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The Western Balkans in transition

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Comments and enquiries should be addressed to the:

European Commission
Directorate-General for Economic and Financial Affairs
Publications
BU1
B – 1049 Brussels, Belgium

This paper only exists in English.

This is the second issue of the "Western Balkans in Transition", which was prepared by staff within the Unit "Economic affairs of Mediterranean and Western Balkan non-member countries" in the European Commission's Directorate-General for Economic and Financial Affairs - Directorate for International Matters[*].

The main purpose of this publication is to give an overview of recent macroeconomic and structural developments for the countries of the Western Balkan region. The structure of this issue is as follows:

- A broad overview of macroeconomic trends in the region and EU relations.
- A section on fiscal consolidation in the Western Balkans;
- A section on macroeconomic developments, structural reforms and international relations for each of the Western Balkan countries.

The paper has been prepared by S. Appel (Croatia, Kosovo (Federal Republic of Yugoslavia)), P. Baut (Albania), F. Di Mauro and I. Hoskins (Bosnia and Herzegovina), M. Habib (former Yugoslav Republic of Macedonia, regional overview), C. de La Rochefordière (co-ordination, fiscal consolidation section), U. Stamm (Federal Republic of Yugoslavia). The authors are grateful to B. Kauffmann, A. Italianer, L. Nilsson and L. Rubinacci for useful comments and suggestions. A special thanks goes to J.M. Marenne for editorial and technical support.

Correspondence: anne.bridoux@cec.eu.int ; barbara.kauffmann@cec.eu.int;

Corresponding editor: Christophe de La Rochefordière,
European Commission,
BU-1 00/30,
B - 1049 Brussels
E-mail: Christophe.Rochefordiere@cec.eu.int

[*] The first issue of the Western Balkans in Transition (2001) is available on the Europa website at: http://europa.eu.int/comm/economy_finance/publications/supplement_c_en.htm

Contents

1. Main economic trends in the Western Balkans

- **In 2001 and 2002, the Western Balkan region continued to grow at a faster pace with respect to the world economy, while inflation steadily declined.**

- **Trade deficits in terms of GDP are still large, but significant private remittances, positive balances of services and official transfers contributed to limit current account deficits.**

- **The continuation of the stabilisation and reform process in the region has improved the economic climate. However, many challenges still lay ahead, such as the fight against corruption, the completion of the privatisation process, and the reform of the public sector.**

The Western Balkan region is composed of relatively small size economies[1]. While the largest country in terms of population is the Federal Republic of Yugoslavia (FRY) with 8.6 million people, Croatia is the largest in economic terms, with a GDP of more than € 22 billion. The population of the whole region is almost 25 million people, equivalent to 6.5% of the EU or one third of the ten acceding countries' population. The GDP of the whole region reaches € 50 billion, equivalent to approximately 0.6% of the EU's GDP or 40% of Portugal's GDP. The GDP per capita at current nominal exchange rates in the region is equal to around € 1,800, with a great difference between the GDP per capita in Croatia (around € 5,100) and that in the other Western Balkan countries, which is below € 1,900[2] (see chart 1).

Table 1. Western Balkans – Macroeconomic trends. 1998 - 2002

		1998	1999	2000	2001	2002[p]
Real GDP growth [(1)]	%	3.8	-3.2	4.5	4.0	3.8
Inflation (end-period) [(1)]	%	15.7	16.4	36.4	12.0	6.1
Exports [(2)]	*million €*	8801	7776	9729	10320	na
Imports [(2)]	*million €*	16690	15036	18423	21461	na
Trade balance with the EU\2	*million €*	-4426	-4205	-5061	-6721	na
Foreign Direct Investment	*million €*	1138	1618	1713	2542	2111

[p] Projections. [(1)] Weighted average. [(2)] Excluding Kosovo (FRY). *Source:* National sources, IMF and European Commission.

Following the recovery in 2000 from the 1999 Kosovo crisis, the Western Balkan region continued to grow by 4% in 2001, despite the slowdown of the world economy. Among the single countries and entities, growth rates showed significant differences. Kosovo (FRY) recorded the largest rate of growth in real GDP (+11%), followed by Albania (+6.5%) and the FRY (+5.5%), while the economy of the former Yugoslav Republic of

[1] The Western Balkans include Albania, Bosnia and Herzegovina (BiH), Croatia, the Federal Republic of Yugoslavia (FRY), Kosovo (FRY) and the former Yugoslav Republic of Macedonia (fYRoM). Unless otherwise indicated, throughout the text FRY data do not include Kosovo (FRY), which is since 1999 under the special mandate of the UN Mission in Kosovo (UNMIK), according to the UN Security Council Resolution 1244. All averages for the region are weighted by nominal GDP, unless otherwise indicated.
[2] According to the World Bank, as of July 2002, the economies of the Western Balkan may be classified as lower middle income countries (GNI between USD 746 and USD 2975), apart from Croatia that is an upper middle income country (GNI between USD 2976 and USD 9205).

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Macedonia (fYRoM) shrank by 4.1%, mainly because of the ethnic crisis which erupted in Spring. The continuation of the stabilisation and reform process in the region has translated into another positive economic performance of the Western Balkans during 2002. For the region as a whole, real GDP could rise by almost 4% compared to 2001, but its level will remain below that at the beginning of the nineties.

Table 2. Country summary - Macroeconomic indicators. 2001 - 2002

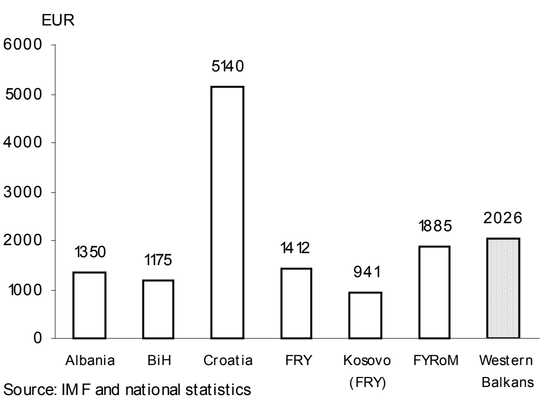
	Population *million*	Real GDP growth %		Inflation (end period) %		Trade balance *% of GDP*		Current account [(1)] *% of GDP*		FDI [(2)] *% of GDP*	
	2001	**2001**	**2002[p]**	**2001**	**2002[p]**	**2001**	**2002[p]**	**2001**	**2002[p]**	**2001**	**2002[p]**
Albania	3.4	6.5	5.0	3.5	3.9	-25.0	-22.1	-6.3	-5.9	5.0	5.8
BiH	4.3	2.3	2.5	3.3	2.3	-36.9	-33.5	-22.3	-20.7	2.9	5.0
Croatia	4.4	3.8	4.0	2.6	3.0	-21.0	-21.5	-3.1	-3.6	6.5	4.9
FRY	8.6	5.5	4.0	39.0	15.0	-26.0	-25.8	-5.5	-8.2	1.5	4.4
Kosovo (FRY)	2.0	11.0	7.0	11.3	6.5	-47.3	-50.2	9.1	-2.0	0.3	0.5
FYRoM	2.0	-4.1	0.5	3.7	3.0	-11.7	-11.4	-10.6	-9.7	13.2	2.0
Western Balkans	*24.7*	*4.1*	*3.8*	*12.0*	*6.1*	*-24.4*	*-24.1*	*-6.0*	*-7.1*	*5.3*	*4.5*

[p]Projections. [(1)]Including official transfers. [(2)]Foreign Direct Investment. *Source:* National sources, IMF and European Commission

Significant progress has been made in reducing inflation. Albania, Bosnia and Herzegovina (BiH), Croatia and the fYRoM have consistently maintained one-digit inflation rates over the past four years. At the end of 2001, the average inflation rate for these four countries was equal to 2.9%. The overall regional picture is distorted by the relatively high inflation of 39% at the end of 2001 in the FRY, which however has rapidly declined from the end-2000 level of 113%, which was caused by the price liberalisation in that year. The trend in the region remains positive in 2002, as the end-year inflation for the region as a whole should decline to some 6%, compared to 12% in 2001, reaching for the first time since 1997 a single digit rate.

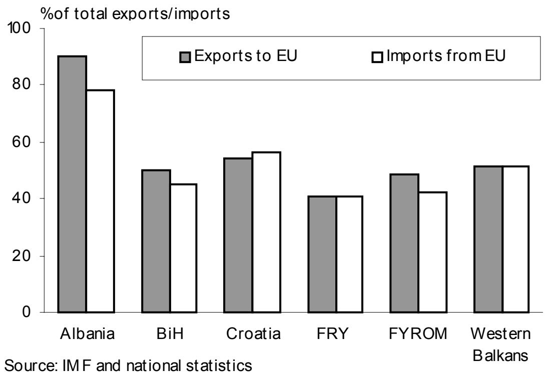
Overall, policies based on external anchors have contributed to economic and price stability. Since all of the economies in the region are fairly open to trade, the prevailing exchange rate regime is a formal or informal peg to an external anchor. Albania, Croatia, Serbia and the fYRoM opted for an informal peg, while BiH has formally adopted a currency board linked to the euro. In most of the cases, the euro is the currency that is chosen as external anchor. In Montenegro, the euro is circulating as sole legal tender, while in Kosovo (FRY) its use has been legalised, even though the

Chart 1. Western Balkans - Per capita GDP. 2001



Source: IMF and national statistics

Chart 2. Western Balkans - Exports to and imports from the EU. 2001



Source: IMF and national statistics

Yugoslav dinar remains the legal tender. Only the Albanian Lek is currently informally pegged to the US dollar.

Western Balkan countries showed large fiscal deficits in 2001, with the exception of the FRY that recorded a general government deficit (before grants) of 1.3% of GDP and Kosovo (FRY), which showed a surplus of 1.3% excluding capital expenditures. In the other countries of the region, 2001 general government deficits as ratio to GDP averaged more than 6%. Fiscal deficits are expected to improve in 2002, with the exception of FRY, including Kosovo. The next section provides an analysis of the fiscal situation in the region.

In 2001, international trade for the region as a whole was not affected by the global downturn. For the second year in a row, both exports and imports registered a positive growth in nominal terms, keeping the momentum after the particularly poor performance in 1999 (see table 1). However, import growth has outpaced export growth, resulting in a progressive worsening of trade balances in the region. In 2001, trade deficits as ratio to GDP were significantly large, ranging from almost 12% in the fYRoM to 47% in Kosovo (FRY). This result is mirrored in the trade deficit of the whole region with the EU, which substantially increased over the past two years, reaching the value of around € 6.7 billion in 2001 (estimate).

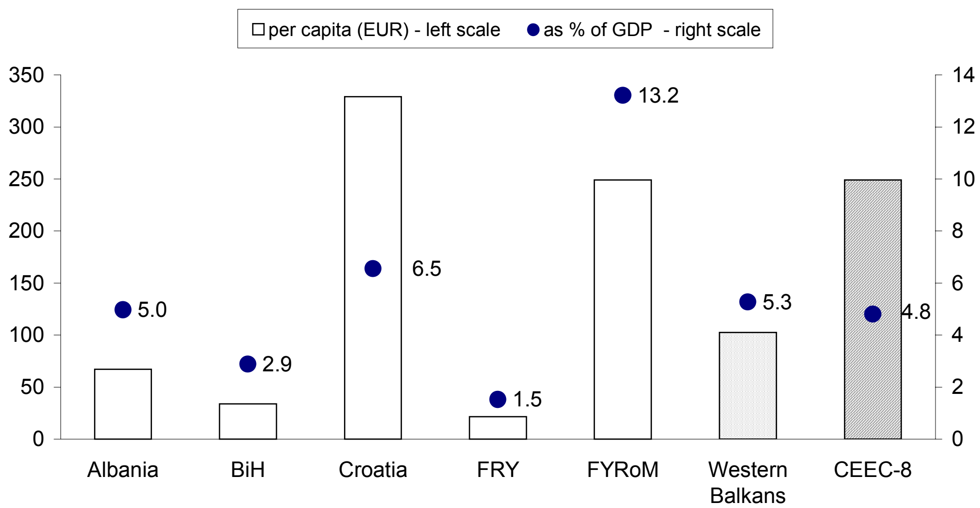
Increasing trade deficits are not necessarily a negative evolution, in particular when they are linked to economic growth and the need to import to satisfy growing investment needs and/or when they are compensated by surpluses in the balance of services.The introduction by the EU of autonomous trade measures in 2000, granting free access to the EU market, represents an important pre-condition for the development of the export sector in the region. As shown in chart 2, the EU is by and large the main trading partner of the Western Balkan countries. In 2001, for the whole region, the share of trade with the EU on total trade was slightly more than 50%, ranging from around 80% in Albania to more than 40% in the FRY. In 2002, trade deficits are not expected to substantially improve.

Current account data show a brighter picture compared to trade balances, thanks to significant private remittances, positive balances of services and official transfers (especially large in the FRY including Kosovo). In 2001, BiH recorded the largest current account deficit, which was 22.3% of GDP, while Kosovo (FRY) showed a significant surplus of 9% of GDP, mainly due to official transfers, which were equivalent to 70% of GDP. In the other countries, the 2001 current account deficit ranged from 10.6% in the fYRom to 3.1% in Croatia, where the tourist sector produced a surplus corresponding to around 13% of GDP. In 2002, the current account deficit is expected to worsen in the two largest economies, Croatia and FRY, leading to an increase in the average deficit for the region to 7.1% from 6.0% in 2001.

In 2001, Foreign Direct Investment (FDI) in the region continued to rise and peaked to € 2.5 billion, doubling since 1998 and corresponding to more than 5% of Western Balkan GDP, a figure that is even higher than the same ratio in the eight central and eastern European countries (CEEC-8) candidate to EU accession in 2004 (see chart 3). This result may be partly explained by the lower level of GDP in the Western Balkans with respect to the CEEC-8. In fact, in per capita terms, 2001 FDI inflows in the region were equivalent to € 100, a level that is significantly lower with respect to the benchmark of the CEEC-8 (around € 250). In 2001, the largest flows of FDI were directed towards Croatia and the fYRoM. In the latter case, the privatisation of the telecom operator alone provided a capital inflow equivalent to 9.5% of GDP. While green field investments so far have been negligible, at this stage FDI flows in the region are mainly related to privatisation. Overall, average FDI flows are, together with other net private capital flows, still insufficient to finance large current account deficits (see table 2). Thus, most countries, with the exception of Croatia, continue to rely on official financial assistance. In 2002, FDI flows in the region, as percent of GDP, are expected to remain broadly stable, to increase in the BiH and the FRY, and to decrease significantly in the fYRoM.

Positive political and institutional developments laid the groundwork for attracting foreign capital in the Western Balkans. The progressive restoration of peace and security and the perspective integration of the region in the EU through the Stabilisation and Association process have considerably improved the political outlook in the region[3]. Moreover, Western Balkan countries made progress in reforming their economies, in particular in the area of small and medium size enterprise privatisation and trade liberalisation, where a broad regional network of free trade agreements has been established thanks to the Trade Initiative sponsored by the Stability Pact[4]. The reform of the banking sector has also advanced. Croatia and the fYRoM have practically completed the privatisation of the sector, the BiH Federation has privatised the largest banks, while the FRY has made substantial improvements in restructuring and cleaning up the banking sector and strengthening banking supervision.

Chart 3. Western Balkans - Foreign Direct Investment - 2001



Source: IMF and national statistics

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[3] Information on the EU's actions in support to the Stabilisation and Association Process are available at: http://europa.eu.int/comm/external_relations/see/actions/index.htm

[4] The Stability Pact, launched in June 1999 on the EU's initiative, is a political declaration of commitment and a framework agreement on international co-operation to develop a long term strategy for stability and growth in South Eastern Europe. The Trade Initiative is part of the Working Table on Economic Reconstruction, Co-operation and Development and focuses its efforts on the liberalisation and facilitation of trade through the reduction and elimination of tariffs and non tariff barriers to trade in the framework of an intra-regional trade co-operation.

These positive steps, however, need to be followed by other reforms, namely, the full respect of the rule of law and the fight against corruption, the transparency of the legal framework, the creation of efficient infrastructures and, more generally, the establishment of a business-friendly environment. Along with these much-needed reforms, Western Balkan economies are expected to continue the transition towards full-fledged market economies through the implementation of important structural reforms, namely, the completion of the process of privatisation, the creation of sound and efficient financial markets, which in many countries of the region are still in embryonic stage, and the reform of the public sector, establishing central treasury systems – which, so far, are most advanced in Albania and Croatia - and through strengthening public expenditure management.

Table 3. International assistance to the Western Balkans[(1)]. 2001 – 2002

€ million	**2001**	**2002[(e)]**
European Union	1,331	1,280
- EC	784	783
- EU Member States	547	497
Other bilateral donors	574	532
IFIs, including EIB	1,395	1,665
Total	3,300	3,477

[(1)] Grants and loans on a commitment basis. [(2)] Data do not include some regional aid envelops. [(e)] Estimates. *Source:* Joint Office EC-World Bank, European Commission.

Donor support, both in the form of grants and loans, plays an important role in financing investment, supporting reforms and meeting balance of payments financing needs. Donor support slightly increased in 2002 (see table 3). While the EU continues to be the main donor, the share of IFI support – the bulk of which is in the form of loans – is increasing. This trend is expected to continue over the medium term with a shift from grant to lending, as the reconstruction phase is largely completed and the recipient countries have developed their access to IFIs and improved their absorption capacity related to profitable investment projects.

Box 1. Donor co-ordination

The European Commission and the World Bank have a leading role as regards the co-ordination of economic assistance to the Western Balkan countries. The Commissioner for Economic and Monetary Affairs and the President of the World Bank co-chair the High Level Steering Group (HLSG), which essentially comprises G8 finance ministers and heads of major IFIs. The HLSG aims to ensure a strategic direction to the process of economic reconstruction, stabilisation, reform and development in the region, including social and institutional dimensions, both at country and regional level and to ensure effective implementation of this strategy. Moreover, the HLSG oversees resource implications for the international community and the donor mobilisation process, and assists in co-ordination and oversees the appropriate conditions of support, ensures consistency of criteria on which donor funding is committed. In order, to assist the EC and the World Bank in its ongoing work of co-ordinating economic assistance to the region, the HLSG decided to establish a Working Level Steering Group (WLSG), consisting of senior officials representing the members of the HLSG. The WLSG works together on an ongoing basis and meets as necessary. The European Commission and the World Bank have established the Office for South East Europe (Joint Office), which is in charge of donor co-ordination and aid mobilisation[5].

[5] See the website managed by the Joint Office http://www.seerecon.org/ for more information.

2. Fiscal consolidation in the Western Balkans.

Countries of the Western Balkans are facing the combined legacy of administered economies and armed conflicts. This legacy was, to various degrees, characterised by poor public sector management, non transparent budget accounting and procedures, significant price subsidies, monetisation of fiscal deficits and a piling up of arrears and debts. While there has been progress over the past years to address these issues in the context of stabilisation and structural reform programmes supported by the IMF, a lot remains to be done.

