USAID/Serbia

Annual Report

FY 2005

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Serbia

Performance:

Background: Serbia is one of two republics in the State Union of Serbia and Montenegro. The latest census carried out by the Serbian Republic Statistical Office in 2002 counted a population of 7.5 million (excluding Kosovo), more than 12 times larger than its sister republic Montenegro. The ethnic composition is considered to be predominantly Serbian (82.86%) with the Montenegrin population comprising less than 1%. The rest of the population is made up of Hungarians (3.91%), Bosniaks (1.82%), and Roma (1.44%). Around 1.08% declared themselves as Yugoslavs, and a further 16 listed ethnicities are all under 1%. Refugees and internally displaced persons (IDPs) make up around 6.7% of the population.

Serbia has made important strides in laying the foundation for democratic consolidation and economic transition, but significant challenges remain. It is essential that the citizens of Serbia begin to quickly receive sustainable economic, as well as political, benefits from the break with the country's authoritarian past. Otherwise, the Serb people will be increasingly susceptible to pressure to reject a transparent and inclusive democratic system and to renew nationalistic calls that inflame ethnic, religious, and cultural differences.

FY 2004 saw a quickening recovery of Serbia's economy. After low economic growth of 2% in 2003 due to drought and industrial sector weakness, GDP (driven primarily by agriculture, manufacturing, retail trade, construction, and financial services) is projected to grow by 6% or more in 2004, the highest since 1997. Industrial production growth of 10% in 2004 was directly linked to successful privatized companies, particularly those with foreign investment. Inflation increased slightly after a three-year decline, but is expected to remain contained at 11% to 12% for 2004. This rise was driven by a combination of external pressures due to higher world oil and commodity prices and continued strong growth of aggregate demand in the economy due to higher growth of real wages and consumption over productivity. Imports continued strong growth of about 42%. Total foreign exchange reserves remain solid and stable at a value equal to nearly five months of imports, bolstered by large unrecorded remittances from abroad.

Serbia's external debt picture improved substantially with the July 2004 conclusion of an agreement with London Club creditors to write-off 62% of $2.7 billion and to reschedule the remainder over 20 years. The debt burden remains heavy but not unmanageable, with total debt at $14 billion. The preparation of a provisional country risk rating by Standard & Poors (S&P) was critical to the London Club negotiation, and led to Serbia receiving its first-ever international credit rating of B+. Publication of the rating has increased interest in Serbia among investment banks and opened doors to new capital for Serbia's quickly developing commercial banking system. The full reintegration into international capital markets resulting from the London Club deal and S&P rating will also provide enhanced financing options to foreign and local investors, and eventually for public finance. In the summer of 2003, the Serbian and Montenegrin governments managed to partially harmonize their economies in order to meet EU conditions for the Stabilization and Association Agreement (SAA). However, the EU stopped work on its SAA feasibility study in early 2004. Progress was stalled until September 2004, when the EU accepted a twin-track economic approach for Serbia and Montenegro that recognizes the states' fundamental economic differences, allowing work to begin again on the feasibility study, which is expected to be ready in early 2005.

After several months of negotiations, agreement on forming a Serbian government was finally reached in March 2004. Since then, Prime Minister Vojislav Kostunica and his Democratic Party of Serbia (DSS) have headed a fragile coalition of several small democratic parties in a minority government that depends on support from Milosevic’s nationalist and barely reformed Socialist Party of Serbia (SPS). Serbia’s first truly democratically oriented president, Boris Tadic, was elected in July 2004, following three failed presidential contests over the previous year. The elections pitted a well-organized group of nationalists with 30% popular support, led by Serbia’s nationalistic Radical Party (SRS), against a block of democratically oriented parties, together representing most of the other 70% of the population. Tadic was victorious in the second round of elections as a result of a concentrated effort of progressive political parties and reform-minded groups that sufficiently engaged and mobilized the Serbian democratic electoral body. The country, however, continues to struggle with weak and ineffective leadership due to continued internal divisions over policy and philosophy within the governing coalition led by PM Kostunica. Political debate remains focused on cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY), the status of Kosovo, and the Union with Montenegro. March saw the outbreak of the most intense inter-ethnic violence in Kosovo since 1999, causing significant material damage and loss of life, and further damaging relations between Serbs and Albanians. The conflict, however, did not spillover into the ethnically-mixed region of Southern Serbia, as many had feared.

