the mobile telephone licence) over the multiple-year period.

19 Projections taken from the *Revised memorandum on the budget and economic and fiscal policy in the year 2008* (www.mfin.sr.gov.yu)

Figure 4.13 presents the development of real GDP and inflation. Since 2003, economic growth has accelerated to an impressive 8.3% in 2006; and 7.1% in the first three quarters of 2007 – mostly on the back of expanding domestic demand in line with rapidly growing real wages and the consumer and mortgage credit boom. In parallel, inflation has declined considerably, although it continues to be somewhat higher than in the euro zone.

Figure 4.13 Real GDP growth rate and inflation in Montenegro, 2000 – 2007



* - Estimates by the Montenegrin Secretariat for Development (for 2007 data refer to first three quarters)

** - Data for January-November 2007

Source: Monstat – Statistical Office of Montenegro

The real sector, employment and unemployment - Montenegro

The expansion of Montenegro's economy since 2001 has been mostly due to services, in particular in the trade, transport, construction and property sectors. This trend has been continued in 2006 and 2007. The manufacturing sector has been traditionally dominated by aluminium (produced by KAP, Podgorica); generating roughly half of the country's industrial output and about 40% of export revenue.

In recent years, tourism and property experienced a dynamic expansion. The former sector is assessed as the future driving force of Montenegro by the Travel and Tourism Council (TTC); which forecasts that tourism will account for about 20% of GDP by 2015. Strongly related is the property boom that was initiated by tourism but which has recently spilled over to residential construction (see Table 4.10).

Table 4.10 Annual growth of activity in industry, construction and tourism (year on year, in %)

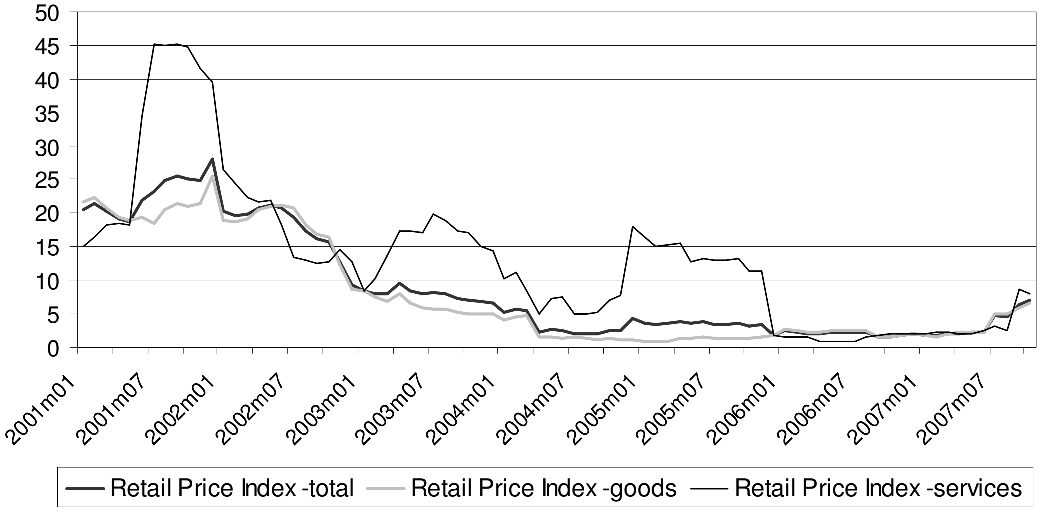
	2001	2002	2003	2004	2005	2006	1-9.2007
Industry (volume of output)	-0.7	0.6	2.4	13.8	-1.9	-2.0	-4.0
Construction (value of works in EUR)			-12.8	18.5	40.3	154.7	-11.1
Construction (effective hours worked)			-8.7	-5.7	22.9	46.3	20.5
Tourism (no. of overnight stays)	25.9	-8.0	7.8	14.7	14.3	13.9	23.2
Tourism (arrivals of tourists)	23.8	-2.4	10.7	17.4	16.6	16.3	19.1

Source: Monstat – Statistical Office of Montenegro

Inflation and money - Montenegro

When Montenegro phased out the dinar at the end of 1999, it anchored its policy with the German mark. However, the transition to low and stable inflation was protracted and single-digit inflation rates were not achieved until 2003. Figure 4.14 presents annual inflation rates. It also shows that the inflation process in Montenegro was driven by inflation in services. This is in line with the Harrod-Balassa-Samuelson hypothesis, which predicts positive inflation differentials in non-tradables vis-à-vis tradables. While prices of goods in Montenegro were reasonably[20] anchored by the Euro, those of services followed trends in the overall productivity and wages in the economy, and thus outpaced goods inflation. Additional inflationary effects came from the gradual liberalisation of a number of sectors, including electricity and municipal services.

Figure 4.14 Annual inflation in Montenegro, year-on-year changes in the Retail Price Index, in %



The specific situation in Montenegro with respect to the money supply hinges on the fact that it adopted the euro (before that the German mark) unilaterally, without the right to issue the currency or influence the monetary policy of the euro zone. Hence the Central Bank of Montenegro possesses very limited instruments to influence monetary aggregates.

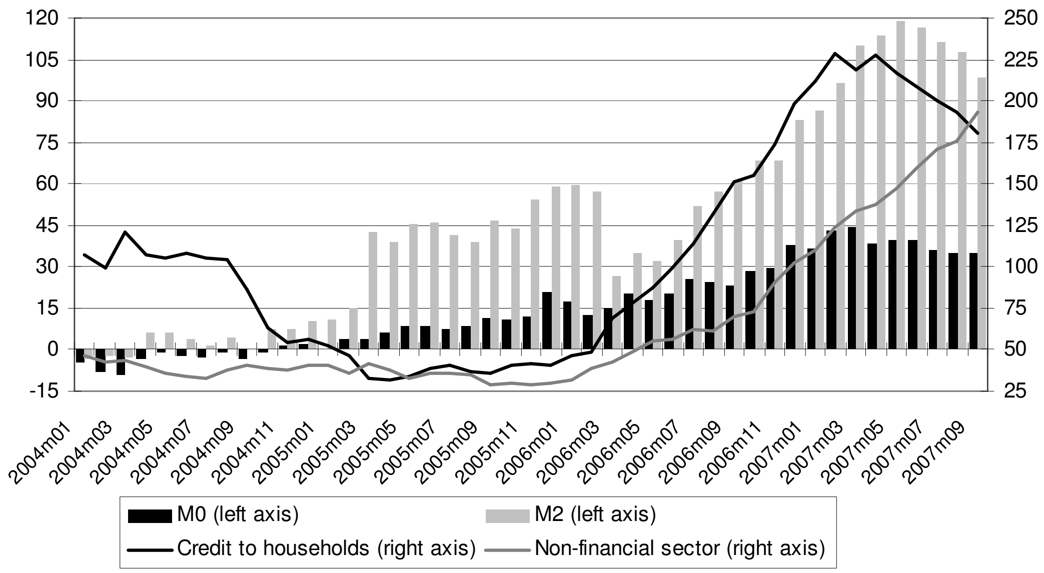
The years up to 2004 were characterised by low activity of the banking sector; as the then mostly state-owned Montenegrin banks offered a limited range of banking products at unattractive prices to a public that still remembered the Yugoslav banking crisis of the 1990s. A change happened in 2005, when the privatised banking sector seized on the improving economic situation and the growing confidence of Montenegrins to expand credit lending. Total loans of the banking sector grew by almost 10% in 2002; 21% in 2005; 43% in 2006, and are even projected to grow by 90% in 2007. The main driving force behind this surge was credit to households fuelled by the property and stock

[20] Even for goods, a positive differential vis-à-vis the euro zone has persisted. This phenomenon was investigated by Lekovic and Wozniak (2003) and Radojevic and Wozniak (2006), and attributed to a sizeable non-tradable element in prices of tradables, as well as the size and imperfections in the Montenegrin market for goods (such as insufficient competition, inefficiencies, barriers to entry).

exchange[21] boom that grew at rates exceeding 100% in 2006, and accelerated further to over 200% in 2007. Credit to enterprises, whose dynamics lagged behind, has recently caught up with the dynamics of household credit as a reflection of the buoyant activity in many service sectors.

The Central Bank of Montenegro, recognising the threat posed by such a credit surge, has introduced a number of measures to limit loans to households; including household credit ceilings and more restrictive household credit ratings. This has resulted in a slow-down in the annual dynamics to a still high 180% (year-on-year) in September 2007.

Figure 4.15 Annual rate of growth of money and credit aggregates in Montenegro, 2004-2007 (year-on-year, in %)



Balance of Payments- Montenegro

Data on Montenegro's balance of payments are presented in Table 4.11 and Figure.4.16. Since 2003 Montenegro's current account has widened considerably from -7% of GDP in 2003 to -10% in 2005 and to -26% in 2006 and as much as -50% in the first half of 2007[22]. This worsening occurred due to rapidly growing imports triggered by the property and consumption boom coupled with sluggish export growth.

The tourism industry has traditionally supplied the country with sizable revenues from the export of services; resulting in positive and significant balances on income from services. After years of gradual growth, 2007 will be another record year; as income surged by 70% in the first half of the year alone, and an excellent 2007 summer season is likely to boost the total 2007 surplus to far beyond above the 2006 record level. Current transfers (mostly remittances) have gained in importance during 2003-2005, but have gradually declined since then.

21 It was common among Montenegrins to take out loans to invest in the stock exchange.

22 Due to seasonal inflows from tourism the first-half of the year, the Current account balance has traditionally been much worse than the all-year figures. This is evidenced by first-half--year figures and all-year figures for 2006 in Table 4.11.

Table 4.11 Balance of Payments of Montenegro, 2003 – 2007 (in thousand EUR)

	2002*	2003	2004	2005	2006	1-6. 2006	1-6. 2007
I. CURRENT ACCOUNT	-157,138	-102,056	-119,642	-154,045	-511,902	-324,789	-463,737
*as % of GDP***	*-12.1*	*-7.3*	*-7.2*	*-8.6*	*-26.0*	*-43.0*	*-50.3*
1. Goods	-424,705	-359,330	-416,436	-513,653	-849,325	-391,777	-582,501
1.1. Export	322,624	270,574	452,148	460,648	648,327	280,699	288,468
1.2. Import	747,329	629,904	868,584	974,301	1,497,651	672,476	870,969
2. Services	100,822	111,663	148,176	195,540	216,403	3,496	80,598
2.1. Export	175,969	191,325	249,529	329,765	433,550	107,883	178,475
2.2. Import	75,147	79,662	101,353	134,225	217,147	104,387	97,877
1.+2. Goods and services	-323,883	-247,667	-268,260	-318,113	-632,922	-388,281	-501,903
3. Income	74,201	87,926	86,242	17,512	30,800	9,286	12,143
3.1. Receipts	99,569	113,753	135,455	62,291	65,334	25,465	41,460
3.2. Payments	25,368	25,827	49,213	44,779	34,534	16,179	29,317
4. Current transfers	92,544	57,685	62,376	146,556	90,220	54,206	26,023
4.1. Receipts	102,755	66,809	73,493	163,455	108,555	60,262	48,012
4.2. Payments	10,211	9,124	11,117	16,899	18,336	6 056	21,989
II. CAPITAL AND FINANCIAL ACCOUNT		16,626	58,858	191,881	521,560	315,644	565,811
A. Capital account			0	0	-14,028	-13,188	-1,376
B. Financial account		16,626	58,858	191,881	535,588	328,832	567,188
1. Foreign direct investment, net	89,183	38,725	50,567	381,213	466,701	159,933	290,305
*As % of GDP***	*6.9*	*2.8*	*3.1*	*21.4*	*23.7*	*21.2*	*31.5*
2. Portfolio investment, net		942	5,524	4,815	-4,444	3,677	2,924
3. Other investment, net		-82,157	-19,446	-20,390	137,001	95,169	244,569
4. Change in net foreign assets		54,517	31,820	-60,900	73,379	72,913	143,295
5. Change in CBM foreign reserve assets		4,599	-9,607	-112,857	-137,048	-2,860	-113,905
III. BALANCE OF CURRENT AND CAPITAL/FINANCIAL ACCOUNT		-85,430	-60,784	37,836	9,658	-9,145	102,074
IV. ERRORS and OMISSIONS, net		-85,430	-60,784	37,836	9,658	-9,145	102,074

Note: Net errors and omissions are explicitly set to the joint balance of the current and capital and financial accounts, resulting in the overall balance of payments equal to zero.

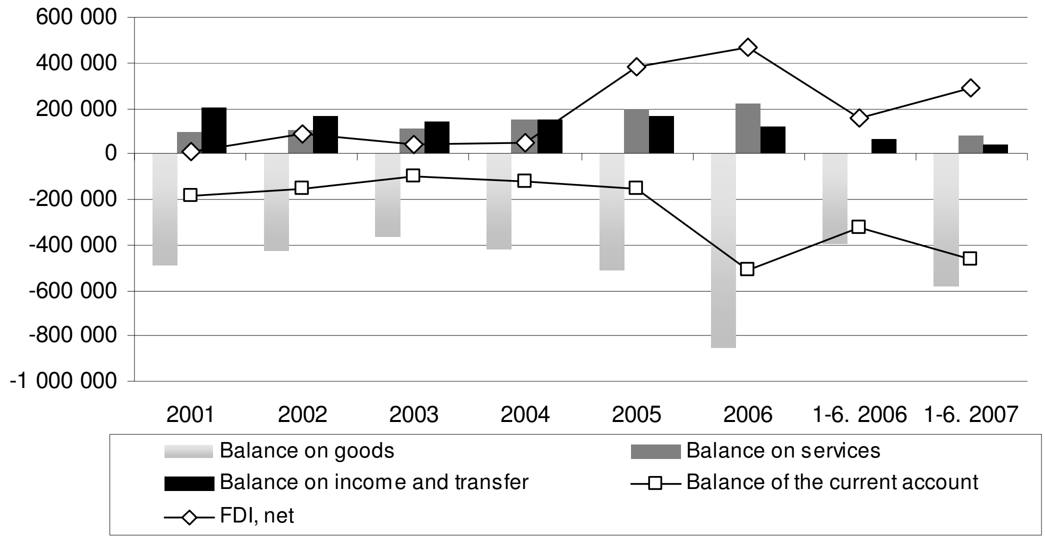
* Data taken from Montenegro Economic Trends no 22, (ISSP, 2006).

** GDP figures for 2006-2007: estimates and projections by the Montenegrin Secretariat for Development

Source: Central Bank of Montenegro

Foreign direct investment was very low during 2001-2004 but increased afterwards. This was mostly due to one-off transactions related to the sale of state-owned companies; and more recently due to massive inflow of funds for construction investment. FDI financed almost 40% of the Current account deficit in 2003-2004, and jumped to 250% of the Current account deficit in 2005 but fell to about 90% in 2006. The year 2007 sees an increasing trend, as the data for the first half of the year point to an 81% increase in FDI (year-on-year), and a higher coverage of the Current account deficit (63%) than a year earlier (49%).[23]

Figure 4.16 Current account balance and FDI in Montenegro, 2001 – 2007



{Source: Central Bank of Montenegro}

Montenegro’s foreign trade has been traditionally dominated by exports of aluminium, which accounted for 50% to 60% of export revenues during 2000-2004, and have dropped below 50% in recent years. Other important sectors are steel, transport equipment, oil derivatives and fruit and vegetables. On the imports side, oil and oil products account for the largest share of trade.

Montenegro's gross international reserves remained modest in the early part of the decade; and stood at €60 million (equivalent to US$74 million) at the end of 2004. Reserves almost tripled in 2005, reflecting inflows from privatisations, and increased to €310 million by the end of 2006. They grew by an additional €114 million in the first half of 2007.

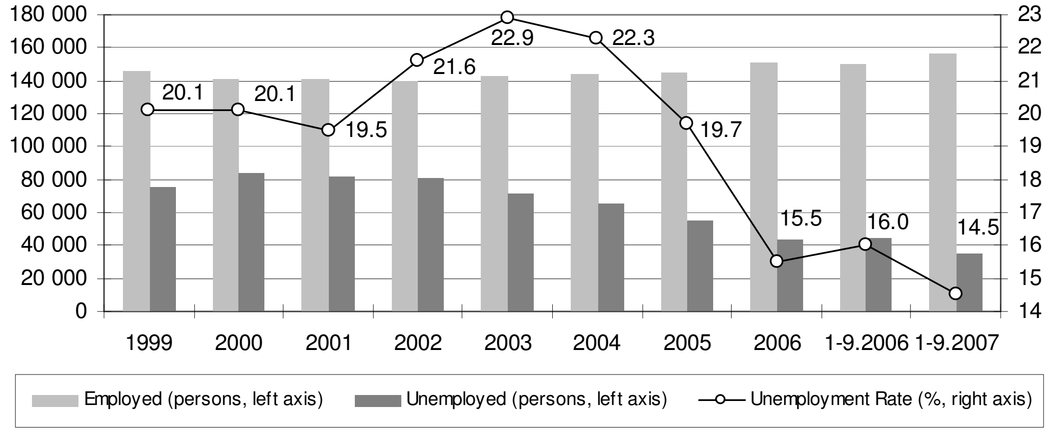
Labour market – Montenegro

Unemployment has been falling rapidly since 2003, while employment picked up slowly in 2006. The trend continued throughout 2007. The trade sector (retail and wholesale) recently overtook the manufacturing sector as the biggest employer (19.6% and 17.3% in 2006 respectively,). The public sector is also a large employer in education, health and administration; employing 8.5%, 8.0% and 6.8% of the employed, respectively; while 7.2% of the employed work in hotels and restaurants.

The buoyant economy has halved the number of unemployed between 2002 and 2006, which led to a sharp decline in the unemployment rate from 23% in 2002 to 15.5% in 2006; and further to 14.5% in the first three quarters of 2007.

[23] Due to the strong seasonality of inflows from services, Current account data in Montenegro is always higher; and the FDI coverage always lower in the first half of the year compared to the second half.

Figure 4.17 Employment, unemployment and the unemployment rate in Montenegro, 1999 – 2007

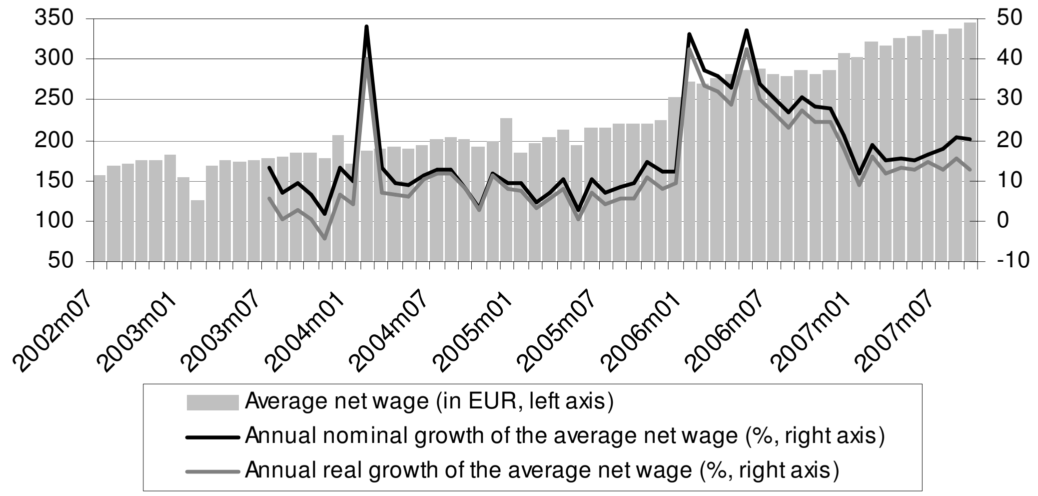


Note: Unemployment rates are ISSP estimates based on official data

Source: Employment Bureau of Montenegro, Monstat, Central Bank of Montenegro

Net wages in the total economy have increased steadily; and have more than doubled between 2002 and 2007 in nominal terms. This has been higher than the labour productivity growth in the economy. On the other hand, in mining and quarrying, as well as manufacturing, the dynamics of wages has been roughly in line with that of productivity; leaving the price competitiveness of Montenegro's exports stable[24]. In real terms, wages grew at an average rate of over 7% during 2003-2005; and 22% during 2006-September 2007.

Figure 4.18 Developments in average net wage in Montenegro, 2002 – 2007



{Source: Monstat - Statistical Office of Montenegro}

[24] Sectoral productivity during 2002-2005 has been investigated by Obradović and Wozniak (2007).

Public finance-Montenegro

Table 4.12 Public Finance in Montenegro, 2002 – 2007

		2002	2003	2004	2005	2006	1-9. 2007
A Total revenue and grants	EUR m	256.80	350.10	379.73	431.79	557.83	522.56
	*% GDP**	*19.7*	*25.2*	*23.0*	*24.2*	*28.3*	*33.4*
	% of the total revenues and grants	100.0	100.0	100.0	100.0	100.0	100.0
Total revenue		89.5	96.4	98.2	96.5	100.0	100.0
Tax revenue		81.4	89.4	88.9	88.5	89.5	97.3
Personal income tax		22.5	18.3	16.1	15.5	13.0	10.5
Turnover (sales) tax		22.0	39.2	41.6	44.8	49.0	54.8
Excises		19.8	16.6	16.2	15.2	13.0	12.8
Taxes on international trade and transactions		10.3	10.5	9.7	9.5	10.2	9.4
Custom tariffs		4.9	10.0	8.9	8.6	10.2	9.4
Custom transit fees		5.4	0.5	0.8	0.7	0.0	0.0
Other taxes		6.8	4.8	5.3	5.8	4.4	9.7
Non-tax revenues		8.1	7.0	8.5	6.8	9.3	8.9
Capital revenue		0.0	0.0	0.8	1.2	1.2	2.7
Grants		10.5	3.6	1.8	0.6	0.0	0.0
Total expenditure and net lending	EUR m	266.77	381.09	405.49	459.71	523.18	386.75
	*% GDP**	*20.5*	*27.4*	*24.6*	*25.7*	*26.6*	*24.7*
	% of the total expenditure and net lending	100.0	100.0	100.0	100.0	100.0	100.0
Total expenditure		92.8	94.2	96.2	93.5	100.3	99.9
Current expenditure		88.7	90.6	93.1	86.9	94.3	91.2
Interest		4.8	3.7	5.9	4.4	4.3	4.5
Non-interest expenditure		83.9	86.9	87.2	82.4	90.0	86.7
Wages, salaries, allowances		41.3	35.2	40.5	33.9	31.9	37.4
Goods and Services		15.7	9.9	11.6	12.5	11.9	14.3
Social insurance and social security transfers		13.4	34.8	25.6	25.5	30.2	30.7
Subsidies to enterprises		6.8	3.8	2.1	1.4	1.2	1.4
Reserves		5.6	2.2	4.1	6.3	5.2	1.3
Other non-interest expenditure		1.1	0.8	3.3	0.4	9.6	1.6
Capital expenditure		4.1	3.6	3.1	6.7	6.0	8.7
Net lending		7.2	5.8	3.8	1.6	-0.3	0.1
Lending		7.3	5.9	4.4	0.0	1.5	1.1
Repayment		0.1	0.1	0.6	0.0	1.8	1.0
Overall budget balance excluding grants	EUR m	-36.93	-43.57	-32.70	-27.91	34.64	135.74
	*% GDP**	*-2.8*	*-3.1*	*-2.0*	*-1.6*	*1.8*	*8.7*
1 Domestic and foreign financing (net)	EUR m	0.57	6.23	19.89	-71.88	-38.47	-56.22
Borrowings		40.45	48.25	51.11	0.00	8.82	2.05
Repayment		39.88	42.01	31.22	0.00	47.29	58.27

		2002	2003	2004	2005	2006	1-9. 2007
2 Privatisation revenue		37.69	12.16	3.54	136.31	6.29	5.08

* GDP figures for 2006-2007: estimates and projections by the Montenegrin Secretariat for Development, for 2001-2005 – official figures from the Monstat - Statistical Office of Montenegro
Source: Ministry of Finance of Montenegro

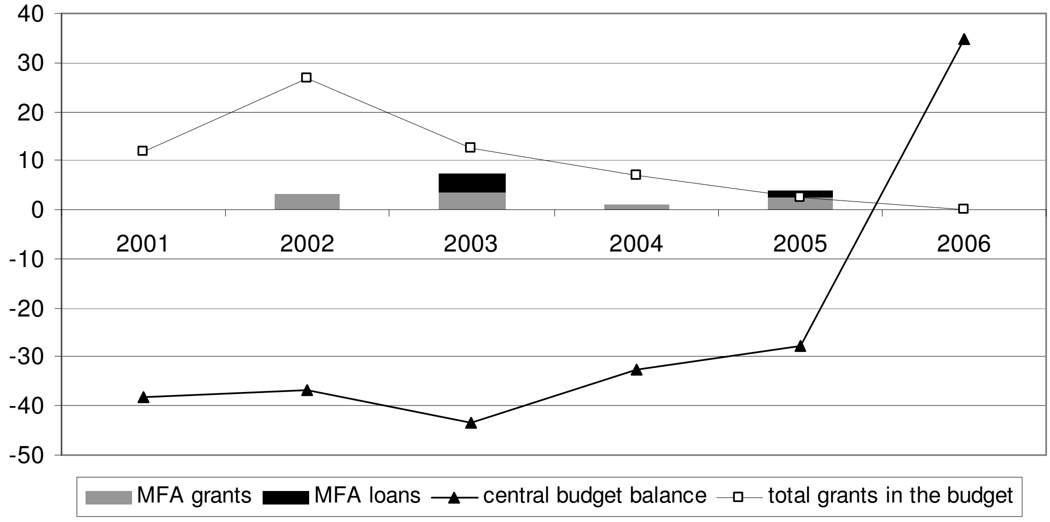
Public finances have improved over the years. The introduction of VAT doubled the revenues in terms of GDP compared to the previously collected sales tax (from 4.3% in 2002 to 9.9% in 2003). Collection of other taxes, such as customs tariffs and excises increased, as well reflecting rising domestic demand and retail sales (but also VAT-induced broadening of the tax base); while that of personal income tax as percentage of GDP declined reflecting the Government's decision to cut tax rates substantially and placed emphasis on indirect taxation. This process has been highly successful, as reflected in the rise of the contribution of indirect taxes to total tax revenue from 65% in 2001 to 80% in 2006.

Current expenditures account for over 90% of total expenditures; of which wages constitute the largest part (over 30%), followed by social insurance and social security transfers including pensions (30%). Subsidies to enterprises have declined substantially as a percentage of total spending; while capital expenditures is stable at 3% to 7% of GDP without consistent trend.

Buoyant economic activity and successful tax reforms have contributed to marked improvements in the budget balance. The overall budget balance excluding grants rose from -2% to -3% of GDP during 2001-2005 to 1.8% in 2006; and to a remarkable 8.7% in the first three quarters of 2007.

Against this background it is useful to analyse the MFA inflows to Montenegro, which accounted for 10% of the total disbursements. Figure 4.19 presents the annual central budget balance (excluding grants), total grants in the budget, as well as the total MFA inflows (both grants and loans). Most interviewees in the Montenegrin Ministry of Finance admitted that the MFA was treated largely as budgetary support. Figure 4.19 shows that while grants covered most of the budget deficit in the first half of the decade; the importance of the MFA was non-negligible in 2003, when it amounted to roughly half of total grants; and 2005 when it accounted for 100% of grants disbursed to Montenegro. On the other hand, 2005 was the year of record-high privatisation revenues (from the sale of the largest Montenegrin enterprise – the aluminium plant KAP), which covered the deficit five-fold; such that the MFA grant did not appear as an indispensable budgetary revenue source.

Figure 4.19 Central budget balance, total grants, and MFA flows in Montenegro, 2001 – 2006



4.3.4 Conclusions

Serbia has achieved sound economic growth. Montenegro has also experienced high economic growth. Curbing inflation has been an enormous challenge for the Serbian authorities. Inflation declined, but at the end of the MFA period, inflation was still high and reached a single-digit number only in 2007. In Montenegro, inflation has declined since2003; reaching 3.0% in 2006. Serbia's Current account deficit worsened gradually since 2000 and reached 11.5% in 2006. Montenegro's Current account deficit widened since 2003 and reached about -26% of GDP in 2006. In Serbia, the capital and financial account balances exceeded the Current account deficit; resulting in positive net inflow of capital and accumulation of reserves. Foreign direct investments started rising in 2003. Foreign exchange reserves have been on a steadily increasing path since 2000. In Montenegro, foreign direct investment was very low in 2001-2004 but increased afterwards due to the one-off transactions related to the sale of state-owned companies; and more recently to the massive inflow of funds for investment in construction. Montenegro's gross international reserves remained modest in the early part of the decade but almost tripled in 2005, reflecting inflows from privatisations. Serbia was successful in balancing central government revenues and expenditures; switching from a deficit into a surplus in 2005 due to tax revenue reforms and improved tax administration. Also in Montenegro, public finances improved over the years due to the buoyant economy and successful tax reforms.

As mentioned previously, the main macroeconomic objectives of Serbia and Montenegro - supported by the international community - included the achievement of low inflation with sustainable growth and external viability. In principle, these objectives have been achieved, but as Chapters 5 and 6 will show that some doubts exist on the sustainability in the medium and long term. Moreover, reducing inflation in Serbia took more time, and was only achieved after the end of the MFA operation.

4.4 Counterfactual

Table 4.13 summarises the evaluation questions dealing with the possible counterfactual analysis of MFA intervention on macroeconomic stabilisation and structural reforms.

Table 4.13 Evaluation questions relating to counterfactual analysis

	Counterfactual
Q0.1	What arrangements would have been implemented if the MFA had not been granted?
Q0.2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)?

The counterfactual on alternative arrangements if the MFA had not been granted assumes a key decision on how to deal with the parallel IMF arrangement financing. Since the latter is a precondition for the MFA, it is assumed that all conditions for the IMF arrangements are in place. However, MFA is not possible because it does not exist as an instrument. The strong assumption is that the actual IMF arrangement would have been in place, at any rate.

In defining the alternative arrangement in the counterfactual, we have examined the most likely behaviour of IFIs, other donors, as well as the possible policy response of Serbian authorities in the absence of the MFA. Structured interviews have been the main evaluation instrument to understand this.

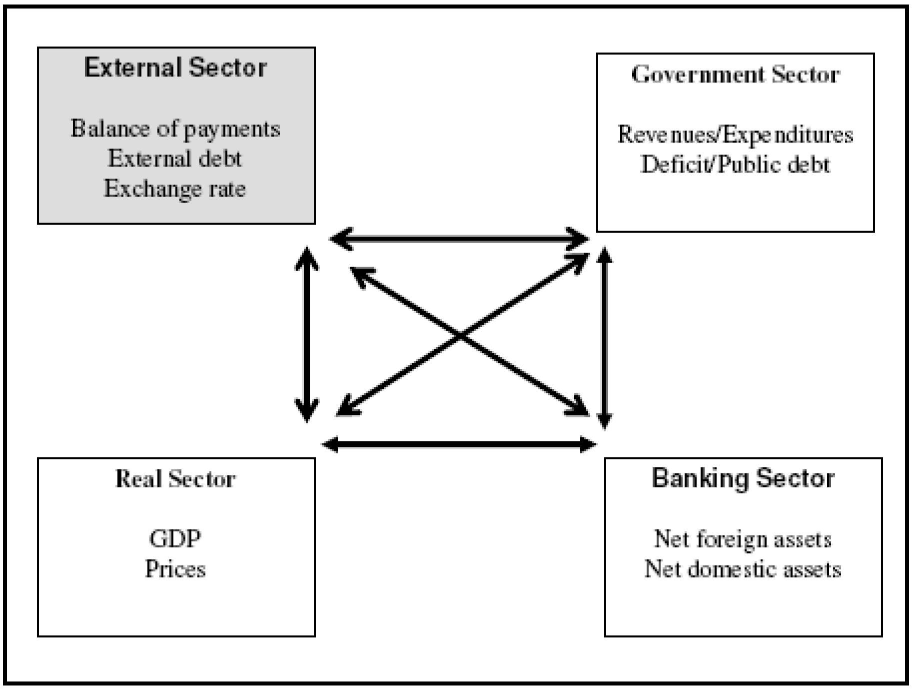
Representatives from the IMF who were interviewed mentioned that the IMF would not have increased the assistance in the three-year Extended Arrangement programme. Also, World Bank officials stated that the World Bank would not have increased its lending programme. IMF representatives confirmed that without the perspective of MFA, the quantitative performance criteria in its Stand-By-Agreement would have been set more austere to enable the country to restore macroeconomic stability. The macroeconomic objectives would not be changed, but the conditions to achieve the targets would be set more austere. Following interviews with Serbian policymakers, other options would not have existed. Since tax reforms and tax administration improvements were on the agenda of the policy makers; adjustment would have come from the expenditure side of the budget

Based on this analysis, the most likely counterfactual scenario contains the following characteristics:
- The IMF three-year Extended Arrangement programme would not have been affected;
- The World Bank and other donors would not have increased their volume of assistance;
- Restructuring of Serbia's debt towards Paris and London Club creditors would not have speeded up or slowed down
- Privatisation would not have been speeded up to generate additional privatisation revenues;
- The privatisation process would not have been implemented at a slower pace due to lack of MFA funds necessary to organise the privatisation process.

Therefore, the proposed counterfactual is the situation in which no other official funds would be available to compensate for the non-available MFA resources. Although access to private capital markets improved between early and late periods of the operation (i.e. between 2002-2003 and 2004-2005), we believe that lack of MFA assistance would generally lead to more fiscal austerity and a harder balance-of-payments constraint throughout the period of operation. From our interviews and analysis, we conclude that fiscal adjustment would be concentrated on the expenditure side of the budget, as institutional capacities to generate additional revenues have already been used. On the balance-of-payments side, we believe that lack of MFA resources would be partly reflected in a lower increase of gross reserves (and reduced need for sterilisation by the National Bank of Serbia) and partly in exchange rate weakening.

A quantitative modelling approach has been used to estimate the macroeconomic effects of the MFA operation. The counterfactual scenario was explicitly modelled; and its results are compared with the actual data. The applied macroeconomic model is similar to the model employed in previous evaluations (evaluation of MFA in the Former Yugoslav Republic of Macedonia, Romania, and Tajikistan). The model recognises links and ensures consistency among four basic economic sectors: real, external, government and banking. Figure 4.19 illustrates these linkages.

Figure 4.19 The model structure – linkages between four basic economic sectors: real, external, government and banking



Several refinements have been introduced to the basic modelling framework to allow a more nuanced analysis of the effects of the MFA operation. The guiding principles of the model improvements were: (i) allowing the widening of the sensitivity analysis and (ii) including country-specific features that may prove to be important in analysing the MFA operation in Serbia. In particular, the model was amended in order to better capture the difficult trade-off between inflation and Current account objectives, which has existed in Serbia during the MFA period. Specifically, exchange rate-inflation pass-through was studied more carefully. This was achieved by modelling tradable and non-tradable economic sectors separately. Whenever possible, elasticity coefficients have been estimated using quarterly series. Appendix A describes in detail the macroeconomic model and the values of the coefficients.

We developed the macroeconomic model in detail only for Serbia, due to data constraints with regard to Montenegro. In any case, the model for Serbia is representative for Serbia and Montenegro combined; since 90% of MFA was allocated to Serbia, given the large size of the Serbian economy. With some exceptions, the quality of macroeconomic data for Serbia is generally acceptable and adequate to estimate most economic elasticities using quarterly series.

In the applied macroeconomic model, the absence of the MFA affects the macroeconomic developments through three main channels. These channels are reflected in the system of identities and behavioural relations that constitute the macroeconomic model.

1. Firstly, there is a direct impact on the balance of payments. In the absence of MFA (both grant and loan) and a lack of alternative sources, the adjustment would take place either through a change in the international reserves or in the Current account; with a corresponding exchange rate depreciation pressure. Specifically, tighter macroeconomic policies would lead to the contraction of aggregate demand which would reduce demand for imports. Depreciation in the real exchange rate would facilitate this adjustment. As a result, the Current account deficit would be slightly reduced, notwithstanding the direct impact of the absence of the MFA grant. In addition, external debt accumulation would be slightly lower if the MFA loan were absent; and would not substituted by other debt-creating flows.

2. The second channel of impact would operate through the public finances. The absence of the MFA grant would imply lower government revenues; while the absence of the MFA loan would imply lower external opportunities to finance the budget deficit. Following the interviews, we believe that the policy reaction would be quite austere. Expenditure would not only be reduced by the size of grant element to initially maintain the original deficit, but also by the size of loan element to avoid the necessity of finding additional deficit financing. As a result, the budget deficit would be actually lower in the counterfactual.

3. Thirdly, the counterfactual would imply a more restrictive monetary policy; with lower reserve accumulation, lower growth in the monetary base and less credit to the private sector.

This general contraction of macroeconomic policies would slow down growth in real output, consistent with the lower demand for imports, lower government spending and less credit to the private sector. The impact on inflation is more difficult to asses as two contradictory forces would exist: (i) the tighter monetary policy would tend to slow down price dynamics in the non-tradable sector, however (ii) exchange rate depreciation would increase import prices. Empirically, the first effect appears to be larger.

Table 4.14 presents the main macroeconomic variables of the counterfactual scenario.

Table 4.14 Macroeconomic aggregates in the counterfactual scenario

	2002	2003	2004	2005
Macroeconomic				
GDP growth rate (% per annum)	4.1	2.3	8.4	6.1
Inflation rate (% points)	21.4	11.7	9.8	17.3
Euro exchange rate	60.7	65.2	72.6	83.0
Balance of payments				
Current account (in millions of USD)	-1264	-1472	-2855	-2240
Capital account (in millions of USD)	2048	2471	3075	4701
Change in reserves (in millions of USD)	911	874	426	1993
Public finance				
Government revenues (% of GDP)	25.3	22.2	23.2	23.8
Government expenditure (% of GDP)	28.9	25.6	24.7	23.8
Government balance (% of GDP)	-3.6	-3.4	-1.6	0.0

Source: Estimations from the model

The quantitative modelling results show that impacts on both growth and inflation would remain rather limited, which is consistent with the small overall size of the operation, as mentioned in section 4.3.

4.5 Net impact on macroeconomic stabilisation

Q1.3: What has been the contribution of the grants and/or loans provided by the MFA operation to the achievement of MFA objectives?

Estimates of the net impact of MFA to Serbia are the result of comparing the actual developments with the counterfactual outcomes. All estimates should be interpreted with caution as they are based on relatively short annual time series and strong assumptions. Interpretation could be focused on signs and the relative size of the effects; rather than on particular numerical values.

The MFA operation allowed for a slightly more expansionary macroeconomic policy that marginally improved economic growth performance. However, the direct short-term macroeconomic impact of the operation was very small, as illustrated by the quantitative results in Table 4.15. Potentially, MFA assistance could have a more substantial impact on the medium-term macroeconomic outlook through the acceleration of structural reforms. This channel is analysed in detail in Chapters 5 and 6.

Table 4.15 Net impact of MFA (differences between actual and counterfactual)

	2002	2003	2004	2005
Macroeconomic				
GDP growth rate (% per annum)	0.09	0.19	0.06	0.09
Inflation rate (%)	0.02	0.05	0.04	0.03
Euro exchange rate appreciation (%)	0.09	0.19	0.06	0.09
Balance of payments				
Current account (in millions of USD)	17.0	2.3	22.4	14.9
Capital account (in millions of USD)	0.0	45.2	0.0	18.6
Change in reserves (in millions of USD)	17.0	47.5	22.4	33.6
Public finance				
Government revenues (% of GDP)	0.2	0.2	0.1	0.1
Government expenditure (% of GDP)	0.2	0.4	0.1	0.2
Government balance (% of GDP)	0.0	-0.2	0.0	-0.1

Note: The values in the table have been obtained as differences between historical values for the respective variables and counterfactual values in the assumed scenario. Only net effects without actual and counterfactual values are presented because actual series for some data contain break points, making the exposition difficult. This has not affected the modelling results.

Source: Estimations from the model

4.6 Indirect macroeconomic effects of structural conditionality

Q3.1: What, if any, has been the contribution of actions resulting in respect of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?

The case studies on bank privatisation and enterprise privatisation address this question. Through the case studies, we examined both the immediate (or direct) impact of structural reform on the balance of payments and the public finance and the medium to long-term (or indirect) impact.

4.7 Unexpected macroeconomic results

Q3.2: Has the assistance given rise to any unexpected short or medium-term macroeconomic effects? What were these and how did they occur?

There was no unexpected macroeconomic effect of the MFA.

5 Impact on structural reforms

5.1 Introduction

This chapter explains our approach to these evaluation questions, and presents the evaluation findings. Table 5.1 presents the evaluation questions which analyse the impact of MFA on structural reforms.

Table 5.1 Relevant evaluation questions for analysing the impact of structural reforms

	Impact of structural reforms
Q2.1	What are the short and medium-term anticipated structural effects of the assistance (in the context of the recipient country's reform programme)?
Q2.2	How relevant are the short and medium-term anticipated structural effects of the assistance to the needs of the recipient country?
Q2.3	To what extent have the short and medium-term anticipated structural effects of the assistance (in the context of the recipient country's reform programme) occurred as envisaged?
Q0.1	What arrangement would have been implemented if the MFA had not been granted?
Q0.2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)?
Q2.4	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?
Q2.5	To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?
Q3.2	Has the assistance given rise to any unexpected short and medium-term structural effects? What were they and how did they occur?

5.2 Structural objectives of the intervention and their relevance

Q2.1 What are the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme)?

This section addresses evaluation question 2.1.

The disbursement of the second and third tranche of the MFA was made conditional on certain requirements for structural reform. The Appendix of the MoU contained the structural conditionalities. Similarly, the disbursement of the fourth and fifth tranche of the MFA was made conditional on additional reform requirements. These conditionalities were part of the SMoU. Table 5.2 lists the conditionalities of the MoU (second and third tranche). The conditionalities can be grouped into three main areas:

I Public finance reform and administration;
II Financial sector reform;
III Private sector development.

Table 5.2 Structural conditionalities listed in the MoU (in red: conditionality achievement)

Sector	Second tranche conditionalities listed in the MoU	Third tranche conditionalities listed in the MoU
	Public Finance Reform and Administration	
Treasury system	The *Serbian authorities* will have established an intermediate modernised Treasury system. In particular, they will have transferred a majority of direct spending units – also representing a majority of public expenditure – to the single Treasury account in the Ministry of Finance and Economy. They will also have established a Central Accounting Division in the Treasury. *Fully met*	The *Serbian authorities* will have transferred all direct spending units to the single Treasury account in the Ministry of Finance and Economy. They will also have taken necessary steps to establish a centralised payroll system under the Treasury. *Fully met*
Debt and asset management		The *Montenegrin authorities* will have established a new institutional setting for debt management and asset resolution. *Fully met*
Tax revenue collection	The *Serbian authorities* will have made progress in modernising the Public Revenue Agency (PRA). Tax collecting functions as regards payroll and income taxes, as well as social security contributions will have been transferred from the Payments Bureau (ZOP) to the PRA. A unified tax identification number will have been created for all legal entities in Serbia. *Fully met*	The *Serbian authorities* will have introduced a unified tax identification number for a majority of natural persons. They will have set up three regional large Taxpayer Offices. *Fully met*
Tax revenue policy		The *Montenegrin authorities* will have enacted the Laws on Games of Chance, on Gifts, and on Inheritance. *Fully met*
		The *Serbian and Montenegrin authorities* will have agreed on the modalities of the introduction of the Value Added Tax. *Became irrelevant*
Public administration	The *Montenegrin authorities* will have adopted a comprehensive employment and wage policy action plan for the public sector. *Fully met*	

Sector	Second tranche conditionalities listed in the MoU	Third tranche conditionalities listed in the MoU
Public pensions	The *Montenegrin authorities* will have adopted a new pension law that shifts pension indexation to the Swiss formula, and raises the minimum retirement age by 3 to 5 years in a phased manner. *Condition could soon be met*	
Customs harmonisation	The *Serbian and Montenegrin authorities* will have agreed on a detailed action plan setting out the precise steps for the harmonisation of customs tariffs. *Fully met, became irrelevant afterwards*	
Anti-money laundering	The *FRY authorities* will have ensured a proper functioning of the Anti-Money-Laundering unit through appropriate funding. The *Montenegrin authorities* will have enacted the Law on Money Laundering. *Serbia: Fully met* *Montenegro: Condition could soon be met*	
	Financial sector reform	
National Bank	The *National Bank of Yugoslavia* will have enhanced and finalised a Supervisory Development Plan for banks. *Fully met*	
	The *National Bank of Yugoslavia* and the authorities will have put monitoring and control mechanisms in place by the end of 2002 to preserve the value of the banks in which the Serbian government has executed debt equity swaps. *Fully met*	
Bank privatisation	The *Bank Rehabilitation Agency* will have launched the recruitment procedures for international consultants, including investment banks, to prepare the privatisation of those 9 of the above mentioned banks in which the Serbian government has majority stakes. *Partially fulfilled*	The *Bank Rehabilitation Agency* will have selected and contracted international consultants - including investment banks - for the privatisation of the 9 banks in which the *Serbian government* has majority stakes and has executed debt-equity swaps. It will have concluded tendering procedures for at least two of these banks. *Waiver granted*
	In *Montenegro*, the tendering procedure for Montenegro banks will have been concluded. *Fully met*	
Banking sector regulation		The *Montenegrin authorities* will have initiated consolidated supervision

Sector	Second tranche conditionalities listed in the MoU	Third tranche conditionalities listed in the MoU
		procedures. *Fully met*
		In *Serbia,* all private sector payments and in *Montenegro* the majority of private sector payments will have been transferred from the ZOP to commercial banks. *Fully met*
	Private sector development	
Bankruptcy	The *FRY authorities* will have adopted a new bankruptcy law, as well as a new accounting law that introduces international standards for accounting and reporting by companies. *Fully met*	
Privatisation	The *Serbian authorities* will have adopted amendments to the Privatisation Law and enacted the Secured Transactions Law. *Fully met*	
	The *Serbian authorities* will have strengthened the institutional capacity of the Serbian Privatisation Agency, which will have approved restructuring plans for five large socially-owned enterprises. The authorities will have also concluded eight restructuring plans for large state-owned companies. *On Privatisation Agency: Fully met* *On socially owned enterprises: Partially met*	
	In *Serbia***,** out of 74 large companies that have been identified for tender privatisation, at least 55 companies will have been offered for sale. In addition, some 400 companies will have been offered through auctions. *Fully met*	In *Serbia*, all 74 companies identified for tender privatisation will have been offered for sale by the Privatisation Agency; for an additional 10 companies, tenders for consultants will have been launched. Moreover, another 300 companies will have been offered for sale through auctions. *Fully met*
	In *Montenegro,* at least five large state-owned companies identified for tendering will have been offered for sale, including the tobacco company and the steel mill company. *Not met, and prospects for progress are uncertain*	In *Montenegro*, an additional number of at least three large state-owned companies identified for tendering will have been offered for sale. *Fully met*
		The *Montenegrin authorities* will have

Sector	Second tranche conditionalities listed in the MoU	Third tranche conditionalities listed in the MoU
		offered the Commodity Reserve Institute or its assets for sale. *Fully met*
Competition		The *FRY authorities* will have adopted a comprehensive competition law. *Became irrelevant when the condition had almost been met*
Business registration – internal market		The *Serbian and Montenegro authorities* will have taken steps to link up company registers in order to ensure that there are no obstacles to the right of free establishment throughout the country. *Became irrelevant*

The SMoU contained the fourth and fifth tranche conditionalities which were this time strictly divided in conditions for Serbia and conditions for Montenegro. Table 5.3 lists both the fourth and fifth tranche conditionalities of the SMoU. As mentioned earlier, the wording of the conditionalities explicitly included the intended structural objectives.