Table 4. General Government Accounts. 2002[p] (in % of GDP)

	Revenue	Expenditure	Balance (before grants)	Balance (after grants)	Foreign financing [(3)]
Albania	24.2	32.2	- 8.0	-5.7	4.9
BiH	47.0	58.6	-11.6	-5.5	10.7
Croatia	45.4	51.5 [(1)]	-6.2	- 6.2	3.8
FRY [(2)]	43.0	48.7	- 5.7	- 4.7	4.0
- Serbia	18.4	23.8	-5.4	-4.5	2.8
- Montenegro	29.0	35.3	-6.3	-3.2	2.4
Kosovo (FRY)	20.8	27.0	-6.1	-5.6	0.5
FYRoM	33.4	36.8	-3.4	-3.4	4.1

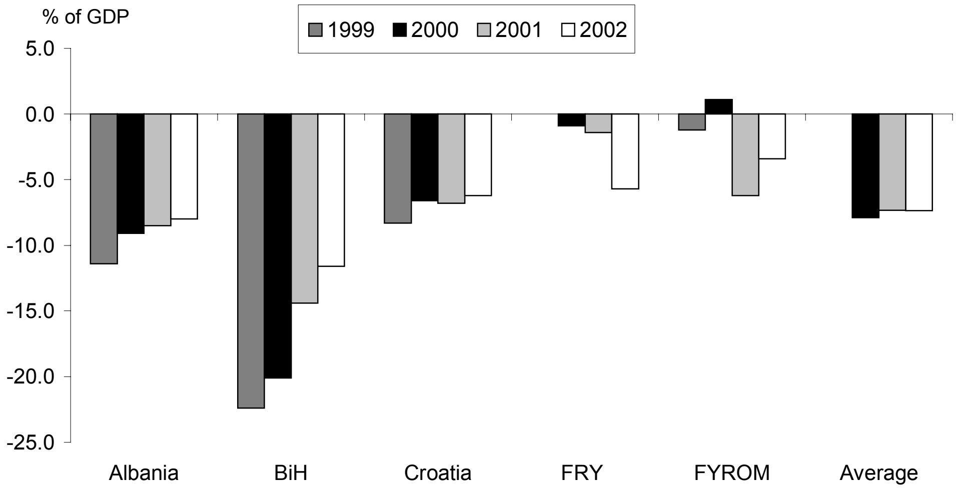
[p] Projections. [(1)] Including 0.5% of GDP net lending. [(2)] For Serbia and Montenegro: planned republican governments fiscal operations, Serbian data as a % of FRY GDP (excl. Kosovo), Montenegrin data as a % of Montenegrin GDP. [(3)] Financing both in the form of loans and grants. *Source:* IMF data

The size of the State. The relative fiscal pressure and share of general government expenditure to GDP varies considerably across the region. In BiH, government expenditure still account for 58.6% of GDP. This is due to a number of factors: the heavy burden of the administration of the two entities - the Federation and the Republika Srpska - and of the cantons and municipalities, which translates into high wage and salary costs; the still large share of the army; and the important weight of social expenditure.

On the other side of the spectrum Albania, and to some extent the fYRoM, have a much lower ratio of public expenditure to GDP (respectively 32.2% and 36.8%) but Albania has a much weaker tax system and narrower bases than the other countries of the region, and less developed public services. The latter observation also applies to Kosovo (FRY) where investment expenditure is funded outside the current budget which does only partially reflect total public spending. The FRY and Croatia are in a very similar situation in terms of relative weight of revenue and expenditure on GDP (see table 4 and chart 5). With General Government expenditure of about 50% of GDP, these countries are in a situation closer to that of EU countries where they account for 47.4%.

Recent fiscal performance has been uneven. Overall in the region, the average General Government deficit widened over the last three years, to about 6% of GDP (weighted average), owing to increases -in the FYRoM and FRY- which compensated reductions recorded elsewhere. These data however need to be interpreted cautiously, particularly in the case of the FRY where until 2000 a large share of public expenditure was not recorded, owing to sizeable quasi-fiscal activities and arrears accumulation.

Chart 4. Western Balkans - General government balance *. 1999-2002



Source: IMF, national sources

* Before grants

N B: For 1999 comparable data are not available on FRY.

The fiscal situation improved in some countries. In Albania, fiscal consolidation is taking place at a slow but regular pace: the authorities have been able to raise fiscal revenue by 3% of GDP from 1999 to 2002. Kosovo (FRY) followed an even more dramatic fiscal improvement through the increase of fiscal revenue, which surged by 10.8% of GDP from 2000 to 2002. In Croatia, a significant consolidation process has taken place over the recent years: general government expenditure was reduced by some 5% of GDP from 1999 to 2002. However, the budget deficit only decreased at a slower pace. BiH achieved a significant fiscal consolidation in 2001-2002. The general Government deficit before grants fell from 20% of GDP in 2000 to 14.5% in 2001 and was planned at 11.6% in 2002.

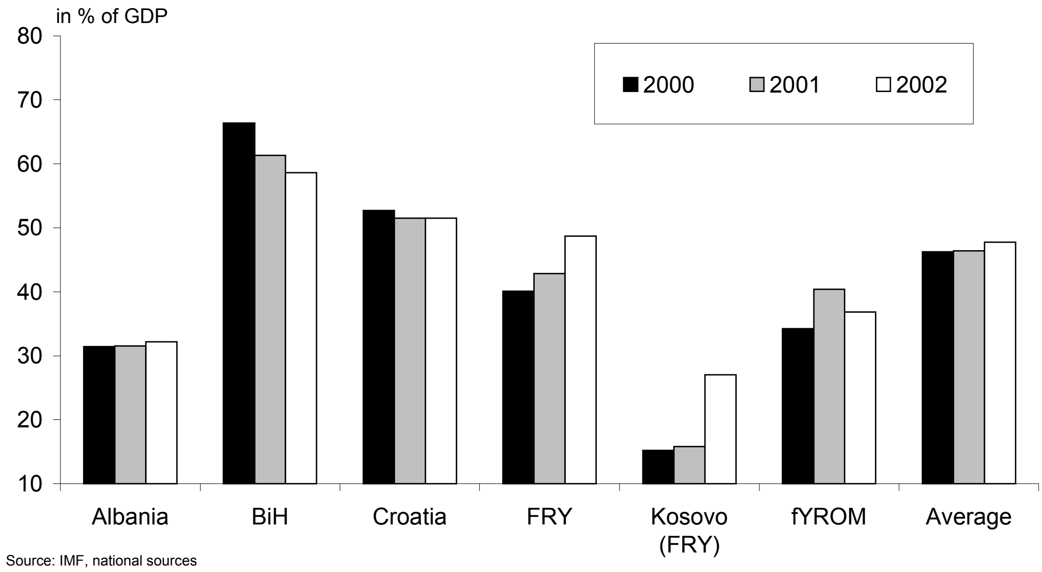
In the two other countries, the FRY and the fYRoM, the recent past was characterised by lower cash deficits in absolute terms, but the trend over the last three years has been negative and the fiscal situation in both countries will require significant adjustment efforts in the near future. In the FRY, the planned deficit widened to 5.7% in 2002, after a drastic budgetary adjustment in 2001 which resulted in a low deficit (1.3% of GDP). In the fYRoM, a sudden surge of military expenditure in the context of the Spring 2001 ethnic conflict, against losses in tax revenue. This led to a considerable budget deficit in 2001 (6.2% of GDP), compared to positive balance in 2000.

This very differentiated situation has major consequences: while all countries of the region currently face significant deficits (from 3.4 to 11.6% of GDP for planned budgets in 2002, before grants), fiscal strategies need to be tailor made, taking into account each country's specific situation. The consolidation process in Albania and Kosovo (FRY) will continue to require a further strengthening of the revenue base and notably a widening of the tax base, whereas countries such as BiH, Croatia and FRY can hardly increase further the tax burden: the onus, in the latter countries, is on the expenditure side, including on the streamlining of public administration, and on continued structural reforms on the resources side, mainly as regards tax policies and administration.

Expenditure

On average, General Government expenditure accounted for 47% of GDP in 2002. The overall trend (see chart 5) is to a slow convergence of the size of the state in the economy - towards levels more sustainable, given needs and financing constraints of Western Balkans countries. This adjustment however lacks momentum. In countries with the heaviest public sector -BiH, Croatia, the FRY- it could be accelerated through stricter prioritisation of public expenditure, streamlining of the administration and more courageous liquidation measures of non viable subsidised public enterprises.

Chart 5. Western Balkans - General Government Expenditures. 2000 - 2002



Source: IMF, national sources

Comprehensive multi-annual government expenditure frameworks have been adopted in a number of countries. In Albania and the FYRoM, a Poverty Reduction and Growth Strategy (PRGS) has been adopted respectively in Spring 2002 and Summer 2002, and foresees a three-year medium term expenditure framework covering priority needs in areas such as health, education and the upgrading of basic infrastructure. This process also advanced in BiH in 2001 and the FRY in 2002, where an interim PRGS was adopted. However, the link of the PRGS with the budget process is not direct and it remains to be seen how each Government will translate PRGS priorities into budget commitments.

Wages and employment policies are a key element of fiscal programmes of adjustment and often the subject of difficult discussions with the IMF. Public wage compression policies have in a number of countries resulted in significant purchasing power losses of public employees and have triggered social tensions. The public wage bill on average in 2002 represented a little less than 10% of GDP in the region. A sizeable reduction of this expenditure took place in Croatia over 1999-2002 –of about 2 percentage points of GDP- and public wages now represent 10.6% of GDP (in 2002), a proportion which is comparable to the EU average of 10.3% o GDP. In the FYRoM, public wages as a proportion of GDP were also reduced over the same period, by 1.5 percentage point of

GDP. However the previous government, facing elections in September 2002, decided in Spring to increase on average public administration salaries by 10%, after several years of freeze. In Serbia, in the first year of stabilisation (2001) employment was sharply cut by 20% and wage bills frozen in all public enterprises, where salaries were about 20% above average. Most countries have not yet adopted consistent public wages and employment policies, including the streamlining of public administration.

Subsidies. Direct price subsidies are generally being eliminated rapidly with the almost complete liberalisation of prices (with a number of exceptions in the case of agriculture, utilities and public transport). However, in several Western Balkans countries subsidies to public enterprises are still a significant component of public expenditure. In spite of their widely recognised anti-competitive impact, they are *de facto* part of the governments' social spending to delay lay-offs and public enterprise liquidation, and are difficult to eliminate abruptly. Even in Croatia, by far the most developed country of the region in terms of GDP per capita and among the most advanced in the transition process, subsidies to enterprises, notably shipyards, and agriculture still accounted for 4.3% of GDP in 2001, a level far above the current 1% share of State Aid in the EU GDP. In other countries, in spite of incomplete data, information available also points to slow decreases. In the FRY subsidies amounted to 4.3% of GDP in 2002. The current three-year programme supported by an IMF arrangement foresees a progressive reduction of subsidies to 3% in 2005. In Albania a number of prices, notably electricity prices, continue to be subsidised. The authorities have planned a progressive elimination of electricity subsidies over the next 2 years.

Reductions in ***military expenditure*** are an important potential source of savings and adjustment. The lack of consistent and transparent data in this area makes comparisons difficult. In BiH, the level of defence expenditure (9% overall in 2000 including off budget spending) remains excessively high, notably owing to the continued joint burden of two separate armies, and further demobilisation of soldiers is essential. In the fYRoM, the authorities have indicated that they expected to demobilise by mid-2003 military personal which had been recruited during the Spring 2001 crisis, which is expected to contribute to the fiscal consolidation process. In Croatia, the share of defence spending has diminished over time to correspond to 2.3% in 2001, but generous schemes for war veterans have increased social spending. In September 2002, the government decided on an internal reorganisation of the military aimed at reducing the total number of staff from the current 40,000 to 27,000.

Revenue

The trend of fiscal revenue as a ratio of GDP, like the evolution observed for expenditure, is not homogeneous in the region: the recent tendency varies between a sizeable increase, in Albania and Kosovo (FRY), where strengthened tax administrations are being built up, and a reduction in Croatia, by some 5% of GDP over the last three years, in line with the overall reduction in relative size of the Croatian Government. In the FRY and the FYRoM, the relative tax burden remained more stable. BiH remains by far the country with the highest tax burden, with general government revenue (before grants) of 47% of GDP in 2002 .

The ***widening of the tax base*** is a key issue and has become a core element of fiscal policies in the region. In Albania, the authorities have managed to increase import and domestic tax revenue as a ratio to GDP by 5 percentage points between 1996 and 2001, notably owing to improvements in the tax and customs administration. This is however a difficult process. In particular, agriculture, which according to official figures represents one third of GDP, has so far not been taxed. In Serbia, the authorities have already undertaken a major tax reform in 2001, encompassing a reduction in the number of taxes, and a widening of the tax base notably through the elimination of exemptions to reduce distortions and increase efficiency.

The ***introduction of VAT****,* necessary to replace outdated sales tax regimes with penalising cascade effects, is often a lengthy and difficult process, requiring a number of preliminary steps in order to enhance the tax administration's capabilities. It is an essential structural reform, which also plays a key role in combating corruption and reintroducing the informal sector into the registered economy. VAT was introduced in July 1996 in Albania and currently represents about 45% of tax revenues. In Croatia, VAT was introduced in 1998 and is presently the widest source of fiscal revenue, accounting for more than 50% of tax revenues. In the fYRoM, VAT was successfully introduced in April 2000 and recent revenue performance in the first half of 2002 has been remarkable, also reflecting resuming growth.

In Montenegro, a VAT law was approved in December 2001 and is expected to enter into force in the course of 2003. Serbia has, in agreement with the IMF, delayed VAT introduction until January 2004. VAT introduction in BiH is currently not foreseen under the current IMF 15-month programme for 2002-2003. It would be an important policy instrument to reintroduce in the registered economy part of the considerable informal sector in BiH and would contribute to the establishment of a single economic space. The indirect tax system is still based in both entities on a simple sales tax.

Liabilities and risks borne by the budget

Past public accounts have frequently underestimated real fiscal deficits. One of the main reasons has been the ***accumulation of arrears*** to international creditors, supplier enterprises, public sector employees or pension schemes. In 1999, the FRY general governments' budget was balanced in cash terms, however some estimates pointed to a possible USD 1 billion deficit in real commitment terms. In 2000, the deficit on a commitment basis was estimated to some 10% of GDP, against only 1% on a cash basis. In BiH, where widespread arrears were reported, averaging over 3% of GDP between 1998-2000, net arrears accumulation was substantially reduced in 2001, to just under 1% of GDP, despite weakening growth.

The size and characteristics of public debt is another key issue which affects fiscal sustainability and consolidation. BiH is by far the country with the highest public debt burden. Including external public liabilities (58% of GDP), claims arising from frozen currency deposits (30% of GDP) and domestic spending arrears (10%), public liabilities are currently estimated at about 100% of GDP.

Table 5. Indicators of status in fiscal consolidation and reforms in the Western Balkans

	Albania	BiH	Croatia	FRY	Kosovo (FRY)	FYRoM
2002 Budget deficit (Gen.Gov.) **- before grants ;** **- after grants (relative to GDP)**	8% 5.7%	11.6% 5. 5%	6.6% 6.6%	5.7% 4.7%	6.1% 5.6%	3.4% 3.4%
Reliance on foreign financing as a proportion of budget deficit (2002)	60%	93%	62%	70%	79% inc. needs of the Public Investment Programme which is 100% donor funded.	100%
Central bank lending to the government	Not allowed under CB statutes, except for short-term (less than 6 months) loans and up to a certain limit.	Not allowed under the currency board arrangement rules.	Forbidden under the 2001 new Central bank law.	IMF annual programme ceiling of lending of the banking sector of 0.5% to 1% of GDP in 2002-2004.	Not relevant (no central bank).	Not allowed under Central Bank statute, except for non-renewable one-day loans.
Establishment of a single Treasury	Mid-1993.	*2002 budgets the first to be executed through the Entities new Treasury systems. State also implemented its system in mid-2002.*	Budget management centralised in MoF, including a single Treasury Account.	Serbia: preparatory steps have been taken, expected to be operational by March 2002. Montenegro : operational in early 2002.	Treasury under Central Fiscal Authority (CFA); CFA and Ministry of Finance and Economy shall be merged by end of 2002.	Began in 1999.
Issuance of T-bills/ T-bonds/ International bonds	First T-bill issuance in June 1994.	Not so far. Conservative fiscal policy under CBA limits domestic borrowing.	T-Bills issued since 1996 Also Eurobonds since February 1997.	Not yet planned (Government bonds issued only to repay frozen foreign currency deposits).	Not so far.	Not yet planned (Government bonds issued only to repay frozen foreign currency deposits).
Introduction of VAT	July 1996	Being considered but not yet programmed.	1998	Serbia: Planned 2004. Montenegro: VAT approved December 2001. Introduction January 2003.	July 2001	April 2000
Existence / status of extra-budgetary funds	No, apart from capital expenditure financed by foreign donor grants.	Substantial public sector activity outside the budget, including externally financed capital projects.	Transferred to the Budget in early 2002, except in the case of two recently created funds.	Consolidated into the republican budgets in Serbia and Montenegro in the course of 2001.	No; however all capital expenditure so far outside the budget (financed from donor grants).	Four off-budget funds (Pension; Health Insurance; Employment; Regional and National Road).

Source: European Commission

However, a number of uncertainties regarding the legal status of war damages claims and the amount of debt which the Governments' budgets will eventually have to assume imply an additional risk for the budget: according to some estimates, war damage claims could add some additional 50% of GDP to public liabilities.

Croatia's public debt increased from 29.3% of GDP in 1997 to 57.5% in 2002, of which an increasing share is financed externally. As privatisation revenues are drying up, the current trends of debt dynamics cannot be maintained. FYRoM has a more sustainable situation in this respect, with public debt estimated at 45% o GDP in 2002. Similarly, in BiH, the often unclear situation regarding the stock of accumulated internal arrears represent a significant threat for the budget of some countries. In Albania, the considerable amount of Government and inter-enterprises arrears (some 3.2% of GDP) was expected to be addressed in the context of a netting operation.

In the FRY, the agreement in the Paris Club in late 2001 has provided the country with generous debt relief terms (66% of net present value). However, the external debt, which is either public or sovereign guaranteed, and that stood at 140% of GDP in 2000, is projected to remain at about 67% of GDP in 2002-2004. Debt servicing, which had been interrupted, has subsequently resumed and requires significant and increasing budget appropriations from both republics over the medium term.

The obligations of the State as a guarantor of foreign loans, given the widespread scope for exercising this guarantee, is an additional potential drain on public finances. In Serbia and Montenegro a large number of enterprises have not been servicing their debts related to sovereign guaranteed commercial loans and a large share of these loans will require the intervention of the State as the guarantor, to service the related external debts. This will put an additional strain on public finances. This will make fiscal consolidation a challenging exercise in the coming years, in spite of the generous Paris Club debt relief.

Fiscal deficit financing

Stabilisation policies have now virtually eliminated the monetisation of public deficits. In some countries, like the fYRoM, the Central Bank is prevented by law to lend to the State (see table 5). In others such as the FRY a lending ceiling is closely monitored in the context of IMF programmes. The main sources of financing for public deficits are thus internal borrowing from banks or households, external assistance (loans or grants) and privatisation receipts.