USAID interests and goals: Once the strongest republic in the Socialist Federal Republic of Yugoslavia, Serbia remains the linchpin to stability in Southeast Europe. Resolution of the future status of both Kosovo and the Union with Montenegro has significant implications for ethnic fragility in neighboring countries such as Bosnia-Herzegovina and Macedonia. Cooperation with the ICTY is a leading concern for U.S. policy and a key criterion for continuing aid.

Donor Relations: The United States is Serbia's largest bilateral donor and coordinates its work closely with the Government of Serbia, other bilateral and multilateral donors, and international finance institutions. Other bilateral donors and their principal areas of focus include Germany (macroeconomic reform, municipal development through GTZ, infrastructure loans through KfW), Sweden (education and training, donor harmonization), Canada (social sector restructuring) and the United Kingdom (macroeconomic reform, local government). The primary multilateral donor in Serbia is the European Agency for Reconstruction (EAR), whose €212 million 2004 program focused on strengthening partnerships with the Government in the process of European integration, as well as fostering economic development and paving the way for investment from international financial institutions. Other multilateral donors include the World Bank (macroeconomic and public administration reform), the International Monetary Fund (fiscal and monetary policy), the European Bank for Reconstruction and Development (infrastructure and trade), the European Investment Bank (infrastructure) and the Organization for Security and Cooperation in Europe (civil society reform, rule of law). UNDP - with funding from the EAR, Germany, Canada, and the Netherlands - is working mainly in civil society development and the rule of law. Although humanitarian aid has dwindled significantly since 2000, a number of organizations such as UNHCR, the International Catholic Migration Commission, and the Danish Refugee Council still have small programs working with refugees and IDPs. On the strategic level, USAID participated in the Donor Coordination Group "Law in Transition," along with major bilateral and multilateral donors that jointly presented a list of critical laws to the new ruling coalition. On the program level, USAID staff and implementers participate in working groups in the areas of Southern Serbia, commercial law, and the rule of law. In 2005, the World Bank will introduce an investment project in order to compliment the work already undertaken by USAID in the area of pension reform.

Challenges: The democratic reform process has slowed considerably in the aftermath of the assassination of Prime Minister Zoran Djindjic in March 2003. Not only has Milosevic's SPS party entered into a coalition with the Government of Prime Minister Vojislav Kostunica and his Democratic Party of Serbia (DSS), but the nationalist Serbian Radical Party has continued to gain political power. Local elections in September 2004 gave anti-reform forces control or greater influence in 22 municipalities, including Novi Sad, the center of the northern province of Vojvodina and Serbia's second-largest city.

Following the dismissal of Parliament in late 2003 and continuing since the formation of the new government March 2004, civil society has found itself without a real political partner. A new Government draft law, which would finally provide a legal framework in which NGOs could operate, instead provides for more restrictive provisions than drafts under earlier discussion. The climate for independent media has also suffered considerable setbacks this year amid extralegal government maneuvering to stack the decks on the upcoming licensing processes in favor of state-favored private media established during the Milosevic period.

Despite intense international pressure, the Government has still failed to fulfill its obligations to cooperate with the ICTY, including failure to arrest or extradite a number of indictees. Against the backdrop of continuing questions about the status of Kosovo, dissatisfaction is increasing on both sides about the future relationship of Serbia and Montenegro in its current union. Under the strain of these unresolved political issues, and the ongoing drain of the poor economic environment, early and extraordinary elections are now expected in the first half of 2005.

