USAID | SERBIA AND MONTENEGRO
FROM THE AMERICAN PEOPLE

Private Sector Development And Business Enabling Environment Assessment

June 2009

Prepared by:

Jim Watson
Michael Borish
Denise Lamaute

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

USAID | SERBIA AND MONTENEGRO
FROM THE AMERICAN PEOPLE

TABLE OF CONTENTS

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

Introduction

USAID assistance to Serbia is guided by a country development program strategy approved in 2005 for the period 2006 through 2010. The current activity with a focus on economic policy reform (Serbian Economic Growth Activity – SEGA) ends in September 2010. USAID/Serbia & Montenegro believes that future USAID assistance can be met by a modification of the existing strategy rather than establishing new development objectives and strategy. The Mission is seeking to validate its assumption that a modified strategy can build upon the lessons learned with SEGA and improve the business enabling environment and strengthen the financial sector while reflecting changes in Serbia’s political and economic environment since 2006.

In this context, USAID/Serbia requested an assessment of Serbia’s assistance needs in the area of economic policy for the period 2011 – 2015 and recommendations for a new activity design to support improvements in the business enabling environment and Serbia’s path to European Union membership. This report entitled “Private Sector Development and Business Enabling Environment, June 2009” responds to a need to: analyze USAID/Serbia’s achievements, identify specific assistance gaps, account for the activities and planned results of other donors, and determine the most effective possible USAID assistance interventions for the future strategy period.

The USAID Assessment Team report encompasses three studies with recommendations for future USAID program activities. They are:

Part I: “Serbia’s Labor Market and Workforce Environment and Social Protection System, primarily the Pension System” prepared by Denise Lamaute, USAID/Washington, Bureau for Europe and Eurasia, May 2009.

Part II: “Financial Sector Assessment” prepared by Michael Borish and Company, June 2009.

Part III: “Business Enabling Environment in Serbia” prepared by Jim Watson, USAID Consultant, June 2009.

The research, data gathering, analysis and writing of this assessment took place in Serbia: Part I in May 2009 and Parts II and III in June 2009. Using information published in various international reports and gathered through more than 90 interviews with senior Government of Serbia officials and private sector leaders, the authors analyzed the USAID assistance accomplishments since 2006 and opportunities facing the Serbian economy.

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

This report presents: (1) a general assessment of SEGA; (2) the major findings of the assessment analysis; (3) recommendations for future USAID macro-economic policy reform assistance; and, (4) a rationale for consolidation of USAID program activities and alternative USAID procurement mechanisms.

The report reflects important recent developments in Serbia that affect the business enabling environment and assistance programming. It is presented to USAID for its internal strategic planning purposes related to possible bilateral assistance for Serbia in the coming years. The report highlights recent economic and financial sector developments and outstanding issues, gaps and vulnerabilities and how these can impact Serbia’s economic growth in the future. It includes an assessment of work done to date under the SEGA project, including commentary from Serbian counterparts about performance and effectiveness, as well as a brief summary of other donors’ activity in the area of macro-economic reform.

Following the Executive Summary, the report is divided into five sections.

Part I gives an overview and analysis of the status on Serbia’s labor market and workforce environment and its social protection system, primarily the pension system. It offers four actionable recommendations that build on SEGA’s work to date and USAID/Serbia’s economic growth and macro-economic stability assistance to the Government of Serbia.

Part II recommends a series of criteria where USAID assistance is considered to be potentially effective in achieving success in Serbia’s financial sector. It sets forth major findings related to: macro-economic and monetary policy; banks and banking; non-bank financial institutions; financial sector infrastructure; and, real sector structural issues. It includes a general assessment of SEGA, future considerations for USAID assistance, and four broad financial sector initiatives recommended for USAID to pursue.

Part III includes highlights of important events which notably upgraded Serbia’s business enabling environment during recent years; areas for improvement in Serbia; the economic growth setting involving macro-economic policy reform; recommendations for USAID program assistance priorities; and, macro-economic outlook for Serbia.

Part IV is entitled “Private Sector Development and Business Enabling Environment Findings and Recommendations” related to Serbia’s: (1) labor market and workforce environment and social protection system, primarily the pension system; (2) financial sector; and, (3) business enabling environment. It offers specific proposals for SEGA II activities supported by USAID assistance.

Part V is recommendations for USAID macro-economic policy reform program activities during 2011 – 2015. It proposes two scopes of work to be prepared this year by USAID

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

technical specialists setting forth USAID-funded design and implementation plans that build upon comparable USAID projects in the Europe and Eurasia region. It describes a SEGA II concept paper outline that envisions two or more components (1) improving the business enabling environment and promoting a stable, more developed and competitive financial sector and (2) enhancing trade and competitiveness. Additionally, the concept paper outline offers an opportunity for consolidation of USAID's economic growth portfolio during 2012 and beyond.

Executive Summary

USAID private sector development and business enabling environment programs in Serbia, sustained for nearly a decade, are contributing importantly to key U.S. Government assistance objectives of helping this country develop a democratic political system and a market economy conforming to European Union accession standards.

However, Serbia remains a highly centralized state with an outdated and often obsolete constitutional and statutory legal framework. The stated policy of modernizing political, social and economic systems remains seriously deficient. The former Yugoslavia Communist/Socialist era of centralization that is still prevalent results in a dysfunctional national-local government relationship. Legal, administrative and operational procedures are overwhelmingly complex and widespread bureaucratic malaise abounds.

Major advances in such areas as central banking, macro-economic and monetary policy, real sector structural issues, national and local strategic planning, budget formulation and execution, citizen participation, investment promotion and public utilities management will not be sustainable in the long-term unless the business enabling environment is strengthened and legally protected.

USAID's currently defined economic growth strategy encompasses a two-pronged approach that includes working at the national level to put in place macro-economic policies and a legal framework to enable the private sector to succeed in both domestic and global markets. To upgrade the quality of business services delivered by municipal governments, USAID is supporting decentralization by working directly with municipalities. Further, programs aim at business development services to selected sectors to strengthen Serbia's competitiveness. During the past decade, particularly during the early years, USAID achieved greater success working at the national level that is providing more top-down support to municipalities than for development of municipal institutions, financial and human resources. The reason for this emphasis was practical. Weak or absent political will at the central level for implementing requisite reform initiatives was pervasive at the local level. The central government is slowly moving toward adopting international standards of best business practice while local politicians waited for clear signals, action and important decisions from their national political leaders. More recently, USAID's economic growth strategy is allocating resources directed at enabling private enterprises to operate more productively and efficiently.

Following the demise of the Milosevic era in 2000, USAID began to initiate activities at the central level in response to an improved political climate. USAID's municipal economic growth activities is now more engaged in helping Serbia address a range of public policy issues that affect private businesses. USAID's dominant focus is advancing trade and competitiveness while continuing to seek opportunities to advance policy reform at the national level. This is based mostly on a perception that the Government of Serbia's commitment to serious national-level changes to the legal framework remains steadfast regardless of the extremely slow pace of reform.

While we understand the challenges to achieving results at the national level given the political environment, we recommend that reform activities be made at the municipal level in tandem with macro-economic policy reform. Significant structural problems remain in the government and enterprise sector, and it is likely to take years to be solved. The impact on USAID planning for financial sector, enterprise/public sector, and municipal development support is that greater strategic cohesion across initiatives/projects is required for USAID to have impact on a long-term basis, and in a manner that supports larger strategic objectives.

It is recommended that USAID/Serbia formulate a flexible approach as it delivers macro-economic strengthening assistance. Since 2001, Serbia has experienced political and economic instability. Its reform path, while steady on some levels, has not had successes that many of its Central and East European neighbors have achieved during the last decade. As such, USAID/Serbia must be prepared to respond to Serbia's fluid political, social, and economic environment to seize opportunities as they surface. Thus, USAID/Serbia should consider a more bottom-up approach to private sector development. As such, a contracting mechanism that offers USAID the flexibility to move between assisting policymakers when political will is strong and assisting municipal governments and the private sector to expand is recommended. Economic growth focused on private sector development is essential for Serbia if it is to generate opportunities for employment and incomes. A strong and vibrant private sector is crucial for long-term economic growth and sustainable economic, social, and political stability in Serbia.

Notwithstanding improvements in the financial sector infrastructure in recent years, more work is needed for reforms to be sustained. The impact on USAID planning for policy reform (e.g. advancement of macro-economic and monetary policy, banks and banking, non-bank financial institutions, financial sector infrastructure, real sector structural issues, pension reform, workforce development and the overall business enabling environment) is that while SEGA's principal counterpart, National Bank of Serbia, has reached a threshold as an effective regulator under Basel I, there will be additional challenges as Serbia (1) moves on to Basel II, (2) seeks to develop the non-bank financial sector, (3) promotes development of a more profitable and more efficient system, and (4) seeks to strengthen Serbia's reputation internationally.

The National Bank of Serbia (NBS) highly values USAID's technical assistance (financed by USAID for almost ten years). Ministers and senior government officials express admiration and appreciation for SEGA's work in financial sector development and advancing pension reform initiatives. Clearly, additional assistance can achieve important results building on the mature relationship developed between NBS and USAID technical assistance providers. This relationship can now evolve into a form of partnership. We, therefore, recommend that USAID develop a plan for the period 2011 – 2015 whereby the Government of Serbia (that is, NBS) begins paying a portion of USAID's technical assistance program expenses. Perhaps, in 2011, NBS should pay 25 per cent of the cost of technical services with incremental increases to 50 per cent or more by the year 2015. If successful, this establishes an excellent model for cost-sharing replication throughout USAID's development assistance program as it contemplates achieving sustainability of its programs beyond a —to be determined" date for USAID departure from Serbia.

Though current USAID economic growth programming is generally of high quality and achieving planned project-specific results, the portfolio overall needs a changed implementation strategy. We recommend a carefully designed, well-articulated strategy of consolidation and Serbian cost-sharing financial support to the portfolio over the period 2011 – 2015. This means a process in which Serbian institutions, associations, and municipal governments with Serbian specialists assume actual leadership and —ownership" of most development programs. U.S. technical assistance contractors and grantees should, when feasible, transition to Serbian grantees and private sector technical service providers whose capacity is developing over the course of the last decade.

The demand for such technical assistance clearly exists while USAID's capacity to meet this need is limited. To keep these services moving forward will require financial support or institutional development support from Serbian organizations and government agencies during the next USAID strategy period. Nevertheless, empowering Serbian entrepreneurial spirit for both for-profit and non-profit entities can be the foundation for sustainability of USAID's economic growth programs.

Some Serbian organizations/agencies, such as NBS and others, are moving toward the technical and financial capacity to retain required outside technical consulting services on a market-driven basis. Thus, the process of Serbians assuming a role and responsibility for accessing technical services should become a common practice over a five year timeframe. This could help ensure sustainability of the USAID programs of providing essential technical services to national and local governments.

Most on-going technical assistance and training is now being provided by Serbian experts/specialists and deployed by various projects over the past five or more years. It is Serbian-to-Serbian and in that sense is already —Serbianized" programming. We recommend that USAID go to the next step by structuring assistance to operate increasingly through Serbian institutions.

A restructured, more tightly strategically focused, continuation of some components of USAID's economic growth portfolio can increase the probability of success with —Serbianization" proceeding alongside strengthened local capacity and increase the chances of sustainability of economic, political and social development after USAID programming ends.

USAID has achieved quite remarkable government development work in Serbia with receptive, capable senior government officials for more than a decade, in spite of a national policy environment that is badly flawed. In our opinion, however, the national government is poorly meeting citizens' reasonable service delivery expectations and is not stimulating private and public sector investment necessary for sustainable economic growth and improving quality of life for a majority of citizens. USAID should define clearly its priority goals and timelines for policy reform at the national level in favor of private sector development and achieving a more favorable business enabling environment.

As described in more detail in this report, we offer the following recommendations for USAID programming consideration:

<u>Workforce Development</u>

Assist the Government of Serbia to:

1. Harmonize the financial and business legal and regulatory environment, including administration and enforcement consistent with EU laws and standards;
2. Develop a national strategy and action plan to achieve business expansion, job creation, and a workforce trained and capable of making a significant contribution to increasing productivity and profitability, and thus increase economic growth;
3. Develop a national pension reform strategy aimed at establishing long-term fiscal stability and sustainability of the pension system;
4. Assist Serbia to access EU pre-accession funds (far greater than any recently

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro
Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

approved EU country has done to date) to leverage and enhance Serbia's bilateral support, particularly the U.S. government.

Financial Sector

1. Strengthen the National Bank of Serbia with a focus on: (a) movement to Basel II, (b) coordination of Basel II with financial stability capacity, and (c) coordination of Anti-Money Laundering/Counter-Terrorism Financing with other agencies.
2. Developing the long-term debt securities market with a focus on: (a) debt management strategy, (b) planning for an improved sovereign rating, (c) financial instruments, and (d) accounting, audit and disclosure.
3. Enhance Anti-Money Laundering/Counter-Terrorism Financing with a focus on: (a) organizational requirements, and (b) staff training.
4. Support an existing Serbian business management education program or establish an American-Serbian management institute with a focus on: (a) general accounting and audit standards, (b) financial management, and (c) specialized management.

Macro-economic Policy Reform

1. Access USAID technical specialists in the Europe and Eurasia Bureau to formulate a design and implementation strategy to: (a) achieve accurate and credible financial reporting throughout Serbia utilizing international accounting and auditing standards, and (b) strengthen an existing accredited educational institution capable of delivering a curriculum meeting international standards for a Master's Degree of Business Administration (MBA) and a Master's Degree of Public Administration (MPA) or support the establishment of a new educational institution (e.g. American-Serbian Management Institute).
2. Prepare a design and implementation plan (scope of work) for a SEGA II (i.e., continuation of SEGA) with more focused policy reform initiatives that conform to recommendations in Parts I, II and III of this report.
3. Collaborate with World Bank, European Bank for Reconstruction and Development, and others to develop a plan for the National Bank of Serbia to partially fund technical assistance received by NBS during the 2011 – 2015 time period.
4. Consolidation of USAID's economic growth portfolio during 2012 and beyond. SEGA, MEGA, Competitiveness, Agribusiness and other projects are mutually supportive, yet possess macro-economic policy reform and business enabling environment activities that could be strengthened by merging the projects into a procurement mechanism encompassing institutional contract, cooperative agreement, buy-in provisions involving other USAID/Serbia and

USAID/Washington programs.

5. Prepare a SEGA II concept paper that envisions two or more components. For example, (a) improving the business enabling environment and promote a stable, more developed and competitive financial sector, and (b) enhancing trade and competitiveness.

Business Enabling Environment in Serbia (June 2009)

The USAID Macroeconomic Policy Assessment Team (Michael Borish, Denise Lamaute, and Jim Watson) conducted more than 90 interviews and reviewed numerous studies and reports while in Serbia during May and June 2009. We believe it is important to highlight several important events which notably upgraded Serbia's business enabling environment during recent years.

1.1 Serbia: Recent Events

The regional free trade agreement CEFTA came into force, opening a much wider market and providing better opportunities for growth. Although harmonization of national markets remains a challenge, recent implementation sends a clear signal of positive effects on Serbia's economic development. After years of negotiation, Serbia signed the Stabilization and Association Agreement with the European Union and unilaterally began implementation of the Interim Trade Agreement. This free trade agreement enables Serbia to adopt international standards and European business practices to the domestic market. As a direct result, Serbia's business climate is enhanced and enables entrepreneurs and portfolio investors to gain confidence in predicting Serbia's business environment.

Further, Serbia's government finalized an important energy sector project with the Russia Federation (involving the privatization of the Serbian petroleum industry. A major state-owned enterprise purchased by Russia's Gazprom Company) in an attempt to provide a long-term solution to the energy dependency Serbia suffers. While ensuring sizeable supplies and building infrastructure are extremely important goals, striving to achieve them needs to be accompanied by transparent decision-making and safeguarding processes and mechanisms.

The Assessment Team met with Serbia's Council for Regulatory Reform that is managing a large, complex project commonly known as the "regulatory guillotine". This project is eliminating obsolete regulations and streamlining complicated procedures long sought by foreign and domestic investors. In the first phase, the regulatory guillotine team is analyzing 250 draft laws, regulations and procedures involving 100 government regulatory bodies, 5,500 previously ratified laws, by-laws, and regulations, and 3,500 international agreements of which 2,000 are multi-lateral and bi-lateral agreements that impact the business environment.

The Council for Regulatory Reform has launched a series of "Open Space" forums scheduled with targeted business entrepreneurs in collaboration with the American

Chamber of Commerce, Serbia's Chamber of Commerce, the Foreign Investors Council, USAID's Municipal Economic Growth Activity project, the Serbian Association of Manufacturers, and Serbia's Association of Accountants. To date, 200 companies submitted suggestions for modernizing the business environment's laws, regulations and procedures. It is expected that in September 2009, recommendations will be delivered to Serbia's President and Prime Minister. Work completed to date and to be undertaken prior to July 2010 is funded by the Swedish Government. Although this project is cumbersome, it is going to achieve important goals toward improving Serbia's business climate. It is removing outdated and pervasive redundancy in Serbia's legislation and establishing progressive, streamlined by-laws. This highly needed reform effort upgrades government oversight and administration with adoption of laws that can replicate international standards of best business practice.

It is anticipated that within the next few years (ideally, earlier), Serbia's new legislation will encompass such new laws as Bankruptcy, Urban Land, Competition, Securities Market, Public Property, Regional Development, Restitution, Pledge Registry, and Company/Corporate. Utilizing cost/benefit analysis for implementation of these and other laws, plus conforming to EU regulations, this effort can have a major positive impact on small, medium and micro enterprises. (As elsewhere, such enterprises are the main source of employment in the economy. They also are a major contributor to both GDP and innovation, the latter of which is sorely lacking in many of the larger enterprises.) Crucially important, with passage of Intellectual Property Rights laws, *inter alia,* it is envisioned that World Trade Organization (WTO) accession can occur in 2010.

1.2 Serbia: Areas for Improvement

Much work remains to improve Serbia's commercial law courts, notwithstanding USAID prior assistance and support related to building an electronic case law data system. While reducing the number of judges and setting competency standards, in 2005, Serbia promulgated the Law on Mediation/Arbitration in an attempt to settle business disputes more efficiently.

New legislation is needed to thoroughly overhaul and renovate Serbia's education system and advance civil society development as well as address the lack of strong management skills within the public sector. Given low national industrial production, high bank loan interest rates, and other impediments to creating a competitive business climate, Serbia has a full plate of economic and social development challenges. Additionally, it continues to face extraordinary political development hurdles. In the first decade of the 21st century, there have been a series of political elections. Despite a semblance of confidence in the current government, recent history is replete with frequent political turmoil. This directly causes a slowdown in reforms and a reduced interest of administration to push for transformation and innovation. Most importantly, frequent elections diminish predictability and minimize the ability of the private sector to formulate business strategies and establish plans for future operations. Consequently, in Serbia, long periods of consecutive election cycles have resulted in the overall slowdown of reforms and reduced the interest of potential new investors.

It is noted that while the final outcome of Kosovo status remains unclear, this process in general terms has not adversely affected Serbia's business conditions. There is considerable confidence in the current government in society at large, and the business community is eager for continuation of the reform process.

The USAID Assessment Team met with a small sample of foreign investors plus the Foreign Investors Council and American Chamber of Commerce Executive Directors. While tentatively optimistic, the foreign business community awaits formulation of a clear economic policy, which would provide the basis for a clearly articulated economic outlook in the coming years. This is a crucial milestone for a predictable business environment attaining and attracting foreign investment. To increase productive investment and create meaningful, competitive, well-paying jobs, the business community is seeking (1) introduction of prudent public spending, (2) amendments to fiscal policy, (3) revisions to anti-monopoly and public procurement legislation, and (4) adoption of advanced securities market regulation. The private sector advocates strongly for conclusion of the privatization of socially-owned enterprises, and a revival of the strategy of privatization/restructuring of state-owned public enterprises. Also, Serbia is long overdue in addressing the politically sensitive issues of (1) urban land privatization, (2) best practice in the issuance of construction permits and broad urban land management and planning principles (and practices), and (3) regulatory and administrative procedures related to these points.

Private sector leaders assert that while managing a complicated maze of political barriers, Serbia's economic policy should not be constricted solely to the macro-economy, but rather entail a broad spectrum of measures that tackle the real-life conditions for doing business. Difficult issues seek long-term solutions, and should be discussed today to secure their resolution in the years to come. A comprehensible plan and decisive set of actions needs to be put in place to address growing concerns about scarce resources: land, infrastructure, and human resources. Finding systemic solutions for each of these issues is a complex and financially consuming process. However, even in these areas, the private sector identifies a number of small obstacles that create big impediments to doing business that are major stumbling blocks which could be overcome and lead to significant and rapid improvement in a short timeframe.

More effort is needed from the Government of Serbia to restructure implementation mechanisms of the existing legislative and regulatory reform framework. Even though innovative and contemporary legislation is being enacted, the impact of these laws is constrained by juridical formalities that are hidden in the by-laws. This issue relates to the actual practice and performance of the courts, and the recognized need to enhance the administrative capacity and quality of public service of the government in general. Foreign and domestic investors put special emphasis on this subject, and its resolution carries potential multiple positive effects – more predictability, more efficient administration, and less potential for corruption. These investors advocate that the overall reform agenda ought to introduce systems which promote equal treatment for all, thus fostering new investment, regardless of whether they are big or small, foreign or domestic.

1.3 Economic Growth Setting: Macro-economic Policy Reform

Serbia's position in the international financial market has been influenced by an increase in the inflation rate and current account deficit, with an increase in political risk. Such trends have contributed to the decrease in Serbia's sovereign credit rating (Standard & Poor's, BB-/negative). According to the World Bank's Doing Business 2008 Report, the position of Serbia is well below where it should be to be competitive and converge with EU standards (86th in the world – composite index). Serbia has made significant improvement in the field of —Getting Credit" (ranking 13th in the world), and its position in the category of —Trading Across Borders" (58th position) is reasonably strong. However, according to other indicators, Serbia's position is weaker in terms of —Starting a Business" (90th position), —Employing Workers" (110th position), —Paying Taxes" (121st position), and —Dealing with Licenses" (149th position).

The assessment of a country's rating often affects future trends in foreign direct and portfolio investment. Low ratings may increase a country's dependence on foreign credits, while the structural weaknesses may add to the country's risk premium, reflected in higher interest rates on its borrowings. Such developments have an influence as well as on domestic interest rates. The main macro-economic risk that Serbia's economy will be facing in the forthcoming years would be an abrupt and major decrease in foreign capital inflows, potentially triggering a balance of payments crisis. For several years, Serbia's economy has been recording high and ever growing current account deficits that have been covered by foreign investment and loans. Given such circumstances, a sudden and sizeable decrease in foreign capital flows would decrease foreign exchange reserves, leading to a depreciation of the national currency, and intensifying difficulties in maintaining foreign currency liquidity. The depreciation of the dinar would add to the already high inflation rate, and probably in a decreased level of economic activity.

In addition to the aforementioned, the economy is facing other macroeconomic risks and challenges: decelerated growth of the world economy (less FDI, slower growth of exports), financial crisis in the world (high interest rates, scarce credit), growth in oil and other raw materials prices, reduced levels of demand for Serbian exports, and a worsening of trade ratio. The aforementioned risks would affect negatively the current account balance for Serbia, and cause a decrease in foreign capital inflows to cover the deficit.

1.4 What does this mean for USAID economic development assistance program priorities?

Sustainable economic development in Serbia during the period 2011 to 2015 will continue to depend greatly on foreign resource inflows. Therefore, with the expected gradual decrease in resource inflows from privatization (compared with past years), Serbia needs to create a stimulating climate for growth in —greenfield" investment. In this regard, it is critical that Serbia accelerate the process of legislative harmonization with EU standards and regulations to upgrade legal security for business operations and investment.

The USAID Assessment Team recommends importance should be attached to:

- Regulation of property rights (building land and construction).
- Market competition in a regulated market and regulation of monopolies.
- Reform of the educational system and harmonization with requirements in Serbia's economy.
- Implementation of financial reporting standards commensurate with international accounting and auditing standards.
- Higher efficiency of local self-government in the building of regional infrastructure, which is needed to attract investors. To increase competitiveness, administrative barriers for business activities must be decreased within local governments.

Property Rights, Real Estate and Construction
The USAID Assessment Team confirmed that very limited progress has been made in recent years. This is a sensitive area and its comprehensive regulation in line with current international legislation and practices is essential for the continuing creation of a favorable and attractive investment and business environment. A clear political nationwide consensus should be established and subsequently implemented.
To help this process, we offer a list of issues remaining to be addressed.
Land Ownership

- Urban construction land remains the sole property of the Republic of Serbia in spite of enactment of the new Constitution.
- Lack of application of provisions of the Law on Urban Planning and Construction, setting forth that if a user of state-owned construction land fails to construct a building within a prescribed time period, his right of use shall cease.
- The legal framework has so far failed to clearly address presently preferred types of land rights. In this regard, lease of construction land is important, since it is not prescribed what will be the status of an investor after the lapse of the lease period.
- Absence of the Law on Property of Local Self-Governments that regulates responsibilities for the disposition of construction land by local governments.
- Minimum prices of the majority of urban land remains determined by Governmental ordinances instead of the market.
- In the absence of a professional real estate industry, there is a need to establish a system of certification or licensing of real estate professionals (e.g., appraisers, brokers/salespersons, title officers, escrow firms and staff).

Construction

- Most important, it is necessary to complete the Cadastre Project in Serbia. The project is funded by the World Bank's IDA and is expected to be finished in 2010.

- Incomplete land books and other land-related records are indisputably a key problem contributing to the existence of irregularities in the process of obtaining clear property rights.
- The overall process of acquiring permits remains non-transparent, long and bureaucratic, primarily as a consequence of difficult and time-consuming processes of collecting all documents needed for application (particularly documents underpinning the rights to land).
- The Law on Urban Planning and Construction, which puts local self-governments in charge of spatial planning, puts construction land at their disposal, which further complicates the situation. Therefore, local regulation is vague with imprecise procedures and criteria for determining prices for municipality/city fees for construction, leasehold and site conversion licenses.
- Inaccessibility of needed data due to lack of information and/or skilled staff. It must be noted that with USAID support, some improvement is visible in several municipalities that have established “one-stop” information offices for foreign investors.
- The construction industry remains predominantly state-owned.

Municipal Real Estate

- Municipalities have not re-allocated state-owned construction land to private investors in cases where the state-owned firms have not constructed a building within the arranged period of time. Such measures were prescribed under the Law on Urban Planning and Construction.
- A large number of real estate properties in prime locations in Belgrade and in other cities remain under municipal ownership. On a case-by-case basis, municipalities are renting these locations at rents substantially below market rates. This process contributes largely to a grey economy and reduces income to municipal budgets, while deterring quality retailers from entering the market.

Restitution

- There is no statutory ground for acquiring ownership of land in cities (“urban construction land”) from the State, although private ownership of land in cities has been allowed since the enactment of the Law on Planning and Construction of 2003. The bar on it was removed by the new Constitution of 2006.
- Acquisition of land for development is possible through several legal forms, the principal being lease from city and/or municipality. As prescribed in the Law on Planning and Construction, different types of titles are recognized, including the rights of former owners.

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

- Churches and religious communities were given an opportunity in the process of filing claims for restitution of ownership of urban construction land and agricultural land and forests, among other rights, pursuant to the Church Property Restitution Law of 2006, provided they filed their claims prior to September 30, 2008.
- The priority of restitution is grounded in its tremendous potential for promoting security of property rights in a symbolic and exemplary manner, since it most clearly shows that the State is returning what it previously confiscated.
- Implementation of the Law on Planning and Construction that pertains to the restitution of land titles has shown significant inconsistencies and irregularities across the nation. There have been many situations in which recognition of the right was either unreasonably delayed or, at the other end of the spectrum, granted to present owners of structures instead of former owners.
- The extent of reforms made in other sectors demand putting in place a clear and transparent process of restitution of construction land, which will lead to a just and efficient system of land titles and add predictability to the market.

Workforce Development, Labor, and Human Capital
The USAID Assessment Team formulated the following recommendations based on interviews and a review of prior studies and reports.

- Additional decreases in labor expenses are necessary to boost the employment rate and reduce so-called ―moonlighting". This can be accomplished through either further reductions in the income tax rate and the income amount exempt from taxation, or by a reduction in social security contributions.
- The Labor Law should be amended to enable the establishment of temporary employment agencies that would be supervised by the Ministry of Labor.
- Changes in the area of employment of foreign citizens are needed to ensure a positive environment for foreign investment.
- Laws, by-laws, and procedures related to employment need to conform to international standards (e.g., terms and conditions of salary compensation, employer claims against employees, contract termination, annual leave criteria, and maternity leave).
- Establish a system for certification or licensing of Human Resource professionals.

Education and Training
Serbia's labor market and work force are still slow to adjust to the changing global market conditions. Therefore, private sector leaders and government officials with whom we met are concerned that the supply of educated, skilled and experienced

employees must be addressed immediately. The demand for skilled employees is increasing faster than the supply. Competition is rising among companies in the recruitment of experienced and qualified people that are in short supply, such as CFOs, financial analysts and controllers, internal auditors, human resource managers, information technology (IT) specialists, and marketing specialists and experts. As a consequence, there is increased pressure on companies to retain high quality employees. Companies are responding by becoming more active in offering personal/professional development and incentives, namely developing compensation and benefits packages built on performance instead of the traditional rigid years of service related payroll schemes.

Both the education system and peoples' mind-sets require adaptation and change to new economic requirements. Previously, employees were accustomed to having secure life-time employment with the same company. In such circumstances, education and training were not a priority for the employee or the employer. Additionally, Serbia's work force has never been particularly mobile. Younger, new entrants to the labor market today are more willing to move to different locations, which should improve their employment and career opportunities. This can be very positive for the economy. However, there is also a risk of —brain-drain", as many young people wish to leave and work outside the country.

Public universities for generations are over-burdened with bureaucracy, and providing education that is not always practical or usable in the job market. The number of private universities has increased, but not all of them offer significantly different syllabi than the public universities, making graduates of universities abroad more attractive for Serbian companies. The educational system is still too rigid and cannot deliver the education needed for new market trends. Even if the university education has improved in numbers of graduates, there is still a need for a more innovative and flexible methodology of teaching. This will enable the education system to meet the changing demands of the contemporary labor market. Private colleges and other learning institutions are starting up in the training areas, but these are not up to international standards. Moreover, they cannot and should not take over the responsibility for Serbia's education system.

The labor market has grown by entries of new international companies. New professionalism creating new competencies has emerged in the market. The unemployment rate, while decreasing prior to the global economic and financial crisis, is now increasing again and remains at high levels. Unemployment is a serious problem for policy decision-makers. Furthermore, there is a lack of appropriate functional and leadership competencies in the market, both in terms of formal education, but also experience as well. Skilled employees are in demand, and supply is not meeting the economy's increasing needs. Also, a large percentage of people with a low level of education demonstrate that re-training is necessary. The Government of Serbia is examining how to persuade and attract people with the right competencies to return to Serbia – those who have been working abroad and have obtained key skills and business understanding from global companies. Foreign companies that the USAID Assessment Team met with report they are happy to appoint Serbians to top positions instead of bringing in expatriates.

1.5 Macro-Economic Outlook for Serbia

The following macro-economic indicators in 2008 for Serbia are:

- GDP real growth: 5.4%
- Budget deficit/surplus: -7.4%
- External debt/GDP: 63.6%
- Current account balance: -17.2%
- Unemployment rate: 14.4%
- Inflation: 10.1%
- Foreign Direct Investment: 1,812,000 Euros

In May 2009, the IMF increased the standby credit to 3 billion Euros, of which 788 million Euros are accessible immediately to weather the economic downturn and maintain stability. Serbia is also considering additional loans from Russia, China and Japan to finance infrastructure projects in the amount of approximately 2 billion Euros.
The total public debt to foreign creditors is over 9 billion Euros, and the government is unlikely to be able to service this debt without selling off its assets (via privatization).
Serbia is a net importer, with a trade deficit of nearly 2 billion Euros for the first four months of 2009.
The Government is the largest single debtor, owing over 1.4 billion Euros to Serbia's industry (and it has a highly negative reputation for making slow and often delinquent payments), while over 600 million Euros is owed by wholesale and retail chains to their suppliers. This creates a liquidity gap, mostly for SMEs that cannot lobby and enforce their rights.
During the 2009 first quarter, the Government issued over 220 million Euro in short-term bonds (average interest rate 16%) due by the end of this year.
Value Added Tax (presently at 18%) is likely to increase to cover the budget deficit, causing inflationary pressures.
Inflation is expected to be above 12%, due to continuous price rises as well as potential increases in excise taxes and VAT.
Since the beginning of 2008, foreign currency reserves declined by nearly 33% to maintain the value of the local currency (Dinar), which for the same period depreciated against the Euro and U.S. Dollar by over 20% and 33%, respectively. This trend is expected to continue due to a lack of foreign currency inflows.
Out of the 107,200 registered enterprises, over 63% (67,900) have severe liquidity problems and their accounts are blocked.
The Belgrade Stock Exchange is still on a downward trend (like most of Europe's stock exchanges) and the BELEXine Index has lost 84% during the period June 2008 to June 2009.
Despite unfavorable credit terms, commercial loans have increased by 29% since January 2008.
In March 2009, the average bank interest rate was 17.4%, compared to 11.1% in December 2007.

2. Private Sector Development and Business Enabling Environment Assessment: Findings and Recommendations

This USAID Assessment Team report encompasses three studies with recommendations for USAID program activities during the period 2011 through 2015. They are:

1. Part I: —Serbia's Labor Market and Workforce Environment and Social Protection System, primarily the Pension System" prepared by Denise Lamaute, Senior Advisor, USAID/Washington, Bureau for Europe and Eurasia, May 2009.
2. Part II: —Financial Sector Assessment" prepared by Michael Borish and Company, June 2009.
3. Part III: —Business Enabling Environment in Serbia" prepared by Jim Watson, USAID Consultant, June 2009.

2.1 Part I: Findings and Recommendations: Workforce Development

One of the greatest challenges that Serbia faces is improving its employment situation. Double digit unemployment and youth unemployment upwards of 40% is a recipe for political, economic, and social instability. Serbia desperately needs sustainable employment growth decisively driven by private sector development. It also needs to reduce the public and informal sectors to eliminate the negative impact that these sectors are having on private sector development. Helping Serbia achieve sustainable economic growth that encompasses inclusive social development and good governance should be considered as a potential USAID/Serbia macro-economic focus during the period 2011 through 2015.

The challenge, therefore, is to assist Serbia in producing more and better jobs for its workforce. To do so is, without question, heavily contingent upon an improved and reliable legal and regulatory environment that is fair, effective, and efficient. As such, USAID/Serbia should remain engaged in assisting Serbia in adopting adequate laws and regulations and in modernizing government administration. USAID/Serbia should help Serbia develop a modern business environment system that can grow and thrive competitively. Without such, private sector-led job creation will continue to remain weak, and thus, undermine the political, economic, and social stability that Serbian citizens and the government seek.

Based on recommendations received during this assessment regarding possible assistance that would help Serbia accelerate private sector development and improve the business enabling environment, four pertaining to workforce development are supported by the Assessment Team. Assist the Government of Serbia to:

5. Harmonize the financial and business legal and regulatory environment, including administration and enforcement consistent with EU laws and standards;
6. Develop a national strategy and action plan to achieve business expansion, job creation, and a workforce trained and capable of making a significant contribution to increasing productivity and profitability, and thus increase economic growth;
7. Develop a national pension reform strategy aimed at establishing long-term fiscal stability and sustainability of the pension system;
8. Assist Serbia to access EU pre-accession funds (far greater than any recently approved EU country has done to date) to leverage and enhance Serbia's bilateral support, particularly the U.S. government.

2.2 Why are these four recommendations important?

The aim of these particular recommendations would be *More and Better Jobs for Greater Economic, Social, and Political Stability in Serbia.* The beneficiaries would be business owners, employees, pensioners, investors, and society at large. These four recommendations are inextricable pieces of a whole. Businesses need an adequate and reliable legal and regulatory environment to compete globally. They also need reasonable and adequate financing and investments as well as a competent and capable workforce to succeed. The workforce needs to be adequately trained to be employable (human capital development), hired (career counseling and guidance), and ultimately improve their standard of living (increased wages and savings). Society needs a balance between the self-reliant and the less productive or capable. And workers need to retire with dignity, with an adequate pension income that does not crowd other societal needs – education, national security, health, etc.

The pension system is fundamentally broken. Pension expenditures run a deficit of 40%, which is funded by the general budget. Moreover, total pension expenditures are 25% of the total government budget, about 5.5% of GDP. Without question, the pension system is unsustainable and needs reforming. From the high pension deficit to the privileged pensions that allow some workers to retire as early as age 50, Serbia's pension system is fiscally unsound and unsustainable. It needs systemic reform immediately.

Serbia is scheduled to receive 84.4 million Euros from the EU Instrument of Pre-Accession Assistance (IPA) program for 36 projects with a 2010 deadline for implementing the projects. Additional funds are expected until EU accession is granted, possibly in 2015 or a few years later. It seems as if these EU pre-accession funds may not be fully or even significantly accessed without various ministries, NGOs, and others receiving training and assistance on how to access EU funds. USAID's strength is its ability to provide technical assistance related to policy formulation and reform processes. USAID/Serbia is well-suited and well-positioned. It has worked closely with the government, NGOs and other donors to provide economic growth and private sector development technical assistance.

USAID should focus its resources on assisting Serbia with drafting laws and regulations and helping to implement and enforce those measures. Sound governance, accountability, transparency and enforcement are needed to ensure a durable reform process and achieve results needed to improve the overall economy.

USAID/Serbia is uniquely qualified to continue to help Serbia close many of its legal and regulatory and business development gaps. It is uniquely qualified to help Serbia create a policy environment that stimulates investment and provides resources for greater development of the workforce, infrastructure, and the overall business community.

2.4 Part II: Findings and Recommendations: Financial Sector

A. Macroeconomic and Monetary

- The recent global economic and financial crisis has tested Serbia, and the results have been broadly positive.

- There is broad acknowledgement that significant structural weaknesses persist, and that these could present challenges in the future in the event of another crisis as well as delay prospects for receiving a future invitation to join the European Union.
- The lack of competitiveness is a consequence and cause of a vicious cycle in which enterprises are often inefficient and/or unable or unwilling to pay taxes.
- Getting the government to induce needed reforms will be complex, costly, risky, and multi-dimensional in terms of requirements.
- Moreover, for enterprises in the private sector to assume greater responsibility, they will need to have mechanisms for clearing arrears and restructuring their finances and operations so that they can become more competitive and creditworthy on a sustainable basis.
- In addition to bank-enterprise issues, there are also substantial inter-enterprise arrears which, along with VAT, add to significant liquidity pressures in the real sector.
- Having accounted for such weaknesses, there is recognition that economic improvements have been made in recent years under difficult political circumstances.
- However, considering the endemic political instability that has persisted and the transformation of national borders, the overall environment for reform has been challenging. Looking ahead, it is clear that many difficult structural-level issues remain.

For USAID: The multitude of risks and challenges means that the upcoming environment for reform could be difficult, even with positive political will and a stable government.

B. Banks and Banking

- The Serbian banking system has undergone major reform in the last decade, and is now well capitalized relative to risk exposures.
- All the key indicators show significant improvement in the banking sector since the SEGA project began.
- There are still considerable weaknesses in the banking system, albeit far less severe than in 2000 or 2004.
- There is also considerable work that needs to be done in the field of banking supervision.
- The FSSP is closely linked to a World Bank program that focuses on building a more efficient and stable financial sector along with initiatives to improve the business environment and strengthen financial discipline via privatization, restructuring, and energy sector reform.
- Despite continued weaknesses, the banking system has shown positive trends in the last several years.

For USAID: Continued weaknesses and challenges in the banking sector include the high cost of operations (e.g., high reserve requirements, high repo rates, high net nominal spreads on lending), continued state ownership of up to 15 percent of banking system assets, and limitations on hedging mechanisms in the Serbian banking system.

C. Non-Bank Financial Institutions

- Serbia's non-bank financial institutions are limited in activity, volume and value.

- The World Bank program tied to the FSSP addresses key outcomes in the insurance and securities markets in addition to banking.

For USAID: There are few risks to Serbia at the moment rooted in the non-bank financial sector, consistent with other markets where non-bank financial services are underdeveloped. The impact of the above on USAID planning is more related to the opportunity cost to Serbia of not developing non-bank activities.

D. Financial Sector Infrastructure

- The banking system has shown itself to be stable and well supervised during the recent financial crisis.
- Notwithstanding progress in banking supervision, there are still weaknesses and a need to sustain progress.
- The bankruptcy framework is underdeveloped and generally not used for debt resolution and contract enforcement issues.
- Serbia was slow to introduce legislation against money laundering and to set up a financial intelligence unit.
- The absence of consolidated accounting reduces risk detection capacity at the NBS, although efforts have been made in recent years to strengthen cross-border cooperation with other supervisory agencies.
- IFRS is now fairly common with the EU-based banks, but is hardly in effect elsewhere in the economy.

For USAID: Notwithstanding improvements in financial sector infrastructure in recent years, more work is needed for reforms to be sustained. The impact of the above on USAID planning is that while NBS has reached a threshold as an effective regulator under Basel I, there will be additional challenges as Serbia (1) moves on to Basel II, (2) seeks to develop the non-bank financial sector, (3) promotes development of a more profitable and more efficient system, and (4) seeks to strengthen Serbia's reputation internationally.

E. Real Sector Structural Issues

- Many of the core problems for future financial sector development relate to structural problems in the enterprise sector, as well as governance and tax administration weaknesses throughout the entire economy.
- There is a well defined agenda to enhance the business environment, strengthen financial discipline, and build a more efficient and stable financial system.
- Key legislative reform to strengthen the business environment includes (1) amendments to the Company Law, Enforcement Law, Privatization Law, and Law on Spatial Planning and Construction, and (2) new Laws on Bankruptcy, Competition, and State Aid.
- One of the key weaknesses in Serbia is governance and accounting standards. Serbian businesses do not operate according to the same principles as many other enterprises in the EU or elsewhere in market economies.
- Such principles also clearly apply to the public sector.

- Another key weakness is workforce development.

For USAID: Significant structural problems remain in the government and enterprise sector, and these will only be solved over a period of many years. The impact on USAID planning for financial sector and enterprise/public sector support is that greater strategic cohesion across initiatives/projects is required for USAID to have impact on a long-term basis, and in a manner that supports larger strategic objectives.

III. GENERAL ASSESSMENT OF SEGA

A. Background

This assignment was not an evaluation of SEGA performance. Nonetheless, the assignment called for lessons learned from SEGA activities over the last few years to determine how USAID should move forward with economic growth assistance priorities. The Scope of Work for the financial sector review included several questions:

- Do the problems or needs that gave rise to the SEGA activity (SEGA) still exist, have they changed, or are there new needs that should be addressed?
- Will there be expected results from SEGA that remain unattained at its completion that should continue to receive USAID assistance?
- Is SEGA's implementation strategy valid or should it be reformulated for future activities?
- Do conditions exist to ensure that SEGA's results will have lasting effects?
- Can we confirm that the Government of Serbia wants, needs, and will use USAID technical assistance and training in reforming its economic policies?
- What approaches to technical assistance have been most effective with the Government of Serbia? For example, would conventional assistance implemented by a contractor or grantee be most effective, assistance from a U.S. Government department or agency (such as U.S. Treasury or the SEC), or a combination of both approaches?
- If the assistance in the period 2011-2015 were to be the final phase of U.S. bilateral assistance to Serbia, how would that affect recommendations of assistance objectives and approaches to delivery of that assistance?

B. Future Considerations for USAID Assistance

USAID assistance should be influenced by the following:

- Strategic Fit with USAID: Consistent with and reinforces 2011-2015 vision regarding support for Euro-Atlantic institutions. For future SEGA work, efforts should continue to promote (1) convergence with BIS, IAIS, IOSCO and related international standard-bearers in the financial sector, and (2) effective implementation of reforms that position Serbia to accede to the European Union and other Euro-Atlantic institutions.

- Comparative Advantage for USAID: Evidence of capacity, a track record, and superior performance by USAID when compared with other donors. For future SEGA work, this is clearly in the financial sector, with particular emphases on legal, regulatory and institutional structures for effective performance and stability.

- Achievable Medium-term Results: Complexity/feasibility for achievement regarding USAID and counterparts' capacity to design and implement effectively. For future SEGA work, this will require a realistic approach to goals and objectives that can be achieved. There is far greater stability at NBS than in government ministries. As such, the probability of achieving medium-term results is higher via continued work with the central bank than it is with government ministries.

- Sustained Long-term Impact: Transferability to counterparts as legacy accomplishment by/from USAID. For future SEGA work, this will be achievable via the NBS. Other initiatives will need to be explored, taking into account the capacity to operate on a sustainable commercial (cost-recovery) basis.

- Major Results from Budgetary Resources: Reflected in how expensive or not the initiatives would be in terms of funding allocations, whether there is a need for co-funding, and if so, what the prospects are for achieving co-funding from other partners. For future SEGA work, this will require closer coordination with major donors to leverage results from USAID budgeted resources. This will also require that USAID look to vendors whose cost structures are lower than what USAID has paid in the past.

- Scaled Available Budget: Balancing achievement objectives with funding parameters to ensure that objectives are aligned with funding, and not out of balance. For future SEGA work, this relates to the above considerations re results from budgetary resources. This will require potentially greater use of Serbian expertise, as well as lower-cost contractors and possibly alliances with other USG agencies.

- Measurable Performance Indicators: As reflected in the ease of compilation of key performance indicators and their usefulness as a monitoring tool. For future SEGA work, this will be relatively easy to structure for the financial sector once clear outcomes and outputs are agreed to with Serbian counterparts.

- Fill Major Economic Development Gaps: Addresses critical needs. For future SEGA work, the approach of continuing to support financial sector reform is critical as a resource for larger economic growth objectives. However, effectiveness will only occur in tandem with other structural reforms, which will require close coordination with the IMF, World Bank and government for the desired results to be achieved. Support for the financial sector without close linkage to reforms in the enterprise sector and government will limit prospects for success.

- Confidence of Success: Prospects for achieving planned results. For future SEGA activity, as per the above, confidence of success will be higher if closely coordinated with reforms in the enterprise sector and government. This includes legal, regulatory and institutional requirements that reduce government ownership in the economy, reduce the position of monopolies, allow for faster dispute resolution, and rationalize the entire government approach to taxation, procurement and regulation.

- Local/Domestic Support (―Buy-in"): Counterpart cooperation, capacity, support and active participation. For future SEGA activity, this is largely guaranteed via NBS and some of civil society. It is largely guaranteed for the moment in the government, but not guaranteed for the long term. Willingness of counterparts to commit resources in conjunction with USAID-funded assistance could serve as a proxy for domestic support.

- Global Development Alliance: Prospects for potential partnerships in Serbia with international entities that could be instrumental in furthering strategic objectives. For future SEGA work, this is an important feature that will be helpful in leveraging resources, accelerating needed reforms, and potentially being indispensable in the establishment of at least one legacy institution.

Specific to future SEGA activities, key findings suggest that future assistance should be influenced by the following:

- Needs: Some of the original needs that existed in the original SEGA design are still in effect, while new challenges have emerged. For future SEGA work, the design will need to be more specific in terms of objectives and targets. In some cases, original needs should not be addressed, as they are too complex, costly or politically risky to ensure success. In other cases, continued support is justified.

- Results: Not all results will have been attained, partly because of overly ambitious targets, the diversion (dilution) of resources, and/or lack of political will/government capacity. For future SEGA work, results will need to be more closely aligned with the core criteria noted above. Above all, greater cohesion will be needed regarding other USAID initiatives, and areas of likely success and impact that can be achieved by 2015 should drive design.

- Implementation Strategy: Achieving a balance of focus and responsiveness is the consensus that has emerged from a discussion of past performance under SEGA. For future SEGA work, it will be important to identify achievable targets and objectives, and then build in a measure of flexibility and responsiveness within those areas.

- Conditions for Lasting Effect: USAID will need to make choices in terms of priorities and resource allocation. In some cases, the greatest needs should not be addressed because the preconditions for success are missing. In other cases, foundations are in place for success. For future SEGA work, it will be important to build on earlier successes that have good prospects for both impact and lasting effect.

- Government Confirmation for Economic Reform: While the government is currently pro-reform, the degree of political will relative to the challenge is still unclear. For future

SEGA work, USAID will need to identify personalities that have demonstrated their commitment to reform, have shown this through their respective institutions, and have articulated a strategic vision that converges with USAID objectives. USAID will also need to minimize the risk of turnover in terms of its institutional partnerships. This means that if there is a shift in cabinet, that sufficient capacity will exist to continue to work agreed to, and not be wholly dependent on the highest levels of government for sustained commitment and support.

- Approaches: Counterparts have spoken highly of TA delivered by USAID. Nonetheless, some have commented on a lack of strategic focus that could reduce net impact. For future SEGA work, USAID will need to be more strategically cohesive and focused, work in tandem with other donors and possibly USG agencies on a complementary and reinforcing manner, and explore less costly approaches to TA delivery.

- 2015 Close Out: There is considerable work to be done for Serbia to establish a stable macroeconomic framework, sort out distortions in the business and tax environment, and achieve sustainable sources of earnings predicated on export competitiveness so that it is able to weather future shocks without excessive dependence on tight monetary policy and donor funding. For future SEGA work, USAID will need to continue to focus on areas of current strength and stability, while working with others on critical structural reforms so that Serbia is able to converge with EU accession requirements. This process will not be fully achieved by 2015, but sufficient commitment to and implementation of reforms by 2015 should be sufficient to get them on the path to an invitation from the EU.

IV. RECOMMENDATIONS TO USAID

Many options for potential support were considered, but were not among the recommended initiatives because (1) other donors are likely to or already are involved without any further need for USAID assistance; (2) USAID does not necessarily have a comparative advantage; (3) they may take too long to achieve needed results; or (4) there are too many risks to being able to achieve objectives, including lack of perceived buy-in. (These are discussed in the report.)

There are four broad financial sector initiatives recommended for USAID to pursue. Three build on existing initiatives and are areas where USAID has a successful track record in other transition countries, and/or represents an area of critical focus. These are (1) continued yet targeted work in banking supervision, with particular emphasis on requirements for standardized/simplified approaches to Basel II; (2) implementation of a viable long-term debt securities market, with initial focus on the local exchange as a platform for a liquid central government securities market; and (3) support for capacity enhancements regarding AML/CFT. A fourth initiative, (4) establishment of the American-Serbian Management Institute, would serve as a wholesale source of accredited management capacity-building for financial institutions, enterprises, government officials and service providers (e.g., auditors, accountants) by offering MBA and MPA courses in conjunction with one or more US universities. Each of these is briefly summarized below.

► #1: Strengthening the National Bank of Serbia: NBS has made significant progress in recent years, and is widely recognized as a source of stability during the recent crisis. However, there are still some areas of needed strengthening. These include:

- Movement to Basel II
- Coordination of Basel II with Financial Stability Capacity
- Coordination of AML/CFT with Other Agencies

USAID assistance would involve short-term (and possibly) long-term TA to (1) coordinate movement to Basel II; (2) strengthen capacity to monitor for and manage financial stability issues; and (3) coordinate and strengthen AML/CFT capacity. Specific outputs would include (1) demonstrated supervisory capacity to determine banks' own credit, market and operational risk management capacity and systems to ensure appropriate levels of capital are in place for banking system stability, and in a manner that is not as restrictive with regard to reserve policy; (2) demonstrated capacity to manage stress in the economy resulting from external shocks, macroeconomic or structural imbalances, cross-border exposures, and/or cross-sectoral (e.g., banking and insurance) exposures, and to ensure the financial system is adequately: capitalized and able to access liquidity to meet all financial and payment obligations; and (3) capacity to prevent any reputation risk or loss of depositor, creditor or investor confidence as a result of money laundering or criminal financial activity. Partners would be a prime contractor and NBS, with significant coordination envisioned with the IMF and World Bank.

Performance indicators could include:

- Capital adequacy of the banking system
- Numbers of banks below minimum capital adequacy and their share of total assets and deposits
- Earning assets/total assets
- Loans to the non-financial sector/total loans
- Non-performing loans/total loans
- Return on average equity
- Return on average assets
- Average credit, assets, deposits and capital per bank
- Compliance with Basel Core Principles of Banking Supervision
- Implementation of Basel II—standardized and simplified approaches—with particular focus on supervisory capacity to monitor for credit, market and operational risk
- Compliance with IAIS and EU Solvency II requirements in insurance

► #2: Developing the Long-term Debt Securities Markets: Serbia's macro-economic framework is out of balance due to poor budget management. The result of this inefficiency is that macro-economic stability is predicated on high levels of foreign exchange reserves to maintain a moderately stable exchange rate, and to maintain confidence among depositors. This imposes an enormous burden on the banks in the form of reserve requirements, making banking a costly business in Serbia. This, in turn, limits the availability and affordability of credit for the private sector. Such constraints in the banking system spill over to the enterprise sector, resulting in significant inter-enterprise arrears as well as other arrears. All of this adds to the cost of business transactions, and keeps the negative spiral moving in a way that makes it difficult to achieve more balanced stability. For these reasons, it is recommended that USAID support development of a long-term debt securities market. Key needs include:

- Debt Management Strategy
- Planning for an Improved Sovereign Rating
- Financial Instruments
- Accounting, Audit and Disclosure

USAID assistance would involve short-term TA to (1) establish criteria and regulatory framework for development of a liquid long-term debt securities market; (2) develop regulatory capacity to ensure issuers and brokers comply with the regulatory framework; and (3) institute the required accounting, audit and disclosure standards required when issues come to market for ongoing integrity and confidence. Specific outputs would include (1) a long-term yield curve to serve as a benchmark for the pricing of long-term instruments and exposures; (2) financial instruments in which banks, insurance companies, pension funds and others could invest to assist with earnings and asset-liability matching requirements; (3) standards for Ministry of Finance to manage its long-term debt strategy predicated on sound fiscal collections, budget management and planning, and improved sovereign ratings; and (4) modernization of accounting and audit standards consistent with requirements in liquid and transparent capital markets. Additional outcomes potentially would include (5) issuance of mortgage bonds, to provide long-term funding instruments in the insured residential mortgage market; (6) issuance of municipal bonds in Belgrade, Novi Sad, or other municipalities potentially able to attract institutional investment; (7) issuance of infrastructure bonds; and (8) issuance of equities by well managed enterprises. Partners would be a prime contractor, the Securities Commission, Ministry of Finance, and an approved Serbian audit firm with IFRS capacity for public sector debt instruments. Significant coordination is envisioned with the IMF and World Bank.

Performance indicators could include:

- Sovereign ratings
- Value of Treasury securities > 1 year maturity
- Volume of trade in the secondary market in Treasury securities
- Value of other long-term savings instruments available for sale by banks, insurance companies and pension funds
- Number and value of non-Treasury long-term issues (e.g., mortgage bonds, municipal bonds, infrastructure bonds, corporate bonds)
-

► <u>#3: Enhance Anti-Money Laundering/Counter-Terrorism Financing (AML/CTF) Capacity</u>: Serbia's economy and investment climate continue to suffer from tax evasion and other weaknesses. This includes criminal transactions. The government was relatively late in establishing a financial intelligence unit, and thus lags behind many neighbors in the region in being able to track suspicious transactions. For these reasons, it is recommended that USAID support efforts to build AML/CTF capacity. Key needs include:

- Organizational Requirements
- Staff Training

USAID assistance would involve short-term (and possibly) long-term TA to (1) tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and assist with the organizational structure and requirements for effective implementation of Financial Action Task Force (FATF) principles and requirements; (2) increase training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors; (3) strengthen capacity and systems to monitor suspicious transactions; and (4) coordinate closely with NBS, law enforcement agencies, and other international counterparts to strengthen AML/CTF capacity. Capacity-building efforts would be linked with assistance to the NBS under Initiative #1 to ensure coordination via NBS operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with its effort to monitor the payment/settlement system. Specific outputs would include (1) demonstrated enhancement of capacity to identify, contain and prosecute suspicious transactions and those responsible for such financial crimes; (2) better public awareness of the costs and penalties associated with such activity; and (3) narrowing of gaps in institutional capacity relative to regional peers. Partners would be a prime contractor, Ministry of Finance, and NBS, with significant coordination envisioned with the IMF and World Bank. USAID should also explore partnerships with UST on this. If feasible, USAID should consider utilizing the same advisor for AML/CTF to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.

Performance indicators could include:

- Implementation of by-laws
- FATF assessment findings of capacity, coordination and effectiveness

<u>► #4: Support an existing Serbian Business Management Education Program or Establish an American-Serbian Management Institute (ASMI)</u>: Serbia's economy and public sector management continue to suffer from weak financial management capacity. This adversely affects government at all levels due to poor budget management and planning. In the private sector, weakness in this area undermines capacity for long-term investment planning. In the financial sector, it adds to the cost of training new recruits. Key needs include:

- General Accounting and Audit Standards
- Financial Management
- Specialized Management

USAID assistance could be offered to an existing university or education institute offering business and financial management courses. Alternatively, USAID could consider establishing an American-Serbian Management Institute to provide the aforementioned courses. This alternative could include provision of start-up capital, combined with resources from other partners, to establish a US-styled, -accredited and -certified program that would provide needed professional training and development in financial management and other needed disciplines. Direct involvement from USAID would require (1) a general mapping of needs as these relate to enterprise, financial sector, and government management; (2) general outline and framework for coursework priorities, staffing and other requirements, and preliminary costing; (3) methods of oversight, management and coordination among other partners and stakeholders; and (4) formalization of agreement with and commitment from Serbian institutions (government, financial sector, professional associations, universities, etc.) to support, participate, and sustain the Institute.

Specific outputs would include (1) introduction of core accounting, audit and financial coursework according to international standards (e.g., IFRS, ISA); (2) narrowing of gaps in business and financial management education relative to regional peers and the EU; and (3) certification to award MBAs, MPAs, and other master's-level education degrees. Partners would be a US university or consortium of universities, the government (e.g., Ministry of Education or Finance or Economy), NBS, professional associations (e.g., Bankers, Chamber of Auditors, AMCham, Serbian Association of Managers, Foreign Investor Council), and universities and think tanks (e.g., University of Belgrade, FREM, CLDS). USAID would need to explore GDA possibilities, as well as potentially consider linkage to existing programs in the region.

Performance indicators could include:

- Numbers of Serbians trained to deliver Master's-level course work
- Numbers of students attending courses
- Numbers of students receiving certificates and degrees
- Numbers of institutions sending employees to attend coursework
- Numbers of licensed and certified actuaries

3. Recommendations for USAID Macro-economic Policy Reform Program Activities during 2011 to 2015:

- At the earliest opportunity, USAID/Serbia should request two scopes of work prepared by USAID technical specialists, setting forth proposed USAID-funded design and implementation plans that build upon comparable USAID projects in the Europe and Eurasia (E&E) region to:

  (1) Achieve accurate and credible financial reporting throughout Serbia utilizing international accounting and auditing standards by both private enterprises, specifically, SMEs, and national and local governments. In the E&E region, SME senior managers change thinking and behavior (strategies and overall business management skills) while applying accurate and credible international accounting and auditing standards. Furthermore, business ethics and corporate governance performance are improved and corruption is diminished by adopting international standards and requirements.

  (2) Strengthen an existing accredited educational institution capable of delivering a curriculum meeting international standards for a Master's Degree of Business Administration (MBA) and a Master's Degree of Public Administration (MPA). Alternatively, support the establishment of a new educational institution (e.g., American-Serbian Management Institute). One of the greatest impediments to Serbia's economic development is the absence of qualified and globally competitive higher education institutions. The feasibility of a cooperative agreement mechanism should be analyzed to ensure financial commitment by the USAID-funded recipient, and to enable the institution to achieve sustainability beyond international donor support.

- Draft a proposed SEGA II design and implementation plan (scope of work) that provides for continuation (beyond September 2010) of SEGA macro-economic policy reform activities. The scope of work should narrow the focus of SEGA initiatives and conform to policy reform recommendations that are presented in Parts I, II and III of this report.

- In collaboration with international finance institutions (e.g., World Bank, European Bank for Reconstruction and Development, others) as well as bilateral development assistance programs in Serbia, develop a plan for the National Bank of Serbia (NBS) to partially fund technical assistance received by NBS during the period 2011 through 2015. USAID has funded assistance to NBS for a decade and achieved results that enabled NBS to manage successfully its role and responsibilities during the current global economic and financial crisis. NBS, Government of Serbia senior officials, and private sector leaders consistently praise and express appreciation for the technical assistance provided by SEGA. It is now time for NBS to begin paying for technical assistance. We recommend a phased cost-sharing approach (e.g., NBS pays 25% of technical assistance activities in 2011 with incremental increases up to 50% or more by 2015).

- Consolidate USAID's economic growth program portfolio during 2012 and beyond. USAID/Serbia has projects and contracts with completion dates between 2010 and 2012 that offer an opportunity to enhance USAID program management to achieve strategic objectives. SEGA, MEGA, Competitiveness, Agribusiness and other projects are mutually supportive, yet possess macro-economic policy reform and business enabling environment activities that could be strengthened by merging the projects into a procurement mechanism encompassing institutional contract, cooperative agreement, buy-in provisions involving other USAID/Serbia and USAID/Washington programs, Strategic Objective activities (e.g. Media Development, Civil Society Advocacy, Student Exchanges, Community Connections, Public-Private Alliances, GDA, etc.), and grant-funded activities.

4. The SEGA II concept paper outline could envision two or more components.

Improving the business enabling environment and promote a stable, more developed and competitive financial sector and enhancing trade and competitiveness.

The following initiatives and intended results are envisioned within each of the components. For example:

Component 1: Improving the business enabling environment and promote a stable, more developed and competitive financial sector.

A. Advance/promote economic reform at the national level.

Result: Reference is made to the detailed recommended macro-economic policy reform activities related to labor market and workforce development, pension reform, promoting a stable, competitive, and more developed financial sector, and improving Serbia’s business enabling environment proposed in Parts I, II and III of this USAID Assessment of Macro-economic Policy Reform report.
Those results enable Serbia to improve its national scores in recognized indexes (e.g. World Bank’s —Doing Business” and World Forum —Competitiveness Index”).

B. Support Strategic Planning for Economic Development.

Result: Ten municipalities engage in efficient and effective support of private sector-led economic development and investment.
Result: Improved procurement practices.

C. Assist municipalities alleviate administrative and regulatory barriers to investment (particular emphasis on property markets).

Result: Barriers to investment significantly reduced through improvements in the functioning of local, municipal property markets.

D. Promote domestic and foreign investment.

Result: National and local level investment promotion agencies providing effective services to domestic and foreign investors.

E. Foster public-private alliances.

Result: Public-private alliances and partnerships (including two GDAs) employed as techniques for stimulating economic developments.

F. Promote national employee benefits and labor costs such as pension and unemployment benefits.

Result: Employee benefits and labor costs competitive within the region.

G. Work with public and private sectors to demonstrate link between workforce development and increased profitability.

Result: Increase in employee productivity.
Component 2: Enhancing trade and competitiveness.

A. Encourage adoption of international quality and productivity standards.

Result: Introduction and application of internationally-recognized quality and productivity standards for Serbian products and services.

B. Industry competitiveness enhancements.

Result: Industry leaders and entities actively promoting and adopting policy and operational changes that improve overall industry competitiveness.

C. European and regional market integration through trade facilitation.

Result: Administrative barriers to trade reduced by introduction of more efficient procedures for bringing products into Europe and other international markets.
Note: USAID/Serbia should produce an assessment of the existing administrative barriers at key custom points, particularly those relevant to municipalities and their industries. The assessment should recommend steps toward increasing transparency and efficiency through administrative reforms.

D. Improve economic governance. Advance one-stop shops.

Result: Delivery of all government business services will be compared to best practices.
Result: Full and open disclosure of government business services will be made available electronically and in government offices.
Result: All government business services that are possible to deliver through one-stop shop-type mechanism will be delivered in at least 50% of all municipalities in Serbia.

E. Pilot development of a unified property registry.

Result: Property registry feasibility and land market assessment.
Result: Pilot property registries in one urban and two rural municipalities.

F. Undertake a trade and competitiveness development program.

Result: Increased export linkages and sales of targeted sectors.
Result: Increased domestic market linkages and sales among parts of Serbia.
Result: Significant alternative employment generated in specific parts of Serbia.

5. Rationale for Consolidation of USAID Program Activities and Alternative USAID Procurement Mechanisms

The rationale for consolidation is predicated on the uncertainty of ―political will" within the national government. Frequent turnover of ministers, senior staff and parliamentary leaders often produces a deceleration of policy reform. When this occurs, the envisioned SEGA II has flexibility to place greater emphasis on working at the municipality level to improve Serbia's business enabling environment.
SEGA II can enable the Mission to access short-term technical assistance services available at U.S. Government agencies (e.g., U.S. Treasury, U.S. Department of Commerce, U.S. Trade Representative, Department of Labor, Department of Justice, Department of Agriculture, and others).

Utilizing a cooperative agreement mechanism for one or two SEGA II sub-components, USAID/Serbia can begin to ―pass the baton" to suitable, potentially sustainable institutions that would continue these initiatives following USAID's presence in Serbia. Further, SEGA II envisions collaborating and co-funding of with the World Bank's policy actions, enhancing business environment, strengthening financial discipline, and building a more efficient and stable financial sector program activities. Reference is made to the World Bank's PFDPL Policy Matrix received from World Bank in June 2009. Moreover, USAID/Serbia and the International Monetary Fund share common macro-economic policy reform objectives and strategies.

USAID has an opportunity to leverage its own financial resources with the World Bank, International Monetary Fund, European Bank for Reconstruction and Development, and European Union to employ appropriate incentives to buttress ―political will" when the pace of reform falters. The USAID Assessment Team validated that the major international finance institutions share common strategic objectives, and that respective financial/technical assistance programs encompass activities and initiatives that conform to advancing international best business practices and standards in Serbia.

Annexes

ANNEX 1: LIST OF MEETINGS – June 2009

Prime Minister's Office
Bosko Zivkovic, Economic Team of Prime Minister's Office
Prof. Dejan Soskic, Economic Team of Prime Minister's Office
Prof. Jurij Bajec, Special Advisor to the Prime Minister for Macroeconomic Issues

National Bank of Serbia
Mira Eric – Jovic, Vice Governor
Kristian Vukojicic, Deputy General Manager

Ministry of Finance
Slobodan Ilic, State Secretary
Vuk Djokovic, State Secretary
Miodrag Didic, Advisor to the Minister

Ministry of Economy
Nebojsa Ciric, State Secretary
Bojana Todorovic, State Secretary
Andreja Marusic, Secretary of the Council for Regulatory Reform
Zorana Gajic, Deputy Head of Regulatory Review Unit
Nenad Ilic, Special Advisor
Milan Stefanovich, Advisor, Council for Regulatory Reform
Andrija Jerinic, Advisor, Council for Regulatory Reform

Ministry of Trade Services
Slobodan Milosavljevic, Minister
Nebojsa Lazarevic, Assistant Minister

European Integration Office
Milica Delevic, Director
Srdan Majstorovic, Deputy Director

Securities Commission
Milko Stimac, Director

Banking and Finance Institutions
Zoran Petrovic, Treasury & Investment Banking Manager, Raiffeisen Bank
Aleksandar Jovic, Director, National Mortgage Insurance Corporation
Danijela Popadic, Legal and HR Division Head, National Mortgage Insurance Corporation
Sasa Jovanovic, Head of Loan Insurance and Risk Management, National Mortgage Insurance Corporation

Nikola Stefanovic, Director, SEAF South Balkan Fund
Rodger Voorhies, President of Executive Board, Opportunity Bank
Goran Pitic, Director, Societe General

Donors
Simon Gray, Country Director, World Bank
Milan Popovic, Operations Officer, World Bank
Bogdan Lissovolik, Resident Representative, IMF
William Infante, Resident Representative, UNDP
Hildegard Gacek, Director, EBRD
Jelena Celenkovic, Associate Banker, EBRD

USAID
Michael Harvey, Mission Director
Marilynn Schmidt, Deputy Mission Director
Jim Stein, Economic Growth Office, Director
Mark Pickett, Director, Local Economic Growth Office
Walter Doetsch, Economic Growth Office, Deputy Director
Nenad Moslaviac, Economic Growth Office, Project Management Specialist
Art Flanagan, Director's Office, Senior Advisor
Assia Ivantcheva, Democracy Office, Director
David Meyer, Senior Advisor, Market Transition Office, EE Bureau

USAID Projects
Rosa Chiappe, Chief of Party, SEGA
Ana Delovic, Deputy Chief of Party, SEGA
Scott Calhoun, Senior Banking Advisor, SEGA
Nikola Altiparmakov, Senior Economist, SEGA
Peter Epstein, Chief of Party, MEGA
Bill Althaus, Evaluation Team, MEGA
Richard Allen, Evaluation Team, MEGA
Hugh Nichols, Evaluation Team, MEGA
Louis Faoro, Chief of Party, Agribusiness Project
James Herne, Deputy Chief of Party, Agribusiness Project
Goran Radojevic, Operations Director, Agribusiness Project
Brankica Obucina, Policy Specialists, Agribusiness Project
Nenad Popadic, Finance Advisor, Agribusiness Project
Vince Gamberale, Private Sector Development Director, Competitiveness Project
Sharon Valentine, Deputy Director, Competitiveness Project
William Seas, Director, Competitiveness Project
Ana Trbovich, Policy Director, Competitiveness Project
Marc Lassman, Enforcement Advisor, Bankruptcy Enforcement Support Project

US Embassy
Tanja Vecerka, Economic Specialist
Tatjana Maslac, Agriculture Specialist
Zlatko Jovanovic, Agriculture Specialist

Accounting/Audit
Nina Bulatovic, Senior Partner, KPMG
Milica Bisic, Head of Markets, KPMG
Nada Sudic, Partner, Deloitte

Civil Society and Business Associations
Boris Begovic, President, Center for Liberal Democratic Studies
Danica Popovic, Center for Liberal Democratic Studies
Marko Paunovic, Executive Director, Center for Liberal Democratic Studies
Ana Firtel Vlajic, Executive Director, Foreign Investment Council
Jelena Bulatovic, Deputy Executive Assistant of Serbian Association of Managers
Bojana Ristic, Executive Director, AmCham
Amalija Pavic, Regulatory Affairs Advisor, AmCham

ANNEX 2: BIBLIOGRAPHY

—Challenges of Introduction of the Mandatory Private Pension System in Serbia," CLDS, 2009.

Financial Stability Report, National Bank of Serbia, 2008.

—First Review Under the Stand-By Arrangement", IMF, May 2009.

—International Competitiveness and Economic Growth in Serbia," CEVES, November 2008.

International Financial Statistics, IMF, October 2008.

Lamaute, D., —Private Sector Development and Business Enabling Environment Assessment", Part 1, May 2009.

Quarterly Monitor, Foundation for the Advancement of Economies, October-December 2008.

—Reforms in Serbia: Achievements and Challenges", CLDS, June 2008.

—Selected Issues", IMF, February 2008.

—Serbia 2008 Progress Report", European Union, November 5, 2008.

—Serbian Banking & Financial Sector—2009", www.allianceinternationalmedia.com , May 2009.

Statistical Bulletin, National Bank of Serbia, April 2009.

—Strategy Statement", USAID, December 2005.

www.belex.rs

www.bis.org

www.imf.org

www.nbs.rs

www.worldbank.org

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

USAID | SERBIA AND MONTENEGRO
FROM THE AMERICAN PEOPLE

Private Sector Development
and
Business Enabling Environment Assessment
April 29- May 12, 2009

Part I

Denise Lamaute

A special thanks to Jelena Mihajlovic for her hard work and keen organizational skills in helping to make this assessment possible.

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

Executive Summary

Private sector development and workforce development, including worker social protection, coupled with rationale, reliable, and equitable laws are critical to the sustainable development of Serbia's economy and the country's regional and global integration. The 2008 elected government, albeit fragile due to a patchwork quilt-type political coalition, seems poised to embrace European Union integration and move the country towards a 21st century market economy. For the last ten years, however, Serbia did not make the political and economic advances that many of its neighbors did.

Serbia has been slow out of the political and economic reform starting gate. While several of its neighbors moved fairly quickly to reform their political and economic landscapes after the fall of communism in 1998 and to join the EU, Serbia did not. Instead, Serbia looked backwards, or perhaps it was just frozen in its tracks, and did little to incorporate 21st century efficiencies in government administration, business, education, or trade. It seemed overly preoccupied with ethnic and religious disputes that stifled its integration into the world economy.

With the assistance of USAID and others, Serbia in 2001 slowly began to introduce legal and regulatory, financial sector, labor market, and macroeconomic reforms. Several new laws and measures have been introduced to address the huge inefficiencies in how the government and businesses operate. The successes to date, however, are not sufficient to promote sustained economic growth and political and social stability even if the current global financial crisis were not a factor. Unemployment is high, the informal economy is large, and the sizeable budget expenditures crowd out private sector growth and development. According to the OECD, employment declined in every year from 2001 through 2006, with a slight recovery in 2007. With the global economic crisis, Serbia's unemployment rate this year is expected to rise over 18%.

Businesses and economic experts point out that Serbia must reform its tax, pension, trade, and real estate structures if meaningful and sustainable economic growth is to be achieved. They also decry the weak education and legal systems that are making Serbia less attractive to foreign direct investments and domestic business expansion.

Serbia's pension reform, which began in 2001, is not finished. Total pension expenditures are 25% of the total government budget, about 5.5% of GDP. Without question, the pension system is unsustainable and needs to be reformed in keeping with a national strategy that addresses old-age security over the long-term. The voluntary pension system is nascent, which some view as having too little traction to address pension adequacy for future retirees. It should be developed and expanded to help citizens save for their retirement as part of the overall old-age security structure in Serbia.

These factors in combination make a compelling case for USAID/Serbia to remain firmly engaged in Serbia. USAID/Serbia is uniquely qualified to help Serbia continue to transition from a planned economy to a modern, regionally, and internationally integrated market economy. Such a transition, unquestionably, takes time and cannot be achieved fully in a few short years. As such, what Serbia now needs is —Next Phase", and in some cases, —FINAL Phase" technical assistance from the donor community to ensure durable economic growth, private sector development, and political stability.

USAID/Serbia's investment in Serbia, thus far, has been substantial. Unmistakably, it is that very reason why a few more years of economic growth and private sector development with a keen focus on workforce development are necessary to enable Serbia to cross the bridge to a well-regulated, effective, and efficient 21st century market economy sooner than later. What we don't want to do is to withdraw our macroeconomic and private sector development technical assistance too early and have Serbia lose the momentum we have helped them build or undermine the successes the country has achieved to date.

Methodology

This assessment, the first of a likely two-part assessment, is a review and analysis of the private sector development and business-enabling environment in Serbia. This particular assessment concentrates on Serbia's labor market and workforce environment and its social protection system, primarily the pension system, as it relates to private sector development and the business-enabling environment.

For a complete picture of private sector development and the business-enabling environment in Serbia, part two of this assessment will need to address the following areas: infrastructure, financial sector development, real estate (land titling, ownership/restitution, construction, and financing), business registration, tax administration, intellectual property and competition law.

The Part 1 assessment was conducted by Denise Lamaute, USAID/Washington, a labor market and social protection specialist in the Europe and Eurasia Bureau. The team, which also consisted of colleagues from USAID/Serbia's Economic Growth Office – Jim Stein and Walter Doetsch - took an informal, information-gathering approach to interviews with key informants. Guided in part by the Mission's questions (including the question, what if USAID/Serbia doesn't continue with this activity or aspects of it?) and supplemented by our own, we sought to understand firsthand the interviewees' perspectives on Serbia's economy, the changes and prospects in current times and the future, its financial sector, mainly the pension system, and the macro and legal and regulatory environment that influences foreign direct investments, business expansion, and job creation.

This assessment employed both primary and secondary data and a mix of research methods for the study. The primary data sources included face-to-face interviews during the period of April 29 – May 12, 2009 as well as the collection of reports and data via e-mail. We interviewed firms, government agencies, non-governmental organizations, and other members of the international donor community.

We asked for recommendations on ways in which relatively modest funds might make the most significant contribution for sustainable economic growth a private sector development in Serbia. We asked about strategies for developing a modern workforce, where new job opportunities might be created, and where policies and capacities needed to be developed to improve the business climate. We asked questions, probed, listened, made site visits to observe programs and agencies first-hand, and enjoyed in lively conversations with a host of Serbian professionals and even impromptu conversations with taxi drivers, shop keepers, and others.

By the middle of the second week, clear themes were emerging, and these themes guided the direction for most of our interviews during the balance of the assessment period, and have formed the basis for the recommendations, thus far. These recommendations may be revised once paired with Part 2 of this private sector development and business enabling environment assessment.

While this analytical process was rigorous and scrupulous, our intention is that the tone of this assessment and its recommendations will be action-oriented, rather than academic. We received many suggestions for possible USAID assistance, and present priority options in the context of taking steps to develop a comprehensive economic growth and private sector development system. We propose a strategy that begins with *system-building,* and includes *institutional and human resource capacity-building.*

We have narrowed the suggestions to four actionable recommendations that build on USAID/Serbia's work thus far in the area of economic growth and macroeconomic stability. The recommendations complement USAID/Serbia's other project areas, as well. The recommendations are - assist the government of Serbia (GOS):

1. Harmonize the financial and business legal and regulatory environment, including administration and enforcement, with EU laws and standards[1];
2. Develop a national strategy and action plan to address business expansion, job creation, and a workforce trained and capable of making a significant contribution to increasing productivity and profitability, and ultimately increased economic growth;
3. Develop a national pension reform strategy that addresses the long-term fiscal stability and sustainable of the pension system; and
4. Assist Serbia access any and all EU pre-candidate accession funds far greater than any other recent EU country has done to date and to leverage and enhance Serbia's bilateral support, in general, and that of the U.S. government, specifically.

Background

Serbia is a small country with a population of only 7.4 million, unemployment about 18%, depending on the source, and a gross domestic product (GDP) per cap of €3424 in 2006, according to the World Bank. Even without a large export economy or a banking sector contaminated with sub-prime mortgages, Serbia is not immune from the global financial crisis. Real GDP growth averaged 7 percent during 2004–07, according to the IMF. However, for 2009, the IMF projects that Serbia's GDP growth will fall to 3.5%. Early 2009 estimates reveal a slowdown in industrial production (17.1%), a drop in exports (13.8%), and a decrease in retail sales (5.6%).[2] Moreover, the country's appetite for imports has resulted in an external current account deficit over 18 percent of GDP in 2008, up from 12.4% in 2007 and 5.7% in 2006, one of the highest deficits in the region.[3] The recent drop in consumer spending, said to be directly linked to increased credit rationing, is expected to have a positive effect on the trade deficit.

Serbia is mainly a country of ethnic Serbs, about 80% of the population. Its long and recent history regarding minorities, particularly Kosovars and Bosnians, continues to present ethnic and religious tensions, as evidenced by the demonstrations and damage inflicted on several embassies, including the U. S. Embassy, last February when Kosovo

[1] In April 2008, Serbia entered into the Stabilization and Accession Agreement with the European Union to begin systemic reforms and harmonization of its laws with EU laws and standards.
[2] Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008
[3] IMF Country Report No. 09/20 January 2009 and European Commission, Serbia 2008 Progress Report

declared its independence.

Serbia's most vulnerable citizens tend to live in Southern Serbia, including four municipalities that border Kosovo and have a large Albanian Muslim population. Other vulnerable areas are the Sandzak, with its majority Bosnian population, and Vojvodina, with 26 nationalities on its territory. The Roma community is hugely discriminated against and thus marginalized.

Unlike its neighbors, Hungary, Bulgaria, and Romania, Serbia did not embrace economic and political reforms immediately after the fall of communism in 1989. Instead, it continued to operate and isolate itself based on outdated economic, social, and political thinking and approaches. As such, it now lags behind many of its neighbors on several levels, particularly when it comes to rule of law, economic growth, and political stability. For example, it has yet to provide full compliance with the International Criminal Tribunal for the Former Yugoslavia (ICTY), which has caused some EU member states to withhold their support for Serbia as an EU candidate. Its gross domestic product (GDP) at purchasing power parity (PPP) per capita is $10,900 (2008 est.) compared to Hungary $19,000 (2008 est.), Bulgaria $12,900 (2008 est.), FYR Macedonia $9,000 (2008 est.), and Croatia $16,100 (2008 est.).[4]

It also has a laundry list of macroeconomic and business development challenges that to continue to stifle private sector development and dampens increased productivity and economic expansion. According to the IMF, the main hurdles Serbia needs to address are licensing, property registration, taxes, weak contract enforcement, high levels of corruption, weak competition policies, small private sector, sizeable public sector, large social transfers, and large infrastructure gaps. Labor costs and social protection transfers are exceeding high at more than 60 percent of total public spending.[5]

According to the World Bank Doing Business 2009 Rank, *Serbia ranks low regarding business development and business enabling* areas when it comes to the ease of doing business in the country out of 181 economies - starting a business 106, hiring 91, paying taxes 126, enforcing contracts 96, and obtaining business licenses 149. These issues will likely be covered in greater detail in the Part 2 assessment of this assessment.[6]

---

[4] CIA Factbook 2008
[5] European Commission, Serbia 2008 Progress Report
[6] http://www.doingbusiness.org/ExploreEconomies/?economyid=206

Labor Market and Workforce Development

Legal and Regulatory Environment

Changes in the Labor Law in 2001 with revisions in 2005 have helped to move Serbia toward harmonizing its labor laws and regulations with EU standards. Nevertheless, according to many interviewees, the labor laws remain weak, rigid, and rarely strictly enforced constraining the private sector.

The Labor Law, No. 70/2001 of 13 December 2001, as amended in 2005, and the 2008 General Collective Agreement provide the legal basis for employment, employer, and employee matters. These collections of laws are the responsibility of the Ministry of Labour and Social Policies.

While the minimum age for employment is 15, those under 18 must obtain written parental or guardian permission to work. The Social Economic Council sets the *minimum wage*, 13,572 dinars (*approximately $250*) per month at the end of 2008. The *average monthly salary* in December 2008 was approximately 38,626 dinars (*approximately $569*).[7] Wage and social contribution arrears, which were common, particularly among the state owned enterprises (SOES) are not as widespread and are no longer reported to be substantial.

The Labor Inspectorate is responsible for enforcing the minimum wage and ensuring a safe workplace. It has been reported that even with ―substantial" technical assistance, the Labor Inspectorate does not operate up to EU or international standards.

Serbia has basically a 40-hour workweek with a legal restriction that an employee may not work overtime for more than four hours a day or for more than 240 hours in a calendar year. Part-time and temporary work did not exist in Serbia until recently and the use of this flexible work arrangement is slowly evolving in Serbia.

In 2005, Serbia adopted the National Employment Strategy 2005-2010. This strategy is designed to achieve sustainable employment growth and increase the employment participation rate in the spirit of the Lisbon Strategy.[8] A key aspect of this strategy is to

---

[7] The Republic Statistical Office reduced the average monthly wage to approximately 30.000 dinars at beginning of 2009, based on acceptance that its methodology in calculating the average wage was flawed

[8] The Lisbon Strategy, also known as the Lisbon Agenda or Lisbon Process, was adopted by the EU in 2000 as an action plan aimed at making the EU ―*the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010*".

transform the National Employment Service (NES), Serbia's employment agency, from a bureaucratic institution focused on record keeping of mandatory social security into a modern public employment service, oriented to client needs and employment policy implementation. For example, in 2007, the NES changed its regulations to exclude as unemployed those who are not seeking jobs.

Even with the employment strategy and recent changes in the law, Serbia's labor laws and rules are not fully grounded to promote a modern, global labor market system. Employment creation has been inadequate to address Serbia's high unemployment, especially among women and youth. Wage, benefits, and hiring and firing rules are often vague, contradictory, and administratively burdensome. With job creation being critically important to Serbia's economic, social, and political well being, the labor market should be re-structured immediately to facilitate employment while advancing both employers' and employees' rights, according to several we interviewed.

The Labor Force

Serbia has a rapidly aging workforce challenged with high unemployment (18% in 2008 and expected to grow to 19% this year), and particularly high youth unemployment (44%). Its labor force of approximately 3.2 million people consists of 2.8 million employed, 25% in the informal sector, and 14% or 450,000 unemployed, according to ILO methodology. About 17% of the population is aged 65 or older while the 2008 fertility rate (births per woman) of 1.6 has been below the reproductive rate since the 1960s. The replacement fertility rate is roughly 2.1 births per woman.

In 2006, more than half of Serbia's 3.2 million workforce was between the ages of 35 and 54. Twenty-three percent of the workforce then was between the ages of 25 and 34. Over 63% of the population is working age (15-64). Only 27.2% of the total population (53.5% of the population were of working age) were employed. [9]

[9] INEKO and ESPI Institute, Labour Market Reforms in Serbia and Slovakia, 2008

QuickTime™ and a decompressor are needed to see this picture.

Source: ILO 2007

The private sector now employs the bulk of the workforce, approximately 71% of all workers, with the balance, 24.6%, employed in the public sector, including the state-owned enterprises (SOES). About 2.4% of the workforce is still with the socially-owned companies, "worker-owned" companies that are slowly disappearing.

Labor costs are relatively low in Serbia. The minimum wage for the period July-December was set by the Social Economic Council at approximately $250 per month. According to figures released in December 2008, the average take-home salary in November 2007 was approximately $500. The gross wage in Serbia was about $650 in 2007 compared to $527 in FYR Macedonia, $300 in Bulgaria, and $528 in Romania.[10]

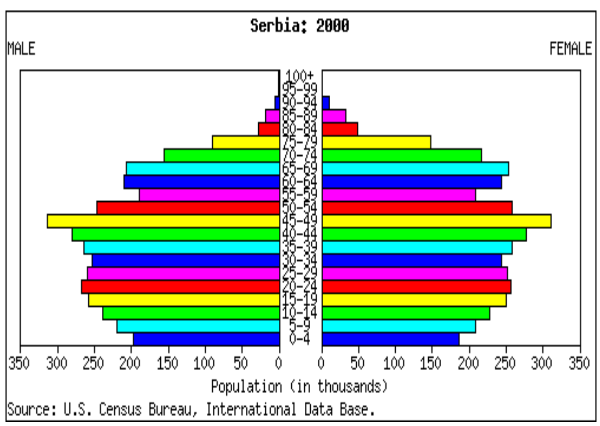
Average monthly gross earnings in national economy in US$ at current exchange rates	
Country	**2007**
Bulgaria	301
Croatia	1 313
Czech Rep.	1 068
Estonia	991
Hungary	1 006
Latvia	775
Macedonia	527
Poland	973

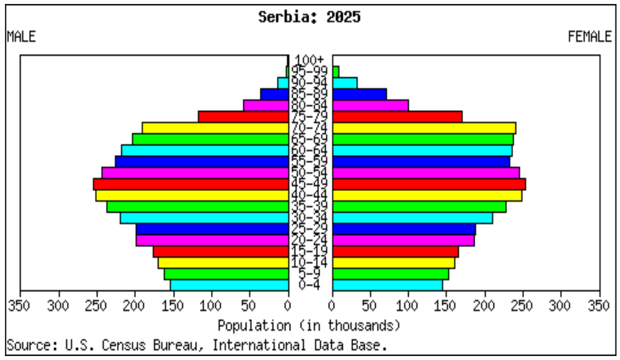
[10] http://www.databasece.com/en/in-emerging-markets

Romania	578
Russia	528
Serbia	**649**
Slovakia	814
Slovenia	1 761
Ukraine	268
Source: Database Central Europe http://www.databasece.com/en/in-emerging-markets	

Demographic trends and projections

Serbia's working age population is projected to decline in both relative and absolute numbers after 2010. While the share of the working age population to the total population is projected to increase from 67.1% in 2002 to 68.3% in 2012, the absolute number of the working age population is projected to drop almost 150,000, from 5,030,000 in 2002 to 4,885,000 in 2012, a net population loss of some 350,000 over the ten-year period. Between 2006 and 2012, an average annual drop in the working age population of 15,000 is expected, particularly as the population of retirees increases during that period.





Employment and Wages

The Serbian Bureau of Statistics conducts two surveys, the RAD survey and the Labor Force Survey (LFS), to measure employment and wages. The RAD survey measures only formal sector workers with employment contracts for whom social security contributions are paid (excludes agricultural workers, unpaid family workers, and army and police workers not covered by the general pension system). The LFS measures a broader section of the labor force based on interviews of individuals from a national sample of households (informal, formal, agriculture workers, unpaid family members and army and police workers).

According to the National Bureau of Statistics and Informatics, 1,985,084 persons were employed in Serbia in May 2008. That month, of the 773,335 registered unemployed, 54% were women.

The LFS reveals an increase in the employment rate from 51.3% in 2007 to 53.3% in 2008 among the working age population (15-64), an increase of about 120,000 workers during that period. The unemployment rate from October 2007 to October 2008 decreased from 18.8% to 14.7%, more than a 100,000 reduction in the number of unemployed. This change is partly attributed to an improvement in the quality of the LFS, without which the unemployment rate for that period would have been about 17.5%. The RAD survey, on the other hand, draws attention to the presumably higher quality jobs (formal sector registered workers) and reveals a decrease in employment, particularly in manufacturing where 9,000 jobs were lost, 2.5% of the employed in that sector. Retail lost 3,000 jobs, 1.5% in that sector.[11]

[11] Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008

Who's Working Where

Long-term unemployment (12 months or more) is about 80% of total unemployment and youth unemployment is 44%.[12] 60% of the Roma population is unemployed and is thus the most vulnerable ethnic community in the labor market.[13] Women's average wages were 16 percent lower than those of men in 2008. There were 54 percent more women unemployed than men, and only 21 percent of women occupied management positions.[14]

According to Serbia's Statistical Office, the highest unemployment rates are in Central Serbia (13.8%), Belgrade (14.2%), and in the Vojvodina agricultural region (14.2%).[15] Central Serbia is also the region with the highest incidence of long-term unemployment. The workforce is characterized as having low educational attainment, primary school or less (22% of those unemployed in 2006), and without sufficient qualified skills. According to the 2002 Census, about 45% of the workforce were low-skilled (primary education or less) and 41% medium-skilled (completed secondary education).

2004-2005 Working Age Population

	2004			2005		
	Total	Male	Female	Total	Male	Female
Labour force participation rate	66.4	75.1	57.9	65.2	74.3	56.2
Employment rate	53.4	63.1	44.0	51.0	61.3	40.8
Unemployment rate	19.5	15.9	24.1	21.8	17.6	27.4
Long-term unemployment (12 months and more)	77.5	75.7	79.0	79.0	78.4	79.6

Source: LFS 2004 and 2005

According to the World Bank (2006), informal employment in Serbia amounts to 43% of all employees and 27% of wages earners, excluding farmers. Youth and the less educated tend to be overrepresented in the informal sector. Small businesses contribute over 45% of GDP, 27% of exports, and 55% of total employment.[16]

2005 Working Age Population by Age and Education

[12] Gligorov, Vladimir, Anna Lara, Michael Landesmann, Robert Stehrer and Hermine Vidovic, *Western Balkan Countries: Adjustment Capacity to External Shocks, with a Focus on Labour Markets,* The Vienna Institute for International Economic Studies, 2008
[13] Arandarenko, Mihail and Aleksandra Nojkovi, *The Labour Market in Serbia Overview*
[14] http://www.state.gov/g/drl/rls/hrrpt/2008/eur/119103.htm
[15] http://webrzs.statserb.sr.gov.yu/axd/en/index1.php?SifraVesti=316&Link=
[16] ETF Country Plan 2009

	Share in Population 15-64	Share in Unemployment	Share in Employment
Age			
15-24	19.2	23.1	7.0
25-64	62.1	71.6	80.0
55-64	18.6	5.3	13.0
Education			
Less than elementary	7.4	4.0	5.4
Elementary	24.1	16.9	17.2
Vocational	20.2	27.7	22.7
Secondary	35.3	40.4	36.5
College or more	13.0	11.0	18.2

Source: LFS, 2005

In 2008, real wage growth was 5.5%, down from 14.6% in 2007. Average monthly gross wages (employer's total per employee expense, including payroll taxes) were 45,723 Dinars (€572) in 2007 compared to 53,868 Dinars (€660) in 2008.[17] The construction and manufacturing industries experienced year-on-year growth of 7.6% and 5.9%, respectively. While the hotel and restaurant (1.2%) and the real estate (4%) sectors experienced year-on-year real wage decreases.

Serbia Gross Wages And Total Labor Costs, In National Currency And Euros						
	2001	**2002**	**2003**	**2004**	**2005**	**2006**
Gross wages in Dinars	8739.0	13260.0	16612.0	20555.0	25514.0	31745.0
Total labor Costs in Dinars	10474.0	15892.0	19993.0	24234.0	30081.0	37427.3
Gross wages in Euros	147.0	218.0	255.0	282.0	307.0	377.7
Total labor costs in Euros	176.0	262.0	306.0	332.0	362.0	445.3
Source: World Bank						

Trade Unions

Trade unions are relatively weak in Serbia. They are primarily organized through three confederations - the Federation of Autonomous Unions of Serbia (SSSS), the Branch Union Confederation 'Independence' (UGS Nezavisnost), and the Association of Free and Independent Trade Unions (ASNS). There are also a number of company-specific unions, mainly in SOES and independent of the confederations. UNISON is a public

[17] Effective January 2009, the Serbian Bureau of Statistic changed the methodology for calculating the average wage, namely, downward to include generally lower wages paid by entrepreneurs.

sector union and member of the British TUC. Only about 20% of the workforce is said to be trade union members, the majority working in SOES or for the government.[18]

Labor Market Inefficiencies

While Serbia is considered a low labor cost country in *relation to its neighbors*, it still has a host of labor market challenges to overcome. First, Serbia urgently needs to improve the efficiency of its labor market. Even with the many labor related reforms Serbia has undertaken, new business growth in Serbia has been too little and far too slow to address the dismal and growing unemployment situation. Further reforms are needed to improve the effectiveness and efficiency of the labor market directed as an integrated part of improving the business climate and increasing productivity. Next, labor regulations should be more flexible, but not at the expense of undermining employees' rights and protections. Most importantly, labor laws and regulations should be enforced consistently and fairly. For this to happen, all of the key stakeholders in Serbia – government, employees, employers, and educators - must collaborate and be moved to action to improve the labor market, workforce employability and readiness, and business development climate in Serbia.

Active Labor Market Measures (ALMMs)

As the economy contracts and unemployment increases, countries often employ active labor market measures (ALMMs) to help redundant workers move to employment more quickly. ALMMs generally focus on skills training, job counseling, public works programs, and even subsidized wages for the unemployed. Serbia spent only 0.1% of its GDP on ALMMs in 2008, barely enough funding to assist 5% of the registered unemployed.[19] An increase in ALMMs expenditures, while needed to counter the effects of layoffs and low job creation, is unlikely in this period of tight fiscal constraints. Nevertheless, Serbia plans to provide career counseling, subsidized apprenticeships for 10,000 recent graduates, on-the-job training for 3,000 unemployed, subsidized employment for the disabled and older workers, grants (€1300) for start-up businesses, and public works jobs for 10,000 unemployed. The 2009 budget for these ALMMs is 3.5 billion Dinars.

---

[18] http://www.unison.org.uk/international/serbiamontenegro.asp
[19] Arandarenko, Mihail Highlights 4: Effects of the Global Financial Crisis on Serbian Labor Market, in the Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008

Pension Reform

The Public Pension System

Pensioners can often count on an increase in benefits around election time. Serbia is no exception. Leading up to the 2008 election, Serbia promised and delivered at the end of 2008 a 10% increase in pension benefits, with average pensions increasing by 13 percent in 2009. As such, pensions are one of the largest expenditures for the Government of Serbia with this recent increase and years of wage indexation, requiring a budget transfer to meet the growing pension deficit of 40% of total pension expenditures, up from 10% of the budget in 1999. In 2009, the GOS projects to pay 25% of its total budget for pensions, up from 20% in 2008.

The social insurance system provides an old-age pension, health, and unemployment benefits. Employers and employees *each pay* 17.9% of gross wages in social protection contributions - pensions and disability (11%), health insurance (6.15%), and unemployment insurance 0.75%).

Beginning in 2008 and to 2011, the retirement age is being increased gradually by 6 months a year to age 65 (men) and age 60 (women). At least 15 years of coverage plus the required retirement age are needed for a minimum pension. A full pension is available to those with at least 40 years of paid-in contributions. Privilege pensioners, those in special work categories, such as miners and ballerinas, need fewer years of service in order to receive a full pension.

The minimum monthly earnings for contribution purposes are equal to 35% of the national monthly average wage, 39,331 Dinars in January 2008. The maximum monthly earnings for contribution purposes are equal to five times the national monthly average wage. The minimum pension is 66% of the net wage, 30,362 in March 2009, about 20039 Dinars ($278)

A disability pension is available for those below the retirement age and deemed totally incapable of working. The required contribution period can be as low as 1 year for those under age 20 to 5 years for those aged 30 or older. There is no minimum qualifying period for a disability resulting from a work injury or an occupational disease.

Survivor pensions are available if the covered deceased had at least 5 years of coverage or was eligible for a disability pension and the survivor is over age 48 if a widow, age 53 if a widower, or disabled, or caring for a child younger than age 15 (age 26 if a student, no limit if disabled). Dependent parents, grandchildren, brothers and sisters may also be entitled to survivor pensions.

Between 2008 and 2011, the age requirement for survivors is being increased gradually to age 50 for a widow, age 60 for a dependent mother, and age 65 for a dependent father.

Serbia has an unfunded defined benefit mandatory pension system, commonly referred to as a pay-as-you-go (PAYG) pension system. In a PAYG pension system, current contributors provide for current pensioners pension income. Serbia's PAYG system had three funds – employees, self-employed, and farmers – which are being merged starting last year.

With the assistance of USAID and other donors, Serbia in 2001 began reforming its unsustainable public pension system. At that time, the pension system experienced large deficits because the number of pensioners was growing while the number of contributors was decreasing. The system also experienced low pensions, high contribution rates, easy access to pensions for those facing unemployment, and a large informal sector that evaded contribution payments.

The Pension Reform Begins

In 2001, Serbia introduced several pension reform measures to begin to address the inadequate and financially unsound pension system. The reforms at that time included:

- Statutory change in pension indexation (from wage to wage and CPI, the 50/50 Swiss model)
- Uniform minimum pensions
- Decrease in the contribution rate from 32% to 19.6%, later increased to 22% (11% of gross wages paid by the employer and 11% paid by the employee)

In 2003 and 2005, further pension reform measures were introduced:

- Increases in the retirement age
- Move to CPI indexation only
- Consolidation of the three public pension funds

The Pension Administrative Agency is largely a benefits processing institution. It has 3,750 employees in 150 offices throughout Serbia and is said to be extremely inefficient. With a declining contribution base while seeing a growing pensioner community, it struggles with outdated equipment and very little employee training to keep up with the needs of this agency. It is, however, optimistic that the $30 million World Bank loan will be a tremendous help in modernizing its operations.

Voluntary Pensions

In 2006, Serbia introduced voluntary pension funds as a likely springboard to mandatory privately managed pension funds in a three-pillar pension system. [20] Recent research and analysis have all but ruled out the introduction of a Pillar 2, a mandatory funded pension scheme, as too costly and too innovative for the current financial market at this time. For more on the feasibility and timeliness of a mandatory private pension scheme in Serbia, see *Challenges of Introduction of the Mandatory Private Pension System in Serbia,* a USAID funded research project published by the Center for Liberal-Democratic Studies, 2009.

There are now 10 voluntary pension funds (VPFs) with 150,000 clients and €50 million in assets, only 0.15% of GDP. Of the 10 VPFs, 9 are foreign owned. The 1 domestic VPF is managed by Serbia's largest insurance company, a socially owned enterprise, and has 45% market share. The two next largest funds have about 20% each in market share.

Most VPF participants either receive a match in contributions from their employer or the employer is the sole contributor to the fund. Only about 5% of participants contribute without an employer-employee relationship.

At the end of 2008, about 80% of the VPF assets were in cash, which returns about 16% annually in local currency. Some assets were in frozen currency government bonds, yielding 6-7% annually, domestic equities, and some real estate. The VPFs, which may invest up to 10% in foreign investments, hold no foreign assets.

Serbia's capital market is extremely shallow without any domestic corporate or municipal bonds and only 3 class A companies listed on the stock exchange. The government of Serbia recently began to issue 3-month treasury notes, yielding the same as cash, about 16% annually in local currency. The VPFs have begun to buy these notes.

Net Assets of Voluntary Pension Funds (in local currency in millions)	**2006**	**2007**	**2008**	**2009 Q1**
Total	**225.9**	**3,045.6**	**4,640.6**	**5,204.4**
Delta Generali	225.9	670.9	1,080.2	1,235.5
Raiffeisen Future Garant	-	122.1	373.5	425.8

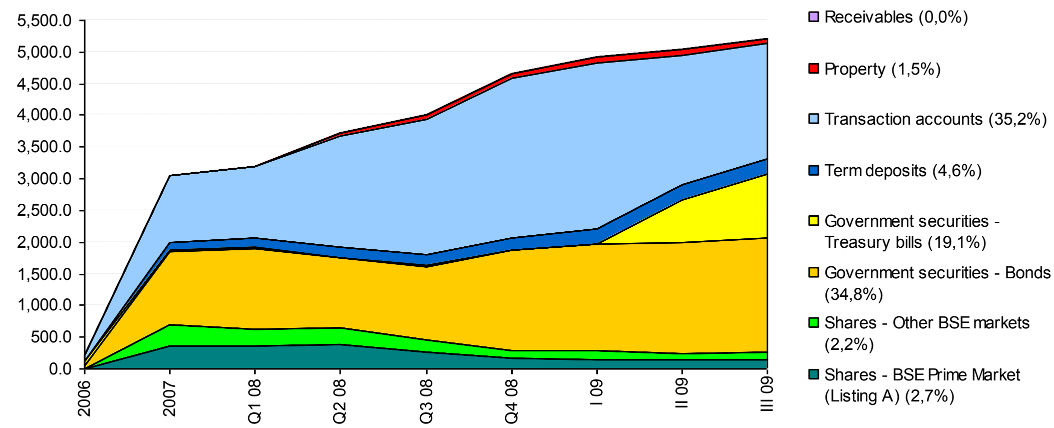
[20] Several countries in the region (for example, Poland, Croatia, Hungary, and Bulgaria) have adopted the three-pillar pension system. Pillar 1 is generally a public pension fund (funded or unfunded), Pillar 2, a mandatory funded scheme, and Pillar 3, voluntary pension funds.

	-	58.7	203.0	244.9
DDOR Penzija plus	-	725.7	869.8	934.7
Dunav	-	1,440.5	1,997.0	2,213.7
Nova penzija	-	23.3	74.7	89.1
Triglav penzija	-	4.4	23.0	27.7
HYPO	-	-	18.8	30.9
Soc. Gen. Štednja	-	-	0.2	1.1
Soc. Gen. Ekvilibrio	-	-	0.3	0.9

Age Structure of Pension Fund Participants

Gender	0-19	20-29	30-39	40-49	50	51	52	53+	**Total**
Male	137	8,617	26,521	31,351	3,316	3,180	3,389	20,779	97,290
Female	85	5,659	17,606	21,825	2,412	2,237	2,383	9,675	61,882
Total number of users	222	14,276	44,127	53,176	5,728	5,417	5,772	30,454	159,172
Percent share of total	0.14%	8.97%	27.72%	33.41%	3.60%	3.40%	3.63%	19.13%	100%
Accumulated funds as a percentage of net assets	0.05%	6.06%	28.60%	36.52%	3.94%	3.73%	3.97%	17.13%	100%

Composition of Voluntary Pension Fund Assets



According to several sources, the VPF market could be more robust if there were a strong financial literacy campaign in Serbia and if the tax treatment of the funds were more favorable. Currently, the VPFs receive only a partial tax exemption for contributions, about €30 per person per month, which tends to be the average contribution per participant. Advocates of greater pension savings argue for greater tax incentives for the VPFs. However, the nascent capital market remains a challenge for the private pension fund system even if greater tax incentives were provided and employers or savers contributed more to these schemes.

Pension Reform Unfinished Business

Serbia's pension reform is not finished. The public pension system continues to need systemic reforms if it is ever to attain a sound financial footing. The voluntary pension system is nascent, which some view as having too little traction to address pension adequacy for future retirees. It should be developed and expanded to help citizens save for their retirement as part of the overall old-age security structure in Serbia.

The public pension system has 2.6 million contributions and 1.6 million pensioners, a dependency ratio (contributors to pensioners) of 1.6. Even with the increase in the retirement age, some pensioners can retire as early as age 50. Moreover, the pension deficit as a percentage of GDP, while shrinking gradually, -8.9 in 2003, -8.0 in 2004, and -7.4 in 2005, crowds out other public spending, according to the IMF.[21] The government budget provides 40% of all pension expenditures. The average pension as

---

[21] As part of the recent €400 million IMF loan, structural conditions include a nominal freeze of pensions and civil service salaries in 2009, which the GOS agreed to as evidenced in a Letter of Intent to the IMF dated December 2008 (Prime Minster Mirko Cvetković, Minister of Finance Diana Draguyinovic , and Governor of the National Bank of Serbia Radovan Jelasic are signatories to this letter). Serbia expects the IMF to approve a €3 billion loan this May for additional budget support.

a share of the net wage has also been shrinking gradually 70.5% in 2003, 67.9% in 2004, and 61.8% in 2006. Nevertheless, pension spending was 12.1% of GDP in 2006 and 11.8% of GDP in 2007.

Until the government can reasonably assure workers an adequate pension income in an environment that is fiscally sound and sustainable, pension reform continues to be a major challenge for Serbia. Moreover, the pension system should be modernized and insulated from political manipulations and election year ad hoc changes. Serbia needs a national pension strategy that is fully integrated in a national employment and job creation strategy. Thus, there is much work yet to be done to strengthen Serbia's pension system to ensure its sustained stability.

Serbia Economic Growth Activity (SEGA)

Since 2001, USAID/Serbia has been engaged in assisting the Government of Serbia in macroeconomic and private sector development. More recently, USAID has been working with Serbian government counterparts, non-governmental organizations, bilateral and multilateral donors, and other US Government agencies to help strengthen the legal and regulatory environment in Serbia with a keen focus on private sector development and job creation. This work is being done under the *Serbia Economic Growth Activity (SEGA),* a $20 million project (GEG-I-00-04-004-00, Task Order 6) covering the period 2006 to 2010. The key counterparts are the National Bank of Serbia (NBS), the Ministry of Finance (MOF) and its Serbia Tax Administration (STA), the Serbian Securities and Exchange Commission (SEC), and nongovernmental institutions such as consulting firms, economic research institutions, and universities. The implementing partner is Bearing Point.[22]

The aim of this project is expected to result in heightened investor confidence in the rules and behavior of key institutions affecting economic growth and investments in Serbia.

Key project components include:
- Macroeconomic policy development capacity building
- Formulation and implementation of laws, policies, and procedures relating to financial, fiscal, and macroeconomic development
- Supervisory oversight and risk management of the financial sector to improve the availability of credit and investment opportunities
- Tax policy and administration and fiscal decentralization reforms
- Public information and education programs for the key reform programs

[22] Deloitte LLP received approval from the United States Bankruptcy Court in April 2009 to purchase Bearing Point's North American Public Services practice. The transaction is expected to close in May 2009.

Several, but not exhaustive, key results to date include:

- Supported tax policy reforms and modernization of the tax system to create a business-friendly environment
- Facilitated the next stages of pension reform, voluntary and mandatory private pension funds, and provided public education on the importance of these initiatives
- Helped the NBS, MOF, and other key government economic institutions and agencies develop and implement their reform priorities, particularly in the area of fiscal reform
- Aided completion of the privatization process for state- and socially-owned enterprises
- Assisted the formulation and implementation of laws, policies and procedures relating to financial sector development and supervision
- Supported the operational and information technology (IT) requirements of the NBS to assist in improving the payments system and implementing financial sector reform

Those interviewed have given USAID's SEGA project high praise. The project is generally deemed efficient and extremely responsive to the government of Serbia's needs. One person expressed his view *that without USAID and SEGA, Serbia's economic situation would be much worse today.* Moreover, the SEC is particularly keen on USAID's continued support. According to the chairman of the commission, no other donors are really assisting Serbia become a developed country, because, *"We cannot have a developed country or a developed democratic country without a well-established and well-organized capital market."*

The technical assistance provided the National Bank under the SEGA project has also been well received and deemed invaluable. In fact, one of the larger voluntary pension funds with operations throughout Central and Eastern Europe considers the National Bank's operations among the top in the region. This VPF attributes the NBS's success to USAID's SEGA project.

The Department of Pensions and Disability Insurance within the Ministry of Labor Employment and Social Policy (MOLESP) were emphatic about the very good technical assistance that it had received from USAID's SEGA project. It was particularly appreciative that three of its staffers received pension training in Washington, DC. It also found the analysis of the prospects of introducing the Pillar 2 mandatory pension scheme most useful for planning and policy purposes. Additionally, this department is most grateful that USAID assisted Serbia in introducing the Pillar 3, the voluntary pension system.

What remains, according to several government officials, academicians, and private sector pension experts, is a national pension system strategy to put the pension system on sound financial footing. Also needed, according to the interviewees, is financial literacy training and education to promote the need to save for retirement. As one interviewee said, *"I should have been taught how to save, but I don't know how."* (Perhaps a financial literacy campaign throughout Serbia is a Global Development Alliance (GDA) possibility with MasterCard, Visa, and/or the local banks and insurance companies. Does USAID/Serbia want to explore this possibility?)

SEGA is said to have fostered greater independent and critical thinking throughout the government and in key research institutions. In some cases, however, the government of Serbia has not taken full advantage of SEGA, as in the case with tax reform assistance where the long-term tax advisor was withdrawn because of the Serbian government's lack of interest. Or, in the case of not allowing mid-level managers to take much needed capacity building training or support that SEGA has to offer.

Full annual contract funding has been another issue for SEGA. Due to the year-to-year uncertainties of State Department certification of Serbia as having complied with the International Tribunal for War Crimes in the former Yugoslavia (ICTY), or the non-certification of Serbia in some years, SEGA received less than the anticipated contracted amount in several years. This has often made it difficult for SEGA to plan or proceed with various aspects of its project plan, such as the grant portion of the contract. No grants have been funded under the SEGA project as had been contemplated when the program was designed.

Other Donors

Since 1997, USAID has been one of the largest bilateral donors to Serbia. Germany is also a major donor as are the multilaterals, particularly the World Bank and the IMF. The EU is expected to be the largest donor in the mid-term as it provides more and more funds to Serbia as a pre-candidate EU accession country.

The EU is slated to provide Serbia about €200 million annually as the country progresses toward EU accession. For 2009, the GOS is expecting the EU to provide €100 million in budget support from the EU's Instrument for Pre-Accession Assistance (IPA) funds. It is also reported that the EU has set aside €1 billion of non-refundable aid for Serbia for the period 2007–2012 for implementing reforms regarding Serbia's EU integration process. Total EU accession loans and grant could reach €2 billion.[23]

The World Bank provided a $30 million loan to Serbia about 5 years ago, which Serbia has recently begun to access. These funds are to upgrade the tax, health, and pension registry of employees and employers and improve the administrative capacity of the NBS.

The National Employment Service (NES) has received active labor market technical assistance from several donors:

- Germany - a capacity building-twining project;
- EU – vocational education training for 2,000 unemployed;
- UNDP – a youth employment program funded by Spain; and
- ILO - a youth employment program to begin this year

See Appendix B for a list of financial sector and macroeconomic donor support to Serbia.

Recommendations

One of the greatest challenges that Serbia faces is improving its employment situation. Double digit unemployment and youth unemployment upwards of 40% is a recipe for political, economic, and social instability. Serbia desperately needs sustainable employment growth decisively driven by private sector development. It also needs to reduce the public and informal sectors to eliminate the negative impact that these sectors are having on private sector development. Helping Serbia achieve sustainable economic growth that encompasses inclusive social development and good governance should be the basis of USAID/Serbia's macroeconomic focus over the next five years.

The challenge, therefore, is to assist Serbia in producing more and better jobs for today's and tomorrow's workforce. To do so is, without question, heavily contingent upon an improved and reliable legal and regulatory environment that is fair, effective, and efficient. As such, the USAID/Serbia should remain engaged in assisting Serbia in adopting adequate laws and regulations and in modernizing government administrations. USAID/Serbia should remain heavily engaged in helping Serbia develop a modern business environment system that can grow and thrive competitively. Without such, private sector led job creation will continue to remain weak, and thus, undermine the political, economic, and social stability that the Serbian citizens seek.

[23] http://www.seebiz.eu/en/macro/srbija/eur-168mn-allocated-to-serbia,41750.html

Based on the various recommendations received during this assessment (Appendix C) regarding possible assistance that would help the country accelerate private sector development and improve the business-enabling environment, four are strongly recommended. Assist the GOS:

9. Harmonize the financial and business legal and regulatory environment, including administration and enforcement, with EU laws and standards;
10. Develop a national strategy and action plan to address business expansion, job creation, and a workforce trained and capable of making a significant contribution to increasing productivity and profitability, and ultimately increased economic growth;
11. Develop a national pension reform strategy that addresses the long-term fiscal stability and sustainable of the pension system; and
12. Assist Serbia access any and all EU pre-candidate accession funds far greater than any other recent EU country has done to date and to leverage and enhance Serbia's bilateral support, in general, and that of the U.S. government, specifically.

Why these four recommendations?

The aim of these particular recommendations, were the Mission to adopt them, would be *More and Better Jobs for Greater Economic, Social, and Political Stability in Serbia.* The beneficiaries of such a successful program would be business owners, employees, pensioners, investors, and society as a whole. These four recommendations are inextricable pieces of a whole. Businesses need an adequate and reliable legal and regulatory environment in other to compete globally and thrive. They also need reasonable and adequate financing and investments as well as a competent and capable workforce to succeed. The workforce needs to be adequately trained to be employable (human capital development), hired (career counseling and guidance), and ultimately improve their standard of living (increased wages and savings). Society needs a balance between the self-reliant and the less productive or capable. And, workers need to retire with dignity with an adequate pension income that does not crowd other societal needs – education, national security, health, etc.

The pension system is fundamentally broken. The pension expenditures run a deficit of 40%, which is funded by general budget. Moreover, total pension expenditures are 25% of the total government budget, about 5.5% of GDP. Without question, the pension system is unsustainable and needs reforming. From the high pension deficit to the privilege pensions that allow some workers to retire as early as age 50, Serbia's pension system is fiscally unsound and unsustainable. It needs systemic reform immediately.

Serbia is scheduled to receive €584.4 million from the EU Instrument of Pre-Accession Assistance (IPA) program for 36 projects with a 2010 deadline for implementing the projects. Additional funds are expected until EU accession is granted, likely in 2015 or so by some accounts. It seems as these EU pre-accession funds may not be fully or even significantly accessed without various ministries, NGOs, and others receiving training and assistance on how to access those funds. With strategic planning coupled with grant and proposal writing training directed at the IPA funds, USAID could help Serbia capture these EU funds, thus leveraging Serbia's donor assistance.

USAID's strength lies in its ability to provide technical assistance and advice on policy formulation and reform processes, in general. Specifically, USAID/Serbia is well-suited and well-positioned in Serbia, having worked closely with the government, NGOs and other donors, to continue to provide economic growth and private sector development technical assistance.

USAID should now focus its energy and resources on assisting Serbia with not only drafting good laws and regulations, but also with implementing and enforcing those measures. Sound governance, accountability, transparency and enforcement is needed in Serbia to ensure a durable reform process and to speed-up the results needed to move the economy along faster.

It is further recommended that USAID/Serbia take a flexible approach as it continues to provide macroeconomic strengthening assistance to Serbia. Since 2001, Serbia has experienced continued political and economic instability. Its reform path, while steady on some levels, has not had the successes that some of its regional neighbors have had in the last 10 years. As such, USAID/Serbia must be posed to respond to Serbia's fluid political, social, and economic environment in order to seize development opportunities as they present themselves. Thus, the Mission may want to temper its top-down approach to macroeconomic and private sector development with a more bottom-up approach.

This current global economic and financial crisis makes it difficult, if not impossible, to gauge the level and extent that Serbia and its neighbors will be impacted by this economic downturn. As such, an instrument that can move easily between assisting the policymakers when the political will is pronounced and assisting new businesses and the private sector expand is highly recommended.

Economic growth focused on private sector development is essential for Serbia if it is to generate opportunities for employment and income generation. A strong and dynamic private sector is crucial for long-term economic growth, and a necessary ingredient for sustained economic, social, and political stability in Serbia.

USAID/Serbia is uniquely qualified to continue to help Serbia close many of its legal and regulatory and business development gaps. It is also uniquely qualified to help Serbia create the right economic growth policy environment that will stimulate investments and provide resources for investments in the workforce, infrastructure, and the business community.

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

Appendix A – Serbia Demographic Overview

Population Mid-2008	7,354,000
Birth Rate (annual number of births per 1,000 total population)	10
Rate of Natural Incr. (birth rate minus death rate, expressed as a %)	-0.4
Population Mid-2025 (projected)	6,719,000
Population Mid-2050 (projected)	5,819,000
Population Change 2008-2050 (projected %)	-21
Population Gain/Loss, 2008-2050	-1,535,000
Infant Mortality Rate (infant deaths per 1,000 live births)	7.4
Total Fertility Rate (TFR)	1.4
Population Age <15 (%)	16
Population Age <15	1,149,000
Population Age 65+ (%)	17
Population Age 65+	1,268,000
Life Expectancy at Birth, Both Sexes (years)	73
Life Expectancy at Birth, Males (years)	71
Life Expectancy at Birth, Females (years)	76
Urban Population (%)	56
Population Living in Urban Areas of 750,000+, 2005 (%)	14
Source: Population Reference Bureau	

Appendix B: Donor Map In Area Of Sega Activities

(See attached)

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

Appendix C:

What Options Emerged (Recommendations) From The Interviews?

FOR EMPLOYERS/BUSINESSES?

- Access to Credit
- Workforce Development for a more skilled and relevant labor force
- Greater private pension fund tax incentives
- *“Save the private sector from the government so that it can grow and thrive; this has nothing to do with the global financial crisis.”*
- Improve the tax burden
- Reduce the regulatory burden
- Reduce/eliminate the informal sector
- Have a stand-alone workforce development activity or increase the funds for workforce development in the competitiveness project
- Help businesses become more productive
- Help businesses value employee training
- Help businesses improve standards so they can export more
- Conduct employer survey to ascertain job demand

FOR EMPLOYEES?

- Focus on Workforce Development to upgrade skills and address increasing layoffs as economy continues to plunge
- Support the introduction of Pillar 2, the mandatory private pension scheme
- Educate citizens about the importance of saving for retirement; *~~I~~ should have been taught how to save, but I don’t know how.”* (Perhaps a financial literacy campaign throughout Serbia is a GDA possibility with MasterCard, Visa, and/or the local banks and insurance companies. Does USAID/Serbia want to explore this possibility?)
- Greater private pension fund tax incentives
- Target EG to the rural poorer areas
- Assist the disabled with job training
- Assist returning Serbians find jobs

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

FOR THE UNEMPLOYED?

- Workforce Development for a more skilled and relevant labor force to move the economy forward and reduce poverty→ certificate or degree adult education programs for dropouts
- Target EG to the poorer areas, generally the rural areas and South Serbia

FOR POLICY IMPROVEMENT?

- *Develop a labor market policy focused on improving the employment rate and the labor force quality with broad participation and input from the relevant Ministries, educators, think tanks, and the private sector to provide a more efficient response to changes in labor supply and demand*
- Develop pension reform strategy for a sustainable pension system integrated in a private sector development and job creation strategy
- Target social assistance to the very poor → Social Assistance Strategy → Farmers' pensions and noncontributory pensions
- Tax reform, including tax incentives for the voluntary pension funds
- Reduce public sector employment
- Shrink the informal economy
- Advance WTO accession
- Improve data collection and analysis capabilities in the government
- The government needs to collaborate across ministries for greater efficiency and better results
- Analyze what are the impediments to business development and job creation

FOR CAPACITY BUILDING?

- Central Bank – bank restructuring, capital adequacy and bank stress test procedures, and implement of Basel II (See UST Larry McDonald re Treasury TA)
- Tax enforcement
- Develop more business start-ups
- Develop medium to small companies, particularly manufacturing and services (not financial sector, which is fairly developed – banks, investment funds, and insurance companies)
- Privatize SOES
- Develop capable government middle-level managers (ministers and political appointees turn over too frequently)

- Stress human resource development capacity building in the public and private skills – *Number one asset in Serbia is youth population*
- Develop cadastre system and enforcement it
- Improve data collection and analysis to improve the quality of policies, laws, and regulations
- Introduce financial literacy in society, particularly the schools
- Increase the capacity of the voluntary pension fund association
- Improve government administration efficiency with long-term sustainable policies
- Support the draft Securities Law toward embracing EU and international standards and best practices
- Government needs to conduct impact assessments of how laws are implemented and what results are they are achieving
- Improve the civil society so that citizens influence government policies and direction
- Integrate USAID's programs across several ministries within one activity to promote collaboration across a variety of government entities
- Continue to support Junior Achievement and connect youth programs to the private sector
- Institutionalize career counseling

Appendix D – People Consulted and Interviewed

Prof. Mihail Arandarenko (expert in Labor issues; FREN Managing Board Director)
Ms. Nikola Altiparmakov, Tax expert in SEGA project
Ms. Rosa Chiappe, Chief of Party SEGA project
Jovan Protic from ILO; SEGA office
Ms. Jelena Bulatovic, USAID SEGA COTR
Mr. Kristijan Vukojcic, Head of the Private Pension Supervision Department; National Bank of Serbia
Profesor Bajec, Special Advisor to the Prime Minister for Macroeconomic issues (pension); Economic Faculty
Mr. Milko Stimac, Head of Securities Exchange Commission;
Ms. Snezana Ristanovic - Director of the Private Pension Fund Raiffeisen Future;
Ms. Sonja Avlijas, Poverty Reduction Coordinator and Researcher, Deputy Prime Minister's Poverty Reduction Strategy Office
Ms. Ivana Aleksic, HD specialist; World Bank, (rescheduled)
Ms. Gordana Matkovic, PhD, Director of Social Policy Studies in CLDS
Ms. Kosovka Ognjenovic, Economic and Social Policy Institute (ESPI Institute)
Mtg with Ljiljana Radivkovic, Ministry of Labor
USAID's PPES project and Junior Achievement on Youth Employment, 5 Pro ject members, including the director Michael Pillsbury
Mr. Ivan Mimic, Republic Pension Fund - Director of Financial Sector
Ms. Milica Turnic, Catholic Relief Service re Labor Law for people with invalidity
Ms. Ana Trbovic, USAID's Competitiveness Project
Ms. Olga Alergus, Director Consulteam, HR firm
Ms. Branislava Zunjic, Serbian Chamber of Commerce
Mr. Dragan Djukic; National Employment Agency
Ms. Valli Corbanese ILO Technical Adviser on Employment in Serbia
Mr. Vuk Djokovic, State Secretary in the Ministry of Finance

Bibliography

Arandarenko, Mihail, *Highlights 4: Effects of the Global Financial Crisis on Serbian Labor Market*, the Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008

European Commission, *Adjustment Capacity to External Shocks of EU Candidate and Potential EU Candidate Countries of The Western Balkans, with a Focus on Labour Markets*, Volume II, 2008

European Commission, *Serbia 2008 Progress Report*

Foreign Investment Council, White Book 2008, *Proposals For Improvement Of The Business Environment In Serbia*

Gligorov, Vladimir, et al, *Western Balkan Countries: Adjustment Capacity to External Shocks, with a Focus on Labour Markets,* The Vienna Institute for International Economic Studies, 2008

ILO, Employment Policy Review Serbia, 2007

IMF Country Report No. 09/20 January 2009

INEKO and ESPI Institute*, Labour Market Reforms in Serbia and Slovakia,* 2008

OECD, *Serbia: A Labour Market In Transition*, 2008

Quarterly Monitor of Economic Trends and Policies in Serbia, Issue 15, October-December 2008

USAID Competitiveness Project *Serbia, Skills Gap Analysis In the IT, Film Production, Apparel and Education Sectors of the Serbian Economy* 2008

USAID, *Strategy Statement the Republic Of Serbia***,** December 2005

World Bank, *Labor Costs and Labor Taxes in the Western Balkans*, February 2008

Private Sector Development
And
Business Enabling Environment Assessment

Part II: Financial Sector Assessment

Prepared by: Michael Borish

June 24, 2009

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

TABLE OF CONTENTS

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

ACRONYMS

AMCHAM	Serbian-American Chamber of Commerce
AML	Anti-Money Laundering
ASMI	American-Serbian Management Institute (proposed)
BCPs	Basel Core Principles
BIS	Bank for International Settlements
CAR	Capital Adequacy Ratio
CFT	Combating the Financing of Terrorism
CPI	Consumer Price Index
DIA	Deposit Insurance Agency
EBRD	European Bank for Reconstruction and Development
ERM	Enterprise Risk Management
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSSA	Financial Sector Stability Assessment
FSSP	Financial Sector Support Program
GDA	Global Development Alliance
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards of Auditing
IT	Information Technologies
KfW	*Kreditanstalt für Wiederaufbau*
MEGA	Municipal Economic Growth Activity
NBFIs	Non-Bank Financial Institutions
NPLs	Non-performing Loans
NBS	National Bank of Serbia
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-As-You-Go
RoAA	Return on Average Assets
RoAE	Return on Average Equity
SAM	Serbian Association of Managers
SEGA	Serbian Economic Growth Activity
SMEs	Small and Medium-sized Enterprises
SOE	State-owned Enterprise

TA	Technical Assistance
UN	United Nations
USAID	United States Agency for International Development
UST	United States Treasury
VAT	Value Added Tax
VPF	Voluntary Pension Fund
WTO	World Trade Organization

EXECUTIVE SUMMARY

I. Background

The following report, "Recommendations for USAID Financial Sector Assistance to Serbia: 2011-2015", has been prepared by Michael Borish and Company, Inc. (MBC) for USAID-Serbia for its internal strategic planning purposes related to possible bilateral assistance for Serbia in the coming years. The report provides an assessment of recent developments and issues for future USAID planning, an overview of SEGA performance and accomplishments, and recommendations on what is considered the best use of USAID assistance in resolving critical issues for 2011-2015.

II. Major Findings Related to the Financial Sector

A. Macroeconomic and Monetary

- The recent global economic and financial crisis has tested Serbia, and the results have been broadly positive.
- There is broad acknowledgement that significant structural weaknesses persist, and that these could present challenges in the future in the event of another crisis as well as delay prospects for receiving a future invitation to join the European Union.
- The lack of competitiveness is a consequence and cause of a vicious cycle in which enterprises are often inefficient and/or unable or unwilling to pay taxes.
- Getting the government to induce needed reforms will be complex, costly, risky, and multi-dimensional in terms of requirements.
- Moreover, for enterprises in the private sector to assume greater responsibility, they will need to have mechanisms for clearing arrears and restructuring their finances and operations so that they can become more competitive and creditworthy on a sustainable basis.
- In addition to bank-enterprise issues, there are also substantial inter-enterprise arrears which, along with VAT, add to significant liquidity pressures in the real sector.
- Having accounted for such weaknesses, there is recognition that economic improvements have been made in recent years under difficult political circumstances.
- However, considering the endemic political instability that has persisted and the transformation of national borders, the overall environment for reform has been challenging. Looking ahead, it is clear that many difficult structural-level issues remain.

For USAID: The multitude of risks and challenges means that the upcoming environment for reform could be difficult, even with positive political will and a stable government.

B. Banks and Banking

- The Serbian banking system has undergone major reform in the last decade, and is now well capitalized relative to risk exposures.
- All the key indicators show significant improvement in the banking sector since the SEGA project began.
- There are still considerable weaknesses in the banking system, albeit far less severe than in 2000 or 2004.
- There is also considerable work that needs to be done in the field of banking supervision.
- The FSSP is closely linked to a World Bank program that focuses on building a more efficient and stable financial sector along with initiatives to improve the business environment and strengthen financial discipline via privatization, restructuring, and energy sector reform.
- Despite continued weaknesses, the banking system has shown positive trends in the last several years.

For USAID: Continued weaknesses and challenges in the banking sector include the high cost of operations (e.g., high reserve requirements, high repo rates, high net nominal spreads on lending), continued state ownership of up to 15 percent of banking system assets, and limitations on hedging mechanisms in the Serbian banking system.

C. Non-Bank Financial Institutions

- Serbia's non-bank financial institutions are limited in activity, volume and value.
- The World Bank program tied to the FSSP addresses key outcomes in the insurance and securities markets in addition to banking.

For USAID: There are few risks to Serbia at the moment rooted in the non-bank financial sector, consistent with other markets where non-bank financial services are underdeveloped. The impact of the above on USAID planning is more related to the opportunity cost to Serbia of not developing non-bank activities.

D. Financial Sector Infrastructure

- The banking system has shown itself to be stable and well supervised during the recent financial crisis.
- Notwithstanding progress in banking supervision, there are still weaknesses and a need to sustain progress.
- The bankruptcy framework is underdeveloped and generally not used for debt resolution and contract enforcement issues.

- Serbia was slow to introduce legislation against money laundering and to set up a financial intelligence unit.
- The absence of consolidated accounting reduces risk detection capacity at the NBS, although efforts have been made in recent years to strengthen cross-border cooperation with other supervisory agencies.
- IFRS is now fairly common with the EU-based banks, but is hardly in effect elsewhere in the economy.

For USAID: Notwithstanding improvements in financial sector infrastructure in recent years, more work is needed for reforms to be sustained. The impact of the above on USAID planning is that while NBS has reached a threshold as an effective regulator under Basel I, there will be additional challenges as Serbia (1) moves on to Basel II, (2) seeks to develop the non-bank financial sector, (3) promotes development of a more profitable and more efficient system, and (4) seeks to strengthen Serbia's reputation internationally.

E. Real Sector Structural Issues

- Many of the core problems for future financial sector development relate to structural problems in the enterprise sector, as well as governance and tax administration weaknesses throughout the entire economy.
- There is a well defined agenda to enhance the business environment, strengthen financial discipline, and build a more efficient and stable financial system.
- Key legislative reform to strengthen the business environment includes (1) amendments to the Company Law, Enforcement Law, Privatization Law, and Law on Spatial Planning and Construction, and (2) new Laws on Bankruptcy, Competition, and State Aid.
- One of the key weaknesses in Serbia is governance and accounting standards. Serbian businesses do not operate according to the same principles as many other enterprises in the EU or elsewhere in market economies.
- Such principles also clearly apply to the public sector.
- Another key weakness is workforce development.

For USAID: Significant structural problems remain in the government and enterprise sector, and these will only be solved over a period of many years. The impact on USAID planning for financial sector and enterprise/public sector support is that greater strategic cohesion across initiatives/projects is required for USAID to have impact on a long-term basis, and in a manner that supports larger strategic objectives.

III. GENERAL ASSESSMENT OF SEGA

A. Background

This assignment was not an evaluation of SEGA performance. Nonetheless, the assignment called for lessons learned from SEGA activities over the last few years to determine how USAID should move forward with economic growth assistance priorities. The Scope of Work for the financial sector review included several questions:

- Do the problems or needs that gave rise to the SEGA activity (SEGA) still exist, have they changed, or are there new needs that should be addressed?
- Will there be expected results from SEGA that remain unattained at its completion that should continue to receive USAID assistance?
- Is SEGA's implementation strategy valid or should it be reformulated for future activities?
- Do conditions exist to ensure that SEGA's results will have lasting effects?
- Can we confirm that the Government of Serbia wants, needs, and will use USAID technical assistance and training in reforming its economic policies?
- What approaches to technical assistance have been most effective with the Government of Serbia? For example, would conventional assistance implemented by a contractor or grantee be most effective, assistance from a U.S. Government department or agency (such as U.S. Treasury or the SEC), or a combination of both approaches?
- If the assistance in the period 2011-2015 were to be the final phase of U.S. bilateral assistance to Serbia, how would that affect recommendations of assistance objectives and approaches to delivery of that assistance?

B. Future Considerations for USAID Assistance

USAID assistance should be influenced by the following:

- **Strategic Fit with USAID**: Consistent with and reinforces 2011-2015 vision regarding support for Euro-Atlantic institutions. For future SEGA work, efforts should continue to promote (1) convergence with BIS, IAIS, IOSCO and related international standard-bearers in the financial sector, and (2) effective implementation of reforms that position Serbia to accede to the European Union and other Euro-Atlantic institutions.

- **Comparative Advantage for USAID**: Evidence of capacity, a track record, and superior performance by USAID when compared with other donors. For future SEGA work, this is clearly in the financial sector, with particular emphasis on legal, regulatory and institutional structures for effective performance and stability.

- **Achievable Medium-term Results**: Complexity/feasibility for achievement regarding USAID and counterparts' capacity to design and implement effectively. For future SEGA work, this will require a realistic approach to goals and objectives that can be achieved. There is far greater stability at NBS than in government ministries. As such, the probability of achieving medium-term results is higher via continued work with the central bank than it is with government ministries.

- **Sustained Long-term Impact**: Transferability to counterparts as legacy accomplishment by/from USAID. For future SEGA work, this will be achievable via the NBS. Other initiatives will need to be explored, taking into account the capacity to operate on a sustainable and/or commercial (cost-recovery) basis.

- **Major Results from Budgetary Resources**: Reflected in how expensive or not the initiatives would be in terms of funding allocations, whether there is a need for co-funding, and if so, what the prospects are for achieving co-funding from other partners. For future SEGA work, this will require closer coordination with major donors to leverage results from USAID budgeted resources. This may also require that USAID look to vendors whose cost structures are lower than what USAID has paid in the past.

- **Scaled re Available Budget**: Balancing achievement objectives with funding parameters to ensure that objectives are aligned with funding, and not out of balance. For future SEGA work, this relates to the above considerations re results from budgetary resources. This will require potentially greater use of Serbian expertise, as well as possibly lower-cost contractors and/or alliances with other USG agencies.

- **Measurable Performance Indicators**: As reflected in the ease of compilation of key performance indicators and their usefulness as a monitoring tool. For future SEGA work, this will be relatively easy to structure for the financial sector once clear outcomes and outputs are agreed to with Serbian counterparts.

- **Fill Major Economic Development Gaps**: Addresses critical needs. For future SEGA work, the approach of continuing to support financial sector reform is critical as a resource for larger economic growth objectives. However, effectiveness will only occur in tandem with other structural reforms, which will require close coordination with the IMF, World Bank and government for the desired results to be achieved. Support for the financial sector without close linkage to reforms in the enterprise sector and government will limit prospects for success.

- **Confidence of Success**: Prospects for achieving planned results. For future SEGA activity, as per the above, confidence of success will be higher if closely coordinated with reforms in the enterprise sector and government. This includes (1) legal, regulatory and institutional requirements that reduce government ownership in the economy, (2) reduce the position of monopolies, (3) allow for faster dispute resolution, and (4) rationalize the entire government approach to taxation, procurement and regulation.

- **Local/Domestic Support ("Buy-in")**: Counterpart cooperation, capacity, support and active participation. For future SEGA activity, this is largely guaranteed via NBS and some of civil society. It is largely guaranteed for the moment in the government, but not guaranteed for the long term. Willingness of counterparts to commit resources in conjunction with USAID-funded assistance could serve as a proxy for domestic support.

- **Global Development Alliance**: Prospects for potential partnerships in Serbia with international entities that could be instrumental in furthering strategic objectives. For future SEGA work, this is an important feature that will be helpful in leveraging resources, accelerating needed reforms, and potentially being indispensable in the establishment of at least one legacy institution.

Specific to future SEGA activities, key findings suggest that future assistance should be influenced by the following:

- **Needs**: Some of the original needs that existed in the original SEGA design are still in effect, while new challenges have emerged. For future SEGA work, the design will need to be more specific in terms of objectives and targets. In some cases, original needs should not be addressed, as they are too complex, costly or politically risky to ensure success. In other cases, continued support is justified.

- **Results**: Not all results will have been attained, partly because of overly ambitious targets, the diversion (dilution) of resources, and/or lack of political will/government capacity. For future SEGA work, results will need to be more closely aligned with the core criteria noted above. Above all, greater cohesion will be needed re other USAID initiatives. Areas of likely success and impact that can be achieved by 2015 should drive design.

- **Implementation Strategy**: Achieving a balance of focus and responsiveness is the consensus that has emerged from a discussion of past performance under SEGA. For future SEGA work, it will be important to identify achievable targets and objectives, and then build in a measure of flexibility and responsiveness within those areas.

- **Conditions for Lasting Effect**: USAID will need to make choices in terms of priorities and resource allocation. In some cases, the greatest needs should not be addressed because the preconditions for success are missing. In other cases, foundations are in place for success. For future SEGA work, it will be important to build on earlier successes that have good prospects for both impact and lasting effect.

- **Government Confirmation re Economic Reform**: While the government is currently pro-reform, the degree of political will relative to the challenge is still unclear.

For future SEGA work, USAID will need to identify personalities that have demonstrated their commitment to reform, have shown this through their respective institutions, and have articulated a strategic vision that converges with USAID objectives. USAID will also need to minimize the risk of turnover in terms of its institutional partnerships. This means that if there is a shift in cabinet, that sufficient capacity should exist to continue the work agreed to, and not be wholly dependent on the highest levels of government for sustained commitment and support.

- **Approaches**: Counterparts have spoken highly of TA delivered by USAID. Nonetheless, some have commented on a lack of strategic focus that could reduce net impact. For future SEGA work, USAID will need to (1) be more strategically cohesive and focused, (2) work in tandem with other donors and possibly USG agencies on a complementary and reinforcing manner, and (3) explore less costly approaches to TA delivery.

- **2015 Close Out**: There is considerable work to be done for Serbia to (1) establish a stable macroeconomic framework, (2) sort out distortions in the business and tax environment, and (3) achieve sustainable sources of earnings predicated on export competitiveness so that it is able to (4) weather future shocks without excessive dependence on tight monetary policy and donor funding. For future SEGA work, USAID will need to continue to focus on areas of current strength and stability, while working with others on critical structural reforms so that Serbia is able to converge with EU accession requirements. This process will not be fully achieved by 2015, but commitment to and implementation of reforms by 2015 should be sufficient to get them on the path to an invitation from the EU.

IV. RECOMMENDATIONS TO USAID

Many options for potential support were considered, but were not among the recommended initiatives because (1) other donors are likely to be or already are involved without any further need for USAID assistance; (2) USAID does not necessarily have a comparative advantage; (3) they may take too long to achieve needed results; or (4) there are too many risks to being able to achieve objectives, including lack of perceived buy-in. (These are discussed in the report.)

There are four broad financial sector initiatives recommended for USAID to pursue. Three build on existing initiatives and are areas where USAID has a successful track record in Serbia and/or other transition countries, and/or represents an area of critical focus. These are (1) continued yet targeted work in **banking supervision**, with particular emphasis on requirements for standardized/simplified approaches to Basel II; (2) implementation of a viable long-term **debt securities market**, with initial focus on the local exchange as a platform for a liquid central government securities market; and (3) support for capacity enhancements regarding **AML/CFT**. A fourth initiative, (4) establishment of the **American-Serbian Management Institute**, would serve as a wholesale source of accredited management capacity-building for financial institutions, enterprises, government officials and service providers (e.g., auditors, accountants) by offering MBA and MPA courses in conjunction with one or more US universities. Each of these is briefly summarized below.

► **#1: Strengthening the National Bank of Serbia**: NBS has made significant progress in recent years, and is widely recognized as a source of stability during the recent crisis. However, there are still some areas of needed strengthening. These include:

- Movement to Basel II
- Coordination of Basel II with Financial Stability Capacity
- Coordination of AML/CFT with Other Agencies

USAID assistance would involve short-term (and possibly) long-term TA to (1) coordinate movement to Basel II; (2) strengthen capacity to monitor and manage financial stability issues; and (3) coordinate and strengthen AML/CFT capacity. Specific outputs would include (1) demonstrated supervisory capacity to determine banks' own credit, market and operational risk management capacity and systems to ensure appropriate levels of capital are in place for banking system stability, and in a manner that is not as restrictive with regard to reserve policy; (2) demonstrated capacity to manage stress in the economy resulting from external shocks, macroeconomic or structural imbalances, cross-border exposures, and/or cross-sectoral (e.g., banking and insurance) exposures, and to ensure the financial system is adequately capitalized and able to access liquidity to meet all financial and payment obligations; and (3) capacity to prevent any reputation risk or loss of depositor, creditor or investor confidence as a result of money laundering or criminal financial activity. Partners would be a prime contractor and NBS, with significant coordination envisioned with the IMF and World Bank.

Performance indicators could include:

- Capital adequacy of the banking system
- Numbers of banks below minimum capital adequacy and their share of total assets and deposits
- Earning assets/total assets
- Loans to the non-financial sector/total loans
- Non-performing loans/total loans
- Return on average equity
- Return on average assets
- Average credit, assets, deposits and capital per bank
- Compliance with Basel Core Principles of Banking Supervision
- Implementation of Basel II—standardized and simplified approaches—with particular focus on supervisory capacity to monitor for credit, market and operational risk
- Compliance with IAIS and EU Solvency II requirements in insurance

► **#2: Developing the Long-term Debt Securities Markets**: Serbia's macroeconomic framework is out of balance due to poor budget management. The result of this inefficiency is that macroeconomic stability is predicated on high levels of foreign exchange reserves to maintain a moderately stable exchange rate, and to maintain confidence among depositors. This imposes an enormous burden on the banks in the form of reserve requirements, making banking a costly business in Serbia. This, in turn, limits the availability and affordability of credit for the private sector. Such constraints in the banking system spill over to the enterprise sector, resulting in significant inter-enterprise arrears as well as other arrears. All of this adds to the cost of business transactions, and keeps the negative spiral moving in a way that makes it difficult to achieve more balanced stability. For these reasons, it is recommended that USAID support development of a long-term debt securities market. Key needs include:

- Debt Management Strategy
- Planning for an Improved Sovereign Rating
- Financial Instruments
- Accounting, Audit and Disclosure

USAID assistance would involve short-term TA to (1) establish criteria and a regulatory framework for development of a liquid long-term debt securities market; (2) develop regulatory capacity to ensure issuers and brokers comply with the regulatory framework; and (3) institute the required accounting, audit and disclosure standards required when issues come to market for ongoing integrity and confidence. Specific outputs would include (1) a long-term yield curve to serve as a benchmark for the pricing of long-term instruments and exposures; (2) financial instruments in which banks, insurance companies, pension funds and others could invest to assist with earnings and asset-liability matching requirements; (3) standards for Ministry of Finance to manage its long-term debt strategy predicated on sound fiscal collections, budget management and planning, and improved sovereign ratings; and (4) modernization of accounting and audit standards consistent with requirements in liquid and transparent capital markets. Additional outcomes potentially would include (5) issuance of mortgage bonds, to provide long-term funding instruments in the insured residential mortgage market; (6) issuance of municipal bonds in Belgrade, Novi Sad, or other municipalities potentially able to attract institutional investment; (7) issuance of infrastructure bonds; and (8) issuance of equities by well managed enterprises. Partners would be a prime contractor, the Securities Commission, Ministry of Finance, and an approved Serbian audit firm with IFRS capacity for public sector debt instruments. Significant coordination is envisioned with the IMF and World Bank.

Performance indicators could include:

- Sovereign ratings
- Value of Treasury securities > 1 year maturity
- Volume of trade in the secondary market in Treasury securities

- Value of other long-term savings instruments available for sale by banks, insurance companies and pension funds
- Number and value of non-Treasury long-term issues (e.g., mortgage bonds, municipal bonds, infrastructure bonds, corporate bonds)

► **#3: Enhance AML/CFT Capacity**: Serbia's economy and investment climate continue to suffer from tax evasion and other weaknesses. This includes criminal transactions. The government was relatively late in establishing a financial intelligence unit, and thus lags behind many neighbors in the region in being able to track suspicious transactions. For these reasons, it is recommended that USAID support efforts to build AML/CFT capacity. Key needs include:

- Organizational Requirements
- Staff Training

USAID assistance would involve short-term (and possibly) long-term TA to (1) tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and assist with the organizational structure and requirements for effective implementation of FATF principles and requirements; (2) increase training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors; (3) strengthen capacity and systems to monitor suspicious transactions; and (4) coordinate closely with NBS, law enforcement agencies, and other international counterparts to strengthen AML/CFT capacity. Capacity-building efforts would be linked with assistance to the NBS under Initiative #1 to ensure coordination via NBS operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with its effort to monitor the payment/settlement system. Specific outputs would include (1) demonstrated enhancement of capacity to identify, contain and prosecute suspicious transactions and those responsible for such financial crimes; (2) better public awareness of the costs and penalties associated with such activity; and (3) narrowing of gaps in institutional capacity relative to regional peers. Partners would be a prime contractor, Ministry of Finance, and NBS, with significant coordination envisioned with the IMF and World Bank. USAID should also explore partnerships with UST on this. If feasible, USAID should consider utilizing the same advisor for AML/CFT to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.

Performance indicators could include:

- Implementation of by-laws
- FATF/Moneyvaal assessment findings of capacity, coordination and effectiveness

► **#4: Establishment of the American-Serbian Management Institute (ASMI)**: Serbia's economy and public sector management continue to suffer from weak financial management capacity. This adversely affects government at all levels due to poor budget management and planning. In the private sector, weakness in this area undermines capacity for long-term investment planning. In the financial sector, it adds to the cost of training new recruits. Key needs include:

- General Accounting and Audit Standards
- Financial Management
- Specialized Management

USAID assistance would effectively provide start-up capital, along with other partners, to establish a US-styled and certified program that would provide needed professional training and development in financial management and other needed disciplines. Direct involvement from USAID would require (1) a general mapping of needs as these relate to enterprise, financial sector, and government management; (2) general outline and framework for coursework priorities, staffing and other requirements, and preliminary costing; (3) methods of oversight, management and coordination among other partners and stakeholders; and (4) formalization of agreement with and commitment from Serbian institutions (government, financial sector, professional associations, universities, etc.) to support, participate, and sustain the Institute. Specific outputs would include (1) introduction of core accounting, audit and financial coursework according to international standards (e.g., IFRS, ISA); (2) narrowing of gaps in business and financial management education relative to regional peers and the EU; and (3) certification to award MBAs, MPAs, and other master's-level education degrees. Partners would be a US university or consortium of universities, the government (e.g., Ministry of Education or Finance or Economy), NBS, professional associations (e.g., Bankers, Chamber of Auditors, AmCham, SAM, Foreign Investor Council), and universities and think tanks (e.g., University of Belgrade, FREM, CLDS). USAID would need to explore GDA possibilities, as well as potentially consider linkage to existing programs in the region (e.g., MBA program with University of Delaware at the University of Sarajevo, EU-oriented programs).

Performance indicators could include:

- Numbers of Serbians trained to deliver Master's-level course work
- Numbers of students attending courses
- Numbers of students receiving certificates and degrees
- Numbers of institutions sending employees to attend coursework
- Numbers of actuaries certified according to international standards

I. INTRODUCTION

A. Background

The following report, "Recommendations for USAID Financial Sector Assistance to Serbia: 2011-2015", is presented to USAID for its internal strategic planning purposes related to possible bilateral assistance for Serbia in the coming years. The report highlights (1) recent developments in the financial sector, along with outstanding issues, gaps and vulnerabilities and how these can impact broader economic and real sector growth in the future; (2) a general assessment of work done to date under the SEGA project, including commentary from Serbian counterparts about performance and effectiveness, as well as a brief summary of other donors' activity in the area of financial sector reform; (3) recommendations on what is considered the best use of USAID assistance in resolving critical issues for 2011-2015; and (4) key performance indicators for monitoring and evaluation.

Recommendations are based on a series of criteria where USAID assistance is considered to be most potentially useful and effective in achieving success. These criteria for evaluation have been agreed to with USAID, and include:

- **Strategic Fit with USAID**: Consistent with and reinforces 2011-2015 vision regarding support for Euro-Atlantic institutions.
- **Comparative Advantage for USAID**: Evidence of capacity, a track record, and superior performance by USAID when compared with other donors.
- **Achievable Medium-term Results**: Complexity/feasibility for achievement regarding USAID and counterparts capacity to design and implement effectively.
- **Sustained Long-term Impact**: Transferability to counterparts as legacy accomplishment by/from USAID.
- **Major Results from Budgetary Resources**: Reflected in how expensive or not the initiatives would be in terms of funding allocations, whether there is a need for co-funding, and if so, what the prospects are for achieving co-funding from other partners.
- **Scaled re Available Budget**: Balancing achievement objectives with funding parameters to ensure that objectives are aligned with funding, and not out of balance.
- **Measurable Performance Indicators**: As reflected in the ease of compilation of key performance indicators and their usefulness as a monitoring tool.
- **Fill Major Economic Development Gaps**: Addresses critical needs.
- **Confidence of Success**: Prospects for achieving planned results.
- **Local/Domestic Support ("Buy-in")**: Counterpart cooperation, capacity, support and active participation.
- **Global Development Alliance**: Prospects for potential partnerships in Serbia with international entities that could be instrumental in furthering strategic objectives.

Based on these criteria, Annex I contains a series of templates by which a range of potential initiatives to remedy key challenges by 2015 (or before) have been evaluated.

The brief assessment and recommendations have been provided by Michael Borish and Company, Inc. (MBC) in conjunction with USAID-Serbia. Mr. Borish has worked closely with Mr. Jim Watson (Private Sector Specialist) during his visit to Serbia (June 9-23, 2009). The financial sector report has also factored in findings and recommendations from an earlier assessment carried out by Denise Lamaute focused on the labor market and workforce development, pension reform, and USAID work in these areas. All content and recommendations are based strictly on the firm's own assessment of developments in Serbia. The opinions expressed in this work are the responsibility of the author, and do not necessarily reflect the official policy of USAID/Serbia or bind USAID to those recommendations.

B. Acknowledgements

Michael Borish and Company, Inc. would like to thank Michael Harvey (USAID/Serbia Mission Director), Marilynn Schmidt (USAID/Serbia Deputy Mission Director), Jim Stein (USAID/Serbia Director, Economic Growth Office), David Meyer (USAID/Washington, Senior Advisor, Economic Growth Office), Denise Lamaute (USAID/Washington, Senior Pension Reform Advisor), Jelena Mihajlovic (USAID/Serbia, Secretary/Program Assistant) and Vesna Miskov (USAID/Serbia, Secretary) for their kind support and guidance. Likewise, many people outside USAID were generous with time and data/information. In particular, Mr. Borish would like to thank SEGA staff for their generous provision of information, honest assessment of what has and has not been achieved, and distance from the effort of MBC to provide an objective view of how to improve the delivery of USAID technical assistance to the financial sector for the 2011-15 period. (A list of the people with whom the team met is found in Annex 2.)

II. DEVELOPMENTS AND EXPECTED CHALLENGES IN THE MACRO-FINANCIAL SECTOR

A. Monetary and Macroeconomic

1. Recent Developments and Current Status

The recent global economic and financial crisis has tested Serbia, and the results have been broadly positive. While requiring a nearly $4 billion (€3 billion) Stand-By Agreement with the IMF and implementation of a Financial Sector Support Program (FSSP)[24], Serbia's economy and financial system have been able to maintain reasonable stability in the last year during a period of regional and global turbulence. This is largely on the strength of significant foreign exchange reserves built up in recent years as a result of privatization proceeds and non-tradable service sector growth, as well as strict monetary and reserve policy of the National Bank of Serbia (NBS) regarding mandatory required reserves held by the commercial banks.

There is broad acknowledgement that significant structural weaknesses persist, and that these could present challenges in the future in the event of another crisis as well as delay prospects for receiving a future invitation to join the European Union. Serbia's business sector is lacking in competitiveness due to (1) the heavy presence of government-owned enterprises (e.g., utilities and other large employers, many of which are inefficient and/or financially troubled), which translates into Serbia having a comparatively small private sector as a share of GDP by regional standards, and which distorts competition due to (1a) government procurement practices favoring such businesses, (1b) preferences regarding certain licenses and permits, and (1c) other forms of influence-peddling that undermine movement to a competitive market economy; (2) weaknesses in the business environment, including unclear property ownership rights, cumbersome licensing and permit processes, complex and inefficient tax administration, workforce capacity, the bankruptcy framework, and corruption; and (3) the overall inability of enterprises to compete internationally in primary (i.e., agriculture, forestry, fisheries) and secondary (i.e., mining and manufacturing) sector export markets.

The lack of competitiveness is a consequence and cause of a vicious cycle in which enterprises are often inefficient and/or unable or unwilling to pay taxes. This reduces the capacity of the government at all levels to render needed services for enhanced economic competitiveness. This also impinges on government investment levels into physical infrastructure needed for long-term competitiveness, as well as recurrent expenditure needed for ongoing service provision (e.g., health, education, pensions) that also impacts workforce capabilities and competitiveness. The result is that the public sector is considered over-staffed

[24] See IMF Country Report no. 09/158, May 2009.

and inefficient, consuming resources at the expense of other requirements that would enhance the long-term sustainability of incomes, investment and employment that, in turn, would improve long-term fiscal prospects,

Getting the government to induce needed reforms will be complex, costly, risky, and multi-dimensional in terms of requirements. While the public sector is inefficient and needs civil service reform, the private sector is currently unable to step into the void to absorb redundant employees and contribute to privately managed pension funds. With wages and pension costs accounting for two-thirds of the budget, there is a clear need for government to reduce this burden. At the same time, there is very little capacity at municipal levels to assume greater responsibility. Thus, the government is stuck with potentially making a bad situation worse during fragile and turbulent times when the investment climate for private sector development and growth is less robust than in earlier years.

Moreover, for enterprises in the private sector to assume greater responsibility, they will need to have mechanisms for clearing arrears and restructuring their finances and operations so that they can become more competitive and creditworthy on a sustainable basis. The potential comprehensive strategy and framework for enterprise restructuring has not been developed yet, nor have resources from the FSSP been tapped for such purposes as of mid-2009. Meanwhile, banks' non-performing loans are rising, and average bank profits are low in relation to what is needed for a substantial capital build-up. While banks remain solvent and well covered relative to risks in their exposures (as reflected in high capital adequacy ratios), the reality is that banks' average profits in 2008 were little more than €13 million on a pre-tax basis, a low figure by global standards. Return on average asset and equity ratios are relatively low (albeit achieved in a difficult year), and actual profits may not be sufficient to cover the costs associated with needed enterprise restructuring of problem debtors that would then position such troubled companies for privatization, new shareholdings, and enhanced efficiency in performance.

In addition to bank-enterprise issues, there are also substantial inter-enterprise arrears which, along with VAT, add to significant liquidity pressures in the real sector. Large enterprises often delay payments to suppliers, which alone undermines working capital for smaller producers and service providers. This problem is exacerbated by smaller firms and suppliers having to pay VAT when they invoice buyers. Such delays add to inflationary pressures, as suppliers need to add on to margins to cover the costs of payment delays and up-front VAT payments from existing cash resources. Additional arrears in the form of delayed payments by utilities and other enterprises to suppliers, employees and sometimes government (e.g., tax arrears) are roughly estimated by the IMF to account for 10-15 percent of GDP.

Having accounted for such weaknesses, there is recognition that economic improvements have been made in recent years under difficult political

circumstances. Serbia is in far better condition than it was a decade ago,[25] and a number of economic indicators show how GDP, FDI and official reserves have increased, while government has managed to contain fiscal deficits to reasonable levels (until recently). Thus, while weaknesses persist, much has been accomplished under difficult circumstances.

However, considering the endemic political instability that has persisted and the transformation of national borders, the overall environment for reform has been challenging. Looking ahead, it is clear that many difficult structural-level issues remain. These are indicated in the unemployment rate and current account deficits, both reflecting weaknesses in export-oriented competitiveness. Such weaknesses make fiscal policy challenging in Serbia due to a small tax base and weak tax administration and collection relative to expenditure. Moreover, with net FDI tenuous and dependent on an improved business environment, low case scenarios could also push debt servicing requirements to levels that squeeze the economy further. Combined external and domestic debt account for about 90-95 percent of GDP in 2008/09, and future debt servicing requirements on external debt will be costly to the economy. Movement with critical financial sector, real sector, and public sector reforms will be needed for Serbia to eventually get closer to being in a position to negotiate accession to the European Union. The following table highlights some key economic indicators that reflect some of the points above.

Macroeconomic Indicators (2000-08)

(*€ in millions unless otherwise noted*)	**2000**	**2004**	**2005**	**2006**	**2007**	**2008**
GDP (1)	€5,500	€16,610	€19,743	€23,500	€29,500	€34,300(e)
Real GDP Growth	5.3%	8.3%	5.6%	5.2%	6.9%	5.4%(e)
CPI Rate—average (2)	71.8%	9.5%	17.3%	12.7%	6.5%	11.7%
Unemployment Rate (3)	25.6%	31.6%	21.8%	21.6%	18.8%	14.0%
Fiscal Deficit/GDP	-3.0%	-1.7%	+0.1%	-2.3%	-3.8%	-4.7%
Current Account Deficit/GDP	-3.0%	-12.7%	-8.7%	-10.1%	-15.5%	-17.1%
Net Foreign Direct Investment	€54	€710	€1,309	€3,400	€1,800	€1,800(e)
External Debt/GDP (4)	140.0%	62.0%	64.1%	63.3%	60.2%	63.6%
Gross Official Reserves (5)	≈€600	€3,157	€4,000	€8,700	€9,500	€8,100
Notes: (1) GDP per capita was $6,782 in 2008; incidence of poverty was 6.6% in 2007; (2) retail prices used for 2000 and 2004; (3) unemployment calculated in 2000 and 2004 with unemployed as numerator divided by the total of employed and unemployed; (4) adding domestic debt would raise the total stock of debt ratio to about 90-95% of GDP in 2008; (5) gross official reserves approximated seven months of imports of goods and services, while "free net reserves" approximated five months of imports.						
Sources: IMF, National Bank of Serbia, author's calculations						

2. Risks and Challenges for the Future

Notwithstanding successes during the recent crisis, there are numerous macroeconomic imbalances that will need to be corrected in the coming years for

[25] See "Reforms In Serbia: Achievements and Challenges", Center for Liberal-Democratic Studies, 2008.

Serbia to be in a position to defend itself against subsequent external shocks or adverse developments.

- GDP is not expected to grow until 2011 in real terms, and this is subject to a restoration of growth in Europe and other markets. Even with growth in Europe by then, there is no guarantee that Serbian exports/trade levels will be restored to prior levels, or that remittances and tourism will add to the economy as they have in the past. Likewise, other mitigating factors such as rising oil prices in global markets may add to factor costs of production in Serbia that will undermine export competitiveness while constraining demand in export markets.[26]
- Unemployment rates are high at 14 percent, under-utilization rates are higher[27], and the labor force is broadly considered to be ill-prepared or ill-trained for many modern economic requirements in a globally competitive marketplace.
- Inflation rates remain high at nearly 12 percent, which then has an impact on interest rates charged by banks and other lenders to borrowers. Weighted average interest rates on dinar loans were 17.3 percent in April 2009. Such high costs slow economic development and invite credit risk in loan exposures due to the impact of interest expense on borrower cash flows.
- Serbia has a very low fiscal revenue-to-GDP ratio, reflecting a long list of business environment and institutional weaknesses regarding tax collection and administration. Serbia's fiscal deficit of 4.7 percent in 2008 occurred in spite of a freeze on public sector wages. With two thirds of budgetary expenditure dedicated to wages and pensions, and without additional revenue collection, fiscal prospects for other required expenditure are negative.
- The current account deficit is high at 17.1 percent in 2008. The deficit is high by global standards, twice the levels recorded in Serbia in 2005, and unsustainable because much of the deficit is composed of consumer goods' imports that add little value to domestic economic competitiveness.
- Foreign direct investment (FDI) is low at less than €2 billion. FDI declined in 2007-08 from 2006 levels, and portfolio investment was negative on a net basis in 2008. Until the business environment improves and financial markets develop, such investment into sub-sectors that have a higher economic multiplier may be deterred. Meanwhile, the limited portfolio investment that had entered the Serbian capital markets has since returned to source or been re-allocated to other markets.
- Serbia's sovereign rating is BB- in foreign and local currency with a negative outlook,[28] an indication of the risk premium associated with Serbia. This is a relatively low rating that implies "speculative" signs, and a heightened risk that adverse economic developments could trigger a downgrade. Sovereign spreads have recently been about

[26] IMF forecasts referred to declining oil prices, which was true until early 2009. However, since publication of the May 2009 SBA Review, oil prices have increased.
[27] Many technically employed workers are not working productively or efficiently.
[28] Ratings received from Standard & Poor's and Fitch Ratings.

900 basis points above the benchmark Emerging Market Bond Index rate, which is high by global standards. This is down from a 1,300 basis point spread in November 2008, but still well above the 500 basis point spread in September 2008.

- While external debt is a reasonable 64 percent of GDP (2008), projected debt service will increase from €5 billion in 2008 to nearly €10 billion in 2014. This is expected to approximate 75 percent of total exports of goods and services, and exceed 20 percent of GDP that year. As this is likely to depend on the issuance of more government securities, interest expense will be more of a cost factor for budget management, and will leave less in the way of revenues available for other needed services and investments.
- Foreign exchange and official reserves remain strong and have helped Serbia during the recent financial crisis. Nonetheless, the high levels of reserves held by NBS also reduce available credit to the real economy, and make available credit more expensive. Moreover, much of the reserve accumulation has derived from privatizations, FDI and tax payments in the non-tradables sector (e.g., banking and finance, telecommunications). Future reserve accumulation may be more difficult if it has to depend increasingly on industrial and resource-based production and exports.
- The build-up of inter-enterprise arrears is particularly costly to small businesses, and puts upward pricing pressure on goods and services due to the need to pay VAT on the date of invoice and to age receivables for up to 300 days.

The impact of the above on USAID planning is that slow reform and continued lack of competitiveness will make it more difficult for Serbia to:

- Achieve real GDP growth on a sustainable basis, or at levels comparable to neighboring countries that are competitors.
- Reduce the unemployment rate and incidence of poverty, and create sustainable jobs that result in rising incomes and well-distributed purchasing power for an increasing number of households.
- Increase capacity to generate foreign exchange, which may lead to future dinar depreciation and, with it, higher rates of inflation and loss of purchasing power for many households.
- Decrease interest rates in the banking system without adding to inflationary pressures.
- Reduce fiscal deficits, which will mean less capacity to meet public needs due to the absence of needed fiscal resources. This also means less funding available from fiscal sources to meet other critical social protection requirements in the future that could become more severe should the economy not turn around after 2010.
- Stimulate trade and investment, already burdened by reduced demand, and poor current prospects for foreign direct investment and privatization.
- Lower the risk premium associated with investment in Serbia, which adds substantial cost to Serbia in attracting such investment.

- Reduce the impact of projected debt service relative to GDP, which will put additional pressure on the macroeconomic conditions of Serbia and potentially translate into lower investment and lending.
- Improve the working capital position of SMEs that supply larger enterprises unless there is more competition, and larger enterprises recognize the value of supply relationships. Part of the arrears problem on inter-enterprise debts is due to the stricter conditions companies have in obtaining loans from a more tightly regulated banking system.

This means that the upcoming environment for reform could be difficult, even with positive political will and a stable government. This is because:

- The economic environment could make it more challenging to generate the tangible results and outcomes that USAID would like to see, such as major GDP and employment growth, significant increases in lending and direct investment, etc. Thus, even well designed and implemented support from USAID will likely not see major favorable results until well into the 2011-2015 program.
- Likewise, because of the institutional capacity-building requirements that may be needed (discussed below), it is uncertain that legal and regulatory reforms alone will be sufficient to generate the kind of impact desired by USAID and other donors, not to mention Serbia.
- Another wild card is the role played by key donors, and the effectiveness of their technical assistance and disbursements. In particular, it remains to be seen at the broad programmatic level what role the World Bank and European Union play in the reform process, particularly as key catalysts for structural adjustment and convergence with EU standards.

B. Banks and Banking

1. Recent Developments and Current Status

The Serbian banking system has undergone major reform in the last decade, and is now well capitalized relative to risk exposures. In the early 2000s, Serbia's banking system was moribund as a result of sanctions from the 1990s, a legacy of imprudent lending activities from the earlier Yugoslav period, a weak and largely informal real sector, and an inadequate legal and regulatory framework. In 2000, the average bank had (1) only $147 million-equivalent in assets, an overvalued figure due to most assets being non-earning; (2) $91 million-equivalent in credit, including claims on government, and also over-stated because banks had not sufficiently provisioned for losses resulting from borrower non-performance; (3) only $10 million-equivalent in deposits, reflecting the absence of confidence and household hoarding of scarce foreign exchange; and (4) $6 million-equivalent in capital, which is more indicative of small "pocket" banks than serious regional and international banks. Most funding derived from outstanding foreign borrowings and other liabilities, while frozen foreign currency accounts were 27.5 percent of total liabilities. Since then, the Serbian banking system has been restructured, and is now largely dominated by EU-based banks from Italy, Austria, Greece and

France.[29] Moreover, the legal framework has been strengthened over the years, and with USAID assistance, banking supervision is now effective. This has translated into the banking system playing an increasing role in economic growth over the years, with financial intermediation rates (e.g., broad money-to-GDP) at 36 percent in 2008, double the ratio in 2000. Likewise, capital ratios are high at 22 percent of risk-weighted assets, and the quality of assets is better today than it was in 2000.

All the key indicators show significant improvement in the banking sector since the SEGA project began. This is reflected in (1) increased lending, with 2008 levels nearly three times levels in 2004; (2) better overall asset quality, with non-performing loans a small fraction of levels in 2000; (3) enhanced earnings, as reflected in positive return measures since 2005; (4) higher depositor confidence, thereby increasing funding for the banking system, and reflected in deposit totals having grown more than three times since 2004; (5) high capital adequacy ratios, at well above 20 percent since the mid-2000s; (6) reduced liquidity constraints, partly resulting from the influx of deposits as well as access to cross-border financing and the superior credit ratings of the foreign banks; (7) better governance and management; and (8) a system that has proven itself able to weather distress and liquidity challenges, with reasonable stability during the recent/global financial crisis. While SEGA alone is not responsible for such developments, the project has clearly been a key contributing factor (as was earlier USAID support for improved banking supervision).

There are still considerable weaknesses in the banking system, albeit far less severe than in 2000 or 2004. The average bank in Serbia is small by global standards, which may presage consolidation in the coming years. The high cost of operations has kept return ratios at fairly low levels (although they are reasonable under current circumstances), and limited the absolute value of net earnings. Banks earned little more than €13 million on average on a pre-tax basis in 2008, and less on an after-tax basis. At the same time, Serbia is "over-banked", as retail networks have spread into unprofitable areas, undercutting bank earnings.

There is also considerable work that needs to be done in the field of banking supervision. While NBS has made major progress over the years, movement to Basel II will require a more risk-based approach that enhances capacity of NBS to determine banks' own capacity for risk management. In the case of the EU-based banks, risk management systems are more complex and better understood than they are at NBS. Thus, NBS capacity to handle pillar 2 of Basel II (supervisory review) will need development. Likewise, the control-oriented approach to supervision will need to shift to a more principles-based approach, which should also encourage banks to be able to manage their asset allocation more freely, and subject to less regulated controls over how they allocate and provision. In this regard, it will be important for other structural reforms in the enterprise sector to take hold, namely (1) centralized property and pledge registries, (2) more comprehensive disclosure of credit quality information related to inter-enterprise arrears, (3) comprehensive bankruptcy and debt remediation

[29] Foreign banks account for about 80 percent of banking system assets.

mechanisms, including efficient dispute resolution mechanisms related to #2, and (4) clear ownership rights to immovable properties in support of a better secured transactions framework.

The FSSP is closely linked to a World Bank program[30] that focuses on building a more efficient and stable financial sector along with initiatives to improve the business environment and strengthen financial discipline via privatization, restructuring, and energy sector reform. Key outcomes in the banking sector that will result from this program include (1) maintenance of capital adequacy for the banking system at a minimum of 12 percent (22 percent at end 2008), with the use of public funds for bank recapitalization utilized only if there is no private sector alternative; (2) enhanced framework for crisis preparedness and crisis management in the event of future shocks; (3) more efficient banking resolution system (in dealing with insolvent and/or illiquid banks unable to meet deposit withdrawal, payment system, or other requirements); (4) well administered and capitalized deposit insurance scheme able to manage fast payouts in the event of need; (5) majority state-owned banks that are profitable and have at least 12 percent capital adequacy ratios; and (6) reduction of the share of government ownership in the banking system to no more than 15 percent of total assets by 2010.

Despite continued weaknesses, the banking system has shown positive trends in the last several years. Much of this has to do with the liberalization of the market, opening up to stronger regional European banks. Another key factor has been strengthened supervision. A third factor has been real GDP growth in recent years, although this is expected to reverse in 2009 and remain flat in 2010 before growth returns. The following table presents some key data indicating progress from earlier years with regard to (1) balance sheet growth in general and per bank, (2) strengthened risk-weighted capital, (3) better asset quality (until very recently), (4) reasonable return ratios under the circumstances, and (5) increasing levels of financial intermediation that have contributed to real GDP growth in recent years.

Banking Sector Indicators (2000-08)

($ in millions unless otherwise noted)	2000	2004	2005	2006	2007	2008
Total Credit	$7,859	$6,152	$7,380	$10,216	$15,554	$17,692
Average Credit per Bank	$91	$134	$175	$265	$435	$512
Total Assets	$12,643	$10,614	$12,658	$21,240	$31,230	$30,604
Average Assets per Bank	$147	$247	$316	$574	$892	$900
Total Deposits (1)	$857	$4,689	$5,512	$9,263	$15,191	$14,197
Average Deposits per Bank	$10	$109	$138	$250	$434	$418
Total Capital	$490	$2,728	$2,833	$4,249	$6,987	$7,027
Average Capital per Bank	$6	$63	$71	$115	$200	$207
Capital Adequacy Ratio (2)	n/a	27.9%	26.0%	24.7%	27.9%	22.0%
Non-Performing Loans/Total Loans (3)	27.80%	22.2%	23.8%	4.11%	3.81%	5.29%
Return on Average Assets	n/a	-1.2%	1.1%	1.7%	1.7%	2.1%
Return on Average Equity	n/a	-5.3%	6.7%	10.0%	10.2%	10.6%

[30] The World Bank is providing $300 million to the FSSP.

Broad Money to GDP	18.00%	24.64%	27.18%	32.04%	38.25%	35.57%
Notes: (1) Deposits do not include Government deposits, nor do they include frozen foreign currency deposits; (2) CAR is regulatory capital to risk-weighted assets; (3) Ratio is net of provisions based on data from nine largest banks; the ratio had increased to 6.58% by February 2009.						
Sources: IMF, National Bank of Serbia, author's calculations						

2. Risks and Challenges for the Future

Notwithstanding progress and recent successes, there are still weaknesses or challenges that persist in the banking sector. These include:

- The high costs of banking (partly due to high reserve requirements) may continue to sustain high net interest margins on loans that are made as part of the cost of doing business. Net spreads as measured by weighted average interest rates on loans less deposits tend to be at 10 percent or more (apart from 2007). Until reserve requirements and other elements of monetary policy ease up, these pricing issues are likely to persist. Such reserve policy is partly driven by inflation and exchange rate considerations, and easing may not occur until Serbia has overcome its many hurdles in the real sector to be competitive in export markets.
- The high costs of banking operations are reflected in the relatively modest return ratios. Until the banking system consolidates further from the current 34 banks to a smaller number, it is less likely that cost savings from efficiencies will help to reduce the overall cost of operations (as measured by transactions, loans, employees, branches, etc.).
- The need for considerable financial and operational restructuring among many of the banks' enterprise borrowers, partly indicated by the rising level of non-performing loans (at 6.6 percent in early 2009). In late 2008, about a third of risk-weighted assets was under stress (delinquent more than 90 days) or impaired in some form. While banks are considered to be adequately capitalized, it is currently unknown what the threshold is for NPL ratios bank by bank before corrective actions may be needed. On the other hand, the major banks are considered to be adequately capitalized, and are also able to access the capital markets via parent banks in the event of any capital shortfalls.
- The need for legal and institutional reforms that affect enterprise performance, namely property rights, dispute resolution, and collateral/secured transactions.
- Uncertainty as to whether the FSSP vehicles for loan restructuring will be sufficient in shifting some of the troubled exposures denominated in foreign currency to those that are dinar-denominated or adequately hedged.[31]
- Uncertainty as to whether continued state ownership in the banking system (albeit limited to 15 percent of total assets, and requiring profitable operations and CARs of at least 12 percent) will serve as a potential vehicle for enterprises with close ties to government officials to defer needed restructuring.

[31] The FSSP provides dinar loans for up to one year, without an explicit rollover provision. Foreign exchange swaps are for two-week periods, although these do have rollover provisions.

- Uncertainty about how efficient a bank resolution process will be among under-capitalized or insolvent banks in which the state has a large or majority share.
- Relatively low levels of credit (at 35 percent of GDP in 2008) when compared with Europe and even some regional countries, albeit recognizing this is a significant improvement from earlier years when the ratio was lower and asset quality was suspect.
- A shortage of long-term funding better matched with long-term asset exposures. The funding structure of Serbian banks is stable, but long-term funding (on-balance sheet) accounts for less than 10 percent of long-term loans.[32] Notwithstanding guarantees and other off-balance sheet items that may cover for some of the mismatch, this still represents a major mismatch. Future economic growth will require availability of and access to longer-term sources of funding, including deposits and other on-balance sheet items that are generally more stable as a funding source. At the same time, NBS will need to monitor rates paid on such long-term funding sources and the impact this will have on banks' liquidity and profitability.
- Foreign exchange risk is endemic, as 70-75 percent of balance sheet values are either in euro or euro-indexed. While the latter helps to protect lenders, such mechanisms are simply a pass-through of currency risk to borrowers that can culminate in increased credit risk should Serbia experience dinar depreciation. For Serbian borrowers whose sales and cash flow are dinar-based, such a scenario would require greater dinar to service and repay loans. Thus, the potential for such companies to face these challenges would correspondingly challenge lenders' asset quality and earnings, and potentially their liquidity and solvency. It is also currently unclear how much of this risk would apply to the Serbian daughter banks of foreign parents on which exposures have guarantees from the Serbian institutions.
- Borrowers are subject to significant interest rate risk on loans, as most lending is on a variable rate basis and can adjust upward at any point.
- There are limited hedging products available for borrowers and investors to hedge their currency and interest rate risk on exposures or borrowings.

The impact of the above on USAID planning is that the high cost of operations (e.g., high reserve requirements, high repo rates, high net nominal spreads on lending), continued state ownership of up to 15 percent of banking system assets, and limitations on hedging mechanisms in the Serbian banking system will make it more difficult for Serbia to:

- Provide lower rates to borrowers to meet enterprise and household needs, particularly as high nominal lending rates are linked to double-digit inflation rates.[33] Such high nominal rates will affect borrower cash flow, particularly if there are rising inflation rates

[32] Data are for the commercial banks as of year end 2008 from the NBS.

[33] According to the Association of Serbian Banks, under current circumstances, bankers believe they cannot run a profitable business without charging at least 16 percent nominal rates on loans. See "Guide to Serbian Banking and Financial Sector—2009," May 2009.

and/or dinar depreciation given the variable rate and indexed products that dominate the market.

- Encourage more lending (based on sound underwriting standards and without compromising asset quality) due to banks' legitimate concerns about the risks of lending to troubled or uncompetitive enterprises, or exceedingly small enterprises. In the case of the market, many of the SMEs are unable or unwilling to meet the creditworthiness requirements that banks have to approve loans or other exposures. Some of the larger companies do not meet key creditworthiness criteria and/or have powerful connections that would put the banks at risk in the event of a default scenario.
- Facilitate needed financial and operational restructuring among troubled enterprises, as such restructuring would require banks to provision and charge off some of their exposures, which would adversely affect earnings unless the NBS permits forbearance.
- Introduce long-term products that can assist with asset-liability management.

This may mean that USAID should consider focusing on alleviating some of the rigidities of monetary policy, working closely on debtor restructuring, and/or focusing on elements of securities market development that might assist with long-term instruments.

- Compromising monetary policy is not recommended, as it would not only clash with the IMF and NBS, but would also interfere with a reform process from recent years that had seen rising credit and declining interest rates. Thus, while the interim period is likely to be challenging, in all likelihood, banks will revive lending as this is needed to generate earnings, and interest rates will come down when inflationary pressures diminish. In the latter case, much of this is structural/fiscal/governmental, and has less to do with monetary policy.
- As such, an intervention that USAID could consider is getting involved in the enterprise restructuring program, particularly as linked to the FSSP and World Bank program. Even more importantly, efforts should be made by USAID to encourage the World Bank to build in legal and institutional reforms in the areas of SME finance, inter-enterprise arrears, dispute resolution and secured transactions as program targets for future assistance.
- Focusing on the development of long-term instruments offered via the securities markets is worthy of support, particularly given long-standing support, recent leadership in developing the new Securities Law, and the need for a government securities market to meet future financing requirements. This is discussed in the Recommendations.

C. Non-Bank Financial Institutions

1. Recent Developments and Current Status

Serbia's non-bank financial institutions are limited in activity, volume and value. There has been progress in recent years in (1) privatizing all but one of the state insurance companies while allowing others (from abroad) to enter the market under regulated conditions (largely, although not completely, compliant with EU standards); (2) introducing leasing, with some regulatory oversight; (3) introducing a framework for voluntary pension funds, and launching such funds; and (4) promoting some investment via the stock exchange. However, by and large, the non-bank financial system is at the beginning stages of development in Serbia.

The World Bank program tied to the FSSP addresses key outcomes in the insurance and securities markets in addition to banking. For insurance, key outcomes are (1) third party motor liability is fiscally secure and a framework to resolve legitimate claims is in force; (2) resolution of failed insurers is carried out according to EU principles; and (3) the government share of insurance premiums written declines to 35 percent by 2010. In the securities markets, key outcomes are (1) development of the capital markets based on an improved and adequate regulatory framework; and (2) the markets are sufficient to provide a benchmark or reference rate for municipal, corporate and infrastructure bond issues. The following box profiles the non-bank financial sector:

Brief Profile of Non-Bank Financial Institutions in Serbia (2008)

Leasing	There are 17 leasing companies which had exposures of about €1.45 billion in leases in late 2008, up from earlier figures that reported contracts at about 84 billion dinar (less than €1 billion). Leasing companies are heavily dependent on foreign borrowings, accounting for about 85 percent of their liabilities. Most leasing companies are part of banking groups. Recent trends have shown an increase in lease contracts for transport, warehousing and communications equipment, as opposed to an earlier focus on commercial trade. However, expectations are that there will be a decline in auto leasing, at a minimum, and this may impact overall volumes for 2009 against 2008.
Insurance	There are 24 insurance companies in Serbia. The penetration ratio (premium revenues-to-GDP) is low at about 2 percent of GDP, well below the EU norm of about 8 percent. Insurance assets are less than 5 percent of total financial system assets. Most insurance is for vehicle insurance, property insurance, and other non-life forms (e.g., health insurance). About 10 percent is life insurance.
Voluntary Pension Funds	There are now 10 management companies managing voluntary pension funds (VPFs). VPFs only began operating in Serbia in 2006, and as such, have shown limited accumulation of assets to date—about 4 billion dinar (about $60 million or €45 million). There were about 157,000 VPF service users in late 2008, and average accounts were about $500-equivalent. As of late 2008, net fund assets were only 0.15 percent of GDP, well below norms in Europe (15 percent) and the region (5 percent). VPFs account for about 2 percent of trading on the local stock exchange. While they lost 7 percent of fund value during the recent financial crisis, these losses were well below the average of 75 percent for the Belgrade Stock Exchange. This is due to their conservative asset allocation in which half of assets are in the money market, 30 percent in government bonds, and only 15 percent in equities.
Securities Markets	Securities markets are limited in Serbia. Market capitalization was about €9 billion at the end of 2008, or about 30 percent of GDP. Trading activity as reflected in turnover levels diminished significantly in 2008, and was about 72 billion dinar (€882 million), or

	about 600,000 dinar (less than €7,000 per transaction). The Government securities market is virtually non-existent apart from the 15-year frozen foreign currency bond that was issued in the early 2000s. To date, the central government has only issued 3-month Treasury bills, although there are now plans to issue 6-month and one-year notes. NBS issues securities as a function of monetary policy, but these are generally liquidity facilities for very short periods. There is no corporate or municipal bond market, nor is there an asset-backed securities market for mortgages, consumer debt, auto lease portfolios, etc. That leaves the equities market, of which there are only three stocks traded on the prime exchange.
Sources: National Bank of Serbia, Securities Commission, "Guide To Serbian Banking and Financial Sector—2009", www.belex.rs	

2. Risks and Challenges for the Future

There are few risks to Serbia at the moment rooted in the non-bank financial sector, consistent with other markets where non-bank financial services are underdeveloped.

- Leasing is still nascent in Serbia, and most borrowings for lease contracts are from banks abroad (or parent banks of banks operating in Serbia).
- Insurance is following prudent principles, with high levels of reserves. The regulatory framework is increasingly aligned with international and EU standards, and there are plans to strengthen solvency requirements. However, the state's ownership position in the industry, as reflected in the high proportion of insurance premiums written set as a maximum target for 2010 (35 percent of total), may distort competition in this industry until the state's share is less.
- Voluntary pension funds have just begun operations two-three years ago. Under difficult circumstances, they have only accumulated about $60 million in assets, although they have already outperformed the market by suffering minor losses that were well below the norm for those operating on the Belgrade Stock Exchange.
- Securities markets are underdeveloped. There are plans to expand T-bill offerings beyond three-month maturities to six-month issues and one-year issues. However, these are narrow by global standards, and present little risk to government under current circumstances relative to current reserve levels.
- It is currently unclear how much potential there is for near-term issuance of debt instruments apart from central government issues or a mortgage bond backed by insured mortgages from the National Mortgage Insurance Corporation. Municipalities have limited capacity, and infrastructure is not in place at the moment. Infrastructure-related bonds would likely require guarantees, which will be increasingly difficult for the government as its debt load and fiscal deficits increase. To the extent that the central government is required to offer partial or full guarantees on public sector bond issues, this will add to contingent liabilities, and this will impact budget expenditure and allocation decisions.

The impact of the above on USAID planning is more related to the opportunity cost to Serbia of not developing non-bank activities. This is important in a number of ways, including:

- Leasing is another form of lending, and essentially provides SMEs with opportunities to finance equipment purchases or other assets without having to make down payments. However, given the number of EU-based banks in the system, there is little need for USAID assistance in this domain.
- A more robust insurance sector would provide needed coverage to businesses and households that would provide protections that are not in place, or are costly due to the reliance on reinsurance. Assuming their capacity to properly assess and price risk, profitable insurance companies are then in a position to (1) invest in the capital markets, with the particular benefit of serving as investment drivers for long-term instruments due to the nature of life insurance and their needs for asset-liability matching instruments; and (2) design savings instruments that provide households and the self-employed with pension-like benefits that assist households during retirement. The insurance market is already 10 percent life insurance, and there will be opportunities for insurance companies to design policies and products that will help Serbians with long-term retirement savings requirements and coverage. Continued USAID assistance to the NBS as insurance regulator may be worth considering, although this needs to be weighed against other options and limitations on resources. One approach may be to link other forms of continued USAID financial sector assistance (e.g., anti-money laundering, securities market development) to specified activities of the insurance sector.
- The introduction of private pension funds or other savings options is essential to help reduce reliance on the PAYG system that is chronically in deficit and a drain on public finances. However, if contribution rates are too high, companies will be deterred from hiring more permanent employees. Meanwhile, stagnation or declines in purchasing power will slow voluntary contributions. As noted above in insurance, a fourth option is to have simple savings instruments available on a retail level, and sold by banks, insurance companies and others that are simple to understand, straightforward in terms of how they are invested, and easy to purchase, transfer and convert. It is not clear that USAID should necessarily take the lead with pension reform. As with insurance, one approach may be to link work with the securities market back to how pension funds manage assets and meet their risk management and reporting requirements, rather than taking on the entire challenge of how to make the pension system meet retirement savings requirements without significant fiscal deficits from the PAYG system.
- Securities market development for company issues will require major changes in the corporate culture of Serbia, including governance, accounting/audit standards, disclosure requirements, etc. In this regard, any USAID assistance should be considered long-term. However, there is clear potential and need to develop a government securities market initially. This is due to the future funding needs of the government, as well as the

broader market need for benchmark rates that exceed one-year terms.[34] There is also potential to develop a small municipal bond market in larger and well-managed municipalities with a sustainable revenue stream, although this will likely take years. A simple mortgage bond that could attract term funding to reduce asset-liability mismatches would be feasible if backed by the insured housing loans covered by the National Mortgage Insurance Corporation, although this was not included as one of the key outcomes in the World Bank program. A long-term yield curve is needed from sovereign issues for other bond issues to occur. During that time, some of the necessary requirements for viable corporate debt and equity markets can be addressed so that the capital markets can play a role in adding to financing options for enterprises and households.

D. Financial Sector Infrastructure

1. Recent Developments and Current Status

The banking system has shown itself to be stable and well supervised during the recent financial crisis. The National Bank (NBS) has been effective in recent years in overseeing a stable system according to broadly recognized prudential norms. While not fully in compliance with the Basel Core Principles,[35] NBS has made major progress in this area since 2000, and now has a strategy to evolve towards standardized and simplified approaches to Basel II. More recently, the NBS intervened to inject liquidity into the system, helping the banks emerge from temporary dislocations in the markets. Thus, from an overall stability position, the banks are showing high levels of reserves and capital under well regulated conditions, and these buffers helped them in the recent crisis. Banking supervision at NBS is credited as having been a key factor in maintaining stability. Further efforts under the FSSP and World Bank program are expected to bolster crisis preparedness.

Notwithstanding progress in banking supervision, there are still weaknesses and a need to sustain progress. Banking supervision still needs to strengthen risk management capacity, including its own capacity to assess banks' risk management systems. As noted above, several of the larger EU-based banks have more complex systems available to them from parent banks than NBS would be able to supervise under Basel II. Assistance is needed in IT and

[34] The government plans to issue Treasury bills with six-month and one-year maturities this year. However, viable securities markets require longer yield curves. These are also important for banks making long-term loans, as is the case in Serbia.

[35] Key weaknesses identified in early 2008 involved (1) accountability and transparency, (2) capacity to assess banks' capital adequacy and risk management systems, (3) market, operational and liquidity risk issues, (4) supervisory approaches, (5) consolidated supervision, and (6) home-host coordination. Improvements have been made in these areas since the self-assessment, and an updated FSAP/FSSA in 2009 will provide a new set of ratings on the degree of NBS (non-)compliance with the Basel Core Principles.

sophisticated modeling, particularly as many of the EU-based banks' parents are moving on to more sophisticated systems and operations under Basel II. Bank examiners will need continued and expanded training to be in a position to assume their responsibilities under pillar 2 of Basel II, namely supervisory review of banks' capacity to manage credit, market and operational risks and the adequacy and sufficiency of capital buffers. Moreover, assistance in this domain should also be linked to efforts to strengthen capacity re money laundering and other financial crimes. This will include coordination with the Ministry of Finance and law enforcement agencies.

The bankruptcy framework is underdeveloped and generally not used for debt resolution and contract enforcement issues. The bankruptcy framework is currently under review, and new legislation is anticipated by late 2009. This is part of the World Bank program to strengthen financial discipline (mainly in the public enterprise sector), and additional legislation is expected at a later date to deal specifically with the bankruptcy and liquidation of banks. However, the judiciary is not experienced or trained to be effective in this domain. Processing of commercial disputes takes a long time, as do other cases due to lack of judicial capacity and weak management systems. The threat of bankruptcy is insufficient to induce creditors and debtors to utilize specialized out-of-court adjudication to resolve problem loans as a vehicle for corporate restructuring. Moving forward with liquidation (for at least partial recovery) is difficult because companies can easily establish new companies without being liable to the original creditor. When bankruptcy and liquidation procedures are utilized, recovery rates are low, at about 25 percent of outstanding obligations (vs. 28 percent in the region and 69 percent in the OECD). Time required is 2.7 years (vs. 3.1 years in the region and 1.7 years in the OECD). Costs of the process are also comparatively high, at 23 percent of the estate (vs. 13 percent in the region and 8 percent in the OECD.)[36] Improvements are expected with the new legal framework, but developing institutional capacity for effective implementation will require time and effort, both in the financial sector as well as the enterprise sector.

Serbia was slow to introduce legislation against money laundering and to set up a financial intelligence unit. This has now been established in the Ministry of Finance, but institutional capacity building is required for this unit to be effective. This includes (1) tightening up on the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and (2) increased training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors. Past experience via the SEGA program was positive, and assistance in this area is all the more important as it permeates the entire economy. Likewise, as it is housed in the Ministry of Finance, support for this should be closely linked to developments under NBS supervision, and potentially the securities markets.

The absence of consolidated accounting reduces risk detection capacity at the NBS, although efforts have been made in recent years to strengthen cross-border cooperation with other supervisory agencies. NBS has tightened up on the qualifications

[36] Data from www.worldbank.org

of auditing firms permitted to do bank audits. However, due to the significant degree of funding from regional banks and cross-border guarantees by the banks in Serbia, there is a risk that off-balance sheet items are insufficiently reported in a manner that would permit NBS to detect key risks before they become problematic. The upcoming FSAP is expected to address this issue later in 2009.

IFRS is now fairly common with the EU-based banks, but is hardly in effect elsewhere in the economy. Borrowers do not provide such statements, and many enterprises are audited by smaller firms that have traditionally focused on tax-oriented accounting. Movement to consolidated accounting is something that should be considered for the financial sector, particularly as banks in Serbia are universal and engaged in other financial services.

2. Risks and Challenges for the Future

Notwithstanding improvements in financial sector infrastructure in recent years, more work is needed for reforms to be sustained. Several of these areas will require coordination capabilities, such as (1) cross-border supervision, (2) coordination with the Securities Commission (in due time), and (3) coordination on illegal and suspicious financial transactions, and potentially with the auditing firms. These include:

- Closure on areas where NBS is not in full compliance (or largely compliant) with the Basel Core Principles.
- Establishment of needed capacity and systems for NBS to be an effective regulator of banks that, in many cases, have or will have more advanced risk management systems and modeling capabilities than NBS.
- Development of a sound dispute resolution and bankruptcy framework that is scaled to the needs and capacity of both the banks and the enterprises, but with sufficient authority to induce needed restructuring work to unfold.
- To the extent that bankruptcy and dispute resolution occurs within the courts, better case management and faster processes.
- Capacity building in the area of money laundering and combating the financing of terror and other illegal activities.
- Movement to consolidated accounting and supervision so that NBS has a better understanding of the fundamental risks to financial stability along with banking sector safety and soundness.
- Enhanced governance capacity and structures in the real sector, including better use of internal data at the firm level to manage risks and report on such risks to creditors and investors at an early stage to mitigate the potential loss that can occur from such risks.

The impact of the above on USAID planning is that while NBS has reached a threshold as an effective regulator under Basel I, there will be additional challenges as Serbia (1) moves on to Basel II, (2) seeks to develop the non-bank financial

sector, (3) promotes development of a more profitable and efficient system, and (4) seeks to strengthen Serbia's reputation internationally. Key challenges include the need for NBS and other regulators to:

- Adapt to more universal activities undertaken by licensed financial institutions.
- Strengthen risk-based supervision of insurance consistent with IAIS and EU Solvency II requirements, and train companies and regulators in IFRS.
- Develop increasingly effective coordination mechanisms between NBS and the Securities Commission over time as that market eventually develops.
- Ensure that any mandatory or voluntary contributions made to pension funds and/or invested in savings instruments (potentially issued by insurance companies or banks) enjoy maximum investor/consumer protection, including portability across institutions (albeit with reasonable fees attached).
- Develop more effective coordination mechanisms for ongoing cross-border monitoring of financial system risks with other financial sector regulators.
- Develop capacity to monitor for macro-financial stability, including more advanced modeling techniques.
- Ensure that all key financial regulatory and law enforcement institutions have adequate capacity to detect and act on suspicious transactions.
- Ensure capacity is developed in a manner consistent with requirements for eventual EU accession.

E. Real Sector Structural Issues

1. Recent Developments and Current Status

Many of the core problems for future financial sector development relate to structural problems in the enterprise sector, as well as governance and tax administration weaknesses throughout the entire economy. Until legislation, regulations and traditional practices are streamlined and overhauled, the system will continue to function well below potential. Current activities focused on legal and regulatory reform are encouraging. However, there will still be significant obstacles to change in many quarters, and developing institutional capacity for effective implementation of reforms will also require time and investment. That elections often interfere with progress will also put future reform activities at risk, particularly if the current downturn in the economy persists beyond 2010 and the public associates the reform agenda with slower (or no) growth and negative economic effects.

There is a well defined agenda to enhance the business environment, strengthen financial discipline, and build a more efficient and stable financial system. The outcome is expected to be (1) a better environment for business start-ups, (2) increased investment from domestic and foreign sources, and (3) enhanced capacity for employment creation, as well as (4) a more efficient and cost-effective public sector. Restructuring, commercialization, and privatization of most remaining state holdings in the financial sector is also expected to make a contribution to this effort, as well as to improve corporate governance structures across the economy as a whole.

Key legislative reform to strengthen the business environment includes (1) amendments to the Company Law, Enforcement Law, Privatization Law, and Law on Spatial Planning and Construction, and (2) new Laws on Bankruptcy, Competition, and State Aid. This effort is being accompanied by a regulatory "guillotine" process across the government that is assessing the need to eliminate, revise, or re-write 2,000 regulations as they apply to the business sector in Serbia. The outcome of this effort is expected to significantly improve the business environment, although capacity for implementation may face limitations. Moreover, some areas of difficulty are expected to persist due to the political sensitivity and actual cost to many involved. These include (1) the loss of control by some state enterprises that have monopoly positions in the economy (e.g., utilities), and serve as a major source of employment, benefits and patronage; (2) local level issues related to the ownership of urban property, practices involved in the issuance of permits and licenses related to land use management and development, and property tax assessments and collections; (3) centralization of and electronic access to comprehensive and linked property and pledge registries; and (4) restitution (or related compensation) of nationalized or confiscated properties.

One of the key weaknesses in Serbia is governance and accounting standards. Serbian businesses do not operate according to the same principles as many other enterprises in the EU or elsewhere in market economies. While the Big 4 and at least one other second-tier accounting firm have offices in Serbia, most businesses do not follow international standards of accounting or auditing. At the same time, such audits are costly for businesses that have often had trouble accessing market sources of credit or investment, particularly small-scale enterprises. Thus, as elsewhere, there is a major divide in the economy, with most enterprises following narrow tax-oriented accounting policies (to the extent they have any policies beyond fundamental cash management) that are considered to be broadly inadequate for licensed financial institutions considering making loans or investments. In general, corporate governance standards and accounting practices will need to more closely converge with market standards for Serbian businesses to become more competitive. This will include movement to more open and accurate disclosure of asset quality and obligations. A simplified framework for tax compliance at reasonable rates would very likely facilitate movement in this direction. (In economies where the formal or informal tax burden is high, there are incentives to hide assets and under-report income.)

Such principles also clearly apply to the public sector. The government's accounts have reportedly not been audited. Good governance practices and modern accounting standards are considered key to accountability, integrity and public trust. The willingness of the household and enterprise sector to pay taxes in the future will largely depend on perceptions of how effective and honest government is in managing resources and rendering critical services.

Another key weakness is workforce development. A constant topic raised in discussions was how unsuitable labor force skills and knowledge are for a modern economy. This is reflected at the vocational level as well as at the managerial level. There is widespread recognition of the need for practical, Master's degree-level business and management education for the enterprise sector as well as the government.

2. Risks and Challenges for the Future

Significant structural problems remain in the government and enterprise sector, and these will only be solved over a period of many years. Key real sector areas that will need transformation for Serbia to converge with EU and international standards, and which are relevant for financial stability and financial sector performance, include:

- Governance standards, which are linked to ethics, accounting standards, and a general corporate culture that recognizes transparency and disclosure as more beneficial to the economy and functioning of the market.
- Tax administration, balancing the legitimate needs of government for revenues to cover needed services and investments, and enterprises and citizens that will need to comply to benefit from such needed services. De-politicizing the tax process will be essential, as will other government practices at the central and local levels.
- Once the regulatory "guillotine" process is carried out and a new legal/regulatory framework is in place, there will need to be ongoing regulatory impact assessments to ensure the continued viability and effectiveness of such regulations across the economy. This can be a government function, but should also involve a range of stakeholders, namely business associations as well as think tanks that are objective.
- While there appears to be significant momentum at the central government level under the current coalition to move ahead with reforms, major obstacles are expected to remain at the local government level. This includes implementation of any Law on Spatial Planning and Construction and Law on Urban Land, and implementation of a sound system for property tax valuation and collection. Delays in the centralization and electronic access of comprehensive and linked property and pledge registries can also be expected to reduce process efficiency and potentially lessen lending and investment.
- Workforce development is another long-term challenge that involves reform of the entire education system, as well as the introduction of modern standards and principles for management. While companies are willing to train new personnel, this represents an additional cost that reduces Serbia's competitiveness. Solutions are likely to require long-term commitments that involve planning, investment and time.

The impact of the above on USAID planning for financial sector and enterprise/public sector support is that greater strategic cohesion across initiatives/projects is required for USAID to have impact on a long-term basis, and in a manner that supports larger strategic objectives. Key considerations for USAID are:

- Continued financial sector support can serve as a vehicle for real sector reforms. As an example, financial institutions offering credit require the observance of accounting and reporting standards, which reflect some form of governance that meets underwriting requirements of the institution making the loan or offering the guarantee. Having enterprises meet such standards serves to enhance their competitiveness as a requirement for obtaining financial resources.
- The reform process is subject to significant political risk, particularly as the last five governments have averaged 1.6 years in office. While the current coalition looks like it might finish its term, USAID will need to work with institutions that are relatively stable, and have demonstrated performance as well as political will.
- There is a need to build up civil society capacity not only for democratic purposes, but precisely because of recent government turnover and political instability. Targeting groups that are able to promote continued reforms irrespective of electoral outcomes helps to build institutions and, in the process, move Serbia along the path to the EU and Euro-Atlantic institutions.
- Given the abundance of problems and absence of capacity at local/municipal government levels, USAID may want to consider targeting the MEGA project to more focused areas and/or determining synergies between MEGA and SEGA. In this regard, legal, regulatory and institutional reform at the local level may have a major impact on investment levels as well as employment creation. Likewise, targeting something like property tax administration and collection at the municipal level would then potentially lead to capacity to issue a municipal bond in a few cases, which would benefit from work under SEGA (should subsequent USAID assistance be provided for securities market development).
- Workforce development is a major challenge, and one that likely exceeds USAID resources and capacity. Nonetheless, there are targeted interventions that could help to boost human capital, namely introduction of MBA and MPA programs with various specializations. This should be linked to one or two US-based programs, and possibly be named the American-Serbian Management Institute and structured as a legacy institution. This would not solve all of Serbia's workforce development problems, but would address a clear gap in the economy. (See Recommendations.)

III. GENERAL ASSESSMENT OF SEGA AND LESSONS FOR FUTURE ASSISTANCE TO THE FINANCIAL SECTOR IN SERBIA

A. Background and Findings Regarding SEGA Design and Performance

The SEGA project is part of **USAID Serbia's Strategic Objective 1: Democratic Governance of the Market Economy Strengthened**. The broad objectives of SEGA include:

- Accelerate ongoing economic reform processes in the sphere of macroeconomic policy, financial sector strengthening, capital markets development and private sector growth.
- Strengthen the supervisory oversight and risk management capacity of the entire financial sector in Serbia.
- Upgrade the human resource and technological capacity of all relevant counterparts, including government institutions and local economic research institutions.
- Improve the government's ability to communicate its message competently and openly about significant reform agendas.
- Provide limited assistance to the government with aspects of the restructuring of state- and socially-owned companies.
- Promote fiscal decentralization through close cooperation with USAID implementing partner under the *Municipal Economic Growth Activity (MEGA).*

The project has coordinated closely with the National Bank of Serbia, Ministry of Finance, Ministry of Labor and Social Welfare, and other related institutions. SEGA has also cooperated and coordinated with the World Bank and International Monetary Fund, both of which are keenly engaged in the stabilization, restructuring and reform of the banking system, and reform of the pension system.

This assignment is not an evaluation of SEGA performance. Nonetheless, the assignment calls for lessons learned from SEGA activities over the last few years to determine how USAID should move forward with economic growth assistance priorities.

The Scope of Work for the financial sector review included several questions. These are answered below, and constitute findings based on discussions with Serbian counterparts, SEGA advisors, and USAID personnel.

- **Do the problems or needs that gave rise to the SEGA activity (SEGA) still exist, have they changed, or are there new needs that should be addressed?**

There is no question that progress has been made in the area of banking and banking supervision. However, the rest of the financial sector is comparatively under-developed, and this now is proving itself to be an issue regarding macroeconomic policy—namely that the system is dependent on high levels of reserves to safeguard stability, and yet the high reserve levels mean there are fewer resources available for lending and investment. Meanwhile, the lack of investment resources is compounded by the weak state of fiscal affairs. The absence of a government securities market only weakens debt management and public policy. Therefore, many of the broad macroeconomic weaknesses and financial structures continue to exist, notwithstanding progress with banking.

At the "micro" or structural level, non-bank financing is still limited. There is more confidence in the system than before, as reflected by higher levels of deposits. However, confidence remains fragile, as reflected in the €1 billion in deposit withdrawals in 4Q 2008. Such fragile confidence means there is limited willingness to commit other resources for longer-term savings/retirement requirements. The initial accumulation of assets in VPFs has flattened, and accounts currently average only $500-equivalent. Thus, the long-term savings/retirement/pension issues persist, and the annual net losses of the PAYG system continue to add to the fiscal deficit.

The securities market remains small and generally illiquid. One of the key challenges moving ahead is the need to develop a long-term government securities market. Past emphasis in Serbia and the region has often been on equities and the stock exchange. However, these markets are not viable until sound governance, accounting, and disclosure standards are in place. This is a function of corporate culture and institutional capacity, and takes years to develop. Serbia is well behind the region in accounting and audit reform, and needs a dedicated strategy to address this for future economic and financial sector development. There is increasing recognition that debt instruments under more conservative parameters and practices are a more practical way to proceed, particularly in current times when risk aversion is high.

New needs have emerged, most notably the importance of a comprehensive strategy for contingency planning and crisis preparedness/management. This has given rise to the need for better coordination and cooperation across regulatory agencies within countries, and across borders. This is particularly pertinent in Serbia where foreign banks from nearby countries dominate the banking market, and will in all likelihood dominate the insurance market in the next five to 10 years. Given Serbia's limited domestic market and recent dependence on reserves partly built up from foreign direct investment and remittance flows, and given its increasing trade volumes with the EU in particular, financial stability is essential for domestic stability. In an environment in which there is likely to be less foreign direct investment, and potentially less in the way of remittance inflows, Serbia will need to become more export-competitive in the tradable goods sector. Given that this is true in the region at large, this means that Serbia will need to develop competitive capacity at a time when other countries are seeking to do the same thing, which will put downward pressure on export prices and make it more difficult for Serbia to generate needed foreign exchange. This will put pressure on the dinar exchange rate, as will increasing debt service payment requirements in the coming years (well before 2015). Serbia has faced hardship before, but in many ways, the conditions are different than they were at the beginning of the SEGA project.

Core needs that will need to be addressed: (1) development of a long-term government securities market; (2) accounting and audit reform and modernization; and (3) expanded capacity to manage financial stability issues on a domestic and cross-border basis, predicated on enhanced risk management capacity at the structural (i.e., financial institutions and enterprise) level and improved fiscal/debt management capacity.

Relevance to USAID: The above initiatives are all ambitious. SEGA has established a foundation for continued work re development of a government securities (and debt) market, and development of risk management capacity in the financial sector for regulators and market institutions.

- **Will there be expected results from SEGA that remain unattained at its completion that should continue to receive USAID assistance?**

SEGA has accomplished a great deal, and this has been recognized by counterparts. On the other hand, there are several initiatives that will be unattained at the completion of the project. These include (1) risk management capacity in the banking sector, particularly the non-foreign banks; (2) accreditation of banking supervisors; (3) full compliance with the Basel Core Principles for banking supervision; (4) risk-based insurance supervision; (5) IFRS training for the insurance industry and supervisors at NBS; (6) association development and self-regulatory capacity in the insurance sector; (7) implementing regulations needed to accompany the Securities Law that is expected to be adopted in 2009/10; (8) improving disclosure standards on the exchange; (9) enhancing Securities Commission capacity with regard to risk-based supervision; and (10) implementing IT systems for electronic reporting by market participants to the Securities Commission.

Other areas of focus where results will not have been achieved include (11) reform of the corporate income tax; (12) review of tax incentives for savings vehicles; (13) improvements in tax collections; (14) building capacity at the Anti-Money Laundering Commission; (15) training obligors on new AML legislation and by-laws; (16) developing a public awareness campaign on money laundering; (17) conducting a public awareness campaign on private pension funds; (18) strengthening the Association of Private Pension Funds; and (19) improving tax incentives for private pension contributions.

Part of the reason why such initiatives will not be achieved by SEGA completion is because (1) the design was too expansive from the beginning, and (2) certain tasks or areas of focus were added to SEGA activities, diverting resources away from activities in the original design. This includes financial education, largely to address consumer protection issues. It is uncertain if any subsequent SEGA activity should assume this responsibility. Likewise, it is not the responsibility of the NBS to manage a call center handling consumer complaints. Rather, this is a matter for the Bankers Association to handle. The role of the NBS should be to use moral suasion in getting the respective associations to handle this, including in insurance, and for NBS to monitor. Should the banks, leasing companies or insurance companies not observe consumer protection requirements, they should be liable for fines and other sanctions, including publicity via disclosure. NBS should also coordinate with the Securities Commission in this regard on investor protection, codes of conduct, etc., particularly as banks are also broker-dealers, and will be investors on the exchange as it expands.

Core needs that will need to be addressed: (1) capacity for financial stability, which actually encompasses #1-10 above, as well as #14-16; and (2) development of long-term savings instruments that relate to #12 and #19 above.

Relevance to USAID: The areas cited above (#1-10, 12, 14-16, 19) should continue to receive USAID assistance, particularly as these relate to future growth and stability. These are inter-related, and therefore should not just be supported on a "silo" basis, but in a manner that recognizes that these parts of the financial system will be increasingly inter-connected over time. This will require better coordination between NBS and the Securities Commission, and with the multitude of regulatory and supervisory authorities in neighboring markets and around the globe (e.g., payment systems issues, AML/CFT).

Some of the additional initiatives deserve ongoing support, namely #12, #14-16, and #19 linked to #12, while other related initiatives probably do not constitute the best allocation of USAID resources. The rationale for continuing to support some and not others is presented below:

- *Fiscal Policy and Administration (#11-13)*: While the time may not be propitious to consider tax incentives for savings vehicles, in the long run, tax inducements to encourage people to save for retirement will likely be needed to eventually reduce the burden of the PAYG deficit on the overall budget. Thus, tax features to savings instruments should be revisited when the time is right (#12). This should be done not only in conjunction with #19 re private pension contributions, but also for banks and insurance companies to allow them to use their retail networks to broaden coverage to the whole country. However, given the complexity and politicization of tax policy, it is recommended that USAID not dilute its focus by taking on such ambitious tasks as corporate income taxes and tax collection, which are shrouded in political uncertainty and which can be addressed by the IMF, World Bank, or EU members.

- *Anti-Money Laundering (#14-16)*: All three areas should be supported because of the importance of capacity for the stability and reputation of the financial system (and country), as well as because of the delay in getting the FIU running. In this regard, the US is also viewed as having a comparative advantage. USAID should explore partnerships with UST on this. If feasible, USAID should also consider utilizing the same advisor to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.

- *Private Pensions (#17-19)*: The importance of pillars 2-3 are recognized for long-term savings, and to gradually reduce or eliminate fiscal deficits resulting from the loss-generating PAYG system. However, under current economic circumstances, USAID should not focus on the pension system. Rather, focusing on #12 in a generic sense should expand out the pillar 4 option (e.g., individual retirement savings instruments) that is likely to be more suitable for Serbia for the foreseeable future. Private pension funds should be encouraged to offer these instruments, as should insurance companies and banks. In the end, if the public policy objective is to increase private retirement savings and gradually reduce the burden of the PAYG system on the budget, then a simpler and more retail-oriented strategy may be more suitable for Serbia, particularly as the mandatory second pillar is not currently feasible (in light of all the restructuring the Serbian enterprise sector will need to go through and the need to keep the tax burden down to provide incentives for hiring).

- *Development of the Actuarial Profession*: Among the additional tasks not originally foreseen, the effort made to date in building the actuarial profession should be supported, continued and expanded. This has much to do with the future of the contractual savings market (e.g., insurance, pension), but even more so because of the potential contribution that can be made to enterprise risk management. Serbian banks, enterprises and service providers (e.g., accounting and audit firms) will need to have licensed risk management experts to help Serbia with overall governance requirements for competitiveness. Increasingly, companies are evaluated on the basis of their risk management capacity, including their comprehensive enterprise risk management capacity. This is a mix of skills, but requires precise and technical capabilities. As statistics improve based on data accumulation and disclosure, actuarial analyses will be important in contributing to Serbia's competitiveness. Existing support should continue, and this should be a natural feed into the development of a legacy institution, such as the proposed American-Serbian Management Institute (ASMI; see Recommendations). Along with other core management courses for both the public and private sectors, ASMI would serve as the vehicle for 21st century management skills in Serbia. The actuarial specialization will not only serve as an advantage to Serbia, but will likely draw students from the region and help Serbia create a high value-added niche that is currently lacking.

- **Is SEGA's implementation strategy valid or should it be reformulated for future activities?**

SEGA's strategy should be reformulated to be more cohesive and synergistic with other USAID initiatives. It should remain focused on financial sector policy and the regulatory framework, particularly as no other donor has distinguished itself in this niche. The IMF and World Bank have led the larger macro-prudential and programmatic reform efforts, and EBRD and multiple EU donors (e.g., KfW, FMO) have been directly involved with market institutions and lending programs. However, USAID is the only donor that has been consistently involved in detail work regarding financial sector regulation and implementation. Moreover, it has stepped into the legal void (e.g., Securities Law) when others have either failed or been absent. Thus, USAID should retain its strategic niche and focus on this area.

In this regard, one of the key requirements for future development is to ensure that banking supervision moves from a prescriptive, control-oriented approach to one that is more risk-based, consistent with Basel II principles. This will require enhanced capacity at NBS to assess banks' own internal capacity to manage and price risk. However, banks will need to be able to more freely determine how they wish to allocate their assets in pursuit of higher earnings. In this regard, a number of reforms will be required, not the least of which are progress on the issue of related legal, institutional and financial sector infrastructure (e.g., property rights and unified/central property registry, unified national/central pledge registry, alternative dispute resolution to shrink inter-enterprise arrears, inclusion of inter-enterprise arrears into the credit information bureau reports). In this regard, close coordination with the IMF and World Bank is recommended.

Moving forward, USAID's SEGA strategy should increase linkage to other initiatives. SEGA currently lacks sufficient linkage to other USAID projects, just as some other projects may lack sufficient focus. As examples for future design consideration:

- *SEGA/MEGA Mix*: There is woefully limited capacity in most municipalities. One of the ways to consolidate focus across the MEGA and SEGA projects is to identify common challenges to core objectives. For instance, key challenges at the macroeconomic level will involve agreement on and eventual implementation of the Law on Spatial Planning and Construction, and the Law on Ownership of Urban Property. While local government-focused in orientation, these laws will ultimately enfranchise ownership rights, which will finally provide investors with clarity and certainty about whether to move ahead with investment under transparent and competitive conditions. (This assumes there is a future solution to the restitution issue.) This will increase investment and employment, which will increase inflows via the balance of payments and increase fiscal revenues at all levels. Accompanied by improved practices regarding the issuance of permits and licenses related to land use management and development at the local level, this will foster increased investment (assuming tax policy, including the full complement of payroll deductions for benefits, is conducive). And then further accompanied by modernization of property tax assessment practices and collections, a viable tax base will potentially evolve at the local level. This, in turn, will then make it potentially feasible for certain municipalities to issue bonds. However, this will also depend on adoption of financial reporting standards based on sound accounting and audit practices that could be driven by the (future) SEGA project with regard to securities market development (following on to the role SEGA has played with the Securities Law). In short, the future MEGA project could focus on (1) permits and licensing related to land use management and planning, and (2) property tax assessments and collection. The most successful municipalities could then be candidates for initial issues of municipal bonds, which would give them an additional financing source to fund needed infrastructure, etc. The future SEGA project would be able to work with those municipalities to bring those bonds to market during the 2011-2015 period.

- *SEGA/Competitiveness Mix*: The design of the Competitiveness project is to identify winning sectors, and provide firm-specific support by pushing a range of reforms from the ground up to facilitate exports and general revenue/employment growth and competitiveness. At a minimum, companies identified as "excellent" should be presented to lenders that are looking for dynamic and well-managed companies. While there is little overlap in terms of the financial sector activities, dialogue would potentially help link companies with certain lenders whose niche focus is on these companies. For instance, SMEs would likely be more attractive to ProCredit or Opportunity Bank. Even more importantly, any initiatives under the new SEGA that would focus on an improved business environment and competitiveness would want to learn from the lessons of the Competitiveness project. To the extent that the latter project is representative, it is possible that the project should drive the agenda for SEGA in terms of non-financial sector considerations on policy reform or interventions, including technical assistance. This is important for next-stage reform of risk-based banking supervision that should be less prescriptive in terms of regulatory rules and controls, and increasingly reliant on banks' internal capacity to evaluate, manage and price risks when making lending decisions. However, such key initiatives should be identified prior to when the (next) SEGA project is designed to avoid the kind of confusion that impaired performance under the current SEGA project. A good source of information on these issues will be Opportunity Bank, given its involvement at the grass-roots level and familiarity with how rigidities in the system interfere with better resource allocation for SMEs. ProCredit Bank would also be a good source of information and guidance in this domain.

- *SEGA/Bankruptcy Mix*: There is significant potential overlap between this project and SEGA due to the significant degree of restructuring required in the enterprise sector, and how this impacts the financial sector. In short, there should be close coordination between the two to maximize opportunities to restructure businesses to be more competitive, and to open up the market to greater competition. This will include liquidation in some cases, and restructuring and divestiture in others. A strong bankruptcy framework that encourages voluntary debt restructuring between parties tied to efficiency improvements that enhance the enterprise's competitiveness and long-term creditworthiness should be encouraged.

- *SEGA/Agriculture Mix*: As the financial sector is not particularly interested in primary agriculture, no effort was made to assess these prospects. However, agribusiness/food processing is a critical sector in the economy, and critical for the financial sector. Thus, any USAID initiatives should be mindful of this sector in the economy being an area of competence and competitiveness in Serbia, and one with growth prospects. The recent progress made with warehouse receipts is a step forward for farmers and financial institutions.

Core needs that will need to be addressed: (1) Greater strategic cohesion with and synergy across USAID projects; (2) coordinated reforms with the IMF and World Bank; (3) broad commitment to the components of financial stability; (4) implementation of a more risk-based approach to banking supervision predicated on key institutional and infrastructure reforms that disclose inter-enterprise arrears and seek to enhance SME liquidity; and (5) enhanced options for asset allocation to bolster earnings and capital by financial institutions.

Relevance to USAID: The next SEGA project needs to graduate beyond Basel I supervision, even if NBS has not achieved full compliance with the BCPs. SEGA also needs to select core areas of focus, and not have its efforts diluted. Recommendations above reflect this focus: (1) financial stability; (2) risk management capacity, including capacity of NBS to assess banks' risk management capacity; (3) AML/CFT capacity enhancement, including linkages to operational risk capacity of the institutions supervised by NBS; (4) enhanced coordination with other regulators, inside Serbia and abroad; (5) methods of promoting retail savings instruments to address long-term retirement savings challenges, as well as to broaden and diversify product and service competition in the financial sector; and (6) securities market development, with particular focus on the central government securities market, and then feasible issues, which are more likely to be plain vanilla mortgage bonds than infrastructure or municipal bonds or corporate debt/equity instruments. Coordination with other USAID projects would improve the environment so that a well regulated financial sector can meet the financing needs of the private sector at competitive, affordable rates.

- **Do conditions exist to ensure that SEGA's results will have lasting effects?**

Conditions exist to ensure that SEGA's results will have lasting effects with NBS. Such conditions are not guaranteed with regard to the Securities Commission or in the area of public sector finance. The Securities Commission lacks capacity at all levels. Likewise, while the current government is pro-reform and carrying out many positive initiatives (e.g., regulatory guillotine), there is less demonstrated capacity in the government to carry out requirements for comprehensive reform. For this reason, it is suggested that future SEGA design be more focused and targeted on institutions where capacity exists (e.g., NBS), and/or on initiatives that are focused to compensate for the lack of capacity at institutions that would be involved (e.g., AML unit in the Ministry of Finance, Securities Commission, higher education).

Such conditions and relationships do not guarantee success. Even with NBS, movement to a more risk-based system implies a less directly control-oriented approach to banking supervision. NBS is likely to continue to focus on reserve management for monetary and broader stability purposes, particularly as structural and fiscal weaknesses in government and the enterprise/household sector imply continued loose fiscal policy. Moreover, rising debts and the lack of investment and export competitiveness will cause strain if NBS wants to maintain some measure of exchange rate stability. As such, continued high reserve requirements in the coming years may lead NBS to maintain a more control-oriented approach, which will then make it more difficult to get resources out to the SME sector for employment and GDP growth over time.

Core needs that will need to be addressed: (1) Greater strategic cohesion with and synergy across USAID projects; (2) coordinated reforms with the IMF and World Bank; (3)

broad commitment to the components of financial stability; (4) implementation of a more risk-based approach to banking supervision predicated on key institutional and infrastructure reforms that disclose inter-enterprise arrears and seek to enhance SME liquidity; and (5) enhanced options for asset allocation to bolster earnings and capital by financial institutions.

Relevance to USAID: The next SEGA project needs to work with other donors to carry out other legal and institutional reforms that constrain SME growth and development, while focusing on targeted aspects of the financial system to increase (1) earnings opportunities and (2) lending to and investment in competitive and creditworthy companies. Meanwhile, (3) development of a bond market, starting with Government securities, will help with #1, and potentially ease restrictive monetary requirements over time, as reflected in NBS reserve policy.

- **Can we confirm that the Government of Serbia wants, needs, and will use USAID technical assistance and training in reforming its economic policies?**

The Government of Serbia wants, needs and will use USAID TA and training to reform economic policies. This is already in evidence in many cases. However, this has been true in some areas more than others. Continued challenges with urban property rights and the business environment issues associated with local government administration remain critical risks. Notwithstanding any challenges in policies, there will be a major challenge with implementation. Throughout the economy, there is evidence of (1) larger companies abusing their positions and running up arrears on obligations to smaller suppliers, (2) government-owned utilities and other companies imposing charges that are inconsistently applied and serve as a tax on private investment, and (3) local vested interests able to obtain government contracts based on non-competitive standards. Moreover, the entire challenge of tax administration remains unsolved. All of these (and other unmentioned) structural weaknesses undermine large economic development objectives. However, there are vested interests that clearly benefit from the current system. These interests will continue to resist reforms, and potential weaknesses in the government may mean that there will be limitations on how far the government can go with effective implementation of reforms.

Core needs that will need to be addressed: (1) Greater strategic coordination of reforms with the IMF, World Bank, EU and other relevant donors; and (2) government stability and longevity to pursue the reform agenda, including making institutional changes that move Serbia closer to market economy standards.

Relevance to USAID: The need for commitment beyond legal and policy changes to actually ensure these new policies are implemented. In some cases, quick hits can be achieved. But the enormity of the challenge suggests that there will be continued resistance in many quarters, particularly if the regional and global economy does not pick up by 2011.

- **What approaches to technical assistance have been most effective with the Government of Serbia? For example, would conventional assistance implemented by a contractor or grantee be most effective, assistance from a U.S. Government department or agency (such as U.S. Treasury or the SEC), or a combination of both approaches?**

There is broad recognition of effective delivery of assistance under SEGA for the financial sector, namely the NBS. Thus, a mix of highly skilled professionals on a long- and short-term basis has been recognized as making a major contribution to the NBS as the rock of stability during the current crisis. This reputation is long-standing, and pre-dates SEGA as there is also recognition that banking reforms in recent years were built on earlier reforms initiated after 2000.

There is also recognition of effectiveness with the Securities legislation being developed, although additional TA for the Securities Commission has not (yet) been recognized, partly due to recent initiation, and partly due to lack of capacity at the Commission.

More broadly, the critique of SEGA has been the lack of focus. However, the general consensus was that SEGA has been effective and responsive. Serbian counterparts were not in a position to discuss efficiency considerations.

As for delivery, there were few suggestions of any importance on how to improve. Some counterparts were aware of UST assistance, although there was limited detail in this regard.

In some cases, the view was held that Serbian nationals could assume some responsibilities. However, there was little criticism of a heavy presence of US contractors. More broadly, Serbian counterparts in government and the private sector believe that their own reform process started later than many others, and therefore a more permanent presence of US contractors in Serbia is warranted as they are still making up for lost time. Serbians frequently alluded to Croatia's position vs. Serbia in a number of areas, and the belief that this is the main regional peer for Serbia to emulate in terms of reforms for future positioning re the EU.

Core needs that will need to be addressed: No real suggestions apart from greater strategic and tactical cohesion, as noted above.

Relevance to USAID: As per the above. The main challenge will be combining focus with responsiveness. Some of SEGA's "under-performance" relates to the need to be responsive to a broad array of initiatives, requests and stakeholders. Introducing greater focus will likely require that some of the earlier responsiveness and flexibility be curtailed.

- **If the assistance in the period 2011-2015 were to be the final phase of U.S. bilateral assistance to Serbia, how would that affect recommendations of assistance objectives and approaches to delivery of that assistance?**

The recommendations and approaches are based on the assumption that the assistance period 2011-2015 is the final phase of US bilateral assistance. As with any program, there will be continued gaps or weaknesses. However, the recommendations in this report are based on 2015 being the last year of bilateral assistance.

B. Future Considerations for USAID Assistance

USAID assistance should be influenced by the following:

- **Strategic Fit with USAID**: Consistent with and reinforces 2011-2015 vision regarding support for Euro-Atlantic institutions. For future SEGA work, efforts should continue to promote (1) convergence with BIS, IAIS, IOSCO and related international standard-bearers in the financial sector, and (2) effective implementation of reforms that position Serbia to accede to the European Union and other Euro-Atlantic institutions.

- **Comparative Advantage for USAID**: Evidence of capacity, a track record, and superior performance by USAID when compared with other donors. For future SEGA work, this is clearly in the financial sector, with particular emphasis on legal, regulatory and institutional structures for effective performance and stability.

- **Achievable Medium-term Results**: Complexity/feasibility for achievement regarding USAID and counterparts' capacity to design and implement effectively. For future SEGA work, this will require a realistic approach to goals and objectives that can be achieved. There is far greater stability at NBS than in government ministries. As such, the probability of achieving medium-term results is higher via continued work with the central bank than it is with government ministries.

- **Sustained Long-term Impact**: Transferability to counterparts as legacy accomplishment by/from USAID. For future SEGA work, this will be achievable via the NBS. Other initiatives will need to be explored, taking into account the capacity to operate on a sustainable and/or commercial (cost-recovery) basis.

- **Major Results from Budgetary Resources**: Reflected in how expensive or not the initiatives would be in terms of funding allocations, whether there is a need for co-funding, and if so, what the prospects are for achieving co-funding from other partners. For future SEGA work, this will require closer coordination with major donors to leverage results from USAID budgeted resources. This may also require that USAID look to vendors whose cost structures are lower than what USAID has paid in the past.

- **Scaled re Available Budget**: Balancing achievement objectives with funding parameters to ensure that objectives are aligned with funding, and not out of balance.

For future SEGA work, this relates to the above considerations re results from budgetary resources. This will require potentially greater use of Serbian expertise, as well as possibly lower-cost contractors and/or alliances with other USG agencies.

- **Measurable Performance Indicators**: As reflected in the ease of compilation of key performance indicators and their usefulness as a monitoring tool. For future SEGA work, this will be relatively easy to structure for the financial sector once clear outcomes and outputs are agreed to with Serbian counterparts.

- **Fill Major Economic Development Gaps**: Addresses critical needs. For future SEGA work, the approach of continuing to support financial sector reform is critical as a resource for larger economic growth objectives. However, effectiveness will only occur in tandem with other structural reforms, which will require close coordination with the IMF, World Bank and government for the desired results to be achieved. Support for the financial sector without close linkage to reforms in the enterprise sector and government will limit prospects for success.

- **Confidence of Success**: Prospects for achieving planned results. For future SEGA activity, as per the above, confidence of success will be higher if closely coordinated with reforms in the enterprise sector and government. This includes (1) legal, regulatory and institutional requirements that reduce government ownership in the economy, (2) reduce the position of monopolies, (3) allow for faster dispute resolution, and (4) rationalize the entire government approach to taxation, procurement and regulation.

- **Local/Domestic Support ("Buy-in")**: Counterpart cooperation, capacity, support and active participation. For future SEGA activity, this is largely guaranteed via NBS and some of civil society. It is largely guaranteed for the moment in the government, but not guaranteed for the long term. Willingness of counterparts to commit resources in conjunction with USAID-funded assistance could serve as a proxy for domestic support.

- **Global Development Alliance**: Prospects for potential partnerships in Serbia with international entities that could be instrumental in furthering strategic objectives. For future SEGA work, this is an important feature that will be helpful in leveraging resources, accelerating needed reforms, and potentially being indispensable in the establishment of at least one legacy institution.

Specific to future SEGA activities, key findings suggest that future assistance should be influenced by the following:

- **Needs**: Some of the original needs that existed in the original SEGA design are still in effect, while new challenges have emerged. For future SEGA work, the design will need to be more specific in terms of objectives and targets. In some cases, original needs should not be addressed, as they are too complex, costly or politically risky to ensure success. In other cases, continued support is justified.

- **Results**: Not all results will have been attained, partly because of overly ambitious targets, the diversion (dilution) of resources, and/or lack of political will/government capacity. For future SEGA work, results will need to be more closely aligned with the core criteria noted above. Above all, greater cohesion will be needed re other USAID initiatives. Areas of likely success and impact that can be achieved by 2015 should drive design.

- **Implementation Strategy**: Achieving a balance of focus and responsiveness is the consensus that has emerged from a discussion of past performance under SEGA. For future SEGA work, it will be important to identify achievable targets and objectives, and then build in a measure of flexibility and responsiveness within those areas.

- **Conditions for Lasting Effect**: USAID will need to make choices in terms of priorities and resource allocation. In some cases, the greatest needs should not be addressed because the preconditions for success are missing. In other cases, foundations are in place for success. For future SEGA work, it will be important to build on earlier successes that have good prospects for both impact and lasting effect.

- **Government Confirmation re Economic Reform**: While the government is currently pro-reform, the degree of political will relative to the challenge is still unclear. For future SEGA work, USAID will need to identify personalities that have demonstrated their commitment to reform, have shown this through their respective institutions, and have articulated a strategic vision that converges with USAID objectives. USAID will also need to minimize the risk of turnover in terms of its institutional partnerships. This means that if there is a shift in cabinet, that sufficient capacity should exist to continue the work agreed to, and not be wholly dependent on the highest levels of government for sustained commitment and support.

- **Approaches**: Counterparts have spoken highly of TA delivered by USAID. Nonetheless, some have commented on a lack of strategic focus that could reduce net impact. For future SEGA work, USAID will need to (1) be more strategically cohesive and focused, (2) work in tandem with other donors and possibly USG agencies on a complementary and reinforcing manner, and (3) explore less costly approaches to TA delivery.

- **2015 Close Out**: There is considerable work to be done for Serbia to (1) establish a stable macroeconomic framework, (2) sort out distortions in the business and tax environment, and (3) achieve sustainable sources of earnings predicated on export competitiveness so that it is able to (4) weather future shocks without excessive dependence on tight monetary policy and donor funding. For future SEGA work, USAID will need to continue to focus on areas of current strength and stability, while working with others on critical structural reforms so that Serbia is able to converge with EU accession requirements. This process will not be fully achieved by 2015, but commitment to and implementation of reforms by 2015 should be sufficient to get them on the path to an invitation from the EU.

C. Brief Summary of Other Donor Activity in the Financial Sector

Apart from the IMF and World Bank, some other donors have been active in selected areas of financial sector developed. This area was not explored in great deal, but in most cases, there was little knowledge among counterparts of what other donors had done in the field.

The most commonly referenced activities were in SME lending, and work with the Deposit Insurance Agency. In terms of SME lending, ProCredit Bank is capitalized by several German (e.g., IPC, KfW), Dutch (e.g., DOEN, FMO) and international groups (e.g., IFC), and is the leading lender to SMEs in Serbia. EBRD has also implemented some SME lines of credit through commercial banks, most recently a €45 million facility through UniCredit. As for the Deposit Insurance Agency (DIA), KfW of Germany is providing assistance.

IV. RECOMMENDATIONS TO USAID

A. Background

USAID has been active in Serbia since 1997. A total of $203 million has been programmed for economic growth and development. Of this, a significant share of assistance has been dedicated to financial sector reform. Since 2001, the USAID assistance program has allocated more than $109 million to support financial sector legislation and regulation, banking supervision, insurance sector legislation and regulation, securities markets development, pension reform, macroeconomic analysis and fiscal policy.

The next five years of programming, from 2011-15, envision a period in which Serbia continues to build on structural reforms that help to boost financial stability while also potentially diversifying financial sector players to induce additional competition. The current system has shown itself to be stable, yet costly in terms of reserve requirements. Return ratios are low, and the vast majority of enterprises is still unable to access or afford mainstream credit from the banking sector. Much of this has to do with a wide range of structural defects in the system, culminating in a high degree of gray market activity.

While the banking sector is relatively stable, significant challenges persist. These will need to be addressed so that Serbia can be prepared for future external crises over which it has no real control. Likewise, ongoing reforms will be needed in the financial sector, government and private sector so that Serbia can increasingly converge with EU requirements for a future invitation to negotiate membership.

As part of this effort, USAID is evaluating its current programming and preparing for a new or revised strategy for 2011-2015. Specific financial support initiatives recommended to be pursued under this new strategy are presented below. These are recommended priorities, taking into account findings and observations from sections II and III.

B. Recommendations

There are four broad financial sector initiatives recommended for USAID to pursue. Three build on existing initiatives and are areas where USAID has a successful track record in Serbia and/or other transition countries, and/or represents an area of critical focus. These are (1) continued yet targeted work in **banking supervision**, with particular emphasis on requirements for standardized/simplified approaches to Basel II; (2) implementation of a viable long-term **debt securities market**, with initial focus on the local exchange as a platform for a liquid central government securities market; and (3) support for capacity enhancements regarding **AML/CFT**. A fourth initiative, (4) establishment of the **American-Serbian Management Institute**, would serve as a wholesale source of accredited management capacity-building for financial institutions, enterprises, government officials and service providers (e.g., auditors, accountants) by offering MBA and MPA courses in conjunction with one or more US universities.

Each of these is discussed below. Detailed templates evaluating strategic considerations and prospects for success are presented in Annex 1.

► #1: Strengthening the National Bank of Serbia

NBS has made significant progress in recent years, and is widely recognized as a source of stability during the recent crisis. However, there are still some areas of needed strengthening. These include:

- *Movement to Basel II*: NBS has a strategy to move on to Basel II. This will require a less prescriptive approach to banking supervision to one that is more risk-based or principles-based. This will require enhanced NBS supervisory capacity to evaluate the credit, market and operational risk management systems of the banks.

- *Coordination of Basel II with Financial Stability Capacity*: NBS is currently undergoing a crisis preparedness exercise. In the future, the maintenance of financial stability in Serbia will depend on more balance between monetary and fiscal policy, as well as on enhanced coordination with other regulatory institutions within Serbia and across borders. The predominance of EU-based banks and high level of cross-border funding flows will require closer integration with regional supervisory bodies. NBS will also need additional expertise in financial modeling to coordinate ongoing stress testing and scenario analyses.

- *Coordination of AML/CFT with Other Agencies*: The integrity and reputation of the Serbian financial system partly rests on its ability to detect and act on suspicious transactions. In the meantime, due to the high degree of informal sector transactions, there is a major opportunity for money laundering and other financial crimes. Meanwhile, organizationally, the financial intelligence unit is housed in the Ministry of Finance (see below). Thus, efforts to link systems utilized for operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with monitoring of the payment/settlement system should be coordinated to support the broader AML/CFT effort, and vice-à-versa.

USAID assistance would involve short-term (and possibly) long-term TA to (1) coordinate movement to Basel II; (2) strengthen capacity to monitor and manage financial stability issues; and (3) coordinate and strengthen AML/CFT capacity. Specific outputs would include (1) demonstrated supervisory capacity to determine banks' own credit, market and operational risk management capacity and systems to ensure appropriate levels of capital are in place for banking system stability, and in a manner that is not as restrictive with regard to reserve policy;

(2) demonstrated capacity to manage stress in the economy resulting from external shocks, macroeconomic or structural imbalances, cross-border exposures, and/or cross-sectoral (e.g., banking and insurance) exposures, and to ensure the financial system is adequately capitalized and able to access liquidity to meet all financial and payment obligations; and (3) capacity to prevent any reputation risk or loss of depositor, creditor or investor confidence as a result of money laundering or criminal financial activity. Partners would be a prime contractor and NBS, with significant coordination envisioned with the IMF and World Bank.

Initial estimates of resources needed for implementation include the following:

- Short-term advisors to assist with financial stability (macro-prudential) issues, including building capacity with modeling for stress testing and scenario analysis.
- Short-term advisors to assist with systems and IT requirements for operational risk assessments under Basel II, as well as linkage to AML/CFT activities.
- Possible need for assistance by short-term advisors to help the NBS supervisors with credit and market risk issues for banks and insurance companies.

It is premature to determine what the budgetary cost would be for such assistance. It is recommended that if NBS seeks USAID TA in these and any other areas, that a brief work plan be established determining activities, performance targets/outcomes, and costs. It is conceivable that a long-term advisor would be required if the work program becomes more detailed and involves more short-term personnel coordination. If this is the case, the resident advisor should assume lead responsibility for at least one of the areas specified above.

Key further questions that will need to be answered include:

(1) Are medium-term results achievable with only short-term TA?
(2) How should TA resources be allocated and focused?
(3) Will efforts to achieve synergies with other USAID initiatives/projects reduce flexibility, and thereby weaken the reputation for responsiveness USAID has built up over the years with NBS?
(4) Should NBS be considered a "graduate" and resources allocated to other institutions that are in more need of assistance?

Strengthening the NBS

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	Central banks are critical to the financial sector stability of the country. Without financial sector stability, Serbia's prospects for joining the EU diminish, which would work against the strategic objective of support for Euro-Atlantic institutions.
Comparative Advantage for USAID	Strong prospects for success. USAID is uniquely positioned to provide assistance.	No other donor has been involved at the structural level. Relations are good between NBS and USAID. IMF would like USAID to continue with its support during a crucial period.
Achievable Medium-term Results	Much is achievable in the medium term, although full implementation of Basel II in banking is unlikely. Results in non-bank areas may be more difficult to achieve.	SEGA has a work plan through late 2010, and key initiatives have been identified for 2011-15. These are achievable, although modest levels of achievement (e.g., standardized and simplified approaches to Basel II) should be targeted prior to introducing complexity into the system.
Sustained Long-term Impact	Building additional capacity at NBS as it approaches EU accession and introduces Basel II will have significant impact in the long term.	USAID has been working with NBS for nearly a decade. NBS is a clear candidate to serve as a "legacy institution" for USAID. Apart from the IMF, no other institution has worked closely on such an ongoing basis as USAID.
Major Results from Budgetary Resources	Results will exceed budgetary resources, as demonstrated during the recent crisis. NBS has acknowledged the importance of USAID support in building NBS capacity. Results will also strengthen coordination, which means strengthening other institutions along with NBS.	USAID TA has been beneficial in contributing to recent stability, and this has occurred partly due to the institutional capacity-building taken on by USAID nearly a decade ago. Because NBS has additional resources, USAID assistance is then positioned to achieve more than what direct assistance would accomplish.
Scaled re Available Budget	USAID TA is more in demand than USAID funding.	One of the advantages for USAID to working with NBS is that the latter has additional funds to implement TA as needed. There is opportunity for USAID project involvement benefit from NBS sources as well as IMF and other funds' sources.
Measurable Performance Indicators	There are numerous indicators of banking and financial stability that are regularly and easily compiled, and useful as a monitoring tool.	Specific performance indicators to be determined. Indicators are easily measurable (e.g., capital adequacy ratios in banking, solvency ratios in insurance, reputation of all licensed banks re AML/CFT), and can easily be broadened to include monetary, macro-prudential and purely structural indicators.
Fill Major Economic Gaps	TA serves as a key contributor to stability, which is indispensable for investment and sustainable economic growth.	A stable banking and financial system is essential for economic growth and development. This is fundamentally accomplished by raising public confidence (depositors) and the intermediation of savings for investment into the economy (loans). These benefits are particularly evident under stable or growing macroeconomic scenarios. Ongoing support will help to close gaps between Serbia

		and its neighbors as well as with the larger gaps re EU.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to the initial capacity built up, and the strong mandate NBS enjoys. NBS is also not subject to the same turnover as other central government institutions. Likewise, USAID enjoys a strong reputation within NBS.
"Buy-in"	NBS would like continued support, as would IMF.	Counterpart cooperation, support and active participation have been in effect for nearly a decade. There is buy-in, and recognition by Serbians and donors that USAID assistance is properly positioned at the NBS.
Prospects for Global Development Alliance	Potential for partnership more likely with other USG or other regulatory institutions.	Uncertain if GDA is optimal for central banks. Alliances are more likely with the Fed or other US regulatory agencies, including UST. This could be enlarged to include FTAF-type assistance for AML/CFT which sometimes runs through the UN.

► #2: Developing the Long-term Debt Securities Markets

Serbia's macroeconomic framework is out of balance due to poor budget management. While fiscal deficits over the decade have not been exceedingly deep, the government still suffers from low revenue collection. However, there is still a substantial cost to the economy, as many households and companies are required to pay informal taxes. Moreover, because of poor and inequitable tax administration, much of the economy operates in the shadows to avoid reporting income and assets. The result of this inefficiency is that macroeconomic stability is predicated on high levels of foreign exchange reserves to maintain a moderately stable exchange rate, and to maintain confidence among depositors. This imposes an enormous burden on the banks in the form of reserve requirements, making banking a costly business in Serbia. This, in turn, limits the availability and affordability of credit for the private sector. Such constraints in the banking system spill over to the enterprise sector, resulting in significant inter-enterprise arrears as well as other arrears. All of this adds to the cost of business transactions, and keeps the negative spiral moving in a way that makes it difficult to achieve more balanced stability.

For these reasons, it is recommended that USAID support development of a long-term debt securities market. Key needs include:

- *Debt Management Strategy*: This project would complement other assistance from the IMF and World Bank on debt management, but gear it to market practices. This would involve planning for issues that would run beyond the one year issue planned for later in 2009 to issues that would run up to five years.

- *Planning for an Improved Sovereign Rating*: Because Serbia has traditionally relied on donor debt and commercial loan syndication, it has not established a framework at the Ministry of Finance for strategic planning related to achieving an investment-grade rating.

- *Financial Instruments*: Because there is no yield curve, there are no instruments for institutional investors (limited as they are). Establishing a long-term yield curve would provide banks, insurance companies and pension funds with earning asset opportunities and instruments to help with asset-liability management. This would also help to provide citizens with options for future retirement savings that could potentially contribute to a long-term solution to reduce the impact of the PAYG imbalance on the fiscal deficit (which would assist with debt management and an improved sovereign rating).

- *Accounting, Audit and Disclosure*: Serbia significantly lags other markets. This project would target standards to assist with government securities initially, but with spillover effects in other markets over time.

USAID assistance would involve short-term TA to (1) establish criteria and a regulatory framework for development of a liquid long-term debt securities market; (2) develop regulatory capacity to ensure issuers and brokers comply with the regulatory framework; and (3) institute the required accounting, audit and disclosure standards required when issues come to market for ongoing integrity and confidence. Specific outputs would include (1) a long-term yield curve to serve as a benchmark for the pricing of long-term instruments and exposures; (2) financial instruments in which banks, insurance companies, pension funds and others could invest to assist with earnings and asset-liability matching requirements; (3) standards for Ministry of Finance to manage its long-term debt strategy predicated on sound fiscal collections, budget management and planning, and improved sovereign ratings; and (4) modernization of accounting and audit standards consistent with requirements in liquid and transparent capital markets. Additional outcomes potentially would include (5) issuance of mortgage bonds, to provide long-term funding instruments in the insured residential mortgage market; (6) issuance of municipal bonds in Belgrade, Novi Sad, or other municipalities potentially able to attract institutional investment; (7) issuance of infrastructure bonds; and (8) issuance of equities by well managed enterprises. Partners would be a prime contractor, the Securities Commission, Ministry of Finance, and an approved Serbian audit firm with IFRS capacity for public sector debt instruments. Significant coordination is envisioned with the IMF and World Bank.

Initial estimates of resources needed for implementation include the following:

- Short-term advisor to assist with long-term debt management strategy and sovereign ratings.
- Short-term advisor to assist with relevant accounting and disclosure standards for a long-term government issue. This could possibly be a long-term position if it involves hands-on capacity-building work with the Securities Commission.

It is premature to determine what the budgetary cost would be for such assistance. It is recommended that USAID explore an alliance with UST re debt management issues. Key further questions that will need to be answered include:

(5) How strategic a fit is support for securities market development, apart from the potential contribution it can make as a catalyst for financial stability?
(6) Are medium-term results achievable with only short-term TA? If permanent advisor(s) is/are needed, is this the best method of allocating resources?
(7) Is the general concept too complex or ambitious, particularly as it depends on accounting reform as well?
(8) Is the objective of using this project as a catalyst for needed government reform (e.g., expenditure management and planning, tax administration and collection, PAYG pension reform) unrealistic or overly ambitious?
(9) What are the prospects for success given low levels of capacity at the Securities Commission?
(10) Even if the Ministry of Finance initially agrees to pursue prudent debt and fiscal management policies, is there a risk that such a project would be reversed with a new election and/or a worsening of the economy, triggering requirements for a soft fiscal policy as largely currently exists (as reflected in very low tax collections and revenue-to-GDP ratios)?

Development of a Long-term Debt Securities Market

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	Securities markets are important for the diversification of financial products, and tradability of such products on an open and transparent basis. Development of the securities markets would help Serbia move closer to EU standards.
Comparative Advantage for USAID	Reasonable prospects for success.	USAID work on the Securities Law has been praised by stakeholders. It is therefore positioned to assist with the next stages, implementing regulations and capacity building. Relations are good between the Securities Commission and USAID. Development of a Government securities market is consistent with IMF objectives, as stated in the FSSP.
Achievable Medium-term Results	Much is achievable in the medium term, although capacity constraints at Securities Commission make this more challenging.	SEGA has a work plan through late 2010, and key initiatives have been identified for 2011-15. The current proposal actually enlarges the effort, which will make it more challenging to achieve in the medium term. However, in the absence of such a debt market, it is unclear how reserve requirements in the banking system will come down, how net spreads will decline, and how credit will become more available and affordable in the enterprise/SME sector.
Sustained Long-term Impact	Building capacity at Ministry of Finance and the Securities Commission will have significant impact in the long term.	The focus of this effort is to induce greater discipline with regard to debt and fiscal management, which will make Serbia less dependent on external sources of reserves for macroeconomic stability. Such a change in operations would represent a major departure from current operations, and have a long-term impact.
Major Results from Budgetary Resources	Results will strengthen fiscal and debt management, add to macroeconomic stability, and contribute to rising financial intermediation which will help with employment creation and GDP growth.	Outcomes are expected to include more efficient methods for pricing long-term exposures, introducing new long-term instruments for saving/investment, and enhanced accounting and audit standards. These will help to increase investment, improve prospects to reduce the PAYG pension system, and establish the foundation for disclosure needed for liquid markets to function properly.
Scaled re Available Budget	Depending on the level of work required for accounting and audit standards, this initiative can be scaled.	This initiative is structured to focus on central Government finance issues initially, thereby narrowing the scope and requirements for issues.
Measurable Performance Indicators	There are numerous indicators that would be easily compiled and useful as a monitoring tool.	Specific performance indicators to be determined. Indicators are easily measurable (e.g., improvements in sovereign ratings, extension and narrowing of short- and long-term yield curves, issues sold and value traded).
Fill Major Economic Gaps	A more balanced macroeconomic framework is needed to reduce the high reserve requirements imposed on the banking system and to reduce the cost of credit for creditworthy	The economy is currently dependent on foreign exchange reserves for macroeconomic and financial stability. The reserve accumulation from past years will be at risk in the coming years. Thus, for a desired easing of monetary policy without adding to inflationary pressures, well managed debt and fiscal policy is required.

	borrowers.	
Confidence of Success	Medium prospects for achieving planned results.	Medium probability of success due to (1) the involvement of two domestic counterparts, (2) dependence of the debt and fiscal management strategy on structural and other government reforms, and (3) need for capacity building at the Securities Commission.
"Buy-in"	Ministry of Finance planning to issue up to one-year securities. Securities Commission seeks USAID support.	Agreement with Ministry of Finance on debt management and issuance strategies would need to be agreed. This may be risky, as the fiscal deficit is rising, and sound budget management will require significant reforms. The Securities Commission is benefiting from current SEGA support and would like it to continue.
Prospects for Global Development Alliance	Potential for partnership more likely with other USG or other regulatory institutions.	Uncertain if GDA is optimal for this initiative. Alliance is more likely with UST re budget management.

► #3: Enhance AML/CFT Capacity

Serbia's economy and investment climate continue to suffer from tax evasion and other weaknesses. This includes criminal transactions. The government was relatively late in establishing a financial intelligence unit, and thus lags behind many neighbors in the region in being able to track suspicious transactions. For these reasons, it is recommended that USAID support efforts to build AML/CFT capacity. Key needs include:

- *Organizational Requirements*: This project would tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit.

- *Staff Training*: Increased training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors is needed to raise public awareness of the costs to the economy, as well as in technical areas related to detection.

USAID assistance would involve short-term (and possibly) long-term TA to (1) tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and assist with the organizational structure and requirements for effective implementation of FATF principles and requirements; (2) increase training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors; (3) strengthen capacity and systems to monitor suspicious transactions; and (4) coordinate closely with NBS, law enforcement agencies, and other international counterparts to strengthen AML/CFT capacity. Capacity-building efforts would be linked to assistance for the NBS under Initiative #1 to ensure coordination via NBS operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with its effort to monitor the payment/settlement system. Specific outputs would include (1) demonstrated enhancement of capacity to identify, contain and prosecute suspicious transactions and those responsible for such financial crimes; (2) better public awareness of the costs and penalties associated with such activity; and (3) narrowing of gaps in institutional capacity relative to regional peers. Partners would be a prime contractor, Ministry of Finance, and NBS, with significant coordination envisioned with the IMF and World Bank. USAID should also explore partnerships with UST on this. If feasible, USAID should consider utilizing the same advisor for AML/CFT to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.

Initial estimates of resources needed for implementation include the following:

- Short-term advisor for AML/CFT technical, operational and systems requirements who would possibly be a long-term advisor if this person is suitable to assist the NBS with their systems, IT and operational risk assessment needs for Basel II.
- Short-term advisor to assist with relevant organizational and inter-institutional coordination and communication protocols.

It is premature to determine what the budgetary cost would be for such assistance in light of how duties may be shared. It is recommended that USAID explore an alliance with UST for implementation. Key further questions that will need to be answered include:

(11) To what extent will an increased crackdown on criminal activity impact resistance to TA delivery?
(12) Will there be any resistance within Ministry of Finance, or difficulties in coordinating with NBS?
(13) Can an AML/CFT advisor also double as someone who could work with NBS on operational risk issues, etc. as part of Initiative #1?

Support to Ministry of Finance and NBS for AML/CFT

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	AML/CFT capacity is essential for a sound financial system, and for the national reputation of the Serbian market and business environment. Capacity is also a strategy priority for Euro-Atlantic institutions.
Comparative Advantage for USAID	Strong prospects for success. USAID/USG is uniquely positioned to provide assistance.	Donor assistance has been limited, although assistance received from SEGA has been well utilized. Relations are good between NBS and USAID, and USAID is uniquely positioned in this regard to assist with coordination and capacity building between Ministry of Finance and NBS.
Achievable Medium-term Results	Much is achievable in the medium term, although prevalence of tax evasion and criminal elements creates challenges.	All assistance objectives are achievable in the medium term. This is a recommended intervention to help Serbia make up for its late establishment of a financial intelligence unit.
Sustained Long-term Impact	Building additional capacity at Ministry of Finance and NBS will have significant impact in the long term.	Capacity enhancement in this area will strengthen Serbia's overall reputation, helping to create long-lasting benefits to the economy.
Major Results from Budgetary Resources	Results will exceed budgetary resources and strengthen coordination between Ministry of Finance and NBS, as well as with international counterparts.	AML/CFT TA provided by USAID could be spread across multiple institutions, providing some resource leveraging. This is particularly the case regarding NBS. It is possible that ST advisory assistance in AML/CFT could involve someone who would assist NBS with some of their IT assessment needs of the banks, an explicit need for the coming years. Meanwhile, that same advisor may be positioned to assist with the specific AML/CFT tasks of the Ministry of Finance.
Scaled re Available Budget	Scaled according to needs, with anticipated benefits greater than direct costs.	TA linkage to both AML/CFT and supervisory capacity at the NBS will generate significant systemic benefits.
Measurable Performance Indicators	There are numerous indicators that can be compiled, although these may be more judgmental re capacity.	Specific performance indicators to be determined. To be driven by FATF principles in a manner similar to BCPs for banking supervision and guidelines from the Financial Stability Forum for financial stability issues.
Fill Major Economic Gaps	TA serves as a key contributor to financial stability and a sound reputation, which is required for investment, long-term growth and convergence with EU requirements.	A stable financial system requires capacity to identify, contain and manage risks related to criminal financial activity. Support for AML/CFT capacity will help achieve this, and will boost confidence in Serbia re the investment climate, rule of law, etc. It will also help to close gaps between Serbia and its neighbors as well as with the larger gaps re EU. This is important as Serbia is a relatively late entrant re the establishment of a financial intelligence unit.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to existing capacity at NBS, relationship of USAID, and earlier successful collaboration between SEGA and the financial intelligence unit. Risks are the degree of criminality in the system.

"Buy-in"	Ministry of Finance would like USAID support for this initiative.	Counterpart cooperation and support can be expected.
Prospects for Global Development Alliance	Potential for partnership more likely with UST.	Uncertain if GDA is optimal for this activity. Alliances are more likely with UST, or possibly to include FTAF-type assistance for AML/CFT which is sometimes coordinated via the UN.

► #4: Establishment of the American-Serbian Management Institute (ASMI)

Serbia's economy and public sector management continue to suffer from weak financial management capacity. This adversely affects government at all levels due to poor budget management and planning. In the private sector, weakness in this area undermines capacity for long-term investment planning. In the financial sector, it adds to the cost of training new recruits. Key needs include:

- *General Accounting and Audit Standards*: ASMI would introduce curricula that would offer standard accounting and audit training consistent with IFRS, ISA and other standards recognized by the accounting profession. Course work is needed for financial accounting (external reporting), cost accounting (internal managerial accounting), and government accounting.

- *Financial Management*: ASMI would offer courses in financial management involving asset management, investment planning, capital allocation, pricing, risk measurement and management, and related needs. Specific principles for enterprises and financial institutions would be part of the MBA program. Specific principles for governments (e.g., central, municipal) would be part of the MPA program.

- *Specialized Management*: ASMI would offer shorter and more customized management certification programs. These would be shorter and involve less course work, and would be tailored to meet specific needs of systematically important institutions and sectors. Such certification programs would also be designed to round out broad management skills among specialized personnel to give them exposure to areas outside their expertise.

USAID assistance would effectively provide start-up capital, along with contributions from other partners, to establish a US-styled and certified program that would provide needed professional training and development in financial management and other needed disciplines. Direct involvement from USAID would require (1) a general mapping of needs as these relate to enterprise, financial sector, and government management; (2) general outline and framework for coursework priorities, staffing and other requirements, and preliminary costing; (3) methods of oversight, management and coordination among other partners and stakeholders; and (4) formalization of agreement with and commitment from Serbian institutions (government, financial sector, professional and business associations, universities, etc.) to support, participate, and sustain the Institute. Specific outputs would include (1) introduction of core accounting, audit and financial coursework according to international standards (e.g., IFRS, ISA); (2) narrowing of gaps in business and financial management education relative to regional peers and the EU; and (3) certification to award MBAs, MPAs, and other Master's-level education degrees. Partners would be a US university or consortium of universities, the government (e.g., Ministry of Education or Finance or Economy), NBS, business and professional associations (e.g., Bankers, Chamber of Auditors, AmCham, SAM, Foreign Investor Council), and universities and think tanks (e.g., University of Belgrade, FREM, CLDS). USAID would need to explore GDA possibilities, as well as potentially consider linkage to existing programs in the region (e.g., MBA program with University of Delaware at the University of Sarajevo, EU-oriented programs).

Initial estimates of resources needed for implementation cannot be determined at this moment. A pre-feasibility needs assessment would have to be conducted. However, figures could potentially be developed based on:

- Comparable projects in the region.
- Phased approaches to curriculum development.

As noted above, it is recommended that USAID explore a multi-party alliance with a US university or consortium of universities, the government, NBS, professional associations, domestic universities and think tanks, and potential benefactors (e.g., wealthy Serbian-Americans). Key further questions that will need to be answered include:

(14) How long would it take to develop fully certified programs like MBAs, MPAs, and specialized management certificates?

(15) Can USAID secure the commitments from a sufficient number of stakeholders to make this a feasible investment?

(16) How expensive would cost recovery be for unsubsidized start-up activities, and would students (or their sponsors) be in a position to fully pay the costs so that ASMI is commercially viable?

Establishment of the American-Serbian Management Institute

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	Financial management expertise and practical skills are needed for institutional strengthening throughout the economy. These are also essential for a better understanding of governance standards and requirements.
Comparative Advantage for USAID	Strong prospects for success. USAID is well positioned to provide assistance in conjunction with others.	There is widespread need, and no systemic or strategically coordinated effort to remedy these business education weaknesses.
Achievable Medium-term Results	Much is achievable in the medium term, although full development of a comprehensive MBA and/or MPA program may not be achievable by 2015.	Significant progress can be made in developing a curriculum, training professors, and moving towards the award of a class of MBAs or MPAs by 2015. Alternatively, one-year management degrees may also be feasible..
Sustained Long-term Impact	Addressing these needs will have a will have significant impact in the long term.	Capacity enhancement in this area will strengthen Serbia's capacity to introduce modern management and financial management techniques throughout the economy. This will have significant and long-lasting benefits to the economy, as well as assist with progress towards convergence with EU standards.
Major Results from Budgetary Resources	Results will exceed budgetary resources.	USAID assistance would achieve results well in excess of direct financial contributions due to the pooling of resources from other partners. ASMI should be structured to be a legacy institution.
Scaled re Available Budget	Scaled according to needs, with anticipated benefits greater than direct costs.	There is recognition that this is an investment that requires agreement with multiple parties. A specific business plan with a strategy and budget would need to be developed. Resource commitments would then shape the phasing and build-up of capacity. In this regard, the project would be scaled.
Measurable Performance Indicators	There are numerous indicators that can be compiled with ease once operations commence.	Specific performance indicators to be determined. Simple measures would include numbers of Serbians trained to deliver course work, numbers of students attending, numbers of students receiving certificates and degrees, numbers of institutions sending employees to attend coursework, etc.
Fill Major Economic Gaps	The absence of trained management personnel is a considerable weakness in the economy. ASMI would help fill that gap.	A market-based economy that is well managed, balanced, and with sustainable growth prospects requires sound financial management. ASMI would address these gaps, with benefits in all sectors of the economy.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to existing capacity within Serbia that simply needs training for more practical applications. USAID can continue to build on successes, like actuarial training under SEGA, to make this a permanent offering that helps to build needed quantitative modeling and risk management capacity in the economy.
"Buy-in"	Likelihood of broad-based	Counterpart cooperation and support can be expected.

	support for this—from government, the private sector, and the financial sector.	
Prospects for Global Development Alliance	Partnership required for implementation and funding.	GDA is optimal for this activity. Alliances with one or more US universities will be essential. Serbian-American benefactors are potentially willing to establish a legacy institution like ASMI. AmCham members may also be able to obtain commitments from parent companies to endow chairs, etc. This includes the Big 4.

C. Other Potential Options for USAID Support

Other areas of potential support were considered, but are not among the four recommended initiatives because (1) other donors are likely to be or already are involved without any further need for USAID assistance; (2) USAID does not necessarily have a comparative advantage; (3) they may take too long to achieve needed results; or (4) there are too many risks to being able to achieve objectives, including lack of perceived buy-in. These are discussed below.

1. Direct Financing into the Market

► Lines of Credit

Lines of credit are not recommended for USAID. Other donors have them in place, and USAID already is providing funding via Opportunity Bank.

► Credit Unions and Micro-finance Institutions

There are no credit unions in Serbia, and the former savings and credit institutions have now been re-licensed as banks. USAID support for Opportunity Bank addresses small-scale credit and deposit mobilization issues.

► Leasing

Leasing has received support from USAID in the form of support for NBS regulatory oversight. Banks are equipped to engage in leasing. No incremental USAID assistance is considered needed. This is also not considered an area of comparative advantage. In emerging markets, this is more of an area of specialization and focus by the IFC. To the extent that any additional support is provided, this could come from the Competitiveness and BES projects as a specific financing tool to be utilized by their client firms.

► **Guarantee Fund**

As with lines of credit, USAID and others have not always had success with guarantee funds. USAID could consider use of a DCA guarantee for specific enterprises. But this would come from other projects (e.g., BES, Competitiveness), not from a future SEGA project. Alternatively, should USAID support the debt securities market initiative (#2), it is possible that a partial payment guarantee to investors could be utilized for a mortgage bond or municipal bond. However, this would need to be determined at a later date. There is no perceived requirement for off-balance sheet support to banks. To the extent that USAID is seeking to support financing of SMEs, its support for Opportunity Bank appears to address this issue.

► **Insurance Sector Development**

SEGA is already helping with NBS regulation/supervision of the insurance sector. Support for this sector is warranted on a limited and indirect basis, namely by (1) continuing to strengthen NBS supervisory capacity (as part of the larger effort to bolster financial stability; (2) enhancing AML/CFT capacity, and ensuring that insurance companies are not utilized as channels for money laundering; and (3) developing long-term financial instruments so that insurance companies can also offer retirement savings instruments, as well as have instruments in which to invest to assist them with asset-liability management. However, net of these efforts, there is no compelling reason for USAID to be more involved in the insurance sector unless USAID chooses to become more active in health sector reform or pension reform. The third activity above is related to pension reform.

► **Establishment of an Enterprise Fund**

USAID-supported Enterprise Funds have achieved notable successes in many transition countries. However, because resources are limited and institutional capacity needs are so great, it is recommended that USAID not pursue this approach. Beyond that, USAID is providing firm-level support through the BES and Competitiveness projects, and has an equity stake in SEAF which invests in private enterprises.

2. Institutional Support

► **Deposit Insurance**

Deposit insurance is an important foundation for long-term confidence and stability. The recent increase in coverage up to €50,000 per account reflects the importance of deposit safety and soundness to financial stability, particularly given the legacy of past losses associated with deposits. However, the DIA is already receiving assistance from KfW. Should specific requests emerge for help with (1) validation that assets are being invested conservatively and according to investment policy parameters, (2) financial modeling re stress testing and scenario analysis, or (3) payout administration and contingency preparation, the future SEGA project should consider targeted short-term assistance. However, in meetings with various parties, there was no significant need expressed for such assistance.

► Accounting/Audit

USAID assistance for enhanced accounting and audit capacity is included in the ASMI initiative. The standard comprehensive accounting and audit project normally supported by USAID is desirable, but not recommended as a top priority because of the resources required, and uncertainty of achievement by 2015. The ASMI initiative constitutes a more focused approach to addressing key standards and educational/training requirements, and could involve work with the associations on the condition they demonstrate commitment. However, expanded work in this domain would likely exceed USAID resource commitments.

► Property and Pledge Registries

There is considerable need for reform regarding urban land privatization for clarity of ownership rights. Work is under way, and new legislation may be adopted in 2009. However, even with new legislation, difficulties with implementation may carry forward for several years. Cadastral work has likewise been under way for several years. While this is one of the most critical needs in the business environment, it is also too ambitious for SEGA to take on. What is recommended is that via MEGA and the Competitiveness projects, that USAID support plans to centralize the property registry and to make it available electronically to lenders in support of future development of a secured transactions framework (i.e., use of such land with clear ownership rights as collateral for financing). Likewise, with regard to the pledge registry, the Competitiveness project should include support for efforts to centralize the pledge registry, and to make it more efficient. It currently is operated on a regional basis, and transactions involving pledged assets can change hands without such information being available via the pledge registry. Some of this involves the ease with which defaulting businesses can walk away from obligations, establish new companies, and transfer assets and pledges without consequences. Reforming these practices is essential for a better business environment and financial sector. However, these reforms can be supported via other USAID projects.

► Credit Information Bureau

The credit information bureau of the Bankers Association is reported to work well. The only proposal is for the credit bureau to increase its disclosure to include inter-enterprise arrears as a means of providing lenders and others with information on companies that are seriously delinquent on their payments to suppliers. However, desirable as this is, it should be part of a larger strategy to clean up and de-monopolize the enterprise sector. Such an endeavor exceeds USAID resource availability.

► Associations

Work with associations is desirable as a basis for capacity building. However, instead of working directly with individual associations, the ASMI initiative is intended to provide needed capacity to association members on a broad basis, rather than pre-selecting specific associations with which to work. Thus, the ASMI initiative is intended to clearly strengthen the accounting and auditor associations/chambers. However, as past experience has not always been favorable, the ASMI initiative puts this on a more voluntary basis (reflecting their buy-in, or lack of), while staying open to other associations that may show greater interest and results (e.g., AmCham, Foreign Investor Council, Serbian Association of Managers).

► Tax Administration

Significant reform and improvement is needed in the field of tax administration. However, this activity is not recommended as the degree of project management would make this difficult to implement, while resistance to effective reform would significantly add political risk to the process, weakening prospects for success. Other proposed activities under future SEGA work are intended to provide incentives for the Government to act on tax administration reform, such as working on a long-term government securities market. However, given the complexity and politicization of tax policy, it is recommended that USAID not dilute its focus by taking on such ambitious tasks as corporate income taxes and tax collection, which are shrouded in political uncertainty and which can be addressed by the IMF, World Bank, or EU members.

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

V. INDICATORS FOR MONITORING AND EVALUATION

The following represents some preliminary indicators for ongoing USAID monitoring and evaluation of progress in the financial sector.

1. Support to NBS

- Capital adequacy of the banking system
- Numbers of banks below minimum capital adequacy and their share of total assets and deposits
- Earning assets/total assets
- Loans to the non-financial sector/total loans
- Non-performing loans/total loans
- Return on average equity
- Return on average assets
- Average credit, assets, deposits and capital per bank
- Compliance with Basel Core Principles of Banking Supervision
- Implementation of Basel II—standardized and simplified approaches—with particular focus on supervisory capacity to monitor for credit, market and operational risk
- Compliance with IAIS and EU Solvency II requirements in insurance

2. Development of the Long-term Debt Securities Market

- Sovereign ratings
- Value of Treasury securities > 1 year maturity
- Volume of trade in the secondary market in Treasury securities
- Value of other long-term savings instruments available for sale by banks, insurance companies and pension funds
- Number and value of non-Treasury long-term issues (e.g., mortgage bonds, municipal bonds, infrastructure bonds, corporate bonds)

3. Capacity Enhancement of AML/CFT

- Implementation of by-laws
- FATF/Moneyvaal assessment findings of capacity, coordination and effectiveness

4. Establishment of ASMI

- Numbers of Serbians trained to deliver Master's-level course work
- Numbers of students attending courses
- Numbers of students receiving certificates and degrees

- Numbers of institutions sending employees to attend coursework
- Numbers of actuaries certified according to international standards

ANNEX I: STRATEGIC CONSIDERATIONS FOR PROPOSED INITIATIVES

Initiative #1: Support to NBS: USAID assistance would involve short-term (and possibly) long-term TA to (1) coordinate movement to Basel II; (2) strengthen capacity to monitor for and manage financial stability issues; and (3) coordinate and strengthen AML/CFT capacity. Specific outputs would include (1) demonstrated supervisory capacity to determine banks' own credit, market and operational risk management capacity and systems to ensure appropriate levels of capital are in place for banking system stability, and in a manner that is not as restrictive with regard to reserve policy; (2) demonstrated capacity to manage stress in the economy resulting from external shocks, macroeconomic or structural imbalances, cross-border exposures, and/or cross-sectoral (e.g., banking and insurance) exposures, and to ensure the financial system is adequately capitalized and able to access liquidity to meet all financial and payment obligations; and (3) capacity to prevent any reputation risk or loss of depositor, creditor or investor confidence as a result of money laundering or criminal financial activity. Partners would be a prime contractor and NBS, with significant coordination envisioned with the IMF and World Bank.

Strategic Consideration	Prospects for Success	Considerations
Strategic Fit with USAID	Consistent with support for Euro-Atlantic institutions.	Central banks are critical to the financial sector stability of the country. Without financial sector stability, Serbia's prospects for joining the EU diminish, which would work against the strategic objective of support for Euro-Atlantic institutions.
Comparative Advantage for USAID	Strong prospects for success. USAID is uniquely positioned to provide assistance.	No other donor has been involved at the structural level. Relations are good between NBS and USAID. IMF would like USAID to continue with its support during a crucial period.
Achievable Medium-term Results	Much is achievable in the medium term, although full implementation of Basel II in banking is unlikely. Results in non-bank areas may be more difficult to achieve.	SEGA has a work plan through late 2010, and key initiatives have been identified for 2011-15. Key among these are (1) introduction of Basel II, (2) closer compliance with EU and IAIS requirements in insurance, and (3) stable pension fund operations, which will depend on cooperation and coordination with the Securities Commission. These are all achievable, although modest levels of achievement (e.g., standardized and simplified approaches to Basel II) should be targeted prior to introducing complexity into the system.
Sustained Long-term Impact	Building additional capacity at NBS as it approaches EU accession and introduces Basel II will have significant impact in the long term.	USAID has been working with NBS for nearly a decade. NBS is a clear candidate to serve as a "legacy institution" for USAID. Apart from the IMF, no other institution has worked closely on such an ongoing basis as USAID.
Major Results from Budgetary Resources	Results will exceed budgetary resources. This has already been demonstrated during the recent crisis. NBS has acknowledged the importance of USAID support in building NBS capacity. Results will also strengthen coordination, which means strengthening other institutions along with NBS.	USAID TA has been beneficial in contributing to recent stability, and this has occurred partly due to the institutional capacity-building taken on by USAID nearly a decade ago. Because NBS has additional resources, USAID assistance is then positioned to achieve more than what direct assistance would accomplish. For instance, development of more sophisticated risk management capacity may rely on USAID TA for techniques and methodologies, yet NBS would be in a position to finance hardware, travel to coordinate with market players or regulators in other jurisdictions, etc. Likewise, AML/CFT TA provided by USAID could be spread across multiple institutions, providing some resource leveraging. It is

		possible that ST advisory assistance in AML/CFT could involve someone who would assist NBS with some of their IT assessment needs of the banks, an explicit need for the coming years.
Scaled re Available Budget	USAID TA is more in demand than USAID funding.	One of the advantages for USAID to working with NBS is that the latter has additional funds to implement TA as needed. Unlike other initiatives, it is unlikely that USAID would require co-funding for the kind of technical assistance it could offer. Moreover, there is ample opportunity for USAID to target TA as needed, and to have project involvement benefit from NBS sources as well as IMF and other funds' sources.
Measurable Performance Indicators	There are numerous indicators of banking and financial stability that are regularly and easily compiled, and useful as a monitoring tool.	Specific performance indicators to be determined. Indicators are easily measurable (e.g., capital adequacy ratios in banking, solvency ratios in insurance, reputation of all licensed banks re AML/CFT), and can easily be broadened to include monetary, macro-prudential and purely structural indicators.
Fill Major Economic Development Gaps	TA serves as a key contributor to stability, which is indispensable for investment and sustainable economic growth.	A stable banking and financial system is essential for economic growth and development. This is fundamentally accomplished by raising public confidence (depositors) and the intermediation of savings for investment into the economy (loans). These benefits are particularly evident under stable or growing macroeconomic scenarios. Results in 2008 vs. 2004 already show major improvements in deposit mobilization, capitalization, and lending to the enterprise and household sectors. Ongoing support will help to close gaps between Serbia and its neighbors as well as with the larger gaps re EU.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to the initial capacity built up, and the strong mandate NBS enjoys. NBS is also not subject to the same turnover as other central government institutions. Likewise, USAID enjoys a strong reputation within NBS, so there is no question at this juncture about being able to work together to achieve success.
Local/Domestic Support ("Buy-in")	NBS would like continued support, as would IMF.	Counterpart cooperation, support and active participation have been in effect for nearly a decade. There is buy-in, and notwithstanding resources and personnel available from other sources, there is recognition by Serbians and by donors that USAID assistance is properly positioned at the NBS.
Global Development Alliance	Potential for partnership more likely with other USG or other regulatory institutions.	Uncertain if GDA is optimal for central banks. Alliances are more likely with the Fed or other US regulatory agencies, including UST. This could be enlarged to include FTAF-type assistance for AML/CFT which sometimes runs through the UN.

Further Questions:

- Are medium-term results achievable with only short-term TA?
- How should TA resources be allocated and focused?
- Will efforts to achieve synergies with other USAID initiatives/projects reduce flexibility, and thereby weaken the reputation for responsiveness USAID has built up over the years with NBS?

- Should NBS be considered a "graduate" and resources allocated to other institutions that are in more need of assistance?

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

Initiative #2: Support to Securities Commission and Ministry of Finance for Development of a Long-term Debt Securities Market: USAID assistance would involve short-term TA to (1) establish criteria and regulatory framework for development of a liquid long-term debt securities market; (2) develop regulatory capacity to ensure issuers and brokers comply with the regulatory framework; and (3) institute the required accounting, audit and disclosure standards required when issues come to market for ongoing integrity and confidence. Specific outputs would include (1) a long-term yield curve to serve as a benchmark for the pricing of long-term instruments and exposures; (2) financial instruments in which banks, insurance companies, pension funds and others could invest to assist with earnings and asset-liability matching requirements; (3) standards for Ministry of Finance to manage its long-term debt strategy predicated on sound fiscal collections, budget management and planning, and improved sovereign ratings; and (4) modernization of accounting and audit standards consistent with requirements in liquid and transparent capital markets. Additional outcomes potentially would include (5) issuance of mortgage bonds, to provide long-term funding instruments in the insured residential mortgage market; (6) issuance of municipal bonds in Belgrade, Novi Sad, or other municipalities potentially able to attract institutional investment; (7) issuance of infrastructure bonds; and (8) issuance of equities by well managed enterprises. Partners would be a prime contractor, the Securities Commission, Ministry of Finance, and an approved Serbian audit firm with IFRS capacity for public sector debt instruments. Significant coordination is envisioned with the IMF and World Bank.

Strategic Consideration	Prospects for Success	Considerations
Strategic Fit with USAID	Consistent with support for Euro-Atlantic institutions.	Securities markets are important for the diversification of financial products, and tradability of such products on an open and transparent basis. Development of the securities markets would help Serbia move closer to EU standards.
Comparative Advantage for USAID	Reasonable prospects for success.	USAID work on the Securities Law has been praised by stakeholders. It is therefore positioned to assist with the next stages, implementing regulations and capacity building. Relations are good between the Securities Commission and USAID. Development of a Government securities market is consistent with IMF objectives, as stated in the FSSP.
Achievable Medium-term Results	Much is achievable in the medium term, although capacity constraints at Securities Commission make this more challenging.	SEGA has a work plan through late 2010, and key initiatives have been identified for 2011-15. Key among these are (1) implementation of the new Securities Act, (2) improving disclosure standards, and (3) capacity building at the Securities Commission to do risk-based supervision. The current proposal actually enlarges the effort to foster a government debt securities market that (4) provides financial instruments that can help reduce the impact of the PAYG system on the fiscal deficit, (5) provides a basis for pricing long-term instruments, (6) structures operations to encourage Government fiscal discipline (linked to sovereign ratings), and (7) calls for intensified efforts to focus on needed accounting and audit standards for meaningful disclosure. These are ambitious targets. However, in the absence of such a debt market, it is unclear how reserve requirements in the banking system will come down, how net spreads will decline, and how credit will become more available and affordable in the enterprise/SME sector.
Sustained Long-term Impact	Building capacity at Ministry of Finance and the Securities Commission will have significant impact in the long term.	The focus of this effort is to induce greater discipline with regard to debt and fiscal management, which will make Serbia less dependent on external sources of reserves for macroeconomic stability. Such a change in operations

		would represent a major departure from current operations, and have a long-term impact.
Major Results from Budgetary Resources	Results will strengthen fiscal and debt management, add to macroeconomic stability, and contribute to rising financial intermediation which will help with employment creation and GDP growth.	Outcomes are expected to include more efficient methods for pricing long-term exposures, introducing new long-term instruments for saving/investment, and enhanced accounting and audit standards. These will help to increase investment, improve prospects to reduce the PAYG pension system, and establish the foundation for disclosure needed for liquid markets to function properly.
Scaled re Available Budget	Depending on the level of work required for accounting and audit standards, this initiative can be scaled.	A more comprehensive and aggressive approach to accounting and audit reform, long overdue, would require more resources than will be made available to/through USAID. Thus, additional partnerships may be required for this initiative. However, this initiative is structured to focus on central Government finance issues initially, thereby narrowing the scope and requirements for issues.
Measurable Performance Indicators	There are numerous indicators that would be easily compiled and useful as a monitoring tool.	Specific performance indicators to be determined. Indicators are easily measurable (e.g., improvements in sovereign ratings, extension and narrowing of short- and long-term yield curves, issues sold and value traded).
Fill Major Economic Development Gaps	A more balanced macroeconomic framework is needed to reduce the high reserve requirements imposed on the banking system and to reduce the cost of credit for creditworthy borrowers.	The economy is currently dependent on foreign exchange reserves for macroeconomic and financial stability. The reserve accumulation from past years will be at risk in the coming years due to the slowdown in the economy, potentially lower remittance flows, and greater competition in the region for foreign direct investment. Thus, for a desired easing of monetary policy without adding to inflationary pressures, well managed debt and fiscal policy is required. The initiative to support development of the long-term debt securities market would provide a framework for (1) observing key requirements for improved sovereign ratings, (2) enhancing financial stability, and (3) encouraging an environment for lower interest rates.
Confidence of Success	Medium prospects for achieving planned results.	Medium probability of success due to (1) the involvement of two domestic counterparts, (2) dependence of the