Domestic borrowing in the Western Balkans provided on average less than 0.5% of GDP resources to finance budget deficits in 2002. Albania is the only country where a large share – more than a third- of the General Government deficit is financed from bank lending. In BiH, under the Currency Board arrangement, the Entities are prevented from borrowing from the Central Bank. Furthermore, under the IMF's stand-by arrangement, they are only allowed limited borrowing from domestic commercial banks. In the fYRoM, internal borrowing is limited to commercial banks, which have a high liquidity position.

The only countries where Treasury bills and bonds have been introduced are Albania and Croatia (see table 5). In Albania the authorities introduced T-bills in 1994 but the weak situation of the economy has not allowed for a significant development of this instrument as a means to finance the important budget deficit. In Croatia T-bills contributed to finance almost half of the central budget deficit in 2001.

Privatisation can provide important public resources, and at the same time inflows of foreign direct investment and hard currencies. On average, privatisation receipts accounted for 1.4% of GDP in the region and contributed to the financing of 20% of public deficits. However this source of public revenue is temporary, irregular, and its potential is often overestimated: in most cases the market value of public enterprises being sold accounts only for a small share of their book value. In Croatia, privatisation receipts amounted to almost 5% of GDP in 1999 and have financed a large share of the public deficit, but are now declining and even scheduled to fall below 2% of GDP in 2003. In the fYRoM, an exceptional operation took place with the sale of the telecom operator to a foreign investor in January 2001, which provided a considerable one-off revenue, amounting to about 9.5 % of GDP, and contributed to weather the shock of the Spring crisis which erupted soon after.

In Serbia, 2002 privatisation receipts were substantially above planned levels. However debt cancellation in favour of enterprises being sold, while necessary to allow for the conclusion of the sales deals, is expected to significantly reduce future net privatisation receipts. In BiH, the lack of momentum of reforms and of readiness of foreign investors to participate in sales procedures is slowing the privatisation process of large enterprises. In Albania, the privatisation of the fixed telephone company, which had been foreseen in the initial assumptions on the 2002 budget, expected to provide revenue of 1.5% of GDP, has been postponed, which triggered a significant rebalancing exercise in Spring 2002.

Rather than a core part of the fiscal revenue policy, privatisation in this context should be seen as a priority to cut recurring outflows from the State budget and to improve the companies' governance and management.

Table 6. Financing of the General Government deficit. 2002[p]

As a % of GDP	**Domestic borrowing**	**Privatisation receipts**	**Foreign financing**	**Total deficit (before grants)**
Albania	3.0	0.2	4.9	8.0
BiH	-0.4	1.3	10.7	11.6
Croatia	0.4	2.0	3.8	6.2
FRY	0.5	1.3	4.0	5.7
Kosovo (FRY)	0	0	21.2	26.8 [(1)]
FYRoM	-1.3	0.6	4.1	3.4
Region (weighted average)	*0.5*	*1.4*	*5.5*	*7.5*

[p] Projections. [(1)] Kosovo (FRY): 2002 budget deficit combined with Public Investment Programme (PIP) needs. Columns do not add on Kosovo (FRY) owing to the positive cash balance carried over from 2001 which financed a substantial share of the 2002 deficit. *Source:* IMF, national data

Foreign financing, given limited availability of domestic resources, is a key issue, notably for investment projects which require long term commitments. On average more than two thirds (see table 6) of the public deficits in the region are currently financed from external resources. Croatia is the only country which has had continuous access to the international capital markets through the past years. For other countries, this source of finance mainly comes from donor support, including IFIs. In countries like Albania and BiH which have a limited borrowing capacity, a large share of these external resources have over the last few years been secured at fully or partially concessional terms. The tendency of donors to scale down their aid programmes will require substantial shifts in resources: the share of loans in external funding, notably from IFIs, is expected to increase.

Structural reforms

Beyond new tax policies and instruments, a number of structural reforms are crucial in the fiscal adjustment process. The unification of the budget, the reinforcement of administrative capacities, in particular of the tax administration, and the establishment of a single Treasury controlling all line ministries' expenditure are some of the first steps which need to be made. The elimination of payments bureaux inherited from the socialist era is a major step requiring a **significant overhaul of tax administration** capabilities, with the transfer to the ministries of finance of a number of tax collection functions previously carried out by the payments bureaux. This took place in 2001 in BiH and the FYRoM, and is now planned over 2003 in Serbia and in Montenegro.

The elimination of **extra-budgetary funds** which proliferated in the end of the socialist period and during armed hostilities in the region is also a crucial issue to ensure fiscal sustainability and has been a recurring requirement of the IMF in the context of the discussion of new Fund-supported programmes. In Croatia, as of 2002, all previous extra-budgetary funds have been transferred to the budget, following IMF and World Bank recommendations. However, two newly created funds (for development and employment) are only loosely linked to the budget and not an integral part of the budget. Moreover, large infrastructure spending will be channelled through government agencies. In the fYRoM a large share of public expenditure is still allocated to transfers to the four off-budget funds: the Pension fund, the Health Insurance fund, the Employment fund and the Regional and National Road fund. The first three funds absorbed resources equivalent to 14% of the fYRoM's GDP in 2001.

The establishment of central ***Treasury systems*****,** controlling expenditure of line ministries, is an essential step in the process of fiscal consolidation, which was lengthy to achieve in a number of countries. Treasury systems were already introduced in Albania and Croatia. In the fYRoM, where the process of transition also started already in the early 1990's, the setting up of the Treasury was initiated only in 1999 and was still in the process of implementation: until 2002 public accounting did not track expenditure on a commitment basis. A two-track accounting system will be introduced starting from 2002 on a trial basis. In BiH, Treasury systems have only been introduced in early 2002 at the entity level, with plans to extend them to local governments and extra-budgetary funds in the following 18 months. The Treasury systems were expected to have a full coverage of operations in mid-2002 at State level, and in end-2003 and mid-2004 in the Federation and the RS respectively. In Montenegro, an interim Treasury system became operational in early 2002 and took full control of line ministry accounts. In Serbia, a number of preparatory steps have been taken and expenditure of line ministries were already brought under the control of the Ministry of Finance. Core Treasury functions were in place in September 2002, but the full establishment of a Treasury is only expected in 2003, notably with the creation of a Central Accounting Division in the Ministry of Finance in March 2003.

Challenges

A number of challenges lie ahead in the context of the design and the implementation of fiscal policies in the Western Balkans.

The expected ***phasing out of grant donor funds*** will require additional fiscal adjustment in those countries that are the most reliant on concessional assistance, namely Albania, BiH and Kosovo (FRY). The fYRoM, which reached graduation in July 2002[6] and is not any more eligible to IDA finance, will have to rely on less conditional funding, but enjoys an overall more solid fiscal situation. In the FRY, where the transition process, although particularly dynamic, started the latest, the budget will continue to rely on important external funding, the degree of concessionality of which remains uncertain.

Trade liberalisation is taking place in an asymmetric way, with free access to the EU market for most products being granted immediately via the EU's autonomous trade measures (ATM). While expected to boost growth, as Stabilisation and Association Agreements (SAA) progressively enter into force it will have a negative impact on fiscal revenue when the countries of the region have to lower their own customs duties. Additionally, in the context of the Stabilisation and Association process, Western Balkan countries are now concluding a number of bilateral Free Trade Agreements with their neighbours, which also imply losses of customs duties, as well as WTO obligations for new members. These developments in trade liberalisation in all Western Balkan countries will require either a maturing of the fiscal system, notably a widening the tax base and strengthening indirect tax resources, or a further prioritisation of public spending, in order to compensate for lost customs revenues.

The ***widespread reported size of corruption and the importance of the informal sector*** in several countries of the region have far reaching economic consequences, including, not least, important losses of tax revenue and social security contributions. According to rankings from various official and non official sources, a number of the region's countries are perceived among the most corrupt in the world. The percentage of firms bribing frequently was estimated in the 2002 Business Environment and Enterprise Performance Survey conducted jointly by the EBRD and the World Bank at 36% in Albania, 23% in the fYRoM, 22% in BiH, 16% in the FRY and 13% in Croatia. Addressing corruption requires strong political public commitments and guidance, clear procurement rules and consistent anti-corruption plans, including the enhancing of

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[6] The per capita income in the fYRoM has exceeded the operational per capita income cutoff for International Development Association (IDA) eligibility, which for the fiscal year 2002 was a 2000 GNI per capita of USD885.

administrative and judicial capacities. Reducing the size of the informal sector, by incorporating it into the registered economy, is also essential. It further requires the completion of VAT introduction, and policies to promote the flexibility of labour markets, enterprise creation and SME development, notably the elimination of cumbersome administrative procedures.

These challenges will require continued ambitious reforms and a constant monitoring of the fiscal situation in the countries of the region, with the aim of ensuring sustainability and to make out of each Government budget an efficient economic policy instrument.

3. Albania

- **The energy crisis which erupted in 2000 is still threatening Albania's economic growth. Consequently, a significant slowdown in GDP growth is projected for 2002 (from 6.5% in 2001 to 4.5-5% in 2002). The fiscal deficit, while decreasing, remains a challenge for the authorities.**

- **Structural reforms need to be actively pursued in the area of the judiciary, public administration reform and privatisation of strategic sectors, including the banking sector. The fight against fraud, corruption and organised crime remains an important challenge. Legal security, including for businesses, needs to be substantially enhanced.**

- **A new 3-year PRGF-supported programme was approved by the IMF in June 2002. Implementation of the programme, which was designed taking into account the country's Growth and Poverty Reduction Strategy, is expected to strengthen the poverty-reduction focus of policies.**

- **The negotiations on a Stabilisation and Association Agreement between the EU and Albania were launched in December 2002. The first negotiating round will take place early in 2003.**

Table 7. Albania - Main Economic Trends. 1998 - 2002

		1998	1999	2000	2001	2002[p]
Real GDP growth	*Percent*	8.0	7.3	7.8	6.5	4.5-5.0
Inflation rate	*Percent (average)*	20.9	0.4	0.0	3.1	5.3
	Percent (end-of-period)	8.7	-1.0	4.2	3.5	3.9
Unemployment rate	*Percentage of labour force*	17.8	18.0	17.1	14.5	14.2
General government balance	*Before grants - Percent of GDP*	-10.4	-11.4	-9.1	-8.5	-8.0
	After grants - Percent of GDP	-8.4	-7.1	-6.8	-6.9	-5.7
Trade balance	*Percent of GDP*	-20.4	-23.0	-21.9	-25.0	-22.1
Current account balance	*Percent of GDP*	-6.1	-7.3	-7.2	-6.3	-8.1
External debt	*Percent of GDP*	31.8	29.1	30.2	28.2	23.3
	Billion €	0.8	1.1	1.2	1.3	1.1
Debt–export ratio	*Percent*	344	180	160	138	120
Foreign direct investment	*Percent of GDP*	1.47	1.39	3.81	4.72	5.81
	Million €	40	48	155	228	167

[p] Projections. *Source:* IMF, National authorities.

Macroeconomic developments

GDP growth reached 6.5% in 2001, which only corresponds to a moderate slowdown when compared to the average 7-8% growth registered in the three previous years. The main contributions to growth came from construction and transport, whereas industrial production, services and agriculture growth were below expectations. Performance in the agricultural sector seems to have been particularly weak. Agriculture was reported to account for some 34% of GDP in 2001, compared to around 50% the year before, but this may be partly due to a difference in the statistical base. Recorded unemployment continued to decline, to 14½ % at end-2001, compared to 17% at end-2000, partly because of continuing economic growth and partly because of a tightening up on enterprises and the grey economy. After a first revision in April 2002, from 7 to 6%, the projected GDP growth rate for 2002 was again revised downwards in October, following an IMF staff mission in the country, to reflect the continuing impact of the energy crisis and failed privatisations. It is now projected to reach 4.5 to 5%.

The energy crisis which erupted about two years ago represents a serious threat for a sustained economic growth in Albania. Causes at the root of this crisis are well known: poor infrastructure leading to important technical losses, widespread electricity theft, weak management of the electricity company leading to low bill collection and uncontrolled consumption, and adverse weather conditions in a country where electricity comes mainly from hydropower plants. The crisis, which materialises in energy shortages, disruptions of production and higher subsidised imports, is seriously affecting both the social and economic life and is putting an additional strain on the budget.

End-of-year inflation reached 3.5% in 2001 (against a 4% target). A surge in CPI, mainly attributed to the energy crisis and higher imported food prices was registered in the first months of 2002, so that year-on-year inflation reached 6.6% in April. To reduce inflationary pressures, the Bank of Albania increased its repo rate by 1 percentage point in April (following another increase of 0.5 percentage point in March). This measure, together with improved performance in the agricultural sector, contributed to a reduction in inflation, which reached 3.6% year-on-year in June. However, new price increases appeared, due partly to the depreciation of the national currency, the Lek, against the euro and partly to September floods that caused extensive damages. Inflation increased to 5.8% in September and it is expected that the 4% end-of-year target will be missed.

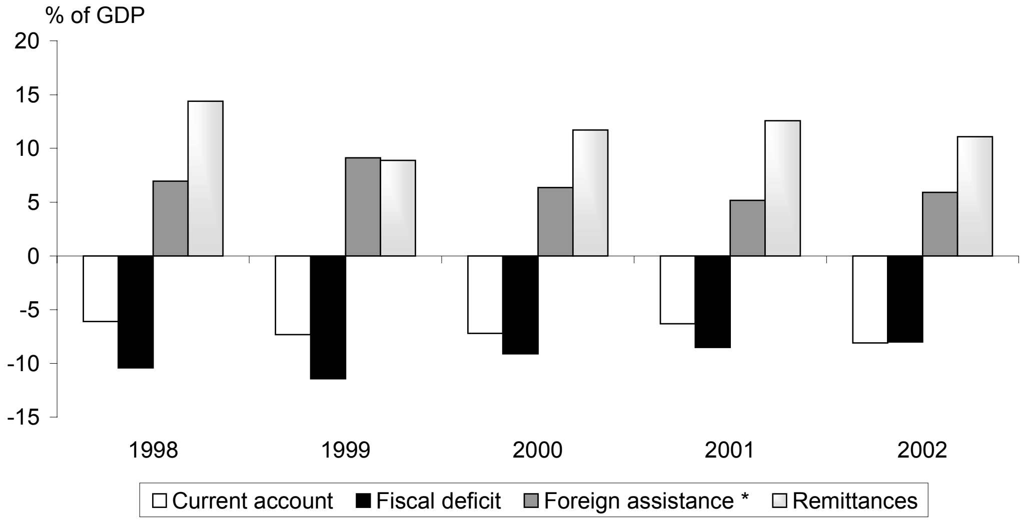
Fiscal performance. In 2001, the fiscal deficit reached 8.5% of GDP, one percentage point below the planned budget. This reflected lower spending, notably on operations and maintenance, whereas revenues were broadly on line with the budget. Tax collection reached 98% of the target. The shortfall was partly due to the political uncertainty at the end of the year - culminating in the forced resignation, on allegations of corruption, of three ministers in early 2002. This had a negative impact on tax administration and payment discipline.

The 2002 budget, which aimed at a deficit of 8.5% of GDP, was revised in Spring to take into account mainly the need for higher subsidised electricity imports and the shortfall in privatisation receipts, due to the postponement to 2003 of the privatisation of the telephone company Albtelekom. The revised budget aims at a deficit of 8%. The spending cuts, which were designed to minimise the impact on poverty alleviation efforts, concern essentially budgeted contributions to the reserve and contingency Fund, as well as investment and maintenance expenditures in non-priority areas. Domestic financing of the deficit (mainly T-bills) is projected to amount to 2.9% of GDP, privatisation receipts to 0.2%, while foreign financing, covering the remaining 4.9%, is projected to be roughly equally split between grants and loans.

External situation. On the external side, the current account reached in 2001 a deficit equivalent to 6.3% of GDP (about € 288 million). The still large trade deficit – more than € 1.1 billion representing about 25% of GDP – was significantly compensated by remittances from Albanians living abroad. These remittances amounted to more than €

600 million, a larger than usual figure reflecting the end-2001 euro conversion effect. Foreign direct investments, amounting to € 228 million, largely contributed to the financing of the balance of payments. The capital account surplus allowed for an increase in hard currency reserves, which reached the equivalent of 4.7 months of imports as of December 2001. In 2002, the current account deficit is expected to widen to 8.25% of GDP, because of a still large trade deficit and a return of remittances to normal level. As of end-June 2002, both the trade balance and the current account balance deficits were broadly in line with projections: the trade balance deficit reached € 588 million, compared a projected € 560 million, whereas the current account deficit reached about € 220 million, compared to a projected € 210 million. For the same period, remittances totalled € 300 million, an amount significantly higher than the projected € 245 million. According to the current 2002-2005 IMF programme projections, the balance of payments should not face any significant financing gap in the course of the programme. Over the 3-year period, foreign exchange reserves are projected to remain at a comfortable level equivalent to more than 4.5 months of imports.

Chart 6. Albania - Selected economic indicators. 1998 - 2002



Source: IMF, national sources

* Official aid (grants and loans), IMF resources, Balance of payments

The current foreign exchange regime is classified as independently floating. However, and in spite of the importance of trade flows between Albania and the EU – the EU represented in 2000 more than 90% of Albanian exports and about 75% of Albanian imports - the Lek is currently informally pegged to the USD.

At the end of 2001, foreign debt reached a level of € 1.31 billion corresponding to about 28% of GDP, which is quite low by international standards. It is expected to decrease to 23% of GDP in 2002, on account of debt forgiveness related to a debt rescheduling agreement with Russia. Debt service was limited to 3.8% of exports in 2001 but is projected to increase to 7% in 2002.

External trade liberalisation. Albania, which is member of the WTO since September 2000, has an overall liberal and open trade system. The country has no quantitative restrictions on imports and only very few restrictions on exports. Since January 2001, the maximum tariff rate is 15%, which is significantly lower than that prevailing in 1999 (20%) and 2000 (18%). Since September 2000, Albania has been benefiting from the exceptional trade measures decided by the Council (Council Regulation No. 2007/2000). They provide duty free access for Albanian exports to the EU market for almost all goods (with particular conditions for certain textile and agricultural products). As far as trade relations are concerned, Albania has already concluded a Free Trade Agreement (FTA) with the former Yugoslav Republic of Macedonia and the latest one, with Croatia, has been recently signed . Negotiations with the Federal Republic of Yugoslavia are at their final stage and they have also started with the other four countries of the region (BiH, Bulgaria, Moldova and Romania). Albania's main commercial partner is the EU, which represents about 75% of Albanian imports and about 90% of Albanian exports.

Structural reforms

Energy crisis response. The authorities have taken measures to address the energy crisis situation. An Action Plan, adopted in December 2000 and revised in January 2002, includes specific targets to reduce both technical and non-technical losses and increase bill collections, promotes the use of alternative sources of energy and envisages modifications in the tariff structure. Developments over the June – September 2002 period have been preoccupying. The main targets - on elements such as bills collection, the payment of arrears by the Government, the installation of meters - were missed and the reorganisation of the electricity company KESH has not been progressing as expected. Given that the restructuring of the sector is largely depending on foreign assistance, a donor community meeting was organised in October at the initiative of the World Bank to discuss the issue and the situation appears to have slightly improved following this meeting. This trend needs however to be verified in the months to come. In any event, a situation similar to that of the Winter 2001, with frequent and widespread power cuts, is expected for the winter 2002. According to the authorities, there are prospects for an exit of the energy crisis by 2004. However, this implies: (i) significant improvements in infrastructure (through projects financed or supported by the World Bank and the EBRD); (ii) the progressive liberalisation of electricity tariffs (however taking into account the need for measures to alleviate the impact of higher prices on vulnerable households); (iii) a diversification in energy consumption (the Government is promoting the use of LPG through fiscal incentives); and (iv) a deep restructuring of the electricity company KESH.