Such political uncertainty fosters persistent low investment, which is exacerbated by macroeconomic risks (fiscal and trade deficits, high debt) and a still underdeveloped business environment. Establishing a business in Serbia remains inhibited by government bureaucracy, which makes the cost relative to GDP per capita to create and register a collateral agreement in Serbia among the highest worldwide. In a standard case, it took 51 days to go through the government procedures to start a business in Serbia, far above the transition country average of 43 days, the OECD average of 25 days, and the U.S. average of 5 days. Closing a business is also excessively difficult.

Serbia's key macroeconomic challenge remains the sustainability of external accounts in an environment of reduced but still significant foreign currency debt and a growing trade deficit expected to reach $7 billion in 2004. An associated concern is the persistent official current account deficit of 13% of GDP. Serbia also faces increased challenges in managing its fiscal burden with debt servicing due to increase in 2005 and ever increasing deficits of social benefits funds. Serbia currently spends about 14% of GDP on pension liabilities. Budget transfers of 6% of GDP to cover the outstanding pension fund deficit represent the single largest budget line item. Serbia's expensive and imperiled pension regime threatens to undermine its ability to reach fiscal sustainability in the future absence of donor inflows, and thus to meet external obligations. Although the government has taken positive steps to contain public sector spending, difficult decisions on deeper structural reforms are needed.

The process of enterprise restructuring in Serbia remained stagnant due to a lack of political leadership and a preoccupation with past privatizations. A more active and functional government would need to address the over 70 large socially- and state-owned companies that must undergo financial restructuring prior to privatization. Other pivotal challenges ahead are to preserve and consolidate macroeconomic gains through fiscal discipline and prudent monetary policy, tied to an increased focus on microeconomic issues that will increase job creation and spur economic development. Institutional strengthening to give ministries the capacity to implement new laws and regulations as well as legal and judicial reform remain critical in order to create an environment conducive to new business growth. Continuing progress in these areas along with simultaneous advocacy for resolution of the political issues will be the primary focus in the coming year.

Key achievements: US technical assistance has focused on strengthening the institutions necessary to sustain economic reform and support the development of a market economy. Achievements towards these ends include efforts in macroeconomic policy reform, fiscal reform, bank supervision, non-bank financial sector regulation, central bank strengthening, financial intermediation and credit mobilization for SMEs, preparation for WTO accession, building the competitiveness of Serbian enterprises, and commercial court capacity building. Accomplishments in community development and local government reform have focused on increasing citizen participation at the grassroots level and increasing the transparency and management capacity of local governments. Civil society and media continued to build their capacity while aiming for sustainability.

1. Commercial Legislation and Institutions: In July 2004, the Serbian National Assembly ratified 10 laws key to improving the environment for business development, investment, and economic growth, including fundamentally important legislation covering bankruptcy, company law, business registration, collateral and execution of court judgments. The new bankruptcy law will increase the speed and transparency of the liquidation of insolvent businesses and will help break one of the key constraints to economic recovery through facilitating large enterprise restructuring and privatization by easing the closure of unproductive portions of state- or socially-owned enterprises prior to sale. USAID technical assistance and funding for the new Business Registry Agency is helping to simplify the process for registering businesses. The agency will also host registries for collateral for secured lending and the leasing of equipment, which are critical for expanding access to credit.

2. VAT: An estimated 41% of Serbia's employable population works in the informal sector. The introduction of VAT on January 1, 2005, may do more to improve revenues and shrink gray market activity than any other single initiative. USAID advisors were instrumental in drafting the legislation and are directly involved in all key aspects of VAT implementation.

3. Competitiveness: Ten-plus years of sanctions cost Serbia fruit growers and processors their international market contacts, with devastating effects on one of Serbia's most important sources of export revenue. In FY 2004, the sector returned to the international scene in a series of high-profile milestones, including award of "best new fruit juice" to Vojvodina-based Fresh & Co at the World Juice Conference in October. In addition to investments and activities aimed in 20 European countries, the company is now holding final talks to market its products in the United States through the elite Whole Foods health food chain. Serbia's apparel industry, recognized for their innovation and quality, have seen similar successes in FY 2004 as they worked together to project a national brand and form a unified strategy for reaching international markets.