Table 5.3 Structural conditionalities listed in the SMoU

Sector	Fourth tranche conditionalities listed in the SMoU		Fifth tranche conditionalities listed in the SMoU	
	Serbia	Montenegro	Serbia	Montenegro
Public finance reform and administration				
Treasury system				To strengthen public financial management and control, transfer all Republican government deposits with commercial banks to the single treasury account. *Not assessed by EC*
Public administration	To raise the quality and performance of the public administration, *adopt*[25] *the Civil Service Law.*		To further enhance the accountability of the public administration, *adopt the Law on Supreme Audit Institution.*	

25 "Adopt" means the adoption by the respectively responsible parliament, if not otherwise stated.

Sector	Fourth tranche conditionalities listed in the SMoU		Fifth tranche conditionalities listed in the SMoU	
	Serbia	Montenegro	Serbia	Montenegro
	Fully met		*Not assessed by EC*	
Public expenditure management	To strengthen the basis for a proper framework and conduct of public finance, *establish a database on municipality finances*. *Fully met*		To provide for a rational fiscal framework conducive to macroeconomic stability, adopt a framework providing for sufficient compatibility between fiscal autonomy at municipality level with macroeconomic stability of the country. *Not assessed by EC*	To improve the quality and scope of statistical data and to provide a foundation for economic analysis, *adopt the Law on Statistics*. *Not assessed by EC*
Financial sector reform				
National Bank		To further enhance the accountability of the Central Bank, start operations of an internal audit committee at the Central Bank of Montenegro. *Fully met*		To strengthen prudential supervision, *establish within the Central Bank of Montenegro a regulatory credit register*. *Not assessed by EC*
Bank privatisation	To improve the efficiency and stability of the banking sector, *appoint privatisation advisors for at least two of the remaining majority state-owned banks at the BRA*. *Fully met*	To improve the efficiency and stability of the banking sector, *launch tender(s) for the sale of (a) state-owned bank(s) so that, after completion, at least 80% of total domestic banking sector assets would be in private ownership*. *Fully met*	To enhance the efficiency and stability of the banking sector, launch initial tenders for sale of state-owned banks sufficient for achieving private ownership of at least 80% of banking sector assets. *Not assessed by EC*	
Insurance company	To improve the efficiency and			

Sector	Fourth tranche conditionalities listed in the SMoU		Fifth tranche conditionalities listed in the SMoU	
	Serbia	Montenegro	Serbia	Montenegro
privatisation	stability of the insurance sector, launch tenders for the selection of privatisation advisors for at least two state-owned insurance companies, accounting for at least 50% of total premium income. *Sufficiently met*			
Bank/insurance sector regulation		To enhance the regulatory and supervisory framework of the insurance sector, adopt the law on insurance supervision. *Waiver granted*		To increase the confidence in, and stability of, the banking system, *make the deposit insurance scheme operational*. *Not assessed by EC*
Private sector development				
Bankruptcy			To facilitate market exit from, and raise the efficiency of the enterprise sector, *initiate bankruptcy proceedings for a significant number of loss-making socially-owned enterprises of the list of 67 monitored enterprises*. *Not assessed by EC*	
Privatisation	To enhance the development of the telecommunication sector, *launch tender for advisor for either the privatisation of one of the two mobile phone operators or*	To enhance the development of the telecommunication sector, *complete the privatisation of the telecommunication company*. *Fully met*	To strengthen the efficiency of the energy and telecommunications sectors by encouraging private companies' market access, *adopt a privatisation*	To improve the efficiency of the aluminium sector and to increase the share of the private sector in the economy, *sell a majority stake of Kombinat*

Sector	Fourth tranche conditionalities listed in the SMoU		Fifth tranche conditionalities listed in the SMoU	
	Serbia	Montenegro	Serbia	Montenegro
	the sale of the third mobile phone licence. Waiver granted		*strategy for the energy and telecommunication sector.* Not assessed by EC	*Aluminijuma Podgorica (KAP) to a private investor.* Not assessed by EC
	To improve the role of the capital market and help strengthen cooperate governance, *fully divest holdings in at least 10% of companies in the portfolio of the Share Fund.* Fully met		To prepare for its privatisation, *finalise the unbundling of railways.* Not assessed by EC	
Competition	To strengthen the regulatory framework of the telecommunications sector and to prepare for further market entry, *start the operations of the Telecommunication Regulatory Agency.* Sufficiently met		To strengthen the regulatory framework of the energy sector, *start the operations of the Energy Regulatory Agency.* Not assessed by EC	

Q2.2 How relevant are the short and medium-term expected structural effects of the assistance to the needs of the recipient country?

From the viewpoint of the MFA objectives, the selection of conditionalities should be driven by the need to prevent future balance of payments and/or budgetary crises by strengthening the economic base of the country and the management of public finances. The selection of conditionality could also be seen in the context of a possible future EU accession of the two countries.

5.2.1 Findings from the structured interviews – Serbia

In general, we can conclude from the interviews that most conditionalities were perceived as relevant to the country's needs. Conditionalities in the areas of financial sector reform and private sector development were seen as important. Most conditionalities in the area of public finance reform and administration were also regarded as relevant, except for those linked to the harmonisation of tariffs and agreement on modalities for VAT.

From the interviews conducted with EC officials in Brussels, we infer that initially a major principle that guided the conditionalities of MFA was the maintenance or establishment of an internal market. An explicit example is the conditionality concerning the agreement by Serbian and Montenegrin authorities to set up a detailed action plan to harmonise custom tariffs. From the interviews with government officials, we infer that the necessity of this harmonisation was not recognised. Progress that was made in this area was solely made to meet the conditionality. Although little local ownership existed for the harmonisation of customs tariffs, the conditionality was met. Another example is the conditionality concerning agreement between Serbian and Montenegrin authorities on the modalities to introduce VAT. The need for this agreement was not recognised by the Serbian Ministry of Finance. IFI officials also considered that these internal market conditions "*would never yield good results*" as the government was not interested.

After topping-up of the MFA a twin-track approach was used in the SMoU, stating conditions separately for Serbia and Montenegro.

Other guiding principles underlying the conditionalities were related to timing considerations (Is the condition implementable so that money can be disbursed within one year?) and the need to provide "enforced messages" by using same conditions as the IMF or the World Bank, as well as the Governments' own programmes. Concerning the latter, we infer from the interviews with national authorities that they perceived the coherence between conditionalities set by the EC, IMF and the World Bank as useful.

5.2.2 Findings from the structured interviews – Montenegro

In Montenegro, the authorities had a large say in the negotiation of the conditionalities. As a result, conditionalities chosen were considered relevant by the authorities. As was the case in Serbia, a large degree of coherence existed between the conditionalities attached to the MFA and those linked to programmes of the IFIs and the SAP process. The conditionalities aimed at establishing or maintaining an internal market were not considered relevant, and were only considered due to EU pressure.

After the twin-track approach was adopted in 2004, Montenegro was eager to show to the EC that is was willing to implement reforms to the EC and to establish a good reputation as a country.

5.2.3 Conclusions

Most conditionalities were considered relevant to the country's needs. For conditionalities linked to establishing an internal market, less national ownership existed. MFA conditionalities were closely linked to the IMF Extended Agreement and World Bank programmes. This coherence was perceived as being useful.

5.3 Gross impact – actual structural reform outcomes

Q2.3 To what extent have the short and medium-term anticipated structural effects of the assistance (in the context of the recipient country's reform programme) occurred as envisaged?

5.3.1 Findings from document analysis and structured interviews – Serbia

As mentioned previously, the structural conditionalities were grouped into three categories:

I Public finance reform and administration;
II Financial sector reform;
III Private sector development.

In general, we infer from the interviews that the volatile political environment in Serbia hampered reforms. The authorities were preoccupied with the Belgrade Agreement and the constitutional changes that resulted from the Agreement, the consequences of the assassination of the Prime Minister in 2003, the formation of a new government, uncertainty over the status of Kosovo, and the independence of Montenegro.

Below, more specific information on each of the conditionalities which are related to Serbia is presented.

I Public finance reform and administration

Treasury system. A central Accounting Division was established in 2002 in the Ministry of Finance, and became fully operational from January 2003. The accounts of all direct spending units were transferred to the Treasury in 2004. Hence, the conditions relating to the Treasury System were fully met. The Ministry of Finance perceived the reforms as very important; and continued with reforms in this area after meeting the conditionalities. Assistance from donors was necessary, since the ministry lacked adequate resources. Technical assistance was received from the US Treasury to implement the reforms. As of May 2007, all civil servants are paid from the single Treasury Account. Since 2006, the Ministry of Finance has received funding from the European Agency for Restructuring (EAR) to improve budget planning, e.g. linking policy priorities to the budget and introducing multi-year planning.

Tax revenue collection. The conditions in the area of tax revenue collection were fully met. A new Law on Tax Procedures and Administration was passed in 2002, which led to the modernisation of the Public Revenue Agency (PRA). Tax collecting functions as regards payroll and income taxes, as well as social security contributions were transferred from the Payments Bureau (ZOP) to the PRA from 2003 onwards. Large Taxpayer Offices were established in 2003. The Ministry of Finance identified a clear national need for these offices. Since fiscal decentralisation has been implemented, the Ministry is currently involved in transferring responsibilities to local governments - for instance in the sphere of local tax collection.

Tax revenue policy. The conditionality of reaching agreement between Serbian and Montenegrin authorities on the modalities of the introduction of VAT was not met, initially. The Serbian authorities were not interested in reaching an agreement with the Montenegrin authorities on the modalities. Montenegro introduced VAT in 2003; Serbia implemented VAT in 2005. Introduction of VAT was postponed in Serbia due to changes in government. Since this conditionality was attached to the disbursement of the third tranche (December 2004 – April 2005), it was no longer considered relevant in the context of the twin-track approach.

Customs harmonisation. The conditionality concerning harmonisation of customs tariffs by the Montenegrin and Serbian authorities was not seen as very important by the authorities. Nonetheless, since it was a conditionality attached to the disbursement of the second tranche of MFA (July – September 2003), an Action Plan was prepared by the Montenegrin and Serbian authorities. One year later, the twin-track approach was adopted and the conditionality became irrelevant.

Anti-money laundering. This conditionality was met. The Serbian authorities established an Anti-Money Laundering Unit. In practice, the Unit reviews the financial administration of companies but does not carry out in-depth research. The Ministry of Finance still considers the fight against corruption to be a very important issue. Currently, a new anti-corruption law is being prepared. The introduction of this law will allow the country to be admitted to the Egmond Group.[26]

Public administration. Both conditionalities in the area of public administration were met: the Civil Service Law and the Law on Supreme Audit Institution were both adopted. The Ministry of Finance considers adoption of these laws very important in the light of EU accession. Ministry staff did not consider the MFA conditionalities as the driving force, since in their view the Stability and Accession process was driving these reforms.

Public expenditure management. This conditionality was completely met. A database on municipality finances was established.

II Financial sector reform

Strengthening of the National Bank. Both conditionalities in this area were fulfilled. The National Bank of Yugoslavia (NBY) – which became the National Bank of Serbia (NBS) – finalised a supervisory development plan for banks, as well as monitoring and control mechanisms. The NBS (former NBY) is regarded as an institution with adequate capacity and financial means to carry out their monitoring and control tasks. However, from the structured interviews, we infer that bank supervision is still rather weak. The regulatory framework (Law on Banks) is good, but supervision needs to be strengthened.

Bank privatisation. The conditionalities attached to the second, third, fourth and fifth tranches of MFA concerned a step-by-step approach of privatisation of banks. The Bank Rehabilitation Agency (BRA) implemented the privatisation. The various steps of the

[26] The Egmond Group is a transnational organisation aiming at reduction of money-laundering and corruption. Members of the Group include the Former Yugoslav Republic of Macedonia, Slovenia, Bulgaria, Albania, Italy, Croatia, Greece and Turkey.

process were sometimes delayed due to changes in government. The conditionalities attached to the second and third tranche of the assistance were partially fulfilled, or a waiver was granted; since Serbian authorities argued that the market lacked the capacity to absorb many companies at the same time. In general, bank privatisation was a clear-cut and successful reform, which is almost fully completed. In 2001, when privatisation started, close to 90 banks were established in Serbia. In the following two years, the number halved: four major banks were liquidated (Beogradska Banka, Beobanka, Jugobanka and Investbanka), some merged with others, and the remaining banks were privatised. By the end of2003, the number was reduced to 40 banks. Since early 2005, the state has sold its majority stakes in Vojvodjanska Banka, Jubanka, Continental, Novosadska, Niska, and Panonska banks. It was generally recognised that financial sector reform was necessary. Currently, competition in the financial sector is fierce. Section 6.2 provides an in-depth analysis of bank privatisation in Serbia.

Insurance company privatisation. This conditionality was sufficiently met. A tender for a Privatisation Advisor was launched for the insurance company DDOR. For the second state-owned insurance company, DUNAV, a tender for an auditing report and restructuring strategy was launched in July 2005. The Government intended to adopt a corrective action plan for DUNAV. No further conditionalities were required. In November 2007, DDOR was sold; the DUNAV insurance company is still state-owned. Currently, the World Bank is assisting in restructuring of DUNAV. With DDOR being recently sold, approximately one-third of the insurance market remains state-owned.

Bank/insurance sector regulation. The condition to transfer the majority of private sector payments from the old payments bureau to commercial banks was met in the autumn of 2003.

III Private sector development

Bankruptcy. This condition is fully met. The Serbian authorities adopted the Bankruptcy Law in 2003. The Accounting Law was also adopted in that year. Although the Bankruptcy Law provides a qualitatively good legal framework, we infer from the interviews that maintenance and control of the law is weak. As a result, in practice, little progress has been made in starting up bankruptcy procedures for companies. Bankruptcy is still considered a taboo in Serbia; and companies fit for bankruptcy may be protected by politicians. The Privatisation Agency (PA) attempts to improve implementation of the law. PA has cooperated well with the Bankruptcy Court and is training staff to become licensed bankruptcy managers. PA is expecting capacity constraints in bankruptcy procedures.

Privatisation – Regulatory Framework. The conditionalities attached to the privatisation of the real sector also followed a step-by-step process. The conditions regarding the regulatory framework – adopting of amendments to the Privatisation Law and enacting of the Secured Transactions Law – were fulfilled. Amendments to the Privatisation Law are expected to be adopted early next year.

Privatisation – Implementation. The institutional capacity of the PA was strengthened. The conditions on tender privatisation and offering of companies for sale through auctions were fulfilled. The conditions concerning starting privatisation procedures for large state-owned companies were only partially fulfilled and are still delayed. The conditionalities attached to the fourth tranche disbursement were met, or a waiver was granted. There is no deadline for the privatisation of state-owned enterprises. The outlook for different state-owned enterprises varies (see section 6.3).

Competition. A Competition Law was adopted in 2005. However, the focus of the conditionality was implicitly on the introduction of a *state-wide* competition regime. When the twin-track approach was adopted, the condition was no longer considered relevant. Meeting the conditions on start-up of regulatory agencies in the Telecommunications and Energy sectors was a time-consuming process. Legislation to establish the Telecommunications Agency was passed in 2003; the Management Board was only established in 2005. The Telecommunication Agency started operations at the beginning of 2006, supported by the EAR. Anti-Monopoly Laws have also been passed, and a Commission on Anti-Monopolies has been established. In practice, the Commission has little power since imposed fines (determined by law) are low. Competition is virtually absent in certain sectors, e.g. food products (especially dairy products), retail and supermarkets. The existence of oligopolies in these sectors hampers competition.

Business registration. Part of this conditionality aimed to link up company registers of both Republics to enable free establishment throughout the Federation. This conditionality became irrelevant after the twin-track approach was adopted. The Registration Agency was established to speed up registration of companies. In practice, the business environment has improved: procedures are faster, and deposits have dropped substantially. A concern in this area is the lack of land available for greenfield investments. Section 5.3.3 shows overall progress in the business environment in Serbia.

5.3.2 Findings from document analysis and structured interviews – Montenegro

I Public finance reform and Public administration

Treasury system. The only conditionality in this area was linked to the fifth tranche; and was therefore not assessed. By the end of 2004, a single Treasury account was fully operational. It is expected that all public expenditure and revenues (except for municipalities) will be directed to and from the single account within the next 3 to 4 years.

Debt and asset management. A special Debt Management Unit was established and staffed in the Ministry of Finance. The authorities substantially improved the regulatory framework to promote efficient debt management. At the time, progress had also been made with respect to the division of assets and liabilities of the former National Bank of Yugoslavia in Serbia and Montenegro. Hence, the condition was fully met. Currently, the debt management strategy for 2005-2007 was established and has been adhered to. The IMF is assisting the country in developing the future strategy.

Tax revenue policy. The Law on Games of Chance, on Gifts and on Inheritance were enacted in 2003 and 2004. The conditions were met. The adoption of the Law on VAT in

2003 and its actual implementation in 2004 was driven by the Ministry of Finance, and is considered a success. VAT is now the main revenue source.

Public administration. The condition on the adoption of a comprehensive employment and wage policy Action Plan for the public sector was fully met. The Plan was adopted in March 2003.

Public pensions. At the time that the conditionality was assessed, progress had been made and the new Pension Law was expected to be adopted in July 2003. Therefore, the conditionality was expected to be met soon. Currently, this reform is considered a successful one - even though the reform was initially difficult to prepare and implement.

Customs harmonisation. At the time of the assessment, an Action Plan was set up, and authorities had agreed to resolve the remaining issues. Since the Commission adopted the twin-track approach shortly afterwards, the conditionality became irrelevant. Currently, all countries in the region have signed the Central European Free Trade Agreement (CEFTA); opening new opportunities for harmonisation.

Anti-money laundering. The Law on Money Laundering was expected to be adopted shortly after the assessment took place. The condition was expected to be met soon. The Law was implemented; and functions in practice. However, in order to have an effective anti-money-laundering policy, a well-functioning court and system of prosecution is required, which is not completely the case.

II Financial sector reform

National Bank. The internal Audit Committee was established in March 2005. Therefore, the conditionality was fully met. The second conditionality, linked to the 5th tranche, concerning a regulatory credit register was not assessed.

Bank privatisation. The conditionalities regarding bank privatisation in Montenegro were fully met. As in Serbia, bank privatisation in Montenegro was generally regarded as a rather smooth process.

Banking sector regulation. Consolidated supervision procedures were initiated by the Montenegrin authorities. The condition on adopting a Law on Insurance Supervision was strictly not met at the time of assessment. However, a waiver was granted, since a major step towards final adoption of the Law was made.

III Private sector development

Bankruptcy. Montenegro had already adopted a Bankruptcy Law in early 2002. Therefore, this condition had already been met in Montenegro.

Privatisation. Privatisation was difficult in the beginning of the process due to a lack of interest by potential investors. The first MFA conditionality – offering for sale of at least 5 large state-owned companies identified for tendering – was not met at the time of assessment since the first tender (for the telecoms company Optel) failed twice; and the authorities were reluctant to issue more tenders with low chances of selling the companies. At the time of the third tranche, Montenegro had caught up with the requirements, and conditionalities attached to the third and fourth tranche were fully met.

Competition. Some progress was made with respect to the adoption of a comprehensive state-wide competition regime. Progress in this regard was solely driven by the conditionality, as both Republics showed no interest. This conditionality became irrelevant after the adoption of the twin-track approach. Competition in general remains a difficult issue in a very small country like Montenegro, but is working well in the banking and telecommunications sectors.

Business registration. A business register was set up in Montenegro. The conditionality aimed at linking up business registers within FRY became irrelevant after the adoption of the twin-track approach. Currently, the World Bank is assisting Montenegro in improving its business environment.

5.3.3 EBRD Transition indicators

Further evidence of the progress made by the authorities in the various structural reform areas is provided by the EBRD transition indicators. Table 5.4 provides a summary overview of progress achieved in Serbia over the period 1997-2006 in some MFA-relevant structural reform areas. The indicators show progress in privatisation and banking reform over the period 2001-2006. No progress has been made in the public utilities sectors (roads, railways, electric power, water and waste water). This progress confirms the information inferred from the interviews.

Table 5.4 EBRD Transition indicators for Serbia

		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1*	Large-scale privatisation	1.00	1.00	1.00	1.00	1.00	2.00	2.33	2.33	2.67	2.67	2.67
2	Small-scale privatisation	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.67	3.67
3*	Enterprise restructuring	1.00	1.00	1.00	1.00	1.00	2.00	2.00	2.00	2.33	2.33	2.33
4	Price liberalisation	2.67	2.33	2.33	2.33	4.00	4.00	4.00	4.00	4.00	4.00	4.00
5	Trade & Forex system	1.00	1.00	1.00	1.00	2.67	3.00	3.00	3.00	3.33	3.33	3.33
6*	Competition policy	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.67	2.00
7	Banking reform & interest rate liberalisation	1.00	1.00	1.00	1.00	1.00	2.33	2.33	2.33	2.67	2.67	2.67
8*	Securities markets & non-bank financial institutions	1.00	1.00	1.00	1.00	1.00	1.67	2.00	2.00	2.00	2.00	2.00
9*	Overall infrastructure reform	1.67	1.67	1.67	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00

		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
10	Telecommunications	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.33	2.33
11	Railways	NA	NA	NA	NA	2.00	2.33	2.33	2.33	2.33	2.33	2.33
12	Electric power	2.00	2.00	2.00	2.00	2.00	2.00	2.33	2.33	2.33	2.33	2.33
13	Roads	1.67	1.67	1.67	2.00	2.00	2.33	2.33	2.33	2.33	2.67	2.67
14	Water and waste water	1.67	1.67	1.67	2.00	2.00	2.00	2.00	2.00	2.00	1.67	1.67

* Low scores and little improvement

** Greyed areas denote the MFA period

Source: EBRD, Transition Report, various years

Table 5.5 provides a summary overview of the progress achieved in the 1997-2006 period in Montenegro in some MFA-relevant structural reform areas.

Table 5.5 EBRD Transition indicators for Montenegro

		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1	Large-scale privatisation	1.00	1.00	1.67	1.67	1.67	2.67	2.67	2.67	3.33	3.33	3.33
2*	Small-scale privatisation	3.00	1.00	2.00	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00
3*	Enterprise restructuring	1.00	1.00	1.00	1.00	1.00	1.67	1.67	2.00	2.00	2.00	2.00
4	Price liberalisation	2.67	2.67	2.67	3.67	4.00	4.00	4.00	4.00	4.00	4.00	4.00
5	Trade & Forex system	1.00	1.00	2.33	2.33	2.67	3.00	3.00	3.00	3.33	3.33	3.67
6*	Competition policy	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
7*	Banking reform & interest rate liberalisation	1.00	1.00	1.67	1.67	1.67	2.00	2.00	2.33	2.33	2.67	2.67
8*	Securities markets & non-bank financial institutions	1.00	1.00	1.00	1.00	1.00	1.67	1.67	1.67	1.67	1.67	1.67
9*	Overall infrastructure reform	1.67	1.00	1.33	1.33	1.33	1.33	1.67	1.67	2.00	2.00	2.00
10	Telecommunications	2.00	1.00	1.67	1.67	2.33	2.33	2.33	2.67	3.00	3.00	3.33
11	Railways	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
12	Electric power	2.00	1.00	1.00	1.00	1.00	1.00	1.67	2.00	2.33	2.33	2.33
13	Roads	1.67	1.00	1.67	1.67	1.67	1.67	1.67	2.00	2.00	2.00	2.00
14	Water and waste water	1.67	1.67	1.67	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00

* Low scores and little improvement; ** Greyed areas denote the MFA period

Source: EBRD, Transition Report, various years

The tables show for instance, that large-scale privatisation progressed better in Montenegro; while in Serbia, small-scale privatisation fared better.

The share of the private sector in Serbia only grew slightly from 40% in 2000 to 55% in 2006. In 2002, the share was merely 45%. In Montenegro the situation is a little better. The private sector share grew from 45% in 2000 to 65% in 2006. In 2002, the share was 55%.[27]

As far as the financial sector is concerned, some degree of development during recent years can be observed. Progress on structural reforms within the banking sector has been substantial. This facilitated rapid growth of the sector and increased financial intermediation. The asset share of state-owned bank declined significantly. Both countries experienced an enormous increase of asset share of foreign-owned banks. Data shown in Table 5.6 are in line with the information inferred from the interviews.

Table 5.6 Effect of bank privatisation in Serbia and Montenegro

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Serbia												
Number of banks	101	112	103	106	104	75	81	54	50	47	43	40
Number of foreign banks	2	3	3	3	3	3	3	8	12	16	11	17
Asset share of state-owned banks (in per cent)	94.1	94.7	92.0	89.8	90.0	89.0	90.9	68.0	35.6	34.1	23.4	23.9
Asset share of foreign-owned banks (in per cent)	0.1	0.2	0.2	0.6	0.5	0.4	0.5	13.2	27.0	38.4	37.7	66.0
Montenegro												
Number of banks									10	10	10	10
Number of foreign banks									3	3	3	7
Asset share of state-owned banks (in per cent)									23.8	19.2	16.4	5.1
Asset share of foreign-owned banks (in per cent)									16.9	23.5	31.0	87.7

Source: EBRD, Data retrieved from www.ebrd.org

* Greyed areas denote the MFA period

5.3.4 World Bank Doing Business indicators

The World Bank's Doing Business indicators are in line with the information on Serbia inferred from the interviews. The establishment of a new business has become a much less cumbersome and costly procedure since 2005 - especially in Serbia (see Tables 5.7 and 5.8).

[27] Source : EBRD, data retrieved from www.ebrd.org

Table 5.7 World Bank Doing Business Indicators for Serbia and Montenegro

Year	2002-2004	2005	2006	2006 new methodology	2007 new methodology
Serbia	no data	95	68	84	86
Montenegro	no data	64	70	76	81

Source: World Bank Doing Business database, data retrieved from www.doingbusiness.org

Table 5.8. Main Indicators for Starting a Business in Serbia and Montenegro

Economy	Year	Rank	Procedures (number)	Time (days)	Cost (% of income per capita)	Min. capital (% of income per capita)
Montenegro	2003	..	..	..	..	..
	2004	..	..	..	..	..
	2005	76	15	24	6.6	0
	2006	86	15	24	6.7	0
	2007	98		24	6.2	0
Serbia	2003	..	12	56	15.9	113.4
	2004	..	12	56	15.0	101.6
	2005	43	11	23	12.0	7.6
	2006	84	11	23	10.2	7.6
	2007	90	11	23	8.9	8.0

Source: World Bank Doing Business database, data retrieved from www.doingbusiness.org

5.3.5 Public Finance Assessment

Another source to examine progress of reforms in the area of Public Finance Management (PFM) is the Integrated PFM Assessment (IPFMA) initiated in 2006 by the World Bank, DFID and IMF; and published in February 2007.[28]

PFM performance is measured by several indicators in six PFM pillars as can be seen in Box 5.1.

[28] Serbia - Integrated Public Finance Management Assessment, World Bank, February 2007.

Box 5.1 Serbia - Public Finance Management Performance

PFM pillar	Status
Credibility of the budget	This is based on revenue and expenditure outturns. Numbers point towards reduced variance between budgets and outturns for the Central government budget during 2004-2007, but as an external audit has not been performed on the Government's budget, overall reliability of data is deemed uncertain.
Comprehensiveness and transparency	Availability of the budget has increased; but transparency of budget data, reporting on public expenditures and data reliability can be improved
Policy-based budgeting	The budget shows key areas of spending.
Predictability and control.	Performance in both this and the previous pillar reveals that while budget preparation processes have improved; the overall credibility of the budget is hampered by serious weaknesses in internal checks and balances in the budget execution.
Accounting, recording and reporting	Externally audited accounts are lacking; causing a lack of integrity of budget data
External scrutiny and audit	External independent auditing of the Government's accounts has yet to become a reality in Serbia

The findings of the EC's Annual Progress Report of 2006, finalised a year before the IPFMA, coincide with these findings. On financial control, the Progress Report concludes that Serbia lacks a strategy for establishing and developing a comprehensive public internal financial control system at the level of all government institutions.

5.3.6 Conclusions

Serbia

Based on these findings, the gross impact of the various conditionalities is summarised in Table 5.9. The assessment of gross impact distinguishes between 'formal progress' and 'structural progress'. A conditionality is assessed as having achieved *formal progress* if it has been fulfilled in accordance with the literal formulation of the conditionality. A conditionality is assessed as having achieved *structural progress* if that reform has become structurally embedded in the Serbian institutional context.

Table 5.9 shows that *formal* progress has been fully achieved for most of the conditionalities (11 out of 15). In the areas of insurance privatisation, enterprises privatisation and competition policy, formal progress is assessed as having been 'partially' or 'sufficiently met'. The EC's own assessment did not qualify any of the conditionalities as being 'not met'. When the twin-track approach was adopted, the conditionalities on tax revenue policy, customs harmonisation, competition policy, and business registration became (partly) irrelevant. Waivers were granted for conditionalities on bank and enterprise privatisation.

The number of conditionalities achieving *structural* progress is lower. Conditionalities in the areas of tax revenue policy, customs harmonisation, competition policy, and business registration became irrelevant and were not integrated into the two country's own systems.

Structural progress in the areas of privatisation of state-owned enterprises and competition policy was limited. Although privatisation of socially-owned enterprises is due to be finalised at the end of 2008; privatisation of state-owned enterprises is lagging behind. The regulatory framework and institutions strengthening competition have been introduced; but in practice some sectors are dominated by oligopolies that are hampering competition.

Although structural progress in the area of insurance privatisation was rather limited during the time-span of MFA; recently progress was made in selling large insurance company DDOR, and initiating restructuring plans for remaining insurance company DUNAV.

Table 5.9 Overview of assessment of the gross impact of MFA conditionalities - Serbia

Conditionality	Formal progress	Structural progress
Public finance reform and administration		
Treasury system	Fully met	Substantial
Public expenditure management	Fully met	Substantial
Tax revenue collection	Fully met	Substantial
Tax revenue policy	Became irrelevant	None
Public administration	Fully met	Substantial
Customs harmonisation	Fully met, later became irrelevant	None
Anti-money laundering	Fully met	Substantial
Financial sector reform		
National Bank strengthening	Fully met	Substantial
Bank privatisation	Fully met (including waiver)	Substantial
Insurance privatisation	Sufficiently met	Substantial
Banking/insurance sector regulation	Fully met	Substantial
Private sector development and business environment		
Bankruptcy Law	Fully met	Substantial
Privatisation enterprises	Partially met (not for SOEs) (including waiver)	Substantial / SOEs: limited
Competition policy	Partly irrelevant, sufficiently met	Limited
Business registration	Became irrelevant	None

Montenegro

Since Serbia and Montenegro were still joined in the FRY when the second MFA package was agreed upon, some overlap in conditionalities existed in the two countries. Table 5.10 gives an overview of the assessment of the gross impact of MFA conditionalities in Montenegro. Similar to the Serbia assessment above, the table distinguishes between formal and structural progress. As described in section 5.3.3, most conditionalities were met in a formal sense. The conditionalities on bankruptcy law and competition policy were partly met. Concerning structural progress, conditionalities on bankruptcy law, privatisation of state-owned enterprises and competition policy were only to a limited degree incorporated in the Montenegrin institutional context.

Table 5.10 Overview of assessment of the gross impact of MFA conditionalities - Montenegro

Conditionality	Formal progress	Structural progress
Public finance reform and administration		
Debt and asset management	Fully met	Substantial
Public expenditure management	Fully met	Substantial
Tax revenue policy	Fully met	Substantial
Pension policy	Fully met	Substantial
Public administration	Fully met	Substantial
Customs harmonisation	Fully met, became irrelevant later	None
Anti-money laundering	Fully met	Substantial
Financial sector reform		
National Bank strengthening	Fully met	Substantial
Bank privatisation	Fully met	Substantial
Insurance privatisation	Fully met (including waiver)	Substantial
Banking/insurance sector regulation	Fully met	Substantial
Private sector development and business environment		
Bankruptcy law	Sufficiently met	Limited
Privatisation of SOE	Fully met	Limited
Competition policy	Partly irrelevant, sufficiently met	Limited
Business registration	Fully met	Substantial

5.4 Synergies with other instruments of EU, IMF and WB

Q2.5 To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?

Based on document analysis and the structured interviews, this section addresses the synergies of MFA conditionalities with other EU initiatives and the programmes of the World Bank and IMF.

5.4.1 Synergies with other EU instruments

Serbia

In 2005, the EC finalised a feasibility study concerning the opening of negotiations on a Stabilisation and Association Agreement (SAA). This feasibility study identified priority tasks for Serbia to be achieved prior to opening SAA negotiations. Table 5.11 provide an overview of synergies between MFA and the Stabilisation and Accession Process (SAP) requirements.

As can be concluded from Table 5.11, some priority tasks mentioned in the feasibility report overlap with MFA conditionalities, mainly in the following areas:

- development of customs infrastructure and improve customs collection;
- anti-money laundering;
- competition policy;

- business registration.

Since the feasibility report was written after the EC decided to adopt the twin-track approach, the establishment or maintenance of an internal market was no longer relevant.

From the interviews, we infer that the SAP was a major driving force for the Government throughout the reform process. As mentioned in section 5.2.2, the implementation of some conditionalities, primarily concerning the regulatory framework, was driven by the SAP rather than MFA.

The progress of Serbia and Montenegro in the SAP has been supported by specific project support given primarily through CARDS programme. The MoU attached to MFA refers to the programme as follows: '*The authorities will ensure, as appropriate, close co-operation with the European Commission and the European Agency for Reconstruction regarding the implementation of the CARDS programme, and the EU customs assistance programme*.' The SMoU does not refer to the CARDS programme.

In practice, linkages existed between capacity building programs initiated by CARDS and MFA. In general, this was confirmed during interviews with EC officials in Brussels. For instance, from 2005, CARDS supported capacity building within the Privatisation Agency through an EAR grant of €6.5 million. The EC also launched technical assistance initiatives such as: the creation of a national Treasury; strengthening of the tax administration; supporting initial steps towards a supreme audit institution; and supporting the transition of the fiscal administration from ZOP to the Public Revenue Agency. In total, close to €60 million was allocated to support public finance reforms during the period 2002-2006. Table 5.11 shows in which MFA areas technical assistance was assigned.

One interviewee remarked that the CARDS programme and the IMF-programme gave rise to disputes within the government that was formed after the assassination of the Prime Minister in 2003. Advocates for EU accession preferred to use the funds for legal reforms; whereas others favoured the implementation of enterprise privatisation. In the opinion of the interviewee, these disputes delayed the implementation of reforms.

5.4.2 Synergies with IMF and World Bank programmes

Table 5.11 also depicts synergies between conditionalities with IMF and World Bank programmes. As can be inferred from both the document analysis and the interviews, MFA conditionalities in the areas of public finance reform and administration and financial sector reform were covered by IMF and/or World Bank programmes. Specific conditionalities in the areas of public finance reform and administration, and private sector development that cannot be traced back to IMF or World Bank programmes were:
- agreement between the Serbian and Montenegrin authorities on a detailed action plan setting out the precise steps for the harmonisation of customs tariffs;
- adoption of a comprehensive state-wide competition law;
- link-up of company registers to ensure there are no obstacles to the right of free establishment throughout the country;

- to strengthen the regulatory framework of the telecommunications sector, and to prepare for market entry - starting the operating of the Telecommunication Regulatory Agency.

The emphasis of the first three mentioned conditionalities was on strengthening the internal market. As mentioned previously, these conditions became irrelevant after the adoption of the twin-track approach. The last conditionality was fully met, and can be exclusively linked to MFA. Technical assistance projects to build capacity within the Telecommunication Regulatory Agency (RATEL) were funded by EAR and the US Trade and Development Agency.

Table 5.11 Synergies between MFA conditionalities and EU-SAP, World Bank and IMF programmes – Serbia

Conditionality	EU-SAP	CARDS	World Bank	IMF
Public finance reform and administration				
1. Treasury system				
- Modernise Treasury System		√	√	√
- Spending units to single account				√
- Establish central accounting division		√		√
- Centralise payroll system		√		√
2. Public expenditure management				
- Establish database on municipality finances			√	
3. Public Administration				
- Civil Service Law & Law on SAI		√	√	√
4. Tax revenue collection				
- Modernise Public Revenue Agency (PRA)		√	√	
- Create unified identification number				√
- Set-up large Taxpayer Offices				√
5. Tax revenue policy				
- Agree on modalities for VAT				√
6. Customs harmonisation	√ (reform)		√ (reform)	√ (reform)
7. Anti-money laundering	√		√	
Financial sector reform				
8. National Bank strengthening			√√	√√
9. Bank privatisation		√	√√	√√
10. Insurance privatisation			√	√√
11. Banking/insurance sector regulation			√	√
Private sector development and business environment				
12. Bankruptcy Law			√	√
13. Privatisation enterprises		√	√√	√√
14. Competition policy				
- Comprehensive competition law	√			
- Energy and Telecoms. regulatory agencies	√	√	√ (Energy)	
15. Business registration				
- link up company registers	√			

Montenegro
Montenegrin officials were under the impression that the synergies between the MFA conditionalities and IMF and World Bank programmes were large. The Ministry of Finance mentioned that all of them were taken from either of them. This reflects the approach that was taken during the negotiations linking the assistance to the set of conditions that were in line with the overall programmes of the IFIs. Thus the MFA provided no extra requirements, but instead gave the Montenegrin authorities an extra political reinforcing tool in the implementation process. Many interviewees mentioned the significance of the MFA in providing the reforms; or privatisation an extra leverage and justification – particularly in case of political sensitive reforms. The Montenegrin officials used the MFA to speed up the political process; and used it as a means of explaining to the public the necessity of the reforms that had been introduced.

5.4.3 Conclusions

Serbia
Synergies between priority tasks listed in the feasibility report and the MFA conditionalities existed in the areas of development of customs infrastructure and improving customs collection; anti-money laundering; competition policy; and business registration.

All MFA conditionalities in the areas of public finance reform and administration, as well as in financial sector reform were covered by IMF and/or World Bank programmes. One very informative international interviewee explained that "*space for additionality was very limited*". Most conditionalities in the area of private sector development that cannot be traced back to IMF or World Bank programmes became irrelevant after the adoption of the twin-track approach. The only conditionality that remained valid concerned the establishment of the Telecommunication Regulatory Agency. This conditionality was part of the Stability and Accession process requirements.

Montenegro
Synergies between MFA conditionalities and conditions attached to programmes of the IFIs and/or the SAP process existed on a large scale. MFA conditionalities were in line with the overall programmes of the IFIs and thus provided no extra requirements; but instead gave the Montenegrin authorities an extra political reinforcing tool in the implementation process.

In the following sections, we will investigate the counterfactual situation concerning structural reforms - i.e. whether the MFA conditionalities would have been achieved if MFA had not existed.

5.5 Counterfactual

Q0.1 What arrangement would have been implemented if the MFA had not been granted?

Q0.2 What are the structural and macroeconomic effects of the most likely implementation scenario(s)?

This section addresses evaluation questions 0.1 and 0.2. A possible counterfactual scenario was established after triangulating the findings from the structured interviews and the Delphi questionnaire.

5.5.1 Structured interviews

Serbia
As mentioned, the coherence between MFA and IFIs' structural conditionalities was regarded as useful by interviewees. Since many were more familiar with the conditionalities attached to programmes from the IFIs; most interviewees were under the impression that if MFA had not been there, the task of reinforcing related conditionalities would have been taken over by one of the other IFIs. As indicated, most conditionalities were in fact already part of existing IMF and World Bank programmes. Furthermore, some conditionalities - for instance in the areas of public administration, anti-money laundering, and bank privatisation - were high on the Government's agenda, according to some respondents.

Montenegro
Due to the synergies between MFA conditionalities and conditionalities attached to IMF and World Bank programmes, all conditionalities would have been implemented if MFA had not existed. As mentioned previously, the strategy taken to select the conditionalities was to choose those conditionalities that were already attached to the IFI programmes, to increase leverage, and to justify to the public the need of these reforms. The added-value of MFA was that it speeded up the implementation of certain reforms.

5.5.2 Delphi questionnaires – Serbia

The Delphi method was used as complementary evaluation instrument to confirm the findings from the structured interviews. The Delphi questionnaire was only used in Serbia due to insufficient potential respondents in Montenegro

The responses to the question *What would have happened to the MFA conditionalit(y)(ies) in the distinguished policy areas if the EU MFA had not existed?* broadly fell into two categories. Without MFA most reforms related to the conditionalities would have been implemented, in any case. Most structural reform conditionalities were in fact integrated in other IFIs' programmes - for instance, conditionalities in the areas of the Treasury system, public expenditure management, and public administration, national bank strengthening and bank privatisation, and bankruptcy. Moreover, respondents replied that about half of the conditionalities would be taken up by the Government itself, specifically those conditionalities in the areas of tax revenue collection, anti-money laundering, insurance privatisation, privatisation of enterprises and competition policy.

According to some respondents, the conditionality related to customs harmonisation would have been strengthened under the Stability and Accession process or by the CARDS programme.

Appendix B contains the complete responses on this specific question in the Delphi questionnaire.

5.5.3 Conclusions

Serbia
Table 5.12 presents the counterfactual assumptions based on a triangulation of the findings from the structured interviews, as well as the responses to the Delphi questionnaire.

Table 5.12 Counterfactual assumptions per conditionality – Serbia

Conditionality	Counterfactual	Comments
Public finance reform and administration		
1. Treasury system	Would have been implemented later.	All specific conditions were part of IMF and WB programmes. MFA funds speeded up reforms in this area.
2. Public expenditure management	Would have been implemented.	Conditionality was part of IMF programme.
3. Tax revenue collection	Would have been implemented later.	Conditionality was part of IMF and WB programmes. Reforms would have been implemented since there was a clear local need; MFA funds speeded up reforms.
4. Tax revenue policy	Would not have been implemented.	Conditionality became irrelevant after Council adopted twin-track approach.
5. Public administration	Would have been implemented.	Establishing a regulatory framework was necessary in light of SAP, and was priority on Government agenda. Moreover, conditionality was part of IMF programme.
6. Customs harmonisation	Would have been implemented.	Plans towards harmonisation with Montenegro would probably have taken place due to the IMF EA condition.
7. Anti-money laundering	Would have been implemented.	Conditionality was part of SAP priority tasks; and therefore high on Government's agenda. Conditionality was also part of World Bank programme.
Financial sector reform		
8. National Bank strengthening	Would have been implemented later.	All specific conditions were part of IMF and WB programmes.
9. Bank privatisation	Would have been implemented later.	All specific conditions were part of IMF and WB programmes. Government was committed to this reform, but MFA supported the implementation of the reform.
10. Insurance privatisation	Would have been implemented.	All specific conditions were part of IMF and WB programmes.
11. Banking/ insurance sector	Would have been implemented.	Conditionality was part of IMF and WB programmes.

Conditionality	Counterfactual	Comments
regulation		
Private sector development and Business environment		
12. Bankruptcy Law	Would have been implemented.	Conditionality was part of IMF programme.
13. Privatisation enterprises	Would have been implemented later.	All specific conditions were part of IMF and WB programmes.
14. Competition policy	Would have been implemented.	Conditionality was part of SAP priority tasks. One condition became irrelevant after Council adopted twin-track approach.
15. Business registration	Would have been implemented.	Conditionality was part of SAP priority tasks. Conditionality became irrelevant after Council adopted twin-track approach.

Most interviewees and respondents of the Delphi questionnaire stated that without MFA, most reforms related to the MFA conditionalities would have been implemented. In the counterfactual, most reforms were integrated in the IFI programmes. Some reforms would have become an integral part of the Government's agenda, at any rate.

Montenegro

Table 5.13 gives an overview of the counterfactual assumptions per conditionality in the case of Montenegro. Due to the synergies between MFA conditionalities and conditionalities attached to IMF and World Bank programmes, in a counterfactual situation, all reforms would have been implemented. The added-value of MFA was that it speeded up the implementation of reforms regarding the Treasury system, tax revenue collection, National Bank strengthening, bank privatisation, and privatisation of enterprises.

Table 5.13 Counterfactual assumptions per conditionality – Montenegro

Conditionality	Counterfactual	Comments
Public finance reform and administration		
1. Treasury system	Would have been implemented later.	Conditionality was part of IMF and WB programmes.
2. Public expenditure management	Would have been implemented.	Conditionality was part of IMF and WB programmes.
3. Tax revenue collection	Would have been implemented later.	Conditionality was part of IMF and WB programmes. It was a priority for the Government; VAT in particular was seen as a much-needed source of revenue.
4. Tax revenue policy	Would not have been implemented.	Conditionality became irrelevant after adoption of the twin-track approach.
5. Public administration	Would have been implemented.	Conditionality was part of IMF and WB programmes.
6. Customs harmonisation	Would not have been implemented.	Montenegro had lower tariffs, and relied heavier on imports than Serbia; and was not interested in raising tariffs due to the price effect and the 'closing-up' signal that it would send to the international community. Instead, a gradual lowering of tariffs was envisaged.
7. Anti-money laundering	Would have been implemented.	Conditionality was part of IMF and WB programmes.

Conditionality	Counterfactual	Comments
	Financial sector reform	
8. National Bank strengthening	Would have been implemented later.	All specific conditions were part of IMF and WB programmes.
9. Bank privatisation	Would have been implemented later.	All specific conditions were part of IMF and WB programmes. However, Montenegro exceeded the quota on the required share of banking assets to be privatised. There was strong political will to privatise; so it is very likely that the processes would have been carried out even without the MFA or IFIs.
10. Insurance privatisation	Would have been implemented.	All specific conditions were part of IMF and WB programmes.
11. Banking/ insurance sector regulation	Would have been implemented.	Conditionality was part of IMF and WB programmes.
	Private sector development and Business environment	
12. Bankruptcy Law	Would have been implemented.	Conditionality was part of WB/IMF programme.
13. Privatisation enterprises	Would have been implemented later.	Conditionality was part of WB/IMF programme. Due to the strong political will to privatise, it is likely that the privatisation of public enterprises would have been carried out even without pressure from the EU or IFIs
14. Competition policy	Would have been implemented.	No information obtained.
15. Business registration	Would have been implemented.	No information obtained.

5.6 Net impact on structural reforms

Q2.4 What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?

This evaluation of net impact will be made through a triangulation of sources using documentary evidence and exchange of correspondence, results interviews with key stakeholders and - in the case of Serbia - also from questionnaires. The analysis focus on possible MFA 'reinforcing effects' on structural reforms at two levels of analysis:

a) *political reinforcing effect*: all relevant actors were familiar with the MFA conditions and perceived them as an incentive to continue their reform efforts (an overall increase of chances of happening);
b) *operational reinforcing effect*: the reinforcing effect led to a verifiable speeding up of reform implementation, or improved the quality of the reforms (the lack of pre-emptive effects of other instruments).

5.6.1 Serbia

Structured interviews

One of the criteria on which selection of MFA conditionalities was based was giving enforced messages by using the same conditions as the IMF or the World Bank. As was concluded in section 5.4, most conditionalities were covered by programmes of these IFIs. Most interviewees were more familiar with the conditionalities of IFI programmes than with the conditionalities that were attached to MFA. As a result, many emphasised that reforms would have been implemented anyway, since they were either attached to the IFI programmes and/or considered already a priority by the Government. The added-value of MFA was considered as 'operationally reinforcing': MFA speeded up the implementation of the reforms in the areas of the Treasury system, tax revenue collection, National Bank strengthening, bank privatisation and privatisation of enterprises.

We infer also from the interviews that MFA was not considered as the main driver behind the reforms. Improving the regulatory framework in the areas of public administration (civil service law, law on supreme audit institution), anti-money laundering and competition policy were conditionalities shared with the SAP process. Since accession to the EU was high on the policy agenda, the SAP process was identified as the main driver of reforms in these areas. Other major reforms, such as bank privatisation and privatisation of enterprises, were high on the Government's policy agenda in 2001. The Government had put clearing arrears high on its policy agenda, since this was a precondition of the IMF arrangement.

Some interviewees regarded the value-added of MFA to be in re-establishing the relations between Serbia and the EU. The first MFA package especially was well-timed; and disbursed when an urgent need existed in the country. Some interviewees also considered that the second MFA package was critical, especially since the political situation during the disbursement of this package was extremely volatile. Moreover, the reforms were costly to implement.

Delphi questionnaire
The Delphi questionnaire contained the following specific question: *What contribution, if any, did the Macro Financial Assistance from the EU have in bringing about these reforms?* Respondents perceived the MFA as having speeded up reforms in the following areas:
- Public finance reform and administration: Treasury system, tax revenue collection, public administration, anti-money laundering;
- Financial sector reform: National Bank strengthening, bank privatisation, bank/insurance sector regulation;
- Private sector development: privatisation of enterprises, bankruptcy law, business registration.

Some respondents considered that MFA put harmonisation of modalities of VAT introduction and harmonisation of customs on the policy agenda; some respondents considered this also the case of insurance privatisation and competition policy.

Appendix B contains the complete responses on this specific question in the Delphi questionnaire.

Conclusions

Table 5.14 summarises the conclusions on the net effect of MFA in Serbia. The conditionalities marked with a plus ('+') in the third column coincide with the counterfactual assumptions ('would have been implemented later') in Table 5.12.

Table 5.14 MFA net structural impact of the counterfactual scenario - Serbia

Conditionality	Political reinforcing effect	Operational reinforcing effect
Public finance reform and administration		
1. Treasury system	none	+
2. Public expenditure management	none	+/-
3. Tax revenue collection	+/-	+
4. Tax revenue policy	none	none
5. Public administration	none	+/-
6. Customs harmonisation	none	none
7. Anti-money laundering	+/-	+/-
Financial sector reform		
8. National Bank strengthening	+/-	+
9. Bank privatisation	+	+
10. Insurance privatisation	+/-	none
11. Banking/ insurance sector regulation	none	+/-
Private sector development and Business environment		
12. Bankruptcy Law	+/-	+/-
13. Privatisation enterprises	+	+
14. Competition policy	+/-	+/-
15. Business registration	none	+/-

Since many national interviewees were not familiar with most MFA conditionalities, only few conditionalities had political reinforcing effects. Stakeholders within the Ministry of Finance clearly remembered the MFA conditionalities concerning the bank privatisation and privatisation of enterprises; and these therefore had a politically reinforcing effect.

Besides looking at politically reinforcing effects on a conditionality-by-conditionality basis, they can also be viewed on the basis of the whole MFA operation. One international interviewee considered that it was impossible to attribute some effects to one institution. The situation at the time of the beginning of MFA required consistent measures underpinning macroeconomic stability; and each institution programme would strengthen every other leverage. Literally: "*Leverage is stronger if all institutions speak in one voice, i.e. has the same condition.*" The (political) signal of MFA vis-à-vis other IFI programmes became very clear after the assassination of the Prime Minister, when the EU decided to front-load and increase the amount of MFA; while other IFI were not able to do so due to their internal procedures. International interviewees considered that in 2003 these decisions supported the position of the Government, at a time when it was really needed. This non-measurable, but influential effect cannot be disregarded.

We have identified operational reinforcing effects regarding five conditionalities (see Table 5.14 indicated as "+'). The conditionality on tax revenue collection became irrelevant; and therefore MFA had no operational effect.

5.6.2 Montenegro

Structured interviews

Most interviewees considered that the majority of the processes (reforms, institutions, privatisations) implied by the MFA conditionalities would have been in place even if they were not part of the MFA or other programmes by the IFIs. Staff at the Ministry of Finance remembered that the process of negotiations was very much influenced by the Montenegrin side, which favoured the conditions where a political reinforcing effect of the EU conditionality could be helpful. This was particularly the case in privatisation – the condition that the Ministry of Finance regarded as having the biggest effect on actual policymaking in the country. Other conditions related to the passing of laws or institution-building were perceived as much less restrictive or binding; in the sense that they could be softened by the authorities - i.e. made non-operational or non-performing in spite of their actual existence.

The Ministry of Finance also underlined that the MFA was regarded by the Montenegrin government as *a credibility-granting,* rather than BoP or budget support instrument. In this sense, it had a very strong politically reinforcing effect. Firstly, Montenegro, being a very small nation – then part of Serbia and Montenegro - was eager to show its responsibility and credibility to the international community and the EU, in particular; and break with the negative image associated with Yugoslavia. Therefore, meeting the conditionalities was seriously regarded as part of this international image- building.

Secondly, MFA conditionalities were used by the Government to justify to the public the necessity of some important, difficult and unpopular decisions. This was the case, for instance, with some privatisations, pension reform and payment system reform.

All interviewees emphasised the disciplining – operational – effect of MFA conditionalities. Whereas most MFA processes would have been implemented anyway; the MFA helped in speeding up the implementation, and granted the entire reform process a special high-priority status.

Conclusions

Table 5.15 summarises the conclusions on the net effect of MFA in Montenegro.

Table 5.15 MFA net structural impact of the counterfactual scenario - Montenegro

Conditionality	Political reinforcing effect	Operational reinforcing effect
Public finance reform and administration		
1. Treasury system	none	+
2. Public expenditure management	none	+/-
3. Tax revenue collection	none	+
4. Tax revenue policy	none	none
5. Public administration	none	none

Conditionality	Political reinforcing effect	Operational reinforcing effect
6. Customs harmonisation	+	none
7. Anti-money laundering	+/-	+/-
Financial sector reform		
8. National Bank strengthening	none	+
9. Bank privatisation	+	+
10. Insurance privatisation	no information	no information
11. Banking/ insurance sector regulation	none	+/-
Private sector development and Business environment		
12. Bankruptcy Law	+	+/-
13. Privatisation enterprises	+	+
14. Competition policy	+	+/-
15. Business registration	none	+/-

As in Serbia, in the case of Montenegro we have also identified operational reinforcing effects regarding five conditionalities (see Table 5.15 indicated as "+').

5.7 Unexpected impact on structural reforms

Q3.2 Has the assistance given rise to any unexpected short-term and medium-term structural effects? What were these and how did they occur?

No unexpected structural effects of MFA could be identified.

6 Structural reforms: case study on bank privatisation

6.1 Introduction

Two case studies on structural reforms have been elaborated to understand better the longer-term effects of structural reforms on external sustainability. Through the case studies, we examine both the immediate (or direct) impact of structural reform on the balance of payments and the public finance and the medium to long-term (or indirect) impact. This allows to address in more detail the meso and microeconomic factors behind certain developments in the medium to long-term. The case studies touch on a whole topic, rather than single conditionalities; and relate to Serbia.

The first case study looks at bank privatisation. The second case study examines the privatisation of enterprises.

6.2 Case study 1: Bank privatisation

6.2.1 Background

Financial market liberalisation is considered a key step in the transition process. Bank privatisation increases not only foreign direct and portfolio investment (and thus resulting in capital inflows), but also needs to lead to more efficient financial intermediation enabling the real sector to develop. In addition, privatisation revenues add to the government revenue sources enabling fiscal consolidation.

Banking sector reform began in 2001 with a comprehensive diagnosis of the situation. At that moment, the country had more than 80 banks. The first stage of reforms (September 2000 - January 2002) focused on the restructuring of the banking sector. It included an analysis of banks, and led consequently to closure of 25 banks; and to a reduction in the number of banks from 84 to 56. The four largest banks, representing more than 60 percent of the bank assets, were closed in January 2002. In the following period (January 2002 – April 2003), the main efforts were concentrated on the revision of the regulatory and supervisory framework. During this period, the privatisation process was initiated; and as part of this process, three local banks were sold to foreign investors. In the period between April and December 2004, activities focused mainly on further privatisation of state-owned banks, and on the consolidation of the banking sector.

The privatisation process of 18 banks in Serbia was to be commenced in August 2002. In practice, it began under the World Bank *Privatisation and Restructuring of Banks and*

Enterprises Technical Assistance Project (approved in April 2003); and continued with the support of the World Bank Private and Financial Sector Structural Adjustment Credit (PFSAC II). The IMF also supported the bank reforms under its arrangements.

To strengthen the importance of banking sector reform, the EC has also included conditionalities related to bank privatisation in the framework of its MFA to Serbia and Montenegro. One of the guiding principles in selecting MFA conditionalities was their coherence with conditions of the IFIs. The second, third, fourth and fifth tranches of the MFA included conditionalities on banking privatisation.

As Chapter 5 showed, the MFA included six structural conditionalities related to the privatisation of banks. The authorities fully met two conditionalities, and in two cases faced difficulties in their implementation, while one condition is still pending. The condition for the disbursement of the fifth tranche has not been technically met, since as of June 2007 only 78 percent of the banks were in majority of private ownership; while the conditionality requires 80 percent.

6.2.2 Actual developments and prospects

The Government has "successfully completed the privatisation of Serbian banks" according to Prime Minister Dinkic[29]. Since early 2005, the state sold its majority stakes in Jubanka, Continental, Novosadska, Niska, Panonska, and Vojvodanska banks. The sales brought Serbia a little under €1 billion. The receipts from privatisation of banks, as well that of enterprises contributed to General government financing (see Table 6.1).

Table 6.1 Revenues from privatisation

	2002	2003	2004	2005 Est.	2006 Proposed	2007 Proj.
Privatisation receipts (% of GDP)* [30]	2.2	4.5	0.6	2.6	6.8	1.0
General government financing (% of GDP)*	4.5	3.2	0.0	-0.8	-2.6	-3.0
		2003	2004	2005	2006	1-11.2007
Privatisation receipts (in billions of dinar)**		29.9	12.9	19.7	72.0	12.9

* Source: IMF Country Report No. 06/384, October 2006 and No. 04/202, July 2004

** Source: Table 4.8 in section 4.3 using Ministry of Finance data

Besides direct impact on the budget, the privatisation of banks and enterprises had also direct impact on the balance of payments. Portfolio investments and foreign direct investments influenced the capital inflows.

Following restructuring, the number of banks fell. This decrease was accompanied by a decrease in the number of state-owned banks and an increase in the number of banks in

29 Igor Jovanovic for Southeast European Times in Belgrade – 18/09/06

30 Total privatisation revenue accruing to the Republican government.

majority ownership of foreign legal entities. The privatisation of state-owned banks raised the number of foreign bank ownership to more than 60% by June 2007.

Table 6.2 Structure of the banking sector in Serbia (in terms of majority ownership)

	2002	2003	2004	2005 Nov	2007 June
State-owned banks	23	17	14	11	8
Share in the balance sum, %	*49.4*	*46.7*	*36.1*	*25.5*	-
Private-owned banks	27	30	29	29	28
- domestic ownership	15	19	18	12	6
- *share in the balance sum, %*	*23.6*	*30.4*	*26.2*	*10.2*	-
- foreign ownership	12	11	11	17	22
- *share in the balance sum, %*	*27.0*	*22.9*	*37.7*	*64.3*	-
Total number	50	47	43	40	36
Assets in percent of GDP	36	30	36	n.a.	n.a

Source: NBS, Economic Review, October 2005; IMF Country Report No. 06/96, Serbia and Montenegro Financial System Stability Assessment, March 2006

While the total number of banks decreased, their assets and liabilities grew. Jelena Zdrale (2006) analysed the quarterly balance sheets of banks and concluded that the growth of the banking sector was driven by banks which appeared as greenfield investment in 2001 and 2002. The majority of foreign banks are greenfield banks[31]. The structure of the banking system's assets and liabilities by ownership is presented in Table 6.3. As result of privatisation of five state banks, and slow growth of the remaining state banks; the share of banks in majority ownership of the state expressed as a proportion of the total assets of the banking system dropped from 52.4% at the end of 2003 to 24% in March 2006. As of March 2006, banks in majority foreign ownership hold over two-thirds of the total banking assets; and this share continued to grow.

Table 6.3 Serbia's banking system 2003-2006 (share in % in the banking system)

	2003 Dec	2004 Dec	2005 Dec	2006 Mar
Domestic state banks				
Assets	52.4	30.7	24.7	24.0
Credit to banks	45.9	34.6	19.8	15.8
Credit to clients	52.7	29.0	23.0	21.9
Securities	41.0	29.2	41.3	39.3
Liabilities	52.4	30.7	24.7	24.0
Liabilities to banks	71.3	47.0	43.4	36.2
Liabilities to clients	48.1	28.1	23.1	22.3
Capital	51.2	29.2	27.7	26.5
Domestic private banks				
Assets	25.6	9.0	7.1	7.0
Credit to banks	21.4	3.7	10.2	8.9

31 These banks did not buy a domestic bank but opened a representative office in Serbia followed by branches.

	2003 Dec	2004 Dec	2005 Dec	2006 Mar
Credit to clients	24.3	8.7	7.2	7.2
Securities	16.5	9.6	10.5	11.8
Liabilities	25.6	9.0	7.1	7.0
Liabilities to banks	19.1	7.5	8.3	9.9
Liabilities to clients	24.3	5.6	4.3	4.1
Capital	34.6	21.2	20.3	19.8
Foreign banks				
Assets	22.0	60.3	68.2	69.1
Credit to banks	32.6	61.6	70.0	75.3
Credit to clients	23.0	62.3	69.8	70.9
Securities	42.5	61.2	48.2	48.8
Liabilities	22.0	60.3	68.2	69.1
Liabilities to banks	9.6	45.4	48.3	53.9
Liabilities to clients	27.6	66.3	72.5	73.6
Capital	14.2	49.6	52.0	53.7
Total stock, in million EUR	5,080.6	6,162.8	9,039.0	9,784.9

Source: Jelena Ždrale, Transformation of Serbia's Banking Sector: Ownership Structure and Growth of Balance categories, December 2003-March 2006

The successful implementation of banking sector reforms - including privatisation of the largest state-owned banks - led to restoration of confidence in the bank system; resulting in replenishment of private savings. Restoration of confidence in the banking sector is reflected in particular by the increase in the currency savings. The structure of the deposits improved in terms of their maturity. Short-term and long-term deposits increased significantly as a share of total deposits; while the share of demand deposits shrank (see Table 6.4).

Table 6.4 Deposit potential of the banking sector

	2001		2002		2003		2004		2005	
	CSD m.	%	CSD m.	%	CSD m.	%	CSD m.	%	CSD m.	%
Demand deposits	72,608	77.1	131,520	75.8	159,353	71.4	183,856	58.7	250,898	51.8
Short-term deposits	20,677	22.0	39,705	22.9	58,587	26.2	120,646	38.5	210,932	43.5
Long-term deposits	845	0.9	2,270	1.3	5,286	2.4	8,754	2.8	22,854	4.7
Total	94,130	100	173,495	100	223,226	100	313,256	100	484,684	100

Source: NBS, Annual Report 2002; NBS, Report on the Financial System of the Republic of Serbia in 2005

The lending activities in the last years of the operation also followed an upward pattern. Total nominal lending increased four times in the period between 2001 and 2005. This growth is characterised by faster growth of lending in dinar, as well as faster growth in lending with longer-term maturity. The biggest share of lending was directed to enterprises. Lending to households doubled between 2003 and 2005 (see Table 6.5). The increasing pace of household borrowing may create a potential risk in the future (excessive indebtedness of households).

Table 6.5 Lending activity of the banking sector

	2001	2002	2003	2004	2005
In dinars	43,131	90,328	126,906	213,206	372,167
In foreign currency	72,454	92,429	82,706	97,824	87,567
Short-term	66,562	105,987	133,277	198,476	281,302
Long-term	49,023	76,770	76,335	112,554	178,432
Banks	-	-	32,026	39,309	46,237
Enterprises	-	-	136,192	190,937	272,135
Public sector	-	-	6,256	8,487	5,637
Other clients	-	-	2,914	1,730	3,810
Foreign persons	-	-	872	2,742	5,104
Households	-	-	28,336	64,136	124,222
Other	-	-	3,016	3,689	2,589
Total lending and credit, CSD million	115,585	182,757	209,612	311,030	459,734
Increase in percent	-	58%	15%	48%	48%

Source: NBS, Annual Report 2002; NBS, Report on the Financial System of the Republic of Serbia in 2005

In terms of ownership, most lending activities have been carried out by foreign banks. At the end of 2005, 68% of all lending was extended by foreign banks; 22% by state-owned banks; and 10% by private banks - as opposed to the situation at the end of 2003 situation, when state-owned banks accounted for 48% of the lending activity; with private and foreign banks accounting for 28.4% and 23.5, respectively.[32] Privatised banks continue to strengthen their position on the market. For example, Privetna Bank developed recently a strategy to strengthen its market position.

Significant improvements were carried out to improve the supervision of the banking sector. Most importantly the legal and regulatory framework was improved; although prudential coverage and regulations were still incomplete. A new Law on Banks (LOB) was enacted in November 2005. Despite this, its application in practice still needs to be improved. The Second Phase Supervisory Development Plan was adopted in October 2005 together with a time bound corrective action plan to address Basel Core Principle deficiencies.

While the privatisation of banks proceeded successfully, and the bank supervision improved significantly; the recent increase in non-performing loans is a source of concern. As emphasised in the Financial System Stability Assessment (FSSA), the rapid pace of credit expansion may have started to erode financial stability as non-performing loans increased - including in the foreign banks. The share of non-performing loans in total lending is quite high. The share of non-performing loans has been rising sharply, particularly among the foreign banks that had spread the credit boom in the last years (see Table 6.6). This development might induce credit risks.

[32] See NBS, Report on the Financial System of the Republic of Serbia in 2005, page 18.

Table 6.6 Share of non-profit loans[33]

	Non-performing loans (NPL) ratios			NPLs minus Provisions to Capital			Share in credit
	Dec 04	Dec 05	Mar 06	Dec 04	Dec 05	Mar 06	Mar 06
State-controlled banks	41.2	37.7	25.0	41.8	39.8	35.3	20.7
Domestic private banks	46.6	51.8	49.7	42.4	53.6	58.9	8.3
Foreign banks	10.0	16.0	16.1	25.8	46.4	48.7	71.0
Total	22.2	23.8	20.7	33.7	46.2	47.4	100.0

Source: IMF Country Report No. 06/384, October 2006

6.2.3 Conclusions

Bank privatisation was one set of conditions of the IMF and the World Bank. The implementation of these conditionalities was not always smooth. Some of the conditionalities were more difficult to implement than others, which resulted in giving a waiver in one case. Overall, the banking sector reform - including the privatisation of banks - is considered to be successful.

The state banking sector shrank considerably in the last five years. The reform of the banking sector, particularly including privatisation of banks, has brought about important economic benefits. The confidence in the banking sector increased; and this led to increase in deposits - particularly household savings. This made an increase in lending activity possible; and bank lending expanded rapidly as a result. The increasing number of foreign banks in recent years, and their relative easy access to capital has led to a sharp increase in credit to the private sector. The financial system is therefore better able to support sustainable economic growth. Nevertheless, the growing share of non-performing loans is posing an increasing risk to financial stability. Credit risk for the foreign banks could result in slowdown of credit growth.

In Chapter 5, we have described the gross and net impact of MFA on bank privatisation. The conditionality concerning bank privatisation was fully met and has been embedded in the national Serbian institutional context (structural progress).

Concerning counterfactual assumptions, we have inferred from the structured interviews and the Delphi-questionnaire that without MFA, bank privatisation would have occurred; since it was both high on the Government's policy agenda, and conditionalities on bank privatisation were attached to programmes of the World Bank and the IMF. Without the existence of MFA, bank privatisation would have been implemented later.

Combining this information, we conclude that the MFA conditionalities on bank privatisation have had a net impact; consisting of an operational reinforcing effect (speeding up of reforms) and a political reinforcing effect.

[33] Ownership structure as of March 2006; NPLs comprise loans in categories C, D, and E, with provisioning requirements amounting to 25, 50, and 100 percent, respectively.

6.3 Case study 2: Enterprise privatisation

6.3.1 Background

The MFA operation contained eight conditionalities related to enterprise privatisation in Serbia. The conditionalities followed a step-by-step process.

While the focus of the conditionalities in the second and third tranche was on privatisation of socially-owned enterprises, most conditions in the fourth and fifth tranches focussed on privatisation of strategic state-owned enterprises.

All the conditions were part of IMF and/or World Bank programmes. There was also a connection with the CARDS programme. The EAR provided a special grant to the Privatisation Agency, which was channelled through the World Bank – the institution that managed and administered the grant.

6.3.2 Actual developments and prospects

After the ensuing wars, Serbian enterprises had a greater degree of obsolescence in assets than in comparable countries in Central and Eastern Europe, due to lack of access to markets, technological advances and new equipment. Enterprises were also highly indebted, due to soft budget constraints in state, socially-owned and mixed firms; as a result of various factors, including the lack of incentives to enforce the repayment of bank loans.

The first privatisation phase was initiated by the introduction of a Federal Privatisation Law in 1991. The main privatisation method was that of selling stakes to insiders at preferential rates. In 1991, the Law was revised; making the conditions more restrictive and imposing limits on the amount that insiders could buy. A new Privatisation Law was adopted in 2001. Unlike previous privatisations, the focus was on selling enterprises to strategic investors. Under this Law, privatisation could be initiated by the company, the Ministry or the buyer. Privatisation was no longer voluntary. Under the scheme, 70% of shares were to be sold to investors; 15% to employees and 15% to a Privatisation Fund. The model also aimed to complete the privatisations that had been started under earlier privatisation models. Since a new government assumed power at the end of 2003, the privatisation process came increasingly into question.

The privatisation policy in Serbia had many objectives in Serbia, for instance: to create an open economy and ownership structure; to maximise investment in the real economy; to achieve social and political acceptability; and to establish a clear ownership structure. Restructuring and privatisation would revitalise those state and socially-owned enterprises capable of becoming market-oriented and competitive. In addition, privatisation intended to stimulate foreign investments in the country.

The privatisation programme in Serbia raised revenues to support the Government's budget.

Privatisation has had some considerable success; as a number of large enterprises were sold to foreign investors.

Table 6.7 presents some relevant background data on privatisation in Serbia. In the period 2002-2007, more than 2,000 firms employing between them a total of more than 320,000 employees were privatised through the Privatisation Agency. To a slight extent,the privatisation revenues have exceeded the expectations as revenues were higher than the book value of the enterprises. As part of the privatisation agreements, investments amounted to more than €1 billion; and social programmes amounted to almost a quarter of that amount.

Table 6.7 Privatisation in Serbia, 2002-2007 (money in 1000 euro)

2002-2007*	Offered	Privatised	Employees	Book value	Selling price	Investment	Social programme
Tender	179	76	78,214	887,095	1,109,762	970,348	276,689
Tender – breached contract		9	4,676	57,697	9,703	59,493	2,042
Auction	1,951	1,458	141,781	1,008,469	906,905	211,623	
Auction - breached contract		257	25,789	143,321	133,912	35,1110	
Tender + Auction	2,130	1,544	219,995	1,895,564	2,016,667	1,181,971	276,689
Capital market	598	461	102,970	431,075	453,128	5,902	
Capital - breached contract	84	45	5,108	39,033	47,822	0	
Capital – Previously privatised through auction or tender	778	552	60,727	4,180	2,668	0	
TOTAL	**2,812**	**2,050**	**328,073**	**2,369,852**	**2,520,285**	**1,187,873**	**276,689**

* until 28 September 2007

Source: Privatisation Agency, Republic of Serbia

Despite this success, in relative terms, the process progressed slowly; and still a lot has to be done.
The share of the private sector in Serbia only grew slightly from 40% in 2000 to 55% in 2006. In 2002, the share was merely 45%. Further restructuring and privatisation will be crucial to ensure sustainable growth and relieve the high Current account deficit by raising productivity and the export capacity of the country. Privatised firms could also generate savings (retained profits), making financial space for new or replacement investments.

The prospects differ between socially-owned enterprises and state-owned enterprises. Privatisation of socially-owned enterprises will continue until the end of 2008. The original deadline of the end of2007 has been changed. New amendments in the Privatisation Law have been proposed, and are expected to be adopted early next year. The amendments include:

- Postponement of the deadline for privatisation of socially-owned enterprises until the end of 2008;
- Simplification of the procedure concerning preparation of documents necessary for auction privatisation;
- Introduction of initial public offerings;
- Liquidation of remaining socially-owned companies not privatised in the new time schedule.

With respect to different state-owned enterprises, the prospects vary. There is no deadline for the privatisation of state-owned enterprises. One of the two majority state-owned mobile operators was sold. Restructuring of the electricity and railway companies, as well as of large socially-owned conglomerates - including the important mining complex - are supported by the World Bank. Political aspects hamper the privatisation, as politicians have a role in the assignment of management of these public enterprises. On the other hand, the capacity of the State to manage public enterprises remains low.[34]

A specific concern is the privatisation of publicly-owned utilities. A privatisation strategy for companies providing utilities at the municipality level will be prepared by the autumn of 2008. The Ministry of Economy and Regional Development will oversee this strategy.

6.3.3 Conclusions

Further progress in privatisation is crucial, in order to ensure sustainable economic growth and relieve the high Current account deficit in the longer term.

In Chapter 5, we have described the gross and net impact of MFA on enterprise privatisation. Four conditions were fully met. One condition was partly met. With regard to one condition, a waiver was granted. Two conditionalities which related to privatisation strategy in telecommunications and energy, and to privatisation preparation in railways were not assessed.

The conditions regarding the regulatory framework were fulfilled. The institutional capacity of the PA was strengthened. The conditions on tender privatisation and the offering of companies for sale through auctions were fulfilled. The conditions concerning starting privatisation procedures for large state-owned companies were partially fulfilled. The conditionalities attached to the fourth tranche were met, or a waiver was granted.

Interviewees and respondents to the Delphi questionnaire confirm that formal progress was achieved, although structural progress was limited.

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[34] See the article by Milojko Arsic and Dusko vasiljevic, "*Restructuring and privatisation of public enterprises in Serbia,* In: Foundation for the Advancement of Economics (FREN), *Quarterly Monitor of Economic Trends and Policies in Serbia*, Issue 9, April-June 2007, p. 22.

Like in the case of bank privatisation, the MFA conditionalities on enterprise privatisation have had a net impact, consisting of a political and an operational reinforcing effect (speeding up of reforms).

7 Impact on external sustainability

7.1 Introduction

Table 7.1 outlines the evaluation questions which analyse the impact of MFA on external sustainability. This chapter explains our approach and presents our findings.

Table 7.1 Evaluation questions on the MFA's contribution to external sustainability

Q4	To what extent has the MFA contributed to returning the external financial situation of the recipient country to a sustainable path over the medium to longer term?
Q4.1	How did the external financial situation of the recipient country evolve prior to and during the MFA operation?
Q4.2	What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?
Q4.3	How is the country's external financial situation likely to evolve in the five years following the final disbursement, given the likelihood of changes to current conditions?

Although the contribution of MFA to medium to long-term external sustainability is part of the generic evaluation questions, this question was not reflected explicitly in one of the sub-questions listed in the *Guidelines for the ex post evaluation of MFA operations*. Previous evaluations led to the insight that the generic question should be made explicit, since the formulated sub-questions did not automatically lead to clear answers on the impact of MFA on external sustainability.

Table 7.2 Additional sub evaluation question for analysing the impact on external sustainability

Q4	To what extent has the MFA contributed to returning the external financial situation of the recipient country to a sustainable path over the medium to longer term?
Q.4.4	What is the MFA contribution to medium and long-term external sustainability prospects?

The sub-question is important, as it explicitly indicates the achievement of the long-term external sustainability objective of the MFA operation. The answer represents a summary assessment of the use of the MFA instrument in Serbia and Montenegro; and is based on the findings of all other chapters. This summary assessment is included in section 7.5, which consolidates all results and put them into a medium-term to longer-term perspective by focussing on the net impact on external sustainability. Firstly, the following three sections of this chapter focus on the first three sub-questions.

7.2 Gross impact – actual evolution of external sustainability indicators

Q4.1: How did the external financial situation of the recipient country evolve prior to and during the MFA operation?

Serbia

In this section we provide the analysis of the evolution of key external sustainability variables in the period 2000 to 2007.[35]

As mentioned in Chapter 4, the Current account deficit in Serbia worsened gradually from 2000 onwards; but this was partly compensated by increased foreign direct investments in recent years. Nevertheless, the gap between the actual and the *sustainable* Current account deficit[36] has been closing in recent years. According to IMF calculations, the long-term constant primary balance that stabilises the debt remains close to 6.4% of GDP; with its actual value reaching 7.1% in 2006. The Current account deficit which in fact reflects fundamental imbalances in the economy is the main source of vulnerability of the economy, as discussed in section 4.3.

Chapter 4 also described developments in the foreign exchange reserves showing a steady increasing trend since 2000; with a particularly marked acceleration in 2006. As a result the level of foreign reserves increased, reducing the vulnerability of the country, especially at time when massive private capital inflow is increasing the risk and potential costs of sudden capital stoppage. Fortunately, the risk of outright capital reversal remains small due to the still predominant medium and long-term character of the inflows.

Apart from the balance of payment developments, the Paris Club and London Club debt rescheduling operations strongly influenced the indebtedness of Serbia. The agreement with the Paris Club, signed in December 2001 provided a basis for bilateral negotiations with each of the Paris Club member countries. These negotiations led to the signing of bilateral agreements with sixteen countries. Accordingly, the signing of the three-year Extended Arrangement with the IMF in 2002 opened the first phase for debt write-off of 51%. The second phase of the debt write-off, following the positive IMF assessment of the three-year arrangement in February 2006, reduced the debt by an additional 15%. A general agreement with the London Club creditors was signed after several years of negotiations in July 2004. This agreement led to the write-off of approximately 62% of the debt with a repayment period of 20 years and a grace period of 5 years. According to its provisions, the debt of the Republic of Serbia was exchanged for bonds in the amount of approximately US$1,080 million. These bonds were listed on the Luxembourg Stock Exchange in April 2005. By signing the agreement with London Club creditors, for the first time, Serbia obtained a credit rating for bonds – ‘B+’ (Standards & Poor) and ‘BB-‘ (Fitch).

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35 We have used data published by the National Bank of Serbia and the IMF Debt Sustainability Analysis for Serbia that was last conducted in October 2006 as part of Article IV Consultation. Data for Montenegro is taken from Annual Reports from the Chief Economist of National Bank of Montenegro, as well as from the IMF 2006 Sixth Review under the Extended Arrangement.

36 The Current account deficit is sustainable if it can be maintained indefinitely without major policy adjustment. In the current analysis, it is approximated by the primary Current account deficit that is consistent with an unchanged level of external debt as a share of GDP.

More recently, and following the conclusion of the Extended Facility arrangement, Serbia started to repay its outstanding debt towards the IMF and the World Bank. Between June 2006 and March, Serbia repaid the total amount of debt to the IMF, i.e. SDR 650 million (around USD 978.2 million); in December 2006, Serbia also repaid €323 million to the World Bank to cover the outstanding principal costs and other costs for 2007-2009.

The combination of the large Current account deficit and substantial private sector external borrowings, official IMF and World Bank programme borrowings, early repayments and Paris and London debt write-offs resulted in a slight decline in total external debt (public and private); which now stands at around 60% of GDP. Conventional debt indicators improved gradually, due to the rapid GDP growth accompanied by export expansion and tax revenue increases. Finally, exchange rate fluctuations between major international currencies - and notably the depreciation of US dollar - also had a positive impact. Table 7.3 presents the sources of the debt dynamics, as well as selected debt burden indicators.

\ Table 7.3 Selected external debt indicators

	2003	2004	2005	2006*
Total external debt as share of GDP	71.4	62.8	64.4	62.6
(a) Impact of CA deficit	*7.8*	*11.2*	*7.7*	*7.1*
(b) Impact of net non-debt flows	*-7.2*	*-4.3*	*-6.5*	*-10.4*
(c) Impact of GDP growth and exchange rate movements	*-18.2*	*-9.5*	*-3.2*	*-0.6*
Total external debt as share of exports	431.0	345.4	311.2	292.5
Total external debt as share of government revenues	151	130	133	144
External debt service (USD million)	423	633	964	2,184
• *Share of exports of goods and services*	*12.6*	*14.0*	*19.0*	*35.4*
• *Share of GDP*	*2.2*	*2.8*	*4.0*	*7.9*
• *Share of government revenue*	*4.7*	*5.8*	*8.3*	*18.2*

Note: * projections

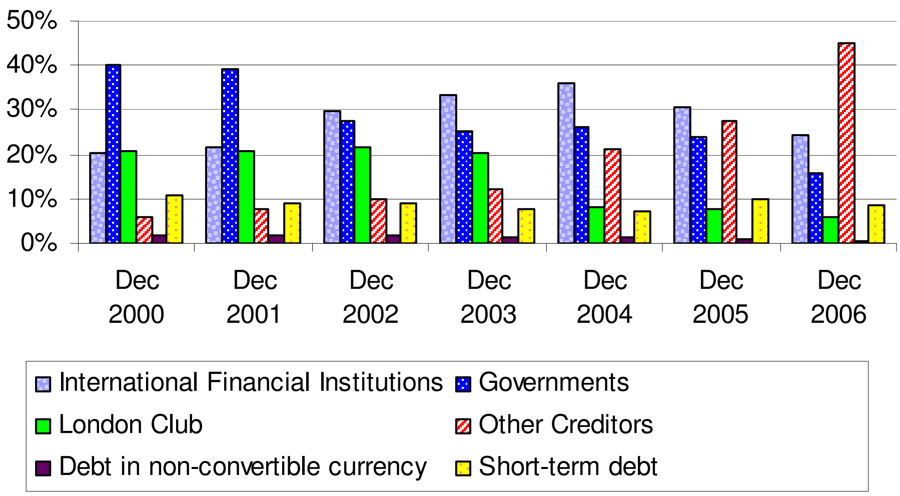
Source: National Bank of Serbia, IMF 2006 Article IV Consultation

The structure of the debt changed substantially. As a consequence of the Paris and London Club debt reduction, and also increased private sector borrowing; the share of public sector debt in total debt shrank from 81% to 59% between 2001 and 2006. Low domestic savings and a high domestic interest rate led to increases in external private sector borrowing being reflected in the doubled share of commercial debt.

The debt to international financial organisations initially gained prominence; as its share in total debt rose from 20% to 31% between 2001 and 2005 as a result of fresh government borrowing. This trend partly reflected the still limited access of Serbia to the international financial markets and the perceived high country risk as reflected in the low country rating. It was partly also the result of the restriction of non-concessionary borrowing (with a grant element below 35%) which was included in the IMF arrangement. Accordingly, international financial organisations (and other donors) were the most important source of funds for financing the budget deficit and public investment projects. However, most recent repayments have reduced the share of debt to financial institutions substantially.

After 2003, external private sector borrowing rapidly increased; and reached 45% of total external debt in 2006, compared to just 6% in 2000. The interpretation of this rapidly emerging private sector external borrowing is not unambiguous. On the one hand, it is a positive sign of improved financial standing of privatised domestic enterprises - particularly foreign-owned banks - that in many instances borrow from their parent companies. On the other hand, it leads to the risk of possible capital reversals bringing large economic costs. However, during interviews, IFI economists considered that this capital flow does not represent (so far) 'hot' money (i.e. short-term, potentially fast-reversible, flows). Nevertheless, the less unlikely scenario of a sudden stop of capital inflows could still affect the external sustainability. In any case, the large accumulated stock of foreign reserves represents an important risk-mitigating factor.

Figure 7.1 Structure of external debt in Serbia



Montenegro

The development of total and foreign public debt of the Republic of Montenegro is shown in Table 7.4. With the exception of the debt write-off, the level of the public external debt of Montenegro was quite stable. Almost 40% of this debt was the debt towards the World Bank; and about one quarter to Paris Club creditors. However, private debt has been growing, although from a very low level. Much of this private borrowing was linked to foreign direct investment, as Montenegrin subsidiaries borrowed from their foreign parent companies.

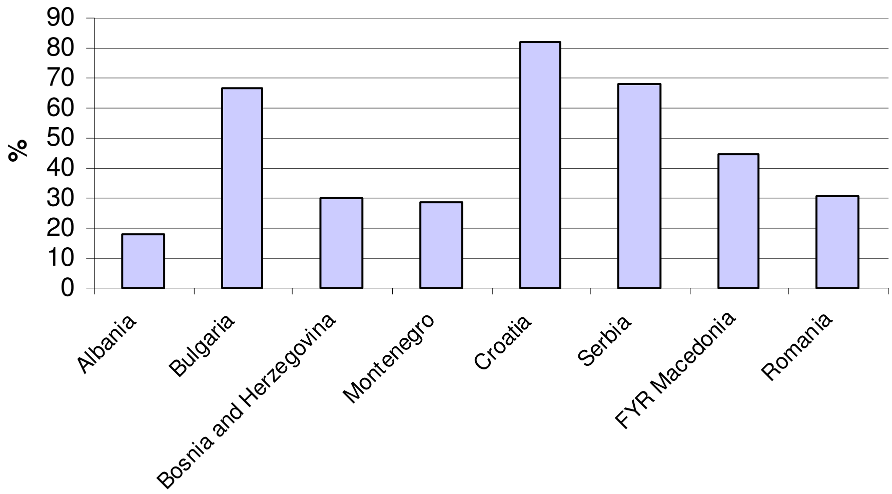
Table 7.4 Montenegro: external debt, 2002-2007

	2002	2003	2004	2005	2006
Total external debt, share of GDP	69.4	35.6	39.2	41.6	40.7
• *Public debt*	*68.7*	*33.0*	*32.7*	*32.0*	*30.8*
• *Private debt*	*0.7*	*2.6*	*6.5*	*9.6*	*9.8*

Source: Annual Reports from the Chief Economist of the National Bank of Montenegro, and IMF, Sixth Review under the Extended Arrangement, 2006

Figure 7.2 compares the external public debt levels for Serbia and Montenegro with other countries in the region. The level of indebtedness is particularly low for Montenegro. However, it should be noted that indebtedness thresholds are much lower for countries with fragile economies and with weak access or no access to the international financial markets.

Figure 7.2 Public external debt as % of GDP, 2006



{Source: Annual Reports from the Chief Economist of the National Bank of Montenegro}

7.3 Identification of major risk factors

Q4.2: What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?

In this section, we present the results of our analysis of the main internal and external factors on which the past, present and future developments of the external financial situation are highly dependent. The focus is on Serbia, with less attention given to developments in Montenegro. The discussion is based on a thorough study of the literature, quantitative analysis and interviews with officials of national authorities and International Financial Institutions (IFIs).

High Current account deficit

The large and increasing Current account deficit in Serbia was one of the main problems in the period of IMF programme implementation that coincided with the MFA operation. The Serbian authorities attempted to address this problem by active exchange rate policy - which was unsuccessful. The tight fiscal policies were also only partly successful in addressing the large private-sector savings-investment gap that signified the core of the existing external vulnerability. At the same time, slow structural reforms did not produce enough supply response, and income policies endangered competitiveness. As a result, the Current account deficit was above the target, unsustainable in the medium term and contributing to the growing external indebtedness.

In the last few years of the MFA operation, the Current account deficit improved slightly. In particular, the most recent export surge improved the outlook substantially. The improvement of the external situation was also facilitated by favourable commodity prices, inflows of FDIs, remittances, as well as restructuring. These positive developments and real exchange rate developments suggest that competitiveness in Serbia is preserved. Nevertheless, the size of Current account deficit and its financing through massive private capital inflows has made the country vulnerable to risks. The prospects of income convergence so far do not explain the rate of inflows of foreign savings, when compared to other transition countries. Namely, Serbia has much higher Current account deficits than Central Eastern European members of the EU (CEE5) and Bulgaria and Romania - i.e. countries with similar growth rates. On the other hand, it has a current deficit comparable to those of the Baltic States that enjoy substantially high GDP growth rates.[37]

Structural weaknesses

Unfortunately, the structural weaknesses perpetuate the imbalance between investment needs and domestic savings. The sluggishness of the reform of the corporate sector has been responsible for the weak governance and continued losses of socially-owned and state-owned enterprises; which has drained domestic savings. Without further progress in privatisation, bankruptcy and restructuring; it would be difficult to expect a positive contribution of the corporate sector to the external position today through savings, and tomorrow through gains from increased productive investments into net export-generating activities.

While the share of investments in GDP remains significantly lower in Serbia than in the CEE5; the discrepancy in saving rates is larger. This is explained by the private consumption rate, whose share in GDP is close to 80%; while it stays under 60% in CEE5. Consequently, high capital inflows are needed to finance the savings gap. This means that the Current account deficit is likely to remain, and will keep the external debt high. Moreover, the imported savings are used to finance expansion in non-tradable sectors and consumption of imported tradable goods, rather than adding to the export capacity of the economy. The data shows that up to 80% of FDIs in Serbia have been located in the non-tradable sector; compared with 58% in the CEE5.

[37] For more detailed statistics and analysis comparing the external vulnerability of Serbia and other emerging south-eastern European economies, see IMF Working Paper 07/236

Vulnerability to exchange rate movements

These two factors combined with lending by banks in foreign currencies lead to vulnerability to exchange rate movements and international financial conditions and sudden stops, in particular. It should be noted that much of the borrowing reflected the improved financial standing of financial institutions and enterprises, many of which have been privatised - allowing them to access foreign financing. In many instances, borrowing was made from parent companies; which reduced the borrowing risk. Nevertheless, the high level of borrowing remains a serious concern as it creates significant foreign currency mismatches.

The biggest mismatch exists in the highly-leveraged non-tradable corporate sector that generally does not hedge against exchange rate risks. However, also banks with large shares of credit in foreign currency remain vulnerable to the exchange rate risks of their clients. A risk-mitigating factor is though the relatively good financial position of households as consumer lending has yet not been developed.

Given the high concentration of the banking sector, and the dominance of banks from just a few home countries (Austria, Italy, Switzerland and France); the sector faces the risk of sudden stops when the parent banking groups reassess their risk and global asset allocations. This is accompanied with the concern that foreign banks are taking risks that are acceptable from their perspective of their global portfolio (as a small share of assets is invested in high-risk high-profit Serbia), but not from the point of view of the Serbian banking system. IMF estimates suggest that while the standard pre-tax profit margin in the EU is 14%; margins between 20% and 25% are expected in south-eastern Europe. This is amplified by direct credit from abroad and intercompany loans. Rapid growth of credit also tends to lead to an increasing share of non-performing loans. While it is generally expected that parent banks would support their local subsidiaries in financial distress, this is not necessarily always the case. A potential currency crisis could therefore also become a banking crisis. However, IFI economists indicated during the interviews that at present "*risks of a banking crisis are considered relatively low*".

It is finally noted that a restrictive monetary policy in the case of possible fiscal slippages and continuing mismanagement of state-owned enterprises with resulting high interest rates would attract short-term capital inflows. Although the short-term indebtedness continues to stay at a low level compared to other countries in the region, it could possibly increase the external vulnerability in the medium term. These inflows could also pose difficulties for monetary and exchange rate policies.

Sensitivity to growth assumptions

Another risk factor that is closely related to structural reform perspectives is the growth in output and exports. The anticipated increases on the supply side, which match the dynamics of aggregated demand, underpin our external sustainability assessment; however, this assessment would change substantially if growth in output were to slow down permanently to below 5% and exports fall below 15%. Progress in economic integration with the EU is the important factor contributing essentially to any economic projections; and is already factored in by exporters and financial markets. If integration were to be halted or delayed, the external sustainability outlook would deteriorate.

Finally, Serbia (and Montenegro) remains exposed to uncertainty concerning international oil prices. In Montenegro, it remains to be seen to what extent the recent surge in tourist-related foreign direct investment in property would generate future service income flows.

Importance of EU integration

Experiences in other regions suggest that highly imbalanced growth is rarely sustainable, and might lead to the financial crisis and sudden stops. Such risks would be particularly high in a country that still benefits little from the credibility of the EU integration process; and that faces potentially destabilising political events. In particular, a fundamental reassessment of the membership prospect or a protracted delay in signing of the Stability and Accession Agreement can spur contagion; as markets seem to currently under-price these risks. Such concerns were shared by at least some officials from both national authorities and international organisations interviewed for this evaluation.

Political stability

Many (international) interviewees consider that the most important factor affecting the economic prospects - and therefore external sustainability of the country - is political stability. In the opinion of one interviewee, the main question to be addressed is: "*What needs to be done to make Serbia a normal country*". Political issues (war criminals, Kosovo, Milosevic heritage) are constantly looming in the background; which is affecting economic expectations. Only political stability, stronger institutions, greater transparency, along with firmer affirmation of the EU integration process can reduce economic vulnerabilities in Serbia.

Further improvement in the external situation would crucially depend on structural reforms, leading to a healthier corporate sector and stronger supply responses to increase domestic and external demand and resulting ultimately in sustainable growth. This is true for Serbia but also for Montenegro; where structural reforms will be vital to increase domestic output and reduce external imbalances. Continued tight macroeconomic policies are necessary to ensure stability of the euro-based Montenegrin economy.

7.4 Projections of external sustainability – baseline and sensitivity analysis

Q4.3: How is the country's external financial situation likely to evolve in the five years following the final disbursement, given the likelihood of changes to current conditions?

Formulation of forward-looking external sustainability projections requires a consistent macroeconomic model with focus on balance of payments dynamics, as well as detailed information about the current composition of debt. In the baseline scenario based on the latest publicly available IMF debt sustainability analysis (DSA)[38], a strong policy response to the growing external imbalance is assumed. Under the baseline scenario, export growth rates would surpass import growth rates by a substantial margin in the

38 IMF, Article IV Consultation, October 2006.

medium term and privatisation driven FDIs would be gradually replaced by greenfield investments. Commercial borrowing would continue to grow; while lending from IFIs would be gradually phased out.

Table 7.5 shows several external debt indicators based on debt stock and debt service in the medium-term. The figures indicate that the country is on a sustainable path; with gradually falling indebtedness. They also indicate that aggregate debt dynamics hide the continued trend towards increasing private sector borrowing. One of the consequences of this shift is the increasing debt service to export ratio.

Table 7.5 Selected external debt indicators: projections 2007-2011

	2007	2008	2009	2010	2011
Total external debt as a share of GDP	59.5	58.4	56.9	55.2	52.5
(a) Impact of CA deficit	*6.9*	*6.0*	*5.5*	*4.6*	*3.9*
(b) Impact of net non-debt flows	*-6.2*	*-6.2*	*-6.2*	*-6.0*	*-5.9*
(c) Impact of GDP growth and exchange rate movements	*-0.1*	*0.3*	*0.5*	*0.8*	*0.7*
Total external debt as a share of exports	262.4	234.5	215.2	196.6	177.6
Total external debt as a share of government revenues	147	148	148	147	141
External debt service (USD million)	3,115	3,752	5,358	6,091	6,598
• Share of exports of goods and services	*42.4*	*43.2*	*54.3*	*54.1*	*51.7*
• Share of GDP	*10.0*	*11.2*	*14.9*	*15.8*	*15.9*
• Share of government revenue	*24.8*	*28.5*	*38.8*	*42.1*	*42.6*

Source: National Bank of Serbia, IMF 2006 Article IV Consultation

A prudent approach requires that major risks to external sustainability are identified and analysed quantitatively. We consider two cautionary scenarios that are closely linked to the risks to external sustainability, as characterised in section 7.3. The assumptions about key economic indicators under both scenarios are presented in Table 7.6

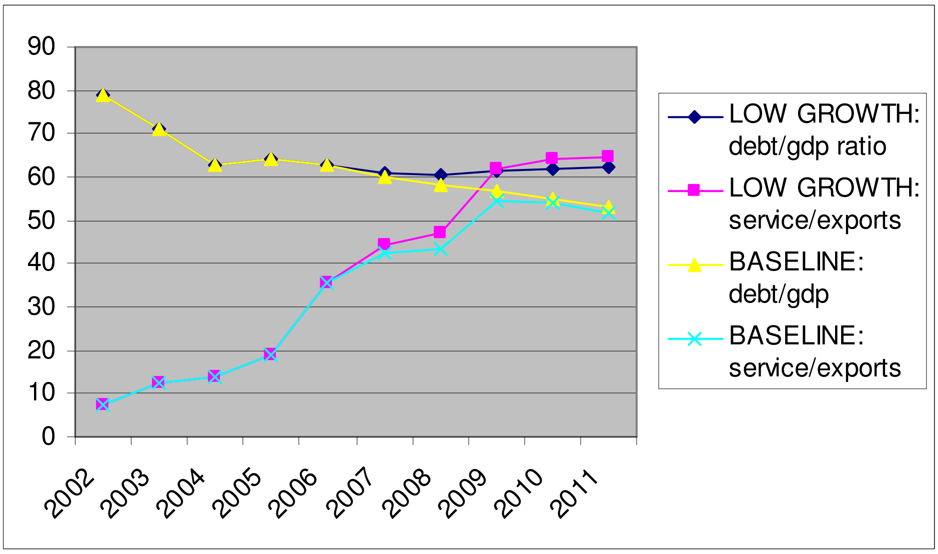
Table 7.6 Assumptions about key economic projections 2007-2011

	2008	2009	2010	2011
Real GDP growth rate (%)				
(a) Baseline scenario	6.0	5.0	5.0	5.0
(b) Slow reform scenario	5.0	4.0	4.0	4.0
(c) Depreciation scenario	2.0	3.5	6.0	5.0
Export growth rate (in US$)				
(a) Baseline scenario	18.3	14.2	14.1	13.1
(b) Slow reform scenario	13.0	8.9	9.2	8.0
(c) Depreciation scenario	17.2	15.3	17.2	14.2
Non-debt creating capital inflows (share of GDP)				
(a) Baseline scenario	6.2	6.2	6.0	5.9
(b) Slow reform scenario	5.0	4.9	4.6	4.4
(c) Depreciation scenario	11.2	9.2	7.0	5.9

Source: National Bank of Serbia, IMF 2006 Article IV Consultation, own calculations

In the first cautionary scenario, the impact of the delay of structural reforms on external sustainability is considered. In the slow reform scenario, the country GDP growth rate would be lower by one percentage point annually; while annual export growth would slow down from an average of 15% to 10% compared to the baseline. These percentages have an illustrative character, as the actual impact of structural reforms on growth rates cannot be credibly estimated. The slower export growth rate would have an unfavourable impact on the Current account and subsequently on debt accumulation. Combined with slower growth in overall output that does not match the aggregate demand dynamics; this would deteriorate the sustainability outlook. This is reflected in the strong rise in the debt service-to-export ratio, and the non-declining debt-to-GDP ratio. Characteristically, the slowdown would have a long-term impact on sustainability which would not be automatically reversed.

Figure 7.3 Debt sustainability outlook: Baseline vs. low reforms

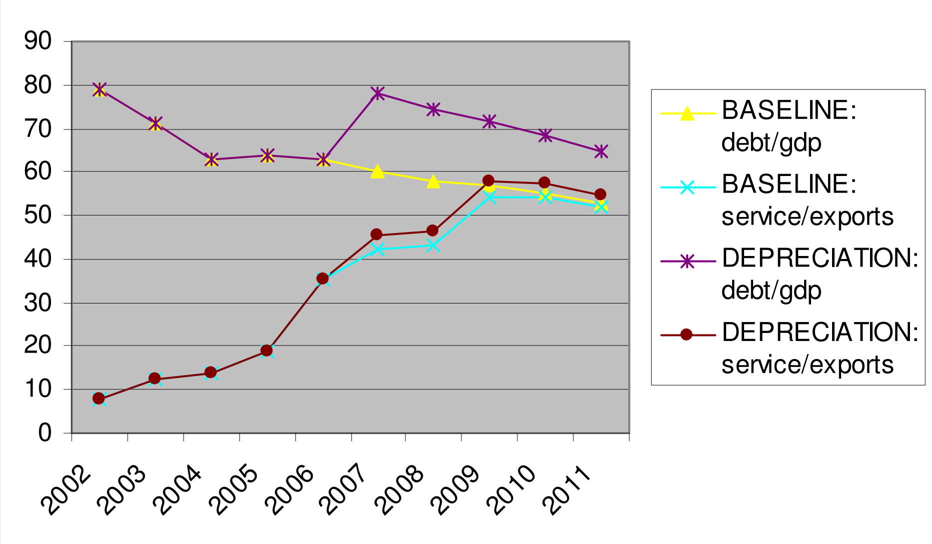


Source: Own calculations

* Compared to the version of the cautionary scenario presented in the interim report, the level of external debt in terms of GDP in this scenario is slightly higher due to the assumption of slower FDI inflow caused by slower reform process. This change requires more external borrowing to cover the Current account deficit.

In the second cautionary scenario, the existing external vulnerability due to external imbalances as explained in the section 7.3 is translated into a minor financial crisis involving a sudden stop of private credit inflows. Doubts about a cooperative resolution of Kosovo's status or problems in cooperation between Serbia and the Hague War Tribunal could be exemplary triggers for this scenario. In this cautionary scenario, the sudden stop would lead to immediate depreciation of the currency by 30%. Again, this number is illustrative though realistic. The depreciation would increase the debt burden as measured as a share of GDP sharply; while the cost of new borrowing would also increase. The external sustainability would thus deteriorate rapidly. In contrast to the slow reform scenario, the outlook would improve gradually afterwards through Current account adjustments and real appreciation. However, the process would be lengthy and costly in terms of lost GDP.

Figure 7.4 Debt sustainability outlook: Baseline vs. rapid depreciation



Source: Own calculations

* Compared to the version of this cautionary scenario presented in the intermediate report, the burden of debt service in terms of exports in this scenario is lower due to the changed assumption about lower response in costs of current financing following the exchange rate depreciation.

7.5 MFA contribution to medium to long term external sustainability prospects

Q.4.4 What is the MFA contribution to medium and long-term external sustainability prospects?

This section provides the summary on the contribution of MFA to the medium and long-term external sustainability chapters.

In the previous chapters and sections, the MFA contribution to medium and long-term external sustainability have been analysed qualitatively and, when economically sound, also quantitatively, where possible. Based on the macroeconomic impact assessment, the structural reform impact assessment, and the gross external sustainability analysis (Q 4.1, Q, 4.2 and Q 4.3) the channels can be identified through which MFA has influenced the medium to long-term external sustainability. In order to further facilitate this identification, the choice of case studies for structural reform analysis was made in a way that would assist in analysing the impact of structural measures on external sustainability by looking at the immediate financial impact and the future growth prospects of the sector.

7.6 MFA channels

There are various channels through which the MFA operation can impact on the medium to long-term perspectives of external sustainability. MFA can result in building an environment more conductive to stronger and/or more stable economic growth in the medium to long-term. These channels in turn have a direct impact on the external balance, e.g. by improving debt and debt service to GDP ratios. Furthermore, MFA can lead to improved macroeconomic management and structural reforms. More prudent and coherent fiscal and monetary frameworks help to keep debt dynamics in check. The structural reforms encouraged by MFA can enhance economic growth potential, including export potential; and can encourage FDIs and other private capital inflows. Finally, the primary declared objective of the MFA is to ensure sustainability of the balance of payments position; and thus to prevent short-term financial disturbances with potentially long-term negative impacts (such as mini or fully-fledged financial crises).

The macroeconomic counterfactual discussed in Chapter 4.4 showed that the direct impact of MFA on economic growth in Serbia has been marginally positive in the short term. The analysis of the impact on the current and capital account indicates that the MFA operation had actually slightly increased debt; as fiscal tightening was most often the policy predicted for the counterfactual situation by officials interviewed. More generally, the MFA operation affected other macroeconomic indicators only marginally - as demonstrated in section 4.5. This was mainly because of the relatively small size of the operation. Even in the year 2003, the largest disbursement of the MFA operation did not exceed 0.4% of GDP (grant and loan combined). Looking at more relevant and smaller aggregates, the scale of the operation also did not appear substantial. Total assistance amounted to less than 1% of country's imports; or 5% of the Current account deficit in 2003. Its contribution to replenishing reserves was also small, as it equalled only 2% of the stock of gross foreign reserves at the end of that period; and 3.3% of increase of reserves during this year. Even two disbursements in the second quarter of 2003 constituted only 8% of the international reserve increase during this quarter. Looking from a medium-term perspective, the total value of the instrument equalled 1.3% of total stock of foreign reserves at the end of 2006 - an amount which did not affect the overall sustainability outlook.

However, the impact of MFA on sustainability would be substantial, if indeed the MFA accelerated structural reforms in 2002-2005; as these reforms provided the basis for higher GDP growth rates in the medium term. The slow structural reform scenario presented in section 7.4 provided a quantitative illustration of how much the sustainability outlook is dependent on medium-term growth prospects. As mentioned in section 7.3, the slowness of corporate sector reform has been responsible for the weak governance; and for continued losses of socially-owned and state-owned enterprises that have drained domestic savings. Without further steps forward in privatisation, bankruptcy and restructuring it would be difficult to expect a positive contribution of the corporate sector to the external position today through savings; and tomorrow through gains from increased productive investments into net export-generating activities. Correspondingly, the most important potential impact of MFA on external sustainability could be due to the pressure on accelerated privatisation of banks and enterprises, as well as their restructuring.

However, as discussed in Chapter 5 of this report, it is very difficult to assess the importance of MFA as a separate instrument in supporting such a policy improvement. We believe that MFA had a political reinforcing effect on the credibility of the overall reform package. It is likely that MFA speeded up the implementation of the reforms in the areas of the Treasury system, tax revenue collection, National Bank strengthening, bank privatisation and privatisation of enterprises. However, it was not the main driver behind the reforms. In any case, MFA emphasis on privatisation contributed, together with the IMF and World Bank programmes, to building up pressure to speed up the process. These in turn contributed to improving medium to long-term sustainability prospects of the country. But this effect is extremely difficult, if not impossible, to quantify; and in any case, its scale should not be overestimated.

Secondly, it is possible to suspect that front-loading of MFA assistance in 2003 could have helped to prevent the major collapse of confidence following the assassination of the Prime Minister. This would suggest a quantitative counterfactual scenario similar to that presented in the rapid depreciation scenario in section 7.4 of this report, although shifted back by three years. However, the majority of our interviewees indicated that such extremely negative scenario of financial crisis in 2003 was highly unlikely.

Overall we conclude that MFA have positively contributed to the medium to long-term external sustainability prospects, albeit this net impact was most likely limited and indirect. The primary channel through which MFA acted in this respect appears to be in the enforcement of structural reforms and improved overall macroeconomic management.

8 Implications of the design and implementation of the operation

8.1 Introduction

This chapter reviews the consequences of the design and implementation of MFA in Serbia and Montenegro on the operation's performance. It addresses the following evaluation question (Table 8.1).

Table 8.1 Relevant evaluation question concerning the implications of design and implementation

	Impact of structural reforms
Q5.1	In what way has the design and implementation of the MFA conditioned the performance of the MFA operation in respect to its cost and its objectives?

The chapter ends with general conclusions and recommendations that will contribute to a future meta-evaluation of several MFA operations, with a view to deriving strategic lessons about the MFA instrument.[39]

8.2 Design and implementation features - Findings

Multiple MFA objectives

As with in other MFA operations, the provision of MFA to Serbia and Montenegro had multiple, though related objectives, i.e.:

- To ease the country's external financing constraints;
- To support the balance of payments;
- To secure the foreign exchange reserve position;
- To support the policy objectives attached to the authorities' reform efforts.

In this operation, initially no other objectives were specified. However, in the SMoU, the last objective was further clarified through explicit wording of the purposes of the conditions in the formulation of the conditionalities. For instance, in the fourth tranche, a condition in the area of financial sector reform was worded as follows: "To improve the efficiency and stability of the banking sector, *launch tender(s) for the sale of (a) state-owned bank(s) so that, after completion, at least 80% of total domestic banking sector assets would be in private ownership."*

[39] We focus only on a few distinctive features of the operation in Serbia and Montenegro; without repeating some of the conclusions and recommendations made in the previous ex-post evaluations of MFA.

This has brought clarity in the MFA programme and allows assessing better whether the underlying purpose of the conditionality has been reached.

In this MFA operation, the interlinkage between the relatively short term objectives and the objective to support reforms of the government(s) was strong. A number of conditionalities related clearly to ensuring the sustainability of the macroeconomy through relevant structural reforms. This evaluation confirms this as the primary channel through which MFA acted was through the 'enforcement' of structural reforms. Given the relatively limited size of the operation, the medium-term objective was the most central one.

Furthermore, various international interviewees of different organisations also emphasised as objective to build relations on economic issues between the EU and Serbia and Montenegro. As such, MFA was seen as a *relationship-building instrument"*. Indeed this has worked well, especially given the volatile history of the region and the need to involve *all* countries in the region - without exception - in the EU integration process concerning macroeconomic issues.

This MFA operation has also demonstrated the political nature or objective of the instrument. In the Serbia and Montenegro case, this is meant positively. After the assassination of the Prime Minister in 2003, the EC frontloaded disbursement and increased the total amount. This political signal is considered to be a "*right*" approach, especially given that the IFIs were slowing down their programmes due to a lack of progress. Although there is no evidence from a very short-term economic indicator; national authorities did not confirm the economic importance of these decisions, but did confirm the political signalling.

In Montenegro the MFA was merely seen as a budget support operation, which is understandable given their use of the German mark and later the euro.

Finally, in Montenegro the authorities attached another – for them important - objective to the MFA: namely the objective of increasing the credibility of Montenegro. The MFA was more a *credibility-granting* instrument, rather than a BoP instrument or budget support instrument. MFA conditionalities were also used by the Government to justify to the public the necessity of some important, difficult and unpopular decisions.

This multiplicity of explicit and implicit objectives of this MFA has been a distinctive feature of the whole operation.

The "flexibility" of the MFA instrument compared to those of other IFI

In a previous MFA evaluation, the insufficient flexibility of the instrument was indicated. The MFA operation in Serbia and Montenegro has, however, showed 'flexibility' in various respects. This does not only relate to the relatively speedy reaction of the EC after the assassination of the Prime Minister, but also to the use of a waiver concerning a condition in the area of privatisation. The two-track approach that was introduced in the SMoU has also been a pragmatic approach; allowing initially formulated conditions to be disregarded.

The selection and number of conditions
As mentioned, most conditionalities were similar to the conditions in the IMF Extended Arrangement in World Bank programmes. This coherence was perceived to be useful. Most conditionalities were considered relevant to the country's needs, except for the EU-specific conditionalities linked to establishing an internal market in the Federation. While the internal market objective has its (strong) merits; one can argue whether given the recent volatile political events in the region, such conditions belonged to this balance-of-payments instrument. In post-conflict countries, other instruments would be more effective to achieve an economic objective that is strongly intertwined with the political history.

In total, there were 54 MFA conditions. Since most conditionalities were similar to the IFI requirements, national authorities had no comments on this large number.

The size and number of tranches
As mentioned above, a particular characteristic of this MFA operation has been the multiple explicit and implicit objectives. Total grants and loans disbursed to Serbia amounted to 2.3%, 5.6%, 0.4% and 2.1% of the Current account deficit in 2002, 2003, 2004 and 2005, respectively. In Serbia, we could not determine any strong link between the MFA funds and the budget. In Montenegro, where MFA was considered to be a budget support instrument; the disbursement was also non-negligible in 2003 when it amounted to roughly half of total grants. Nonetheless, the overall size of the disbursements was relatively small. In our view, this emphasises again the importance of the structural reform objective besides the political objective.

Publicity of the operation
Interviewed officials from the national authorities in Serbia were not familiar with the MFA operation, except for a few 'insiders' who had worked in the Ministry of Finance. Many officials of other institutions were aware of the conditions, but related them to IMF or World Bank programmes. Exceptions were mainly conditions related to bank and enterprise privatisation. We have understood, contrary to the experience with the MFA operation in Bosnia & Herzegovina, that no press releases by the EC (Delegation) were made in the country in order to improve the visibility of the MFA instrument.

8.3 Conclusion and recommendation for future MFA operations

We draw two distinct conclusions which originate from our analysis and interpretation of the MFA operation in Serbia and Montenegro. The first conclusion and the recommendation relate to the many objectives attached to the MFA instrument; and the second to the selection of conditionalities.

- *Multiplicity of objectives*: As explained in section 8.2, this MFA operation had multiple objectives which were specified in the Council decision. These multiple objectives related to the balance of payments and the international reserve position of the country/countries. The EC had also another - not explicitly formulated - more institutionally-related objective with this instrument: namely, relation-building. National authorities in Serbia appeared to have attached value to the explicit reform support objective. In Montenegro, officials emphasised the – not explicit - budget support and the image-building elements. This multiplicity of objectives, and the fact that a number of them were never made explicit made the original intentions of the MFA incomprehensible; and have complicated the assessment of the effects of MFA. Other instruments would be at least as effective in achieving the non-explicit objectives.

Among these multiple objectives, a hierarchy of objectives can be determined - being the strengthening of the balance of payments position. In the Serbia and Montenegro FA case, the outcome of the evaluation confirms in particular the medium-term effects of structural reforms on the balance of payments position. While it can be argued that the "multiplicity of objectives" can be seen as a positive characteristic of the operation; it could divert attention away from the main original economic-oriented objectives of MFA.

We strongly recommend maintaining the original objectives of MFA and using other instruments to achieve other non-balance-of-payments related objectives.

- Selection of conditions: As mentioned, the MFA initially included conditions related to the internal market. In the SMoU, these conditions were abandoned due to the political realities as the Federation fell apart.

  We recommend analysing during the design of the operation whether in post-conflict countries and whether other instruments would be more effective to achieve an economic objective which is strongly intertwined with the very recent political history of the country prior to including it in a MFA operation.

Appendixes

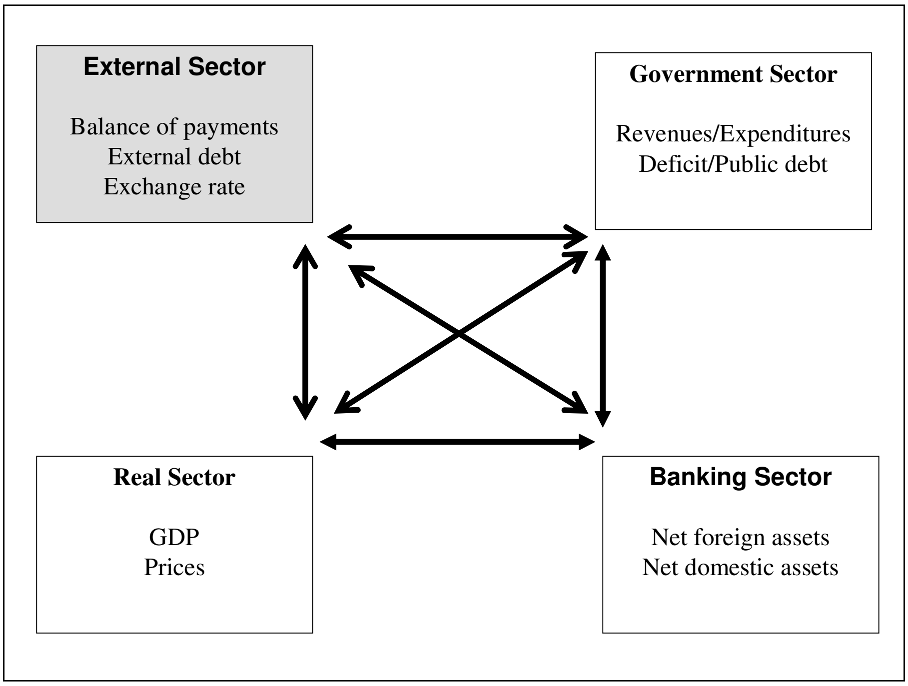
Appendix A: Modelling approach to the counterfactual

General description

In order to illustrate the macroeconomic effects of the counterfactual(s), a quantitative modelling approach has been used. The basic structure of the model that recognises links and ensures consistency among four basic economic sectors (real, external, government and banking) is illustrated in Figure A1.1, below. The applied macroeconomic model is broadly similar to the model employed in previous evaluations (evaluation of MFA in the Former Yugoslav Republic of Macedonia, Romania, and Tajikistan). However, some major changes have been introduced to better adapt the model to Serbia's specifics. These changes are most visibly reflected in behavioural equations explaining inflation growth, exchange rate growth and economic growth.

The main part of the model has been calibrated using annual IMF data available from recent IMF Country Reports, IMF World Economic Outlooks and from the National Bank of Serbia. The data has been used to derive the alternative – counterfactual - path of major macroeconomic variables in the absence of the MFA.

Figure A1.1 The basic structure of the model that recognises links and ensures consistency among four basic economic sectors: real, external, government and banking



Key features of the model

The absence of the MFA affects the economic system through four channels. Firstly, there is a direct impact on the balance of payments. The second channel of impact operates through budgetary accounts. The absence of the grant element would reduce government revenues. The absence of loan element would imply lower external financing opportunities for the budget deficit. Thirdly, more restrictive monetary policy would involve lower net foreign assets, and potentially also less credit to the private sector.

Differential approach

All channels described above are explicitly modelled to capture differences between counterfactual and actual scenarios. The model is linear and accordingly, most equations used in the model describe the difference between counterfactual and actual values of variables. For example, the equation for a variable X that is determined by some two other variables Y and Z typically has the following form:

$$DIF(X) = F(DIF(Y), DIF(Z))$$

where DIF (…) is the difference between counterfactual and actual value of a variable and F() is selected function form (identity or behavioural equation, as discussed below)[40]. The advantage of such specification is the strong focus on variability related to the MFA intervention and the straightforward interpretation of obtained results in terms of net impact of the intervention.

Identities and behavioural equations

There are two basic kinds of equations used in the model: identities and behavioural relations

Identities are equations that must hold by definition to ensure accounting consistency (e.g. balancing the balance of payments, financing budget deficit, equating assets and liabilities of the banking sector). The only necessary assumption in simulating the counterfactual in case of identities is the determination of the size of the adjustment of each of the variables entering the identity in response to a shock. Often this choice is conditional on either policy responses or external factors, such as access to international financial markets.

In the case of behavioural relations (e.g. explaining GDP growth, prices in tradable and non-tradable sectors and exchange rate movements), the equation has a stochastic character; and reflects the economic impact that would take place according to economic theory - ideally confirmed by statistical evidence available through estimation based on quarterly time series. The model assumptions involve the choice of the variables that are best in explaining the dynamics of independent variables and this allow quantification of the size (elasticity) of the impact. The elasticity can be estimated, calibrated or simply assumed.

[40] Sometimes the percentage difference between counterfactual and actual values is also used and is then denoted by %DIF (…) in the discussion below.

Although the model consists of larger number of equations, in the next sections, we describe the four most important identities and three behavioural equations that are at the core of the simulation model of the counterfactual.

Balance of payments identity

The first essential equation necessary for establishing the counterfactual is the identity describing the balance of payments. Below we show a stylised version of the actual equation, which illustrates the character of modelling choice in determining the type and strength of the BoP response in the counterfactual scenario:

> DIF (MFA grant + other CA items) + DIF (MFA loan + other KA items) = DIF (reserve accumulation)

where DIF is the difference between counterfactual and actual value as defined previously, CA is the Current account; and KA is the capital and financial account. The absence of the disbursement of MFA is reflected in a drop in external loan disbursements in the capital and financial account. As the balance of payments has to balance ex post, the resulting tighter BoP constraint must lead to adjustment in other items. The assumed adjustment involves a combination of lower foreign reserve accumulation and Current account adjustment. Reserve accumulation is subject to the discretion of the national monetary authorities (i.e. National Bank of Serbia), and we assume that roughly two-thirds of the additional BOP constraint is reflected in lower accumulation of foreign reserves in the counterfactual. The rest of the adjustment takes place through Current account items - primarily through the slowdown of imports.

Budget identity

The second core identity used in the formulation of the counterfactual describes budgetary accounts. The stylised version of this equation is:

> DIF (Gov Expenditures) – DIF(MFA grant + other Gov Revenues) = DIF (MFA loan + other Deficit Financing items)

The absence of MFA grant assistance is recorded in the budgetary identity as lower revenues; while the absence of an MFA loan is recorded as lower external deficit financing. In order to balance the books, the Government needs to adjust its expenditures and/or revenue collections, and/or identify alternative sources of deficit financing. In this respect, the counterfactual is fully determined by the availability of alternative sources of financing and policy decisions about fiscal tightening. Following the interviews conducted in Belgrade, Brussels and Washington DC, we have determined that access to alternative financing was very problematic; and an increase in revenues was implausible due to the revenue reforms already implemented. We believe that expenditures would not only be reduced by the size of grant element to keep deficit unchanged, but also by the size of loan element to avoid the necessity to find additional deficit financing. As a result, the budget deficit in the counterfactual is actually equal or lower than in reality.

Banking sector balance sheet identity
The third core identity describes the accounts of the banking sector. This stylised presentation illustrates key linkages with the balance of payments that is determined through a series of auxiliary identities. Net foreign assets (NFA), and budgetary accounts determine the size of credit to the government (NDC government), with adjustment in other items of net domestic assets (NDA) affecting the money supply changes.

DIF (NFA) + DIF (NDC government) + DIF (NDA other) = DIF (Money Supply)

The adjustment to these disturbances in the counterfactual depends mainly on policy responses. It is assumed that the National Bank sterilises half of the lower foreign reserve accumulation through faster growth of net domestic assets. This would reduce the negative impact on the overall money supply in the counterfactual. However, credit to the private sector of the economy would not be seriously affected; as additional deficit financing from the domestic banking sector has been disregarded.

Real sector behavioural equations
The set of core identities described above, together with other auxiliary equations constitute the logical framework of the model, and indeed produces most of the presented results. However, in order to quantify the impact of the counterfactual situation on the real sector, behavioural equations have to be introduced. This is a challenging task since the character and strength of the linkages from balance of payments, fiscal and monetary developments to the real sector are highly speculative - neither standard theory, nor available econometric literature provides precise insights into the size of these effects. Due to short time series and structural breaks, it is also not always possible to properly estimate relevant elasticities using quarterly data series. In such situations, elasticities are selected within the range typically found in other countries or assumed in similar models.

The prediction of counterfactual inflation is based on decomposition of the Retail Price Index on its tradable and non-tradable elements, given the knowledge of the actual weight of each category in the index. This allows better monetary and exchanging rate determinants of the real price level to be analysed.

DIF (Prices) = 0.23 DIF (PriceNonTrad) + 0.77 (PriceTrad)

It can be shown by manipulation of the basic identities that differences in prices of tradable goods can be explained by changes in the level of real exchange rates; whereas the real exchange rate is defined as the relative price between tradable and non-tradable goods. Quarterly estimation is the source of the elasticity of pass-through from real exchange rate to prices of tradable goods.

DIF (PricTrad) = 0.4 DIF (RealExRate)

Prices of non-tradable goods are in turn driven by changes in money supply with the elasticity estimated using the quarterly series:

DIF (PriceNonTrad) = 0.5 DIF (Money Supply)

In order to predict the real exchange rate, we link it to the endogenous improvement of Current account that is facilitated with the real depreciation. We could not estimate the size of this impact given the limitations of statistical data. Therefore, we use an elasticity usually reported in similar studies.

DIF (RealExRate) = 0.5 DIF (Current Account)

With these prices and real exchange rates dynamics, we are able to also predict the changes in nominal exchange rates. This approach allows us to study explicitly the trade-off between inflation and the Current account.

Concerning GDP growth, it was not possible to model these dynamics through changes in GDP expenditures categories grouped into domestic private absorption (private consumption plus private investments), government (consumption plus investments) and net export as we have initially planned. Unfortunately, contrary to earlier announcements, the Statistical Office did not publish quarterly GDP figures broken down into expenditure categories; and at this point it is not clear whether these basic statistics will even be launched in the future.

Given this statistical gap, GDP growth is crudely predicted using a reversed import function. This approach reflects the fact that GDP growth is restrained by a tighter balance-of-payments constraint given the import needs of consumption and investments. The tightness of this constraint is assumed based on the standard results of estimation of an import demand function in other countries; while imports are derived from the balance-of-payments identity.

DIF (GDP) = 0.5 DIF (Imports)

It should be noted that this approach to analysing short to medium-term macroeconomic adjustment is relatively satisfactory. However, it will necessarily fail to capture medium to longer-term effects of structural reforms.

Sensitivity analysis
Tables in the main text of the report present point estimates of the potential impact of the MFA intervention that are obviously dependent on specification and assumed parameter values. Interpretation of results should therefore be concentrated on signs and relative size of effects, rather than on particular numerical values. Nevertheless, the qualitative results are quite robust to modifications in the parameter values within the reasonable range. In particular net effects remain small for virtually all plausible parameters.

Appendix B: Delphi questionnaire and some results

Delphi method

The Delphi method is a qualitative approach that relies on *judgemental* estimates based on respondents' insights and collective knowledge. The Delphi method uses an iterative questionnaire survey that can be adapted to gain informed forecasts from past events. The Delphi method envisages a combination of:

1. estimates of the *subjective* probability attached to the occurrence of particular events;
2. issue-items requesting ranking by respondents according to *importance*;
3. goal-items about the *desirability* of certain options; and
4. options-items requesting respondents to identify *alternative* courses of action.

Delphi is an anonymous iterative process carried out in several steps. It aims to structure conflicting and dissenting views, with a view to reaching a final consensus. The Delphi exercise that has be used in this evaluation comprised of two steps. The first step was carried out during the first field mission in Serbia and in Washington DC; and preliminary results were presented in the intermediate report. In the second step, respondents were given the opportunity to explain, reassess, or even change their responses when confronted with the initial consolidated results.

Delphi questionnaire

A questionnaire was used to assist in establishing counterfactual situations concerning the structural conditions. However, it also contains some additional questions related to macroeconomic effects. Initially it was intended to have separate final questionnaires developed for Serbia and Montenegro, but interviewees in Washington DC already commented that it was not possible from an analytical perspective to complete separate questionnaires for both countries. They also stated that in any case, during the period under review, the main emphasis was on Serbia. They advised in favour of producing only one questionnaire. Therefore, the Delphi questionnaire was only used to gain additional structured information with respect to Serbia.

Each questionnaire was preceded by a written introduction, a summary of the MFA operation, and instructions on how to fill in the questionnaire. In addition, our local experts contacted all the people we interviewed, in order to offer them assistance in completing the questionnaire. The questionnaire and the additional background documentation have been translated into the Serbian language.

In total, ten questionnaires were returned in the first round. In the second round, respondents were given the opportunity to explain their answers – especially in case their responses deviated from the majority view – and provide additional information. The opportunity to reflect on the questionnaire is one of the distinct features of the Delphi method. Most respondents gave similar responses to the following questions:

- How do you assess progress *in general* in the following policy areas in comparison with the situation at the end of 2002?
- How do you assess the relevance of these specific reforms at the time they were proposed in relation to the national reform agenda?

However, in the case of the following questions, opinions were more varied:

- What contribution, if any, did the Macro Financial Assistance from the EU have in bringing about these reforms?
- What would have happened to the MFA conditionalit(y)(ies) in the distinguished policy areas if the EU MFA had not existed?

In most cases, interviewees explained how they perceived the question; and why they had chosen a specific answer, e.g. why they chose to answer MFA shaped the contents of a specific reform rather than of speeded up the implementation of the reform. On one occasion, a respondent modified his answers on a specific reform as he felt he had been mistaken.

The section below follows the questions included in the final questionnaire.

Macroeconomic Part

1) How do you assess the current overall macroeconomic stability of Serbia/Montenegro in comparison with the situation in mid-2002?

Worsened	The same	A bit better	Much better	Don't know

Why?

2) In your judgement, what is the likelihood of a financial crisis in Serbia/Montenegro in the following years?

Year	More unlikely	Little unlikely	Little likely	More likely	Don't know
2002					
2003					
2004					
2005					
2006					

Why?

3) How do you assess the relative contribution of Macro Financial Assistance from the EU to the stabilisation process when compared to other contributions (IMF, World Bank, other bilateral donors?

Worsened things	No contribution	A minor contribution	A substantial contribution	Don't know

Why?

___

4) How did you perceive the objective of Macro Financial Assistance? Was it mainly addressing balance of payment problems? Or did you perceive it more as budget support? Support to structural reforms? Or did you perceive the contribution of Macro Financial Assistance in another way? (Please ensure that the total adds up to 100%).

Balance of payment support	…%
Budget support	…%
Facilitation of structural reforms	…%
Other if applicable………………….. (specify)	…%
TOTAL	100%

5) How could an MFA role have been enhanced (please score 0 for no enhancement x for minor possible enhancement, xx for enhancement, xxx for strong enhancement)

More timely delivery	
Fewer conditions attached	
Larger grant component	
Other if applicable………. ………………….specify	

6) What would have happened if the MFA had not existed?

	Very unlikely	Unlikely	Likely	Very Likely	Don't know
IMF					
Larger programmes					
Tighter policy conditions					
More relaxed policy conditions					
World Bank					
Larger programmes					
Shift from project loans to structural adjustment loans					
Tighter policy conditions					

	Very unlikely	Unlikely	Likely	Very Likely	Don't know
More relaxed policy conditions					
Other donors					
Increase their programmes					
Switch money from TA					
More debt cancellation					
Serbian Government					
More taxes					
Less public spending					
More borrowing					

6) Please elaborate on the macroeconomic and balance of payments consequences of your more likely scenario from Question 4. What would be the most important outcome in the economic sphere if the Macro Financial Assistance had not existed?

____

____

____

Structural Reform Part

7) How do you assess progress in the following policy areas in comparison with the situation in mid-2002?

	Worsened	The same	A bit better	Much better	Don't know
Treasury system					
Public expenditure management					
Debt and asset management					
Tax revenue collection					
Tax revenue policy					
Public administration					
Public pensions					
Customs harmonisation					
Anti-money laundering					
National Bank strengthening					
Bank privatisation					
Insurance privatisation					
Banking/insurance sector regulation					
Bankruptcy Law					
Privatisation enterprises - General					
• *Telecommunication*					

	Worsened	The same	A bit better	Much better	Don't know
sector • *Energy sector* • *Aluminium* • *Railways* Competition policy • *Telecommunication sector* • *Energy sector* Business registration					

8) What contribution, if any, did the Macro Financial Assistance from the EU have in bringing about these reforms?

	Put the issue on the policy agenda	Speeded up delivery	Shaped the contents of the reforms	Don't know
Treasury system Public expenditure management Debt and asset management Tax revenue collection Tax revenue policy Public administration Public pensions Customs harmonisation Anti-money laundering National Bank strengthening Bank privatisation Insurance privatisation Banking/insurance sector regulation Bankruptcy Law Privatisation enterprises - General • *Telecommunication sector* • *Energy sector* • *Aluminium* • *Railways* Competition policy • *Telecommunication sector* • *Energy sector* Business registration				

9) How do you assess the relevance of these specific reforms at the time they were proposed in relation to the national reform agenda?

	Not relevant	Minor issue	Relevant	Top priority	Don't know
Treasury system					
Public expenditure management					
Debt and asset management					
Tax revenue collection					
Tax revenue policy					
Public administration					
Public pensions					
Customs harmonisation					
Anti-money laundering					
National Bank strengthening					
Bank privatisation					
Insurance privatisation					
Banking/insurance sector regulation					
Bankruptcy Law					
Privatisation enterprises - General					
• *Telecommunication sector*					
• *Energy sector*					
• *Aluminium*					
• *Railways*					
Competition policy					
• *Telecommunication sector*					
• *Energy sector*					
Business registration					

10) What was the relative importance of the following factors in bringing about reforms? (Please ensure that total adds up to 100%)

	Government 's own commitment	IMF pressure	World Bank pressure	EU SAP	EU MFA	TOTAL
Treasury system						100%
Public expenditure management						100%
Debt and asset management						100%
Tax revenue collection						100%
Tax revenue policy						100%
Public administration						100%
Public pensions						100%
Customs harmonisation						100%
Anti-money laundering						100%

	Government 's own commitment	IMF pressure	World Bank pressure	EU SAP	EU MFA	TOTAL
National Bank strengthening						100%
Bank privatisation						100%
Insurance privatisation						100%
Banking/insurance sector regulation						100%
Bankruptcy Law						100%
Privatisation enterprises - General						100%
• *Telecommunication sector*						100%
• *Energy sector*						100%
• *Aluminium*						100%
• *Railways*						100%
Competition policy						100%
• *Telecommunication sector*						100%
• *Energy sector*						100%
Business registration						100%

11) What would have happened to the following conditionality if the MFA had not existed?

	Would have been incorporated in IMF programme or WB programme	Would have been strengthened under Stability and Accession process or CARDS	Would have autonomously become part of Government agenda, anyway	Would have been totally neglected so far	Don't know
Treasury system					
Public expenditure management					
Debt and asset management					
Tax revenue collection					
Tax revenue policy					
Public administration					
Public pensions					
Customs harmonisation					
Anti-money laundering					
National Bank strengthening					

	Would have been incorporated in IMF programme or WB programme	Would have been strengthened under Stability and Accession process or CARDS	Would have autonomously become part of Government agenda, anyway	Would have been totally neglected so far	Don't know
Bank privatisation Insurance privatisation Banking/insurance sector regulation Bankruptcy Law Privatisation enterprises - General • *Telecommunication sector* • *Energy sector* • *Aluminium* • *Railways* Competition policy • *Telecommunication sector* • *Energy sector* Business registration					

Other

Consolidated responses on a few specific questions in the questionnaire

Table B.1 Responses to the question: What would have happened to the MFA conditionalit(y)(ies) in the distinguished policy areas if the EU MFA had not existed? (multiple answers possible)

	Would have been incorporated in IMF or WB programme	Would have been strengthened under Stability and Accession process or CARDS	Would have autonomously become part of Government agenda, anyway	Would have been totally neglected so far	Don't know
Treasury system	**7**		6		
Public expenditure management	**6**	2	4		

	Would have been incorporated in IMF or WB programme	Would have been strengthened under Stability and Accession process or CARDS	Would have autonomously become part of Government agenda, anyway	Would have been totally neglected so far	Don't know
Tax revenue collection	5		**7**	1	
Tax revenue policy	5	1	**6**	1	
Public administration	**5**	3	3	2	
Customs harmonisation	**3**	**3**	**4**	1	2
Anti-money laundering	2	3	**5**	1	1
National Bank strengthening	**8**		5	1	
Bank privatisation	**8**		5		
Insurance privatisation	4	1	**7**		
Banking/insurance sector regulation	**6**	1	5	1	
Bankruptcy Law	**7**	1	4	2	
Privatisation enterprises	4	2	**6**		
Competition policy	2	2	**7**	3	1
Business registration	**4**	2	**4**	3	1

Table B.2 Responses to the question: What contribution, if any, did the Macro Financial Assistance from the EU have in bringing about these reforms? (multiple answers possible)

	Put the issue on the policy agenda	Speeded up implementation of the reforms	Shaped the contents of the reforms	Don't know
Treasury system	2	**7**	3	2
Public expenditure management	3	**4**	**4**	1
Tax revenue collection	1	**5**	2	3
Tax revenue policy	**3**	**3**	**3**	**3**
Public administration	3	**5**	2	2
Customs harmonisation	**4**	3	2	3
Anti-money laundering	4	**5**	2	2
National Bank strengthening	2	**6**	3	3
Bank privatisation	1	**8**	2	1
Insurance privatisation	**4**	3	2	2
Banking/insurance sector regulation	3	**5**	3	1
Bankruptcy Law	3	**5**	3	2
Privatisation enterprises	1	**7**	4	2
Competition policy	**3**	**3**	2	3
Business registration	2	**6**	2	2

Appendix C: References

European Commission

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Appendix D: Persons interviewed

Name	Institution	Position
European Commission		
Mr C. Pavret de la Rochefordière	European Commission	Deputy Head of Unit, DGECFIN
Mr Frank Kohlenberger	European Commission	Desk Officer Serbia and Montenegro, DGECFIN
Mr Uwe Stamm	European Commission	Former Desk Officer Serbia and Montenegro, DGECFIN
Ms Therese Sobieski	European Commission	Head of Unit, DGELARGE
Mr Dimitrije Stankovic	The Delegation of the European Commission to Serbia	Economic Officer
Mr Olivier Boonen	European Agency for Reconstruction	Programme Manager Enterprise and Vocational Training
International Financial Institutions		
Mr Andreas Westphal	International Monetary Fund	Former Desk Economist, European Department; now Fiscal Affairs Department
Mr Harald Hirschhofer	International Monetary Fund	Resident Representative in Belgrade
Mr Michael Edwards	World Bank, Washington DC	Task Team Leader DPL, Financial Sector Specialist
Mr Alexander Pankov	World Bank, Washington DC	Private Sector Development Specialist
Mrs Carolyn Jungr	World Bank, Washington DC	Former Country Manager in Belgrade; now in Washington
Mr Abebe Adugna	World Bank, Washington DC	Former Montenegro Country Economist, PEIR, Montenegro Country Memorandum Task Leader
Mr Mathew Vergis	World Bank, Washington DC	Country Economist for Serbia
Mr Andrej Popovic	World Bank Country Office Serbia	Private and Financial Sector Officer, located in WB office in Belgrade
Mr Jan-Peter Olters	World Bank Country Office Montenegro	Representative for Montenegro
National authorities in Serbia		
Mr Tihomir Podunavac	Republic of Serbia – Securities Commission	Head of Department for Development of Financial Market and International Cooperation
Ms Gordana Lazarević	Republic of Serbia Ministry of Finance	Previous Assistant-Minister of International Economic Relations (MOE) Current Assistant-Minister of Finance
Mr Branko Hinić	National Bank of Serbia	General Manager, Economic Analysis and Research Department

Name	Institution	Position
Ms Nadia Benkirane-Todorović	National Bank of Serbia	Manager, Foreign Credits and Loan Division
Mr Zoran Nišavić	National Bank of Serbia	Manager, International Organisation and EU Division
Mr Mihailo Nikolic	National Bank of Serbia	Economic Analysis and Research Department
Mr Miodrag Didic	Republic of Serbia Ministry of Finance	Advisor to the Minister
Mr Radosav Marinkovic	Republic of Serbia Ministry of Finance	Head of Unit
Ms Branislava Žunjić	Serbian Chamber of Commerce	Secretary
Mr Branko Radulović	Republic of Serbia Ministry of Economy and Regional Development	Consultant, seconded by the World Bank
Mr Edvard Jakopin	Republic of Serbia Republic Institute for Development	Director
Mr Bojan Dimitrijevic	Republic of Serbia Ministry of Trade, Tourism & Services	Minister of Trade, Tourism & Services; Previous dean of Faculty of Economics, University of Belgrade
Ms Vesna Dzinic	Republic of Serbia Privatisation Agency	Acting Director
Mr Vladislav Cvetkovic	Republic of Serbia Privatisation Agency	Deputy Director
Mr Wojtek Mlodziejewski	Republic of Serbia Privatisation Agency	Restructuring Advisor (funded through EAR-grant)
Mr Srdan Majstorovic	Republic of Serbia European Integration Office	Deputy Director
Mr Nikola Jovanovic	Republic of Serbia European Integration Office	Lawyer
Mr Nebosja Ciric	Republic of Serbia Ministry of Economic and Regional development	Assistant Minister
Mr Miladin Kovacevic	Republic of Serbia Republic Statistical Office	Deputy Director
Mr Goran Radosavljevic	Government of the Republic of Serbia Office of the Deputy Prime Minister Department of Economy and Finance	Head
Mr Aleksandar Ilic	Government of the Republic of Serbia Office of the Deputy Prime Minister Department of Economy and Finance	Operational Analyst

Name	Institution	Position
Mr Vuk Dapcevic	Government of the Republic of Serbia Office of the Deputy Prime Minister Department of Economy and Finance	Operational Analyst
Ms Tatjana Isakovic	Government of the Republic of Serbia Office of the Deputy Prime Minister	Advisor to the Deputy Prime Minister for Cooperation with the IFO
Resource persons in Serbia		
Ms Jelena Galic	Deloitte d.o.o.	Director Management Consulting
Ms Dragana Petrakovic	Deloitte d.o.o.	Senior Consultant Management Consulting
Mr Goran Milićević	Komercijalna Banka ad Beograd	Executive Director for Marketing and New Banking Products Development
National authorities in Montenegro		
Vladimir Kavaric	Republic of Montenegro Ministry of Finance	Secretary of the Ministry of Finance
Milorad Katnic	Republic of Montenegro Ministry of Finance	Assistant Minister for Economy, Finance, International Cooperation and Games of Chance Sector
Mr Nikola Vukicevic	Republic of Montenegro Ministry of Finance	Assistant Minister of Finance
Mr Vladislav Karadzic	Republic of Montenegro Ministry of Finance	Advisor to the Minister
Ms Nada Medenica	Republic of Montenegro Ministry of Economic Development	Deputy Minister
Ms Biserka Dragicevic	Republic of Montenegro Ministry of Economic Development	Advisor to the Minister
Ms Zorica Kalezic	National Bank of Montenegro	Special Advisor to the Governor
Stela Boskovic	National Bank of Montenegro	Director of the Directorate for Development and Systemic Risk Supervision