Financial sector reform. Some progress in the reform of the financial legal framework was registered in 2001 with the adoption of the law on securing charges, which, together with the opening of the registry for movable property, contributed to an expansion of credit in 2001. Reform continued in 2002 with the adoption by Parliament, in March, of the deposit insurance law (limited to a maximum of the equivalent of € 5,000 per account). However, the presentation of the law to Parliament led to a loss of confidence and withdrawals of about 10% of total bank deposits in the two main banks (the Savings Bank and the National Commercial Bank) in late March and early April. Both the Bank of Albania and the banks, more particularly the Savings Bank – which accounts for about 80% of banks deposits in Albania -, reacted promptly and adequately. The high liquidity position of the Savings Bank, whose lending activities had been severely restricted by the monetary authorities, enabled it to weather these unforeseen needs. The Bank of Albania also decided in April a new interest rate increase to encourage bank deposits. The crisis was short and confidence was rapidly restored.

Interest in buying the remaining State-owned bank, the Savings Bank, has so far been very limited. After the bank was tendered, there were only two Italian banks in the short list of bidders, which however withdrew from the tender in June after having concluded their due diligence of the bank. Prospects are now for a streamlining and strengthening of the bank, in consultation with foreign partners, in preparation for a second privatisation attempt. No receipts from this privatisation have been programmed in the 2002 State budget.

Enterprise restructuring and privatisation. Restructuring of public companies, in particular loss making utilities, remains a key challenge for the coming years. It is expected that the electricity company KESH will be restructured through the internal unbundling of the company into three cost centres (generation, transmission and distribution). A number of issues – such as the setting up of a computerised financial management system, a revaluation of assets, allocation of debts and receivables - need however to be solved before this unbundling can be carried out.

Whereas the privatisation of all SMEs has been completed, some 80 large enterprises remain to be privatised, including 56 water companies. Inter-enterprise arrears represent an important impediment to the privatisation of most of the remaining state-owned enterprises. Poor management combined with a lack of payment discipline led to the accumulation of a large stock of inter-enterprises arrears and tax obligations within the public sector. These arrears are equivalent to about 3.2% of GDP and some of them can be considered as hidden subsidisation. With IMF technical assistance, a regularisation process has now started, which aims at cancelling as many of these arrears as possible through bilateral and "circular" netting. Particularly concerned by this problem, are, as debtors, the water companies - which have important energy bills to pay and almost no resources - and, as a creditor, the electricity company KESH.

No debt forgiveness is foreseen in the privatisation process, except for companies with exceptionally bad balance sheet positions. The privatisation of the telecommunications company Albtelekom had to be postponed given the lack of interest from international potential investors. Both the unfavourable situation in the telecommunications sector in general and the accumulated arrears legacy were responsible for this failure. The World Bank financed a technical assistance programme with a view to increase the company's market value before proceeding with its privatisation, now expected for 2003.

Corruption. Albania is reported to be one of the most corrupted countries in the region. Corruption undermines political stability, the rule of law, and the economic development, including foreign investments. According to the 2002 Business Environment and Enterprise Performance Survey conducted jointly by the EBRD and the World Bank, more than 30% of firms are frequently bribing Albanian officials, which costs them some 3% of their annual revenues. Among the main factors favouring the spread of corruption – the fiscal administration, including customs, and the judiciary are the most concerned - are the low level of salaries, the pursuit of fast personal enrichment and the lack of strict administrative control.

The first anti-corruption strategy, adopted in 1998, had limited effects. It was revised in April 2000, with a view to take on board the requirements of the Stability Pact Anti-Corruption Initiative. An intermediary step was the setting up in early 2001 of an Anti-Corruption monitoring group (ACMG), with the support of the donor community. In June 2002, the Albanian authorities adopted an Action Plan, based on the work of the ACMG, which aimed at implementing the Anti corruption Strategy. A strengthening of the judiciary is the highest priority in this context.

Public administration reform. The reform of public administration is one of the priorities of the authorities. Attempts to improve the technical capacities of the ministries and to foster a modern civil service culture include the de-politicising of staffing appointments by increasing the authority of permanent heads of ministries and the implementation of open competition procedures for the selection of personnel. However, following the recent presidential elections and the appointment of a new government, a significant number of dismissals have been observed at head levels in several administrations.

A Growth and Poverty Reduction Strategy (GPRS), prepared by the Albanian authorities through a participatory process involving the civil society and development partners, was adopted in November 2001. Albania was the first country in Europe to have adopted such a strategy, with the following priorities : (i) promotion of sustainable and inclusive economic growth, (ii) governance and public sector management, (iii) development of private and financial sectors, (iv) promotion of human development (health, education, labour market and social protection, social capital reinforcement), (v) infrastructure development; (iv) rural and urban development and (vi) poverty and environment.

International relations

Relations with IFIs. Albania joined the International Monetary Fund in October 1991 and has benefited since then from several IMF-supported economic stabilisation and reform programmes. At the end of the PRGF-programme (Poverty Reduction and Growth Facility) in July 2001, negotiations with the IMF on a new programme to be largely based on the Growth and Poverty Reduction Strategy prepared by the Albanian authorities were initiated and were concluded in March 2002. Prior actions – adoption by Parliament of the revised 2002 budget, implementation of the agreed action plan for the restructuring of the electricity sector, settlement of Albania’s arrears on debts owed to Russia – were fulfilled, allowing the IMF Board to approve - on 19 June 2002 - a new 3-year economic programme to be supported by a USD 37 million concessional PRGF.

Albania joined the World Bank in October 1991. A new 3-year Country Assistance Strategy (CAS) was adopted by the World Bank Board on 20 June 2002. This CAS, the main aim of which is to reduce poverty by supporting Albania's GPRS, is considered as a roadmap for the World Bank Group's assistance program to Albania for the 3-year period. The CAS sets out three broad objectives: (i) improve governance and strengthen institutions; (ii) promote sustainable private sector growth; (iii) foster human development. Three credits, totalling USD 65 million, have already been approved in its framework: a Poverty Reduction Support Credit, a Financial Sector Adjustment Credit, and a Power Sector Rehabilitation and Restructuring Project.

The EBRD's strategy, which was revised in 2002, focuses its action on private sector development and support to SME's, participation in strategic privatisations, more particularly on banking and telecommunications sectors, and infrastructure financing and development, particularly in the energy and transport sectors.

EC assistance. The EC has supported the country's reforms with PHARE - for the period 1991-2000, Albania has benefited from a total Community assistance of € 1,021 million - and, since 2001, with CARDS assistance. A Country Strategy Paper (CSP) for Albania covering the period 2002-2006 was published in October 2001. It identifies the following main priorities for financing under the CARDS programme: justice and home affairs, administrative capacity building, economic and social development, environment and natural resources, and democratic stabilisation. Out of a total amount of € 181.4 million of CARDS assistance for the period 2001-2004, € 35.5 million and € 44.9 million have been allocated, respectively for 2001 and 2002. Since 1995, the EIB has signed loans worth € 149 million, essentially in transport infrastructure and the energy sector.

Stabilisation and Association Process. Albania has been participating in the Stabilisation and Association process since its very beginning and has benefited from its overall co-operation framework, including preferential trade concessions, financial assistance and the prospect for an enhanced, far-reaching contractual relationship with the EU through a Stabilisation and Association Agreement (SAA). A mandate allowing the Commission to start negotiations was adopted by the EU Council in October 2002 and the negotiating process was expected to be launched before the end of the year.

4. Bosnia and Herzegovina

- **The high reconstruction and aid-led growth rates have fallen significantly and the challenge now is to generate self-sustaining domestic growth.**

- **It is important that the new government, to be formed after general elections in early October 2002, continues and accelerates the reform effort in BiH.**

- **The country's 'Jobs and Justice' reform programme, adopted in July, identifies areas where progress is urgently needed, such as improving the business environment and enhancing efficiency of the public sector; at the same time, the new IMF stand-by arrangement, agreed in August 2002, should provide a framework for continuing stabilisation reforms, through measures aimed at ensuring fiscal and external sustainability.**

- **The Stabilisation and Association Process provides the overall framework for continued institutional, political and economic reforms; after the formation of new governments in BiH, a Feasibility Report could be launched, in view of negotiations for a Stabilisation and Association Agreement.**

Table 8. BiH - Main Economic Trends. 1998 - 2002

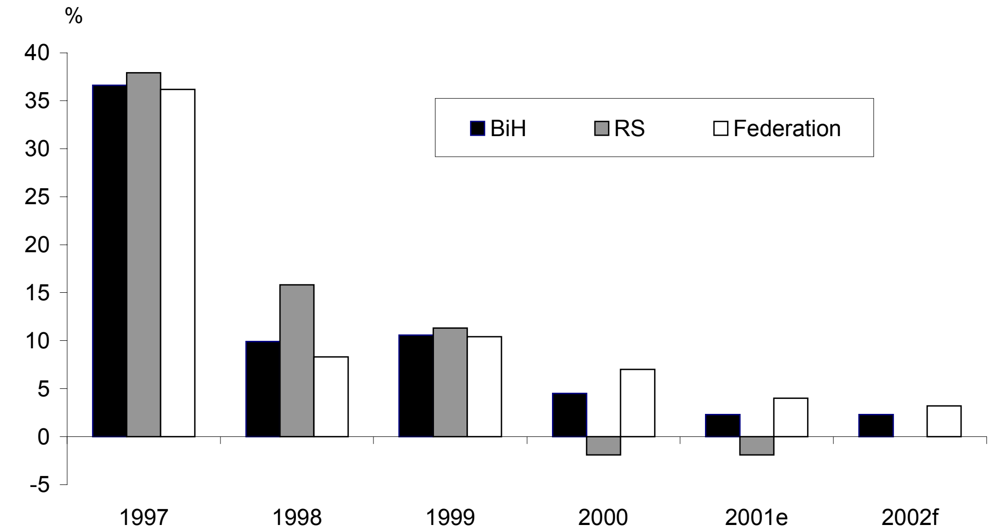
		1998	1999	2000	2001	2002[p]
Real GDP growth	*Percent (average)*	9.9	10.6	4.5	2.3	2.5
Inflation rate	*Percent (CPI average)*					
	Federation	5.2	-0.7	1.9	1.7	1.5
	RS	-14.0	14.1	14.6	7.3	4.4
Unemployment rate [1]	*Percent of labour force*	37.4	38.9	39.7	40.1	41.0
Consolidated general	*Before grants - Percent of GDP*	-20.1	-22.4	-20.1	-14.4	-11.6
government balance	*After grants - Percent of GDP*	-8.0	-9.1	-10.1	-6.3	-5.5
Current account balance[2]	*Percent of GDP*	-20.9	-20.8	-21.6	-23.1	-21.3
External debt	*Percent of GDP*	68.1	69.6	67.4	57.7	62.0
	Billion €	2.6	3.1	3.2	3.0	3.0
Debt–export ratio	*Percent*	236	239	218	183	192
Foreign direct investment	*Percent of GDP*	2.3	2.0	3.4	2.9	5.0
	Million €	89	85	163	145	259

[p] Projections. [1] Official estimate. [2] Excluding official transfers. *Source:* National sources, IMF, World Bank, EC estimates.

Macroeconomic developments

GDP growth. Data indicate that the high GDP growth rates which accompanied BiH's reconstruction since the end of the war in 1995 have steadily fallen (see chart 7). The growth rate for 2001 was revised downwards, from around 5% to 2.3%, due to a slowdown in the FBiH and a recession in the RS. Construction activity has been slowing (-4.5% in the Federation and –18% in RS for 2001) as aid flows fall. In the Republika Srpska, industrial production fell by 14% in 2001, and the slowdown continued in early 2002 with first quarter industrial output data showing a year-on-year decline of 12%. In the Federation January-September industrial output rose by 7.5% year-on-year compared to the same period in 2001. Latest data suggest that the harvest was strong and real output in BiH in 2002 could increase by more than the mid-year estimate of 2.5%.

Chart 7. BiH - Real GDP Growth. 1997 - 2002



Source: IMF, national sources

Official figures as of June 2002 point to a 42% rate of unemployment (40% in 2001), although the World Bank unofficial estimates suggest that the rate is one half of the official figure, due to a large informal sector. The recent slight increase is largely due to the downsizing of the military.

Monetary Stabilisation. Inflationary pressures continue to be subdued due to continued strict adherence to the rules of the currency board arrangement, established in mid-1997, which has also led to the universal acceptance of the common currency, the convertible marka (KM). This was initially pegged on a 1:1 basis to the Deutsche Mark and is now pegged to the Euro (at the rate of € 0.51129 to 1 KM). The previously significant inflation differential between the two Entities is converging to a low level: in the Federation of Bosnia and Herzegovina (FBiH) inflation has been well below 2% in the past three years, while it has constantly decelerated in the Republika Srpska (RS), reaching single-digits in 2001. Increased economic integration between the two Entities has been a determining factor in this convergence. Across BiH as a whole, in 2001 average inflation was 3.3% with an end of period rate of 0.8%, reflecting the stabilising effect of the currency board. Data to September 2002 show retail price inflation in both the Federation and RS remaining on a downward trend.

Exchange Rate. The CPI-based real effective exchange rate depreciated by about 5% in 2001, reflecting the sharp appreciation of the Yugoslav dinar; this provided some room for unit labour cost increases, which will have to be closely monitored in the future to avoid harming BiH competitiveness.

Fiscal Situation. Despite weak growth, BiH managed in 2001 to reduce the high general government deficit (before grants, on a commitment basis) from 20% of GDP in 2000 to broadly 14.5% of GDP. With tax revenues largely unchanged overall, and other revenues falling by 1% of GDP, this reduction was driven by the expenditure side of the budget, with total expenditure falling from broadly 66.5% of GDP in 2000 to 61% of GDP in 2001. These reductions were achieved through cuts in pensions but also in investment spending which lower grant financing made necessary. The stock of domestic spending arrears continued to increase by 1% of GDP in 2001, however at a much slower pace than in 2000, to reach 10% of GDP. In 2002 the authorities are aiming for further progress with a consolidated budget deficit of 11.5% (5.5% after grants), and a further fall to 7% of GDP in 2003 (3% after grants). 2002 data for government deficits is consistent with this aim with revenue performance for the first nine months better than expected.

Overall, fiscal performance is improving but remains unstable. With separate fiscal entities tax competition is prevalent and no institution has sole responsibility for the total fiscal position in BiH. The public debt stock, including domestic arrears (of some 10% of GDP excluding war compensation and frozen foreign currency deposits), is expected to rise from 68% of GDP at the end of 2001 to 71% of GDP at the end of 2003. However, including frozen foreign currency accounts (30% of GDP) and potential war claims (perhaps more than 50% of GDP) the total stock of public debt is over 150% of GDP. These large claims on the government need to be addressed.

High expenditures are driven by the high public wage bill and payments to war veterans. The revenue base of the Entities is narrow with 90% of total Federation revenues coming from indirect taxes, while sales, excises and customs duties only account for 56% of total RS revenues. The federal system adds a major complication to fiscal policy making, in particular, in view of the necessary overhaul of indirect taxation and introduction of VAT. There is a need to harmonise systems and responsibilities to avoid harmful tax competition and to make tax policy more coherent.

Box 2. BiH - Institutional Setting

The constitution of BiH only attributes limited competencies to the State government. The State budget, lacking its own revenues, depends largely upon Entity transfers to meet its main responsibility, notably, foreign debt service. The complex arrangements whereby the Entities, Republic Srpska (RS) and the Federation (FBiH), and Brcko enjoy a great deal of autonomy, including over fiscal policy, has often made it difficult to identify a single national policy agenda. It is these complex constitutional arrangements, including an important role for the High Representative, which play a major role with regard to the development of the economic framework.

External Situation. Data are weak but the export recovery initiated in 2000 appeared to continue in 2001 and imports also remained robust despite weakening domestic demand and lower aid for reconstruction. However, the trade deficit remains large at broadly 36% of GDP. Earnings from services and factor income fell by 8% and 5% respectively. First quarter 2002 data for the Federation and RS show falling exports and imports, although the first quarter trade deficit for the Federation remained similar to the first quarter 2001 level, while in RS the trade deficit shrank by 7% compared to the same period the year before. The current account deficit remains substantial and (excluding official transfers) it even increased to 23% of GDP in 2001 from 21.5% in 2000. It is expected to remain large but strengthened public savings should contribute to a small improvement this year (at around 21% of GDP).

The EU accounts for around 45% of BiH goods exports, with Italy being the most important market, and around 30% of BiH imports. BiH's 2000 trade agreement with the EU permits free access of most goods. However, to take full advantage of the agreement, the country must comply with EU veterinary and phyto-sanitary standards, by quickly establishing appropriate certification procedures to meet EC standards. BiH has, together with the other countries of South East Europe, signed the Memorandum of Understanding on Trade Facilitation and Liberalisation developed through the Stability Pact, under which trade in products will be progressively liberalised. As from mid-2002 free trade agreements were in effect between BiH and all of the former Yugoslav republics. Negotiations are continuing with Albania, Romania, Bulgaria and Turkey and WTO accession could occur in early 2003 if preparations proceed as planned.

FDI remains very weak with a decline in net FDI to € 145 million in 2001 compared with € 163 million in 2000. FDI is expected to increase this year (projected at € 260 million) and it is vital that efforts are made to improve the investment climate given the need to attract higher levels of private capital in the future in the context of declining aid flows.

Despite low levels of FDI, strong foreign currency inflows were witnessed in the last quarter of 2001 in the context of the introduction of Euro notes and coins in the 12 EU countries. Individuals exchanged Deutsche Marks (previously unrecorded) for KM which led to large increases in the monetary aggregates. Broad money growth increased by 89% during 2001 compared to a growth rate of 14% in 2000. Foreign currency reserves reached over 5 months of imports at the end of 2001 compared to broadly 2 months of imports at the end of 2000, and are expected to reach over 6 months of imports in 2002.

External debt. This stood at 58% of GDP at the end of 2001 (and is estimated at 56% in 2002); its structure by lender shows that 50% of it is owed to the World Bank, 19% to the Paris Club, 5% to the London Club and 4% to the IMF. Debt service as a percentage of exports of goods and non-factor services is relatively low, reflecting the concessional nature of much of the debt and favourable debt rescheduling agreements. However, total external debt service will increase in the medium term, from USD 81 million in 2001 to USD 200 million by 2004 (a debt service ratio of broadly 9%) as payments to international financial institutions increase.

Structural reforms

Tax and Customs Policies. Progress has been made in these areas in 2001 with the unification of indirect tax rates across the Entities, and the introduction of Entity Treasury systems give better control over commitments and expenditures.

Inter-entity harmonisation continues, with double taxation on inter-Entity trade ending in July 2002. The restructuring of tax and customs administrations is also underway in both Entities. The Customs and Fiscal Assistance Office (CAFAO) programme which is funded by the EU and includes assistance from European customs and tax experts, is contributing to the development of customs and tax systems based on modern European standards.

Privatisation. Privatisation performance has been disappointing in both Entities, with the performance of the RS particularly slow. Delays have been partly due to overoptimistic expectations of the authorities on the market value of enterprises, but also because of the lack of current information on enterprise debts. While the privatisation of small and medium enterprises is virtually complete in both Entities, progress on the sale of “strategic” enterprises, which could attract foreign investors, has lagged behind. Eight large enterprises are earmarked for privatisation in 2002 in the Federation, and, in the RS, the authorities plan to complete the privatisation of medium-sized enterprises by the end of 2002.

In September a new bankruptcy law was passed, which should help to improve the business environment. The current government has also sought to improve this environment by facilitating both entry and exit of firms, by lowering administrative costs, and by strengthening the legal framework for foreign direct investment.

Financial Sector Reform. The target of privatising all banks by the end of 2002 is expected to be broadly fulfilled in the first quarter of 2003. Recent progress has been encouraging and foreign capital in the banking sector is significant. There are six more banks to be privatised in the Federation and eight in the RS. At the end of the year there will be 29 banks in the Federation and 13 in the RS, but mergers, as well the increase in the minimum capital requirement and strengthened regulations, will reduce these numbers.

A State Deposit Insurance Agency has been created from the two Entity agencies in August 2002. Adequate banking regulations including supervision rules and prudential regulations have been established, although responsibility for this remains with the Entities rather than with the Central Bank. In this context, progress is also being achieved on moving towards a single banking sector regulator, with legislation being harmonised. Early in 2002 stock exchanges opened in Banja Luka and Sarajevo, but market capitalisation is still insignificant.

Although the loan performance of BiH banks has improved substantially, commercial lending remains in fact very low, with little long-term bank lending, and hence an under-developed intermediation role for banks; this is mostly due to lower economic growth, which limited profitable lending opportunities, and the fact that many companies in BiH need restructuring. It also reflects the difficult business environment and the short-term nature of deposits. In this environment, banks seek security or guarantees on lending, for example, through collateral. However, given weakness in the legal system for property rights, such guarantees are not easy to enforce.

In the insurance sector, so far only insurance for third-party liability exists in BiH; no legal framework exists on supervision, in a market where large cash payments are involved. The Community is providing support for drafting a modern insurance law that will establish a legal framework, including a state insurance commission overseeing the supervisory bodies of the entities.

Corruption. The post war situation in BiH was particularly conducive to the development of corrupt practices and there is a consensus both outside and within the country that corruption is widespread. Corruption in BiH takes many forms and affects business and private citizens alike. It ranges from bribes to advance administrative formalities or authorisations, to selectivity in tax assessment and collection and the blatant sale of smuggled goods.

In spite of a comprehensive Anti-Corruption Strategy being in place for several years and being implemented by the OHR and a number of donors and international organisations in cooperation with the BiH authorities, BiH needs to make further efforts to tackle the problem of corruption. Corruption has a corrosive effect on public confidence in the political system and economic development will only proceed faster when investors are operating within a common and transparent system. As levels of corruption decrease, BiH will also secure badly needed additional fiscal revenues.

International Relations

IMF relations. In May 2001, the IMF completed its final reviews for the stand-by arrangement (SBA) agreed in May 1998. After some delays, notably due to a disagreement with the Entities' authorities over war veteran benefits and pensions, a new 15-month SBA of about SDR 67.6 million was approved by the IMF Board in August 2002; the first tranche of SDR 19.6 million was disbursed soon after. The programme focuses on policies to achieve post-reconstruction growth through a continued commitment to the currency board arrangement and further significant fiscal consolidation. In addition, the programme foresees structural reforms in the areas of tax policy, privatisation, trade policy and improvements to the business environment.

World Bank relations. After an initial post-war strategy based upon reconstruction, the World Bank's emphasis has shifted towards helping BiH achieve sustainable growth. With this aim the second, USD 72 million, *Public Finance Structural Adjustment Credit* (PFSAC II) is almost completed. This builds on the first operation and aims at improving inter-Entity coordination, priority setting for public spending and improving budget and debt management, pension and social safety net issues. In May 2002, a USD 44 million *Business Enabling Environment Adjustment Credit* (BAC) was approved in support of the Government's program to improve the investment climate. A USD 50 million *Enterprise and Bank Privatisation Adjustment Credit* (EBPAC) was completed earlier this year and a second *Social Sector Adjustment Credit* (SOSAC II) is being prepared.

EC assistance.. The Community has supported the process of economic reforms in BiH through Community macro-financial assistance. In May 1999, the Council decided to provide BiH with macro-financial assistance worth € 60 million (Decision 1999/325/EC), in the context of the IMF programme agreed in May 1998. The Community assistance was disbursed in three tranches, in line with reform progress, with the final tranche being released at the end of 2001. In the context of the new IMF programme, the Council of the European Union decided on 5 November 2002 to provide to BiH further macro-financial assistance of up to € 60 million, comprising a loan element of up to € 20 million (with a maturity of 15 years) and a grant element of up to € 40 million (Council Decision 2002/883/EC). Like the first package, the implementation will be linked to progress in economic and structural reform.

The EC has also supported the country's reforms under the OBNOVA programme and, since 2001, with CARDS assistance. The 2002 CARDS annual programme adopted by the Commission in May 2002 foresees commitments of € 71.9 million. The assistance principally focuses on refugee return, customs and taxation reform, justice and home affairs and economic development. The Multi-annual Indicative Programme foresees €

63 million and € 58 million for 2003 and 2004 respectively. The EIB has signed loans worth over € 160 million in the roads, rail, and electricity sectors.

Progress with the Stabilisation and Association Process. The Commission recently decided that the Road Map of steps covering political, economic, and democracy, rule of law and human rights issues was substantially completed with 15 out of the 18 steps being fulfilled, and some progress on the remaining three. After the formation of governments in BiH, the Commission foresees to put to Member States the case for opening a Feasibility Report, allowing a decision to be made on whether or not to embark upon negotiations for a Stabilisation and Association Agreement.

5. Croatia

- **With a GDP per capita above € 5,000 in 2001, Croatia remains well above the level of the other countries of the region; Croatia has been successful in further integrating its economy in the regional and international trade.**

- **In spite of a regular reduction of expenditure from the central budget, the General Government's fiscal stance remains weak and is a source of vulnerability for the economy.**

- **In a difficult political and social environment, Croatia has shown slow progress in implementing structural reforms in particular of the labour market and public enterprises thus hampering the export performance.**

- **In line with its obligations under the SAA, Croatia is making serious efforts to establish the necessary legislative framework. However, institutional reforms need to be accelerated, including the reform of the judiciary which is crucial to the legal security of enterprises.**

Table 9. Croatia – Main Economic Trends. 1998 - 2002

		1998	1999	2000	2001	2002[p]
Real GDP growth	*Percent*	2.5	-0.4	2.9	3.8	4.0
Inflation (retail prices)	*Percent (average)*	5.9	4.3	6.2	4.9	2.8[(1)]
	Percent (end of period)	5.4	4.4	7.4	2.6	3.0
Unemployment rate	*Percentage of labour force*	11.4	13.6	16.1	15.8	14.5
Central government balance [(2)]	*Percent of GDP*	-3.0	-7.4	-5.7	-5.4	-4.3
General government balance [(2)]	*Percent of GDP*	na	-8.2	-6.5	-6.8	-6.2
Trade balance	*Percent of GDP*	-18.8	-16.6	-17.4	-21.0	-21.5
Current account balance	*Percent of GDP*	-6.7	-7.0	-2.4	-3.8	-3.6
External debt	*Percent of GDP*	44.3	49.6	59.7	57.5	61.7
	Billion €	8.2	9.8	11.8	12.7	14.0
Debt–export ratio	*Percent*	209.3	224.6	240.9	234.7	273.4
Foreign direct investment	*Percent of GDP*	3.9	7.1	5.8	7.0	4.9
	Million €	746	1,327	1,169	1,529	1,171

[p] Projections. [(1)] I-VIII 2002. [(2)] Accrual basis. *Source:* IMF.

Macroeconomic developments

Despite the worldwide slowdown, the macroeconomic performance of Croatia has been positive in 2001, as is the general outlook for 2002. The Croatian economy grew in 2001 by 3.8% driven by domestic demand, notably private consumption, and a favourable tourism activity. Industrial production posted a solid growth of 6%, but the construction and agriculture sector remained subdued. In 2002, GDP is estimated to grow by 4% (year-on-year) resulting from continued growth of domestic demand, especially investment and personal consumption. The construction and (wholesale and retail) trade sector display high growth rates. First indications seem to confirm a satisfactory tourism season but with lower growth rates than in the past two years.

Industrial output picked up again recently, showing a 4.6% growth in the first ten months over the same period last year. For the entire year, the authorities revised upwards the expected real GDP growth rate to 4.2%, which is essentially in line with the revised IMF estimate.

In an environment of ongoing restructuring and growing labour force, unemployment remains high but there seem to be first signals of a gradual easing of the situation. The Labour Force Survey based on ILO standards had put the average unemployment rate in 2001 at 15.8% (2000: 16.1%); the IMF expects the rate to go down further to 14.5% in 2002 (for the first six months the rate stands at 15.2%). The official unemployment rate stood at 21.7% in September, thus representing a (minor) decline (-0.1 percentage points) to the previous month and to the September figure in 2001 (-0.3). It remains to be seen whether and to what extent the increasing openness of Croatia and related competitive pressures on domestic producers and thus employment will be over-compensated by the job creation of small and medium size enterprises.

Monetary policy. Croatia has achieved a high level of price stability in the past years using the exchange rate as nominal anchor. Furthermore, the new Central Bank law defines price stability as the primary objective of monetary policy. In 2001, retail price inflation slowed more rapidly than expected to an average rate of 4.9% despite a loosening of monetary policy, and stands at 2.2% for the first ten months of the year compared to the previous year. The development of producer prices has been even more modest with an average rate of 3.6% in 2001 and a 0.8% fall of prices for the first ten months 2002. Even with administered increases of energy prices as of 1 September, the inflation target of 4% in December 2002 seems achievable. This positive development is the result of a number of factors, notably a stable exchange rate, trade liberalisation, wage moderation, productivity increases and enhanced competition in the retail sector.

The effectiveness of monetary policy is however limited. The past structural excess liquidity coupled with a weak payments system and liquidity management practices of banks have hampered the development of money markets and interest-sensitive monetary instruments. Furthermore, the Croatian economy is characterised by a large degree of currency substitution or de-facto euroisation (roughly three quarters of bank deposits and almost half of bank domestic placements are either in a foreign currency or indexed to one).

Fiscal situation. In line with the IMF framework under the past Stand-by arrangement (SBA), the deficit of the *consolidated central government* (on an accrual basis) has been reduced from 5.7% of GDP in 2000 to 5.4% in 2001. On the expenditure side, overall expenditure increased by 4.1% in 2001 compared to 2000, essentially due to transfers to the pension and health funds. The wage bill was even reduced by 3.8% reflecting the wage freeze and streamlining of the public wage coefficient grid. On the revenue side, tax revenues increased by 4.2%. VAT revenue remains the single most important revenue source and increased by more than 8%.

For 2002, the *central budget* foresees a rise in revenues by 4.2% over 2001, half of it coming from VAT (+5.6%). Expenditure shall remain almost unchanged in nominal terms, thus dropping in real terms. The wage bill is set to fall by 2.7%. According to the Ministry of Finance, the authorities aim to achieve a deficit of the *consolidated central government* budget of 4.3% of GDP, in line with the IMF programme. However, delays in reducing or even containing expenditure (e.g. by postponed reform in the military) and lower than expected revenues (e.g. excise) are causing problems to attain the deficit target: in the first half of the year the cash deficit (without privatisation receipts) reached HRK 3.6 billion (€ 485 million) compared to a planned annual deficit of HRK 6.8 billion (€ 917 million). Against this background, the Government recently submitted to the Parliament a draft re-balancing of the budget.

From a *general government perspective*, the past fiscal adjustment has been less impressive[7]. The IMF estimates that the general government balance even slightly deteriorated in 2001 to 6.8% of GDP compared to 6.5% the previous year notably as a result of delayed implementation of cost-cutting laws in extra-budgetary funds. For 2002, the Fund expects only a modest decline to 6.2%, essentially due to some delays in an ambitious highway construction programme. Accordingly, the general government debt further increased to 55.1% of GDP in 2001 (53.2% in 2000) and is expected to reach 57.5% in 2002. With a primary balance currently well below the level needed to stabilise public debt, the current trends are thus not sustainable.

External Trade. In 2001, the negative performance of trade was partly offset by strong travel receipts and private transfers delivering a current account deficit of 3.8% (see chart 8). Travel income surged in the main season (Q3) by some 32% compared to the previous year; the surplus in the services balance exceeds by far the results of the past years. For 2002, the current account deficit is expected to slightly decline to 3.6% of GDP: an again improved tourist season, albeit at lower pace, and services as well as reduced cross-border shopping should offset a worsening of the negative merchandise balance ensuing from private investment and the initiation of large public investment projects.

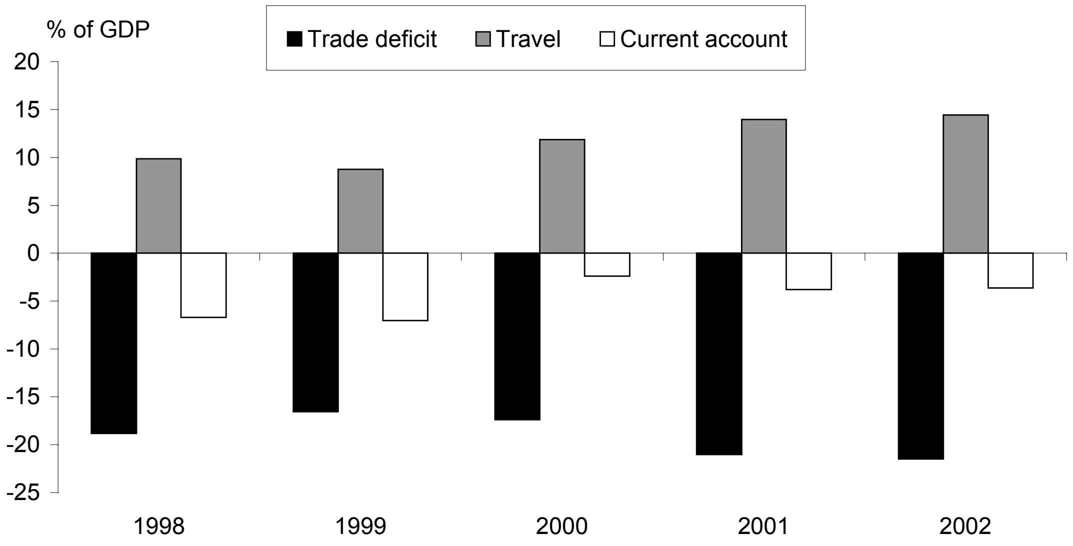
The EU remains the main trading partner with about 55% of total trade (exports and imports). Croatia was the second country to sign with the European Communities a Stabilisation and Association Agreement (SAA) on 29 October 2001. An interim agreement is in force as of 1 March 2002, essentially covering the trade provisions of the SAA until its ratification by all Member States. After intensive negotiations, Croatia has concluded so far 11 Free Trade Agreements (FTA) covering 27 countries (including the 15 EU-MS). Thus, 80% of Croatia's trade is currently covered by preferential trade agreements. Croatia has signed FTAs with the other countries of the Western Balkans except with the FRY, which is still under negotiation. Membership of CEFTA (the Central European Free Trade Agreement) is envisaged to start from 1 January 2003.

The explanation for the disappointing export performance does not seem to lie in a loss of price or cost competitiveness, but rather in the lack of reform in the labour and enterprise sector and the remaining administrative barriers to foreign investors. The export structure is largely unchanged and thus reflects the continued domination of former and current public enterprises (in particular shipbuilding with large import components). Croatian trade is also restricted since it is not yet integrated in the pan-

[7] Consolidated general government consists of consolidated central government, local governments and off budget agencies (Croatia Highways, Croatian Roads, Croatian Privatisation Fund and Bank Rehabilitation Agency).

European system of diagonal cumulation. Furthermore, regarding the exports to the EU, Croatian companies are often not able to apply the EC standards.

Chart 8. Croatia - Balance of payments developments. 1998 - 2002



Source: IMF, national sources

Exchange rate. The current foreign exchange arrangement is classified as managed floating with no pre-announced path for the exchange rate of the Croatian Kuna. The exchange of eurozone currencies into the euro went smoothly and is likely to have reduced the high cash circulation of foreign currencies. Ensuing from the changeover inflow as well as continued capital inflows (e.g. through tourism, privatisation receipts and international lending for reconstruction needs), pressures for appreciation are mounting. More generally, the volatility of daily exchange rates and the frequency of interventions by the HNB seems to have increased. The HNB publicly announced its willingness to maintain the exchange rate stable pointing to its ample and steadily growing reserves (some USD 5.6 billion at the end of June representing almost 6 months of goods and services imports). Unilateral euroisation not being an option, the IMF advocates for more exchange rate flexibility.

External debt. Croatia has succeeded in maintaining access to international capital markets at favourable conditions (the leading credit ratings remained unchanged at the low end of investment grade) and issued a number of bonds denominated in euro, yen and US dollar. Foreign debt has continually increased to a level of USD 11.2 billion at the end of 2001 corresponding to 57.59% of GDP. As of 31 August 2002, external debt stood at USD 13.3 billion[8]. Debt service was still relatively high at 23.1% of exports in 2001 but slightly improved relative to 2000 (23.5%).

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[8] The exchange rate movements between the euro and the US dollar may distort the picture since about 60% of the debt are supposedly denominated in euro.

Structural Reforms

Overall ***progress with structural reforms*** has recently been slow reflecting a fragile government coalition and public opposition. Progress has been achieved in rationalising social transfers and implementing the second pillar of the pension system, starting fiscal decentralisation and introducing a single treasury. On the other hand, reforms lag behind in other areas, such as privatisation, education, health and the judicial system. Labour market reform, already debated for a long time, encounters strong opposition and is not yet adopted. The reform of the police and defence sector is a difficult and time-consuming exercise. Moreover, the implementation of legislation proves to be difficult owing to delays in preparing by-laws and weak institutions. Corruption is a wide-spread phenomenon in Croatia, albeit on a lower level than in other countries of the region.

Public expenditure management. So as to modernise its budgetary management, the Ministry of Finance is implementing a new chart of account and also the new GFS classification (2001). The single treasury account is not yet fully operational but shall cover the entering of commitments still in 2002. In this process, the number of government accounts is being consolidated to the legally required minimum. However, the coverage of the entire public sector, notably health, is incomplete. Against this background, the government halted further steps in its general aim to progress in fiscal decentralisation.

Public administration reform. Based on a FIAS study on administrative barriers to foreign investment (January 2001), the Croatian authorities have started a comprehensive initiative to implement the findings of the study. The government adopted in February 2002 an action plan with detailed measures of short and long-term nature, which is under the supervision of Deputy Prime Minister Linic. Croatia has launched a forum on competitiveness along a Harvard Business School model, which will result in Croatia being listed in the ranking of the World Economic Forum. As key elements, it strengthens the dialogue between the government and the business environment and develops tools and the capacity for monitoring the investment environment. A one-stop shop is being set up to guide foreign investors. To create a favourable business environment, further efforts will have to be made to enhance the capacity of the judicial sector.

Enterprise and financial sector reform. The EBRD estimates that the private sector share in GDP remained at 60% in 2001 as it was in the previous two years. The progress in privatising large enterprises has been slow in 2001 and so far in 2002 with the partial privatisation of INA, the gas and fuel monopolist, being the most prominent project. Small-scale privatisation, managed by the Croatian Privatisation Fund (HFP), is progressing gradually albeit behind original plans. Labour productivity of the industrial sector improved in 2001 compared to the previous year and in the first months of 2002 reflecting the on-going restructuring. The financial performance of large state-owned enterprises could be enhanced. However, subsidies remain high and in particular the loss-making and state-owned shipbuilding industry represents an ongoing threat to the budget.

The privatisation of banks has been almost completed (with almost 90% of assets owned by foreign investors). Contrary to previous plans, the authorities plan to merge two remaining State banks, the Croatian Postal Bank (HPB) and Croatia bank, and to privatise only a share of up to 25%. The largest insurance company was scheduled for privatisation in 2002; but the government cancelled the well-advanced tender and announced that it will initiate a new tender.

According to performance indicators, the profitability and soundness of financial institutions has improved. It remains to be seen whether the recent growth of lending activity in particular to private households will have an impact on the credit quality. The foreign ownership of banks is showing first results e.g. in terms of available products and loan maturity. Private banks have been allowed to operate payments systems, formerly carried out exclusively by the Central Payments institution (ZAP). The professional management of a recent crisis (Rijecka banka) and the growth in deposits in the context of the euro conversion provided evidence of growing confidence. However, the development of capital markets is still in an infant stage; the purchase of Croatian companies has further reduced the number of listed companies.

International relations

Relations with IFIs. On 29 March, the IMF completed the second review under the 14-month precautionary stand-by arrangement (SBA), which formally expired on 18 May 2002. The authorities underlined their willingness to conclude a successor arrangement (also of a precautionary character). Such an arrangement is indeed an important element for a credible policy of fiscal consolidation. The future SBA is expected to be grounded on a broader definition of government so as to better assess the fiscal consolidation process. Negotiations did not conclude by mid-November but are scheduled to resume in early December.

The *World Bank* is playing an important role in Croatia. Since 1993, the Bank committed a total amount of USD 972 million for 19 projects (of which 11 are still active). A Structural Adjustment Loan (SAL) of USD 202 million was signed in December 2001 and a first tranche of USD 102 million was disbursed in February. A supervision mission for the second tranche took place in October identifying a number of implementation concerns. The Bank deems feasible to disburse the second tranche prior to the closing date of the loan at the end of March 2003. In addition to financial assistance, the World Bank provided for several analytical and policy studies through its agencies. It has only recently opened its South Central Europe Regional Office in Zagreb, which covers Bulgaria, Romania and Croatia.

External assistance. EC assistance for the Western Balkans is summarised under CARDS. The current CARDS commitments benefiting Croatia total € 60 million in 2001 and € 59 million in 2002 (focussing on the areas democratic stabilisation, economic and social development, justice and home affairs, administrative capacity building and environment) and are likely to increase slightly thereafter. In November 2000, the *European Investment Bank (EIB)* mandate was extended for lending to Croatia. As of September 2002, six projects have been signed and one project awaits signature totalling € 226 million.

Croatia joined the *European Bank for Reconstruction and Development (EBRD)* in March 1993. By September 2002 the EBRD had made a cumulative commitment of about € 1,011 million in Croatia, contributing to a total project value of some € 3 billion. About two thirds of EBRD's portfolio was in private and one third in state projects.

Stabilisation and Association Process. Croatia has been participating in the Stabilisation and Association process since its very beginning and has benefited from its overall co-operation framework, including preferential trade concessions and financial assistance. As mentioned, it was the second country to sign a SAA. The credibility of Croatia's aspirations to become a candidate for EU membership depends in the first instance on how successfully it implements this far reaching agreement, which offers a clear route to bringing the country closer to EU standards. Croatia is making serious efforts to establish the necessary legislative framework. However, equal efforts must be made to concentrate on a programme of structural reforms.

6. Federal Republic of Yugoslavia (FRY)

- **Economic policies in the FRY in 2001 and 2002 were continuously geared towards sustaining macroeconomic stability through tight monetary policies, supporting an ongoing process of inflation reduction.**

- **Despite impressive achievements in structural reforms since late 2000, important economic challenges lie ahead, such as the restructuring of large, insolvent, and over-staffed public enterprise sector and the provision of social support for the neediest.**

- **Even after substantial debt relief agreed by the Paris Club in 2001, the FRY economy is likely to rely on official financing as private funding, although on an upward trend, will by far not reach sufficient levels to match the financing requirements over the medium term.**

- **The FRY is still at an early stage in the EU Stabilisation and Association process. Expert meetings have been held in 2001 and 2002, and the next step will be a report on the feasibility of embarking upon negotiations for a Stabilisation and Association Agreement.**

Table 10. FRY – Main Economic Trends. 1999 - 2002

		1999	2000	2001	2002[p]
Real GDP growth	*Percent*	-18.0	5.0	5.5	4.0
Inflation rate	*Percent (average)*	42.0	73.0	91.0	20.0
	Percent (end-of-period)	50.0	113.0	39.0	15.0
Unemployment	*Percent of labour force*	27.0	27.0	28.0	29.0
General government balance (1)	*Percent of GDP*	na	-0.9	-1.4	-5.0
Trade balance	*Percent of GDP*	-15.9	-22.3	-26.0	-25.8
Current account balance (1)	*Percent of GDP*	-7.5	-7.6	-10.9	-11.7
External debt	*Billion €*	8.9	12.2	13.5	8.7
Debt-to-export ratio	*Percent*	na	453	429	273
Foreign direct investment	*Percent of GDP*	0.9	0.3	1.5	4.4
	Million €	105	27	184	570

[p] Projections. (1) Before foreign grants. *Source:* IMF, FRY authorities.

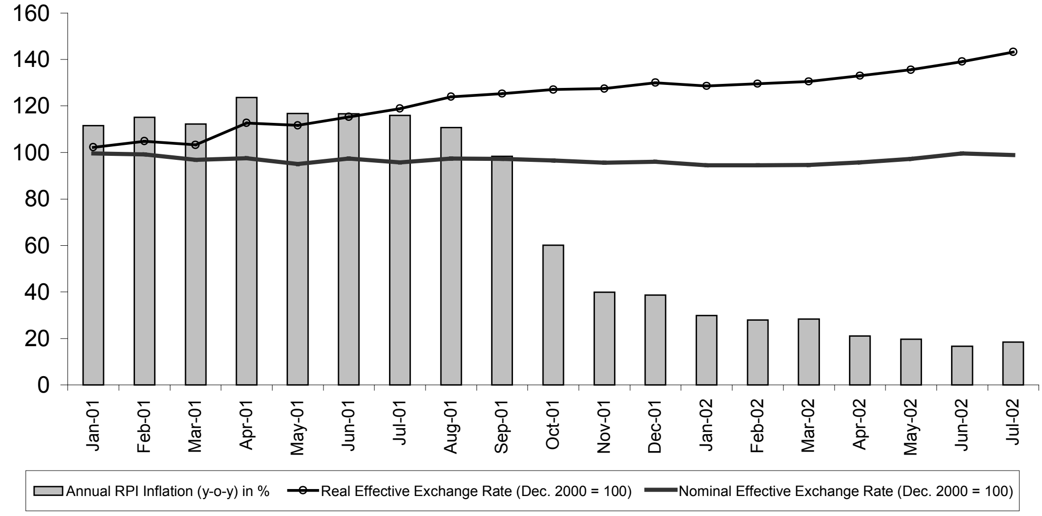
Macroeconomic developments

Real GDP in the FRY grew by an estimated 5.5% in 2001 (including 3.5% in Montenegro), somewhat faster than projected, and was mainly driven by agricultural output recovery (20-25%) and increased activity in services. Industrial production has been performing poorly throughout 2001, with a particular reduction in the latter part of the year, and during the first quarter of 2002. In Serbia, industrial production has somewhat stabilised since April 2002, but was all but stagnant in the first nine months of the year compared to the same period of the previous year. In the same period, Montenegro's industrial production registered an 11% drop, largely due to a 50% fall in the production of electricity, water and gas, which account for a quarter of total industrial output. Industrial production in the FRY (-1.1% in the first nine months of

2002) is expected to increase by 2-3% in 2002. Real growth is estimated at 4%, mainly on the basis of an estimated 10-20% increase in services while agricultural production is expected to stay at the 2001 level.

Price developments in the FRY present a mixed picture. End-year retail price inflation in 2001 has come down considerably to 39% (from 113% at end-2000) despite increases in electricity prices and indirect taxes. Core inflation in 2001 was estimated at 15%. In the first half of 2002, the process of inflation reduction continued and inflation had fallen to around 16% (year on year) by August 2002, in spite of a 50% increase of electricity prices in Serbia in July 2002. Montenegro recorded a lower end-2001 inflation rate of some 24% compared to the figure for the whole FRY, but it was higher than the targeted 15%. In the eight months to August 2002, retail prices both in Serbia and Montenegro increased by some 9%, and the authorities have revised end-of-year inflation downwards from 20% to 15% in Serbia and from 15% to 10% in Montenegro. A stability-oriented monetary policy, supported by real wage containment in the public sector has clearly supported the process of inflation reduction in 2001 and 2002.

Chart 9. FRY - Inflation and exchange rate developments.
Jan. 2001 - July 2002



Source: IMF, national sources

The consolidated general government accounts in the FRY recorded a cash deficit before grants of some 1.4 % of GDP in 2001 (around € 157 million), compared with a programme target of 6.1%. This includes a Montenegrin fiscal deficit (before grants) of around 5% of GDP of that republic. The considerably lower than programmed cash deficit in 2001 was in part due to improved revenue performance as a result of tax policies implemented in the first half of 2001 (turnover taxes, excises and gross income tax). But it mainly reflected the action taken to severely compress expenditures as delays occurred in receiving revenues from privatisation and foreign financial assistance. The deficit was financed through domestic borrowing (0.6% of GDP as planned) and foreign financing (0.8% of GDP as compared to a programmed 4.1%). In line with a sustainable level of expenditure, the consolidated FRY budget deficit for 2002 was planned to be in the order of 5.7% of GDP, to be financed through domestic borrowing (0.5% of GDP), privatisation receipts (1.3%) and foreign financing (4.0%). Recent projections point to a lower deficit of around 5 % of GDP.

Revenue performance in *Serbia* in the first half of 2002 has been mixed. While tax revenues were reportedly below programmed level mainly due to lower than expected growth and inflation, budget revenues from privatisation exceeded their target of € 130 million and amounted to more than € 190 million in October 2002. A Serbian draft budget for 2003 was submitted in October 2002 and foresees a fiscal deficit of around 5% of GDP. *Montenegro* appeared to remain under severe fiscal pressure. Lower than expected revenues, in particular in the first half of 2002 necessitated some discretionary spending cuts. The authorities expect to keep the fiscal deficit at 4% of Montenegrin GDP, as programmed (after 10.5% in 2000 and 7.5% in 2001), to be covered through foreign financing and domestic lending. The authorities have prepared a draft budget for 2003 with a higher fiscal deficit compared to 2002 of some 4.5%, reflecting new expenditure burdens, in particular a planned annual transfer amounting to € 50 million (in line with Montenegro's share in FRY's GDP) to finance joint federal functions after the adoption of a new Constitutional Charter.

External situation. The FRY current account deficit in 2001 (before grants) was considerably lower than originally projected (10.9% instead of 14.6%), although imports grew more than expected (by 30% instead of 21%) and exports were slightly below the projected amount. This improvement was due to higher than expected inflows of remittances from abroad (i.e. € 1,400 million instead of an estimated € 1,000 million) In the first nine months of 2002, the FRY registered a higher than expected trade deficit, in spite of a large 20% increase in exports compared to the same period of the previous year. However, imports increased even to larger extent (by 25%) in that period, mainly as a result of a strong domestic demand for both consumables and investment goods. The current account deficit before grants, which had been projected at 12.8% in 2002 in the IMF programme, is now projected to reach some 11.7% of GDP. This is mainly due to a continuous stronger than expected net inflow from remittances. Net capital inflows including higher than expected Foreign Direct Investments (estimated at € 570 instead of € 400 million in 2002) and loans from official creditors are projected to more than offset the current account deficit, leading to an expected increase of gross foreign reserves to some USD 2,100 million by end-2002 (or 3.4 months of projected imports). The value of the Dinar remained broadly stable at around YuD59 per € since early 2001, reflecting both increased confidence in the domestic currency and favourable developments in the foreign exchange market. In real terms, the Dinar appreciated by about 45% since end-2000 (see chart 9), however, this was mainly due to price liberalisation and price adjustments of non-tradable goods whereas tradable goods increased in line with nominal depreciation of around 2.6% during 2002. The authorities seem to see only limited scope to affect the real exchange rate through monetary and exchange rate policy in the current economic context.

Overall, the external viability of the FRY economy will remain a challenge. Important financing requirements, mainly resulting from debt service obligations, mostly in the form of interest payments, and the need to further strengthen foreign exchange reserves, will continue to put a heavy strain on the balance of payments. As for 2003, the IMF foresees a further slight reduction of the current account deficit from 11.7% to 10.9% of GDP, debt amortisation payments of around USD 50 million, and a further increase in gross foreign exchange reserves by around USD 0.6 billion while official financing in the form of grant and loans is expected to amount to some USD 1.3 billion.

Box 3. FRY - External debt restructuring

In November 2001, the FRY concluded an agreement with Paris Club creditors which details a two-phased 66% reduction in the net present value of outstanding obligations to Paris Club creditors (some € 5.100 million at end-2001). The first phase (51%) became effective in early May 2002, when the IMF Board completed the third and final review under the stand-by arrangement (May 2001 – May 2002) and approved a three-year Extended Arrangement to support the FRY's economic programme in 2002 – 2005. The second phase (15%) will become effective upon completion of the IMF programme (expected in March 2005). Negotiations are continuing with London Club creditors to settle FRY's outstanding financial obligations towards commercial creditors (some € 3,178 million at end-2001). The FRY's total external debt amounted to around € 11.2 billion in mid-2002.

Trade liberalisation. Commendable progress was achieved in 2001 in liberalising the price and exchange regime. The trade and customs regimes were liberalised in spring 2001. The EC had already unilaterally granted to the FRY autonomous trade preferences in autumn 2000. In the course of 2001, the FRY has started to negotiate Free Trade Agreements with a number of countries of Southeast and Eastern Europe, under the Stability Pact MoU. Agreements with BiH and Hungary were concluded in March and July 2002, respectively. Negotiations with Croatia, Slovenia and Albania are under way. Free Trade Agreements, which were signed back in 1996 with the FYR of Macedonia and with Russia, are still in force.

Structural reforms

Progress has been commendable in 2001 and throughout 2002, in particular in the area of expenditure control and tax policy, and the cleaning-up of the banking system. It appears that privatisation has gained momentum since early 2002, in particular in Serbia. The near-term agenda for further restructuring of public administration and the real sector is encouraging.

Public Finance Reform. In Serbia, important preparatory steps have been taken towards establishing a fully-fledged Treasury system and expenditure control has been improved considerably. A new law on budget was enacted in February 2002 and foresees a central approval of commitments, i.e. line ministries are no longer able to commit funds and authorise payments without the consent of the Ministry of Finance. A fully-fledged Treasury is expected to become operational in spring 2003.

Substantial preparatory work has been undertaken in Serbia to formulate a Public Expenditure Optimisation Strategy, and a formal working group has been established in May 2002. Work has been undertaken in the area of health expenditures, state aid to public enterprises, and proposals for public sector wage policy reforms have been developed, including measures to identify "ghost" employees on public sector payrolls.

In Montenegro, further substantial progress has been achieved in setting up a Treasury in the Ministry of Finance, supported by technical assistance from the EC and USAID.

In early 2002, an interim Treasury became fully operational. It is likely to lead to increased transparency and strengthened financial discipline, paving the way for a prioritisation and eventual reduction of expenditures. A new procurement law, which was enacted in mid-2002, will support this process.

Following wide-ranging tax reforms in Serbia in 2001, that significantly contributed to an improved revenue performance in the second half on 2001 as a result of a broadened tax base and a reduction of tax exemptions, further progress has been achieved. In June 2002, the Parliament approved an amended law on financial transaction taxes that foresee a substantial reduction of tax rates. The medium term objective is to abolish the tax altogether. Also in June 2002, the Serbian government adopted a set of laws aimed to combat corruption and grey market activities, in particular the Law on Tobacco and the Lottery Law. In late September 2002, it approved a set of new tax policy measures aimed at stimulating investment and employment creation. Measures include a reduction of corporate taxation from 20% to 14%, tax holidays for new investments and employment above certain thresholds, exemptions from the sales tax for a number of goods, as well as the abolition of the capital gains tax. Most of the new tax laws were endorsed by the Serbian Parliament in November 2002.

In the area of tax administration in Serbia, a blueprint for tax administration reforms was adopted in May 2002; however, implementation has been slow so far. The modernisation of tax collecting agencies, including the establishment of a modern payment system will continue to be a major challenge in the context of public finance reform. The dismantling of the old centralised payment system (ZOP) is foreseen for 2003.

Montenegro has continued tax reforms with support from foreign advisors. The Montenegrin Parliament at end-2001 approved a package of six tax laws. Four of these laws, namely the laws on income and profit taxation, on excises and on tax administration have already been implemented in the course of 2002. The authorities were expecting positive effects of these new laws on revenue collection in the second half of 2002 and in 2003 after revenue performance had been below target in the first half of 2002. The two remaining laws of the 2001 package, the tax on real estate and the VAT law were planned to come into force in early and mid-2003, respectively. A Large Taxpayer Office was established in Podgorica in mid-2002.

Private Sector Development. In Serbia, the process of privatisation through tenders and auctions has gained some momentum since early 2002. Total proceeds from privatisation in the first 10 months of 2002 amounted to € 270 million, compared to program target of around € 130 million. Following the tender privatisation of the first three large cement companies in January 2002, another six enterprises were sold through tenders in the course of 2002. The Ministry of Privatisation intends to launch investment tenders for a group of some 74 large socially owned companies by autumn 2003 out of a total of around 150 companies that are planned to be tendered in the next three years. In order to facilitate the privatisation of less profitable firms through international tenders, the authorities plan to amend the Privatisation Law to reduce the length of obligatory post privatisation employment protection from five years to one year as in the case of auction privatisation. A total of about 4,000 small and medium sized enterprises in Serbia, accounting for about 40% of the workforce will be offered through auctions, and the authorities expect that some 2,000-2,500 could be sold, implying a success rate of

50-60%. First rounds of auctions were held at the Belgrade Stock Exchange in spring and summer 2002 with limited success; most of the companies offered could not be sold due to their weak financial position. In August 2002, the authorities adopted a decree, which foresees a substantial streamlining of auction procedures. From March to October 2002, some 88 companies were offered through auctions, and the authorities expect to offer another 170-200 companies by the end of the year, and around 100 enterprises per month in 2003.

The Serbian authorities adopted a by-law on enterprise restructuring in January 2002, and have contracted financial advisors for 30 companies out of a total of about 49 large conglomerates that are likely to be subject to pre-privatisation restructuring over the next years. For 15 of them the advisors have prepared restructuring plans. Moreover, measures have been taken to improve the overall business environment. They include the adoption in December 2001 of a new labour law that increases labour market flexibility, as it foresees more liberal wage fixing and hiring practices.

In Montenegro, following the completion of the mass privatisation programme in end-2001, progress with tender and auction privatisation has been limited. The state's majority stake in Montenegro's telecom company as well as of parts of the Aluminium Company could not be sold so far due to a lack of investor's interest. In 2002, the main success was the sale of Yugopetrol to a Greek company in October for some € 65 million cash and some € 35 million investment commitments. Tenders for a steel and a tobacco company were expected by the end of 2002, and the authorities were confident that privatisation would gain momentum in the course of 2003 with a total number of some 53 companies in different stages of tender procedures. In late December 2001, the Montenegrin government adopted a blueprint for enterprise restructuring, which foresees the restructuring of a total of around 100 companies on a voluntary basis. A pilot project for 16 companies has been initiated in April 2002, and inspections in the pilot companies have not yet been finished with the exception of a wood processing company for which a restructuring plan has been finalised.

Financial sector reform. The Federal authorities have made further progress in strengthening banking supervision by the NBY. A new draft law on the National Bank of Yugoslavia (NBY) has been prepared setting out the supervisory functions of the NBY. It should be noted that after the entry into force of the Constitutional Charter the NBY would cease to exist. Its functions will be taken over by two central banks on republican level. A revision of the law on banks came into force in April 2002; it obliges banks to comply with stricter prudential regulations, to harmonise minimum ratios in line with Basle and EU standards, to define credit policies and to organise internal audits. A bank bankruptcy law was already enacted in October 2001.

Further progress in restructuring and cleaning up the banking sector in *Serbia* has been achieved. Eight banks are currently under liquidation procedures of the Bank Rehabilitation Agency (BRA), including four large insolvent state owned banks that were closed in January 2002.

In mid-2002, approximately 48 banks remained in Serbia (compared to 86 banks a year ago) after a number of banks had been closed, or merged, or put in the process of liquidation. Some 15 banks are currently in the process of rehabilitation under the BRA. A common feature of these 15 banks are a huge share of outstanding liabilities that resulted from Paris and London Club debt as well as from frozen foreign currency deposits. During 2002, the Serbian authorities elaborated a plan to restructure these banks on the basis of a debt workout. In August, the government executed debt equity swaps in these banks that put 9 of these banks into majority and 6 into minority state ownership. The authorities have begun to formulate a strategy for the efficient transfer of government shares in these 15 banks to private ownership in 2003 after writing off bad loans owed by enterprises with good potential for privatisation. In the meantime, the government and the NBY will put in place enhanced management, control and monitoring mechanisms to preserve the value of these banks prior to their privatisation.

Following the adoption of new banking legislation in *Montenegro* at end-2000, all banks were subjected to on-site assessments and applied for new licences. Seven banks had been re-licensed, and two new licenses were issued, one of which for a bank with private ownership. The government's decision to rehabilitate the largest bank, Montenegro Banka, was taken in late December 2001and in early 2002 the government assumed € 11.5 million guaranteed liabilities in exchange for non-performing assets of € 24 million. The authorities intend to privatise the bank in early 2003.

International Relations

Relations with IFIs. Following the political and democratic changes in the Federal Republic of Yugoslavia (FRY) in October 2000, the FRY authorities made considerable progress in establishing links with international organisations and in particular in normalising the country's financial relations with multilateral and official bilateral creditors. In October 2001, the FRY cleared all its outstanding arrears towards the European Investment Bank (EIB) of some € 232 million and thus paved the way for the inclusion of the FRY in the guarantee mandate for external action of the EIB and the subsequent start of first lending operations for investment projects.

An IMF Extended Arrangement for 2002-2005 of about USD 860 million was adopted in May 2002. The first programme review started in October 2002 and the Fund was expecting to successfully complete it in early 2003. The World Bank disbursed a first Structural Adjustment Credit (SAC) to support reform measures in the area of health and education in March 2002, amounting to USD 70 million. A second SAC of USD 85 million in support of privatisation, enterprise development and sound financial systems was approved by the World Bank's Board in end-May 2002. A third SAC to support social programmes (USD 70 million) is programmed for later in the year or early 2003. In addition, some USD 30 million in grant assistance as well as USD 30 million under IFC projects are expected to be disbursed in 2002. The process to develop a Poverty Reduction Strategy was launched in April 2002 and; interim strategies were adopted by the authorities of Serbia and Montenegro in mid-2002.

EC assistance. Apart from general Community support provided under the CARDS programme (€ 630 million in 2000-2002 to support among others institution building in public administration and sector reforms in energy and transport), the Community supported the process of economic reforms in the FRY through the provision of macro-financial assistance of € 345 million, of which € 120 million were provided in the form of grants, in the context of the IMF stand-by programme adopted in June 2001. The first tranche of this assistance amounting to € 260 million (comprising € 225 million loan and € 35 million grant) was released in October 2001. The second (grant) tranche of € 40 million was disbursed in January 2002, following a satisfactory review of conditionality and the signature of a Supplemental Memorandum of Understanding (SMoU), which specified the economic and structural policy conditions for the payment of the third (grant) tranche of € 45 million. In August 2002, the third and final tranche was released after the FRY authorities had satisfactorily met the SMoU conditionality. In early November 2002, the Council decided to provide to the FRY further Community macro-financial assistance of up to € 130 million, of which € 75 million in the form of grants. The objective of this assistance is to underpin economic policies in the context of the IMF Extended Arrangement, and in particular to support the balance of payment and strengthen the foreign exchange position of the country.

Stabilisation and Association Process. Working groups of EC and FRY technical experts have met five times from July 2001 to July 2002 to assess the state of progress on political, economic and sector reforms. The next step in the process would be the preparation by the Commission of a Feasibility Study on the feasibility of embarking upon negotiations on a Stabilisation and Association Agreement. The timing depends on progress with reform implementation, but also on the finalisation of the new Constitutional Charter as well as an Internal Market Action Plan (see box 4).

Box 4. The Belgrade Agreement

On 14 March 2002, representatives of the federal government, Serbia and Montenegro signed a framework agreement on "Proceeding points for the restructuring of relations between Serbia and Montenegro" (the "Belgrade Agreement"). It committed the two republics to remain together in a constitutionally restructured "State Union of Serbia and Montenegro". The signing was witnessed by EU High Representative, Solana, and was the end-point of continuing efforts on the part of the EU to preserve a single state and avoid a further fragmentation of the Western Balkans.

The agreement foresaw the establishment of joint functions and institutions: a president to be elected by a unicameral parliament and a Council of Ministers responsible for foreign affairs, defence, international and internal economic relations and the protection of human and minority rights. The agreement also allowed for a shared representation among the two republics in federal ministries and international organisations.

The signed agreement was ratified in the federal and both republican parliaments. However, the agreement is not very detailed and left much to be defined in further negotiations. Its full implementation requires the development, adoption and implementation of a **new Constitutional Charter** to be adopted by all three parliaments at a later stage.

On economic issues, the agreement obliges member states to establish a common market with a free flow of people, goods, services and capital. Existing problems should be addressed through a harmonisation of the economic system, primarily in the area of trade and customs. This is being addressed through the development of an **Internal Market / Trade Action Plan** on economic harmonisation.

The development of and negotiations on a new Constitutional Charter as well as on an Internal Market / Trade Action Plan were to large extent facilitated through EU experts. Delays occurred, however, during summer 2002 and again in the run-up to the Serbian presidential elections in September and the Montenegrin parliamentary elections in October. At the time of writing, no agreement has been reached either on a new draft Constitution or on a comprehensive Action Plan.

7. Kosovo (FRY)

- **Economic activity is still fuelled by donor funded reconstruction. Despite first signs of a shift from retail trade to other economic activities including manufacturing, this trend is still too weak to have a sizeable impact on exports.**

- **The challenge for Kosovo will be to design economic and financial policies so as to achieve medium-term sustainability, which will entail to move towards sustainable public finances, to enhance control and restructuring of public enterprises and to create a favourable business environment.**

- **The establishment of the Kosovo Trust Agency (KTA) will allow for enhanced transparency and accountability of enterprises and is expected to drive the privatisation process forward. The legal framework and law enforcement still need further strengthening.**

- **UNMiK and the PISG need to follow EU-compatible practices in the political, economic and sectoral reform processes. The SAP Tracking Mechanism shall serve as an instrument to monitor and drive the reform processes.**

Table 11. Kosovo – Main Economic Trends. 2000 - 2002

		2000	2001	2002[p]
Real GDP growth	*Percent*	na	11.0	7.0
GDP deflator	*Percent*	na	11.3	6.5
GNP/GDP ratio	*Percent*	145.9	139.3	133.1
Consumption	*Percent of GDP*	163.9	147.3	141.2
Investment	*Percent of GDP*	67.8	54.1	43.7
Kosovo consolidated budget balance	*Before grants - Percent of GDP*	-6.6	1.3	-6.1
	After grants - Percent of GDP	1.3	4.9	-5.6
Kosovo integrated budget balance	*Before grants - Percent of GDP*	-51.0	-32.3	-26.8
	After grants - Percent of GDP	1.3	4.9	-5.6
Trade balance	*Percent of GDP*	-68.5	-47.3	-50.2
Current account balance	*Percent of GDP*	5.8	9.1	-2.0
Foreign direct investment	*Million €*	0	5	10

[p] Projections. *Source:* IMF, World Bank, Ministry of Finance and Economy.

Macroeconomic developments

According to available data, economic activity rebounded strongly in 2001, with real GDP growth in the order of 11%. Partly reflecting the reduction of international presence and donor assistance, the IMF and the authorities expect the real growth rate to descend to some 7% in 2002 and 4.5% in 2003. Reconstruction is still going on, agriculture is recovering and there is a vibrant private service sector. There are indications of a shift from retail trade to other economic activities including manufacturing, albeit on a level too low to have a sizeable impact on exports. The high unemployment (according to the authorities in the order of 50%) and the weakness of the social security system remain challenging issues. Inflation (GDP deflator) was expected to decline from 11.3% in 2001 to 6.5% in 2002.

The provision of public services has improved but public utilities, notably the energy utility, continue to suffer from unreliable supply and still very low cost recovery. The situation in the energy sector has been aggravated again by a lightning strike in July 2002, which seriously damaged one power plant. As regards infrastructure, the improvement of road quality is visible but the main arteries suffer from degradation due to the permanent use of heavy traffic including military. Nearly 100% of the rail track is considered operational, which is reflected in increasing passenger and freight flows. Telecommunication largely relies on the mobile network but the PTK (Post and Telecommunication company of Kosovo) is preparing investment programmes to upgrade the fixed line network.

Budget performance. The final outcome of the Kosovo budget 2001 was better than initially expected owing to a favourable combination of economic growth, the introduction of VAT and improved taxpayers' compliance. Domestic revenues reached € 292.2 million, thus slightly exceeding total committed budget expenditures (€ 287 million) for the first time. This surplus adds to disbursed donor assistance of € 76m and to the positive cash balance carried forward from 2000 (€ 27 million). In early 2002, the accumulated cash balance thus reached some € 100 million.

Box 5. Kosovo – Institutional framework

Following the elections of 17 November 2001, the establishment of the Provisional Institutions of the Self-Government in Kosovo (PISG) in March 2002 has changed the political and institutional structures in Kosovo. Based on the UNMiK Regulation establishing "A constitutional framework for provisional self-government in Kosovo" of 15 May 2001, policy-making is now divided into two spheres: the functions transferred to the PISG and the functions reserved to the SRSG (so-called "reserved powers"), while leaving ultimate power under UNSCR 1244 with the SRSG[9].

This new division of responsibilities is reflected in the Kosovo General Budget 2002 (approved on 22 December 2001, UNMIK Regulation no. 2001/37). It consists of three parts: the PISG, the reserved powers under the SRSG and the municipalities. The Central Fiscal Authority (CFA) will maintain an overall supervisory role but the Ministry of Finance and Economy (MFE) is responsible for the implementation of the budget allocated for the PISG[10]. The CFA and MFE with the help of the IMF recently adjusted the original presentation of the budget by consolidating the different schedules along international standards and summarising all capital investment. The donor-financed Public Investment Program (PIP) covers most of the capital investment spending but is essentially outside the budget.

For 2002, economic growth, the introduction of modern taxes (like income and profit tax) and the broadening of the tax base contribute to a further increase in expected

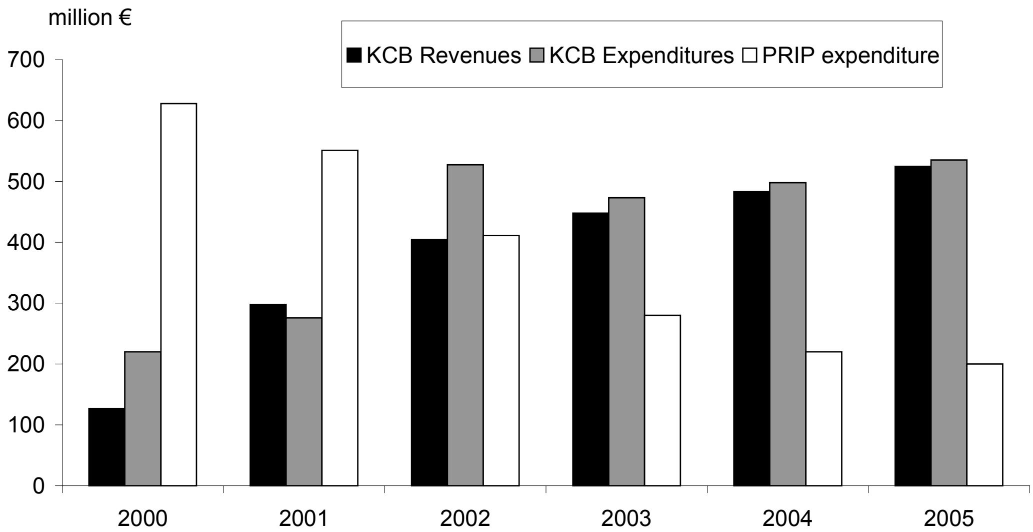
[9] Based on UN Security Council Resolution 1244 of 10 June 1999, the International Community has set up an international security presence (KFOR) and an interim civil administration - the United Nations Administrative Interim Mission in Kosovo (UNMIK). UNMIK is headed by the Special Representative of the UN-Secretary General (SRSG).

[10] There is commitment to merge the CFA and MFE by the end of the year but the definition of powers reserved for the SRSG have still to be decided.

domestic revenues: based on the mid-year review, revenues estimates have been revised upwards by some 16%, now totalling € 415 million. This positive development allowed for an increase in budget expenditure devoted to a large extent to the establishment of a government structure. Total consolidated government expenditures are expected to rise by € 29 million (5.8%) totalling € 536.4 million. This evolution is mainly due to transfers to KEK as a consequence of the accident in the energy sector, to wages and salaries, and to the proposed increase of the basic pension payment (from € 20 to € 28 per month).

As a consequence, the overall deficit before grants including the one-off capital expenditure related to the use of the accumulated cash balance totals € 121.5 million. Expected grants of € 10 million and the carried over cash balance shall reduce the residual financing needs to about € 17 million. Adding the foreseen outlays for the Public Investment Programme (PIP) of a revised € 410.5 million results in the Kosovo Integrated Budget (KIB). The financing gap remains unchanged since PIP expenditure are already funded by donor grants (see also chart 10).

Chart 10. Kosovo - Integrated budget. 2000 - 2005



Source: IMF, World Bank, national sources

Monetary issues. Kosovo does not carry out a monetary or exchange rate policy since its de-facto currency has been the DM, followed by the euro since the successful conversion in the beginning of this year. Deposits in the banking system peaked in December 2001 essentially a consequence of the conversion to euro[11]. Since then, deposits shrank but seem to have stabilised by mid-year. Even though the loan portfolio of banks more than doubled by June 2002 compared to December 2001, loan activity in general remains constrained - it corresponds to 15% of deposits - reflecting the limited maturity available (essentially below 12 months) at rather high interest rates.

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[11] Already in September 1999, UNMIK legalised the use and possession of any foreign currency in Kosovo. Without being explicit, the regulation recognised the fact that Kosovo at the time was and still is a largely cash-based economy with the deutsche mark being the preferred currency in Kosovo.

External sector. Economic activity is still fuelled by donor funded reconstruction resulting in considerable official transfers and a huge trade deficit in the order of 79% in 2000 and 60% in 2001. Despite first signs of a shift from retail trade to other economic activities including manufacturing, the economic recovery is still too weak to have a sizeable impact on exports: they amounted to less than 3% of GDP in the first half of 2002 and 1-2% in the first half of 2001 and 2002. Owing to the official transfers, remittances and factor income from donor-related employment, the current account shows a surplus (5.8% of GDP in 2001 and 9.1% in 2002).

Structural Reforms

Financial sector development. As of June 2002, the Banking and Payments Authority of Kosovo (BPK) had fully licensed seven commercial banks in Kosovo operating 35 branch and 32 sub-branch offices. Given the expansion of operative banks, the BPK as planned has transferred the provision of the payments system to commercial banks and only retains inter-bank settlement functions. As of July 2002, about 60% of wage payments were effected on a non-cash basis through bank accounts, which represents a considerable progress. In this process, the BPK closed down most of its branches. As regards the insurance sector, BPK so far licensed 6 companies and is setting up financial rules for sound management and accountancy. Insurance products remain limited to insurance against third-party liabilities. Once the rules for the investment policy of insurance companies are defined, the challenge will be to enable domestic investment possibilities.

Enterprise restructuring and privatisation. As of 1 July 2002, the Kosovo Trust Agency (KTA), formally established in mid-June 2002, had taken over the control over all public enterprises previously shared among Pillars. The KTA was granted wide responsibilities: authority and rights of a trustee, the administration of all public enterprises (55), including public utilities, and "socially owned enterprises" (SOEs, up to 550), the transfer of assets to new companies ("spin-off approach"), the liquidation of enterprises and initiation of bankruptcy proceedings. Only SOEs will be privatised. The KTA is expected to play a key role in enterprise reform and privatisation. Its Charter, by-laws and Operational Policies have been prepared and are being discussed by its Board.

65 SOEs were already evaluated and classified according to viability criteria. As a result, the KTA has targeted a first wave of 27 SOEs for privatisation, to be initiated in the fourth quarter of 2002, to be followed by a second wave of 13. There seems to be a widespread overestimation of the actual value of SOEs and the expected revenues. This may have to do with the fact that according to a recent UNMIK report these large enterprises do not pay taxes and rents and make large profits by renting out their premises. It is estimated that only 20% of the SOEs can be privatised as going concerns. The receipts of privatisation shall be kept on trust accounts until any possible claims have been settled. Bold decisions have to be taken and the future sale agreements are expected to focus on long-term commitments in investment and employment creation rather than on sales prices.

Audits of public enterprises could not be undertaken before the transfer of the enterprises to the KTA. Audits on KEK (the Kosovar Electricity company), PTK and Pristina airport are currently being carried out; within the next 4-6 months other major enterprises are due to be audited, too. In the past, the IMF and the Commission expressed similar concerns on the lack of control over sizeable funds held, in particular with the PTK, outside the budget. The KTA is preparing plans for a restructuring of public enterprises, including their incorporation. A regulation establishing a legal framework in the energy sector is being implemented. A new supervisory board in KEK in conjunction with the EAR (European Agency for Reconstruction) funded management support programme should pave the way for substantial improvements in this area.

Progress in the commercial law framework has been slow in the last 18 months. Even though a number of draft regulations had been completed and transmitted for legal clearance, the legislative progress was seriously hampered by the preparation of the elections in November 2001 and subsequent delays in establishing the Provisional Institutions of Self-Government (PISG). According to the Constitutional Framework, economic legislation is part of the powers transferred to the PISG and thus the Kosovo Assembly is assigned with its adoption. Following its establishment, UNMIK passed on the drafts to the Kosovo Assembly, which announced its commitment to deal with it as a priority but no decisions have been taken.

International Relations

External financing. Under its current status, Kosovo does not benefit from the IMF or World Bank under conventional programmes. However, since the end of the conflict, IMF and World Bank staff have been providing technical assistance and policy advice. The World Bank has also provided selective financial support on a grant basis for reconstruction and rehabilitation, including budgetary support.

Kosovo's needs for capital investment remain high. Given a foreseeable trend of declining donor grant funds, Kosovo is confronted with the need to secure other sources of finance so as to continue its capital investment plans. Since commercial lending is not expected to be an immediate option for sizeable projects, access to other sources of finance, such as lending from IFIs, including from the EIB, would be critical for Kosovo's long-term development. Any domestic or external borrowing of Kosovo has to be based on a strong revenue base and a sufficient capacity to service debt so as not to endanger fiscal sustainability.

EC Assistance. By 2002, the Community supported Kosovo with two exceptional financial assistance packages. A first grant of € 35 million, approved in February 2000, was disbursed in two instalments in 2000 as part of a broader Community assistance package of € 360 million (including support for infrastructure (notably energy), agriculture, housing, health and enterprise development). Another grant of up to € 30 million was approved in June 2001: a first tranche of € 15 million was released already in September 2001, and the remainder is expected to be disbursed by the end of the year 2002. These funds are provided in parallel to € 315.5 million committed under CARDS assistance in 2001 (inter alia for infrastructure (notably energy), agriculture, housing and local government) and € 135.4 million in 2002 (notably energy, institution building, housing and economic development).

Stabilisation and Association Process. Notwithstanding the unresolved status question, both UNMiK and the PISG should ensure to follow EU-compatible practices in the political, economic and sectoral reform processes in Kosovo. To this end, the SAp Tracking Mechanism has been established as an instrument to monitor and drive the reform processes. A first seminar was held in Brussels in November 2002 to begin a deeper technical relationship with the institutions in Kosovo, explaining the EU and its policies, particularly towards Kosovo.

8. Former Yugoslav Republic of Macedonia (fYRoM)

- **The 2001 security crisis severely affected the performance of the economy in the former Yugoslav Republic of Macedonia (fYRoM). In 2001, GDP fell by more than four percent and the general government balance sharply worsened, but monetary stability was maintained and the external anchor to the euro was successfully defended.**

- **In 2002, the economy should post a mild non-inflationary recovery, while the general government balance should also improve with respect to the previous year.**

- **Opposition parties won the September 2002 parliamentary elections. One of the first tests of the newly established Government will be to agree an economic policy programme with the IMF, to be supported by a stand-by arrangement.**

- **During 2002, the process of institutional reform that is supported by the Stabilisation and Association Process has resumed. The fYRoM is expected to improve the implementation of the new legislative framework and to fulfil the commitments of the Interim Agreement with the EU and the Framework Agreement.**

Table 12. FYRoM - Main Economic Trends. 1998 - 2002

		1998	1999	2000	2001	2002[p]
Real GDP growth	*Percent*	3.4	4.3	4.6	-4.1	0.0-0.5
Inflation rate	*Percent (average)*	0.8	-1.1	5.8	5.5	3.0
	Percent (end-of-period)	-1.0	2.3	6.1	3.7	2.5
Unemployment rate	*Percent of labour force*	34.5	32.4	32.2	30.5	30.5
General government balance	*Percent of GDP*	-1.7	0.0	2.5	-6.0	-4.7 [(1)]
Trade balance	*Percent of GDP*	-11.2	-10.6	-15.5	-11.7	-11.4
Current account balance	*Percent of GDP*	-9.9	-5.1	-3.1	-10.8	-9.7
External debt	*Percent of GDP*	40.1	40.6	41.5	41.5	42.4
	Billion €	1.2	1.5	1.6	1.6	1.6
Debt–export ratio	*Percent*	109.8	125.2	112.8	124.7	126.6
Foreign direct investment	*Percent of GDP*	4.7	0.7	4.9	13.2	2.0
	Million €	150	23	190	498	76

[p] Projections. [(1)] IMF May 2002 revision. *Source*: National sources, IMF.

Macroeconomic developments

The fYRoM gained its independence from the former Yugoslavia in 1991. During the first half of the nineties the economic growth of the country was negatively influenced by the instability in the region. In the second half of the past decade, the fYRoM achieved macroeconomic stabilisation, bringing down inflation rates to a single digit and setting the stage for resumption in growth. Economic growth reached its peak in 2000 (+4.6%), but it was abruptly halted by the outbreak of the security crisis during 2001.

In 2001, real GDP dropped by 4.1% and industrial output declined by 3.1% on annual basis because of the uncertainty, risk and disruptions created by the unrest and fighting in the north-west area of the country in the first half of the year. The crisis took a heavy toll on the steel, the chemical and the tobacco industry, and on the textile sector. Total agricultural production decreased by 13.1% (preliminary data), also as a consequence of unfavourable weather conditions towards the end of the year.

Growth should resume during 2002, as a result of a rebound effect after the crisis–related recession of the previous year. In the first six months of 2002, according to official national sources, industrial production fell sharply by 11.2% compared to the same period of the previous year, due to the combination of internal and external factors, such as the closure of loss-making companies and the slowdown of the world economy. However, in June 2002, industrial output rose by 2% on annual basis, showing the first positive growth rate since December 2000. The authorities forecast a slow GDP growth of 0.5% during 2002. Nonetheless, this partial recovery might be fragile and should be supported by structural reforms of the economy, in order to raise, in particular, the competitiveness of exports.

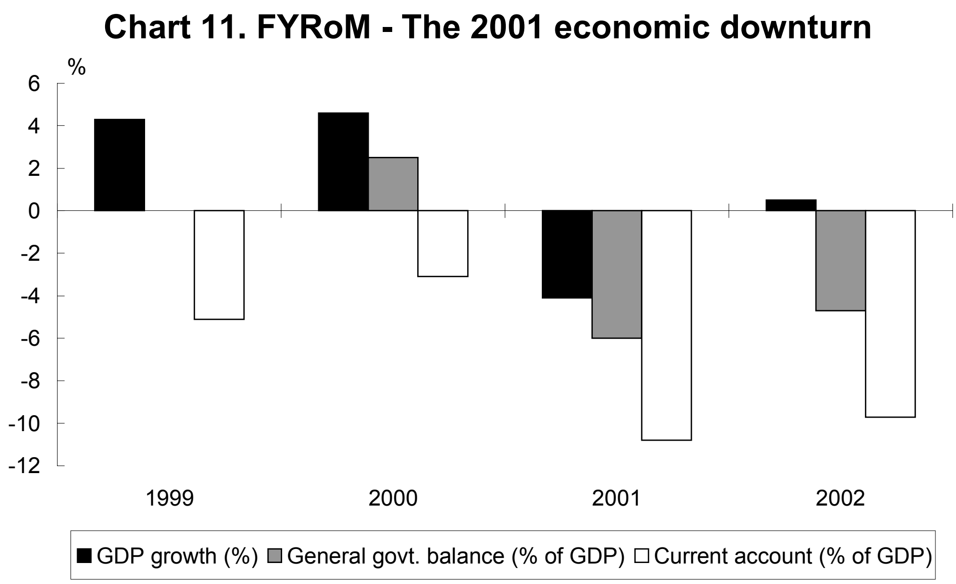
In spite of the 2001 recession, the official unemployment rate declined from 32.2% in 2000 to 30.5% in 2001. This result may be attributed to the enrolment in the security forces of young unemployed people and to changes in statistical methods. Interpretation of these data and trends deserves special care, as the informal sector has a significant role in the fYRoM economy.

Fiscal situation. The fiscal position worsened markedly in 2001, given the increase in expenditure for military and security purposes and the lower than expected revenues caused by the slowdown of the economic activity. The general government budget recorded a deficit of around 6% of GDP. With respect to the previous year, total expenditure as percentage of GDP increased by 6.2% and total revenues fell by 2.3%. The fall in revenue was partly mitigated by the introduction of a temporary tax on financial transactions in mid-2001, which generated a significant source of revenue, equal to 1.3% of GDP or almost 4% of total revenue in 2001.

In 2002, the fiscal position is expected to improve with respect to the difficult previous year, owing to reduced security-related expenditures and higher than expected revenues. Revenues have been boosted by the favourable VAT collection and the temporary tax on financial transactions, which expires at the end of the year and, most likely, will not be subject to a further extension. In spite of some expansionary expenditure measures - such as the average increase by 10% in public sector wages and the decision to compensate depositors for the lost savings in the 1997 collapse of the pyramidal saving house TAT – the authorities estimate that the general government deficit should decrease to 3% in 2002. According to the IMF, the deficit should be higher and reach 4.7% of GDP.

Monetary policy. Notwithstanding the difficult conditions of 2001, the National Bank managed to defend the anchor of the denar to the euro[12] and secure price stability. At the end of 2001, the year-on-year increase in consumer prices was 3.7%, bringing the average inflation rate to 5.5% over the whole year. During the first eight months of 2001, the National Bank intervened on the foreign exchange market buying domestic currency in order to defend the parity, selling around € 156 million of its foreign reserves. At the same time, the National Bank tightened the monetary policy, increasing interest rates and reserve requirement rates. In June, the interest rate on 28-day bills of the National Bank, the main instrument to control liquidity in the money market, peaked to 20%. The signature of the Ohrid Framework Agreement, on 13 August 2001, settling the ethnic conflict, eased the tension in the foreign exchange market and allowed the National Bank to rebuild its foreign currency reserves. The latter reached the equivalent of € 880 million at the end of 2001, and continued to grow during the first half of 2002, rising up to € 884 million – about six months of imports of goods and services – at the end of May.

Since November 2001, the National Bank started easing the monetary policy, lowering the rate on 28-day CB bills to 15%. During the first half of 2002, the 28-day reference rate of the central bank bottomed out at 13%, while consumer prices increased on average by 2.5% compared to the same period of the previous year, implying high real interest rates and a relatively tight monetary policy. The authorities forecast average inflation at around 3% for the whole year 2002.



Source: IMF, national sources

External situation. Since the mid-nineties, the fYRoM has recorded large trade and current account deficits and has relied on official donors' assistance to finance these

[12] Turbulence on the foreign exchange market started in Spring 2001 and the nominal exchange rate of the denar reached its highest value against the euro (MKD 66 per euro) in the second decade of June. In the second half of 2001, the exchange rate returned towards its long-run trend of MKD61 per euro.

deficits. In 2001, the contraction of economic activity brought a reduction in the foreign trade by 16.5% with respect to the previous year. Imports fell more than exports, improving the trade deficit, which however remained large and reached € 472 million, corresponding to more than 12% of GDP. As official and private transfers and GDP dropped because of the security crisis, the current account deficit as share of the GDP soared from 3% in 2000 to more than 10% in 2001. Foreign direct investment was boosted by the privatisation of the national telecommunications operator in early 2001 and reached € 498 million by the end of the year, corresponding to more than 13% of GDP. These non-recurring hard currency privatisation receipts played a key role in weathering the economic impact of the security crisis. In 2001, foreign debt as a percentage of GDP levelled off at around 42%.

External deficits are expected to remain high in 2002. The trade deficit rose by more than 60% in the first semester 2002 compared to the first half of 2001, reaching almost € 350 million. A sharp increase in exports would be needed over the second half of the year to meet official projections that had anticipated an improvement of the deficit in 2002. Given the current trend, this improvement appears unlikely and the 2002 trade deficit is expected to exceed its 2001 level. Due to an expected increase in public and private transfers, the current account deficit should slightly decline to 9.7% of GDP in 2002 (without taking into account donors' financing), compared to a deficit of 10.8% in 2001.

Trade liberalisation. The fYRoM is a small open economy, with a GDP of € 3.85 billion at current market exchange rate, representing around 0.04%, of EU-15 GDP (2001), and a share of foreign trade to GDP equal to 100% (2000). The country has reinforced its vocation to trade openness by signing a Stabilisation and Association Agreement (SAA) with the EU in April 2001 (the first country to sign such an agreement), which was followed by the entry into force of the Interim Agreement on trade and trade-related matters in June of the same year[13]. Regional integration was strengthened through the establishment of several free trade agreements with neighbouring countries[14]. In mid-September 2002, the Working Party on the accession of the fYRoM to the WTO has completed the negotiations, removing the remaining obstacles to the participation of the country to the WTO, which is expected in Spring 2003.

Structural reforms

Public administration reform. The reform of public administration is one of the authorities' priorities. In April 2002, the World Bank's Board approved a Public Sector Management Adjustment Credit (PSMAC) of USD 15 million to the fYRoM, which aims to improve fiscal sustainability and enhance rationalisation, transparency and accountability of resource use. The authorities have already begun a functional analysis of Government activities in order to identify non-essential functions, which may be

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[13] The EU remains the major trading partner of the fYRoM. In 2001, the EU was the destination of 49% of fYRoM total exports, and was the origin of 42% of fYRoM total imports.

[14] The fYRoM signed free trade agreements with Slovenia, FRY, Croatia, Turkey, Bulgaria, Ukraine, Albania and BiH; and initiated negotiations with Romania.

hived off and carried out by the private sector or eliminated. The authorities should also reinforce the control of the wage bill and implement wage decompression in order to grant adequate incentives to public sector employees and retain technical expertise in the administration.

The reform process made some progress in the area of public expenditure management. The reform of the treasury system was launched in 1999. At present, a treasury single account, identifying all budget users, as well as a system of internal auditing are being introduced but are not fully operational. Nevertheless, the main challenge in the area of fiscal reform is the development of decentralised government, which is one of the major commitments envisaged by the 2001 Ohrid Framework Agreement. In January 2002, the parliament adopted a Law on Local Self-Government which defines a broad set of municipal responsibilities. The implementation of this law depends on the adoption of a new Law on Local Government Financing, which will establish the share of fiscal resources that local governments may manage and retain, as well as on the adoption or modification of up to other eighty relevant laws.

According to several sources, corruption is widespread in the country. The authorities acknowledged the gravity of the problem and, in April 2002, approved an Anti-corruption Law, which provides for the establishment of an independent State Commission that is accountable to the Parliament. On 12 November 2002 the Parliament elected the members of this Anti-corruption Commission, which held its constitutive session on 18 November.

Enterprise reform. The 2001 security crisis caused a temporary setback in the process of enterprise restructuring and private sector development. So far, the major achievements have been in the area of small-scale privatisation, where the process is close to completion, with 95% of small and medium enterprises that entered the programme already privatised. On the contrary, the problem of several large loss-making enterprises still has to be addressed. In 2000, the government had launched an Action Plan, which identified 40 companies to be restructured, privatised or liquidated. The initial intention was to restructure the majority of these companies; nevertheless the restructuring has been complicated by the companies' accumulation of losses over the years and, now, most of the firms are heading towards liquidation. The authorities now expect to find a solution – i.e. liquidation of most of them – for 26 of these firms by the end of 2002 and then to complete the overall process by the end of 2003. In September 2002, Jugohrom - a large metallurgical company that used to employ almost 2,000 people and which, in 1999, showed the largest loss of all the firms covered by the Action Plan – was sold to the French company "SCMM".

Financial sector reform. During the past few years, the banking and the financial sector has undergone a significant reform process. In 2000, a new Banking Law was adopted. In 2001, the National Bank focused on the implementation of the new legal regulatory framework, issuing directives for the uniform application of the core Basle principles and practices for banking supervision. In 2001, the parliament approved a law on Money Laundering Prevention. In 2002 the central payment system operated by the Payment Operations Bureau was abolished and the Law on the National Bank of the Republic of Macedonia was approved. The banking system has been almost completely privatised – about 84% of the total capital of banks is private – and remains significantly concentrated, as the two largest banks control about 55% of total assets. However, the sector continues to suffer from structural problems such as lack of lending activity, resulting in a high liquidity situation – the capital adequacy ratio is equal to 25.9%, according to the latest information. High spreads between lending and deposit rates – about nine percent – show that the banking system is not competitive enough, while the volume of bad loans – around 20% of credit exposure – remains high.

International relations

Relations with the IMF. The IMF Poverty Reduction and Growth Facility and Extended Fund Facility programme, which was approved in 2000, went off track in the first part of 2001. In December 2001, the fYRoM authorities and the IMF agreed a six-month Staff Monitored Programme (SMP) providing a macro-economic framework, with a view to laying the groundwork for a new upper credit tranche arrangement by the end of June 2002. In May 2002, the authorities failed to reach an agreement with the IMF on a new stand-by programme. The two parts disagreed on the impact on medium-term fiscal sustainability of the decisions to unfreeze wages in the public sector without reviewing the wage structure and to compensate depositors in failed pyramid schemes. In mid-November 2002, the new government that was formed after the elections resumed the technical negotiations on a new Stand-by arrangement.

EC and donor assistance. In March 2002, foreign donors, including the European Commission and the World Bank, pledged € 172.6 million for 2002 balance of payments support, € 85.9 million for reconstruction and rehabilitation in conflict affected areas and € 50.4 million for the implementation of the Ohrid Framework Agreement in 2002, totalling € 308.8 million. Additionally, donors pledged € 274 million for other development assistance in 2002.

The Commission has already implemented part of the macro-financial assistance decided by the Council in November 1999 (€ 80 million), which was increased by € 18 million in December 2001, bringing the total assistance to up to € 98 million. After the disbursement of € 30 million in December 2000/January 2001, a second tranche of € 22 million was disbursed in January 2002. The release of the outstanding amounts pledged for balance of payments support – up to € 46 million – is dependent on the conclusion of a new stand-by agreement with the IMF, as well as the satisfactory implementation of economic policy conditions, which have been agreed with the authorities in Summer 2002.

Under the current CARDS programme, the fYRoM benefited from around € 56 million of EC assistance in 2001, and almost € 42 million in 2002. The EC focuses its intervention on the areas of economic and social development, democracy and the rule of law, and justice and home affairs.

Stabilisation and Association Process. The coming into force in June 2001 of the Interim Agreement on trade and trade-related matters with the EU represented an important step in the country's effort to move closer to the EU. The 2001 security crisis slowed down the process of institutional and legislative reform, which resumed during 2002. Improvements are expected in the implementation of the Interim Agreement and in the fulfilment of the obligations of the Framework Agreement, as well as in the fight against corruption and the reform of the judiciary system.