4. Judicial Reform: Special courts to combat both organized and war crimes have been set up following the Djindjic assassination. To date there have been approximately 12 organized crime indictments naming over 150 individuals, and the special courts have already begun trials of high-profile assassinations, including Djindjic and former Milosevic ally-turned-rival Ivan Stambolic. USAID is also supporting the first analysis of the true extent and causes of case backlogs in the non-commercial courts and improving the ethical and professional standards of judges, prosecutors, magistrates, and young lawyers. Recognizing that commercial courts are central to effective reform legislation, protecting U.S. business interests, and unlocking the potential of Serbia's economy, USAID also initiated a program to strengthen this special sector of the judicial system.

5. Democracy: Serbia finally elected a president in June following three failed attempts over the previous year. Civil society organizations, independent media outlets, and progressive political parties worked together on a major get-out-the-vote effort to help mobilize democratically oriented voters and elect a democratically oriented candidate. Enhanced press coverage of the election included broadcast of the first televised presidential candidate debate. USAID support also enabled daily reporting from the ICTY in The Hague, including live transmission of the Milosevic trial.

6. Community Revitalization: Almost 400 income-generation projects throughout 196 communities around Serbia were undertaken in FY 2004, for a total value of over $14 million. A third of these were in the agricultural sector, where USAID investments produced an increase of more than $5.3 million in sales. Three hundred and twelve micro-enterprise grants and 180 small-business grants assisted in the creation or expansion of small and micro-enterprises and the generation of new jobs. Such economic development activities generated 178,000 person-months of employment and $13 million in additional income.

7. Local Government: Thirteen Citizen Assistance Centers (CACs) and 12 One-Stop Permitting Centers opened in municipalities across Serbia. The centers have cut the average time for issuing building permits from 30 days to one-seven days and from seven days to one-three days for business permits. The time it takes to resolve social-services applications has been cut in half. Public-private partnerships to create Business Improvement Districts (BIDs) have also been established in four municipalities, one of which has already seen a 10% increase in employment and a 17% growth in business volume for restaurants and cafes.

For more information please visit www.usaid.org.yu.

Gender implications: In USAID's Interim Strategic Plan for Serbia and Montenegro gender is a key cross-cutting issue. The gender issue is integrated and institutionalized at all stages of Mission's work, e.g. policy or activity planning, implementation, and monitoring and evaluation.

Results Framework

169-0130 Accelerated Development and Growth of Private Enterprise
SO Level Indicator(s):
Serbia Ranking on WEF Growth Competitiveness Index
IR 169-0131 Financial and Banking Systems Stabilized and Restructured
IR 169-0132 State and Socially-Owned Enterprises Privatized
IR 169-0133 Commercial and Related Laws Enhanced and Strenghtened
IR 169-0134 Serbia and Montenegro/Serbian Economy Reconnected to International and Regional Market Networks

169-0200 More Effective, Responsive, and Accountable Democratic Institutions
SO Level Indicator(s):
Public Opinion Polls (% of Citizens in Opinion that Serbia is Moving in the Right Direction)
IR 169-0201 Capacity and Competitiveness of Independent Media Enhanced
IR 169-0202 Civil Society, Political Party, and Trade Union Capcity to Serve and Represent Citizen Interests
IR 169-0203 Rule of Law Increased

169-0210 Increased, Better Informed Citizens' Participation in Political and Economic Decision Making
SO Level Indicator(s):
% of SLGRP Municipalities in Which There is Citizen Input to Key Decisions (n=50)
CRDA Communities Mobilize at Least 25% of Project Costs
IR 169-0211 Citizens Improve their Living Conditions through Participation in Community Development Committees
IR 169-0212 Improved Interactions Between Citizens and Local Governments
IR 169-0213 Transparent Financial Management and Improved Service Delivery by Local Governments
IR 169-0214 Broadened Minority Participation in the Political Process and Decision-Making

169-0230 More Effective, Responsive and Accountable Local Government
169-0310 Humanitarian Community Services and Facilities
169-0410 Special Initiatives
169-0420 Cross-Cutting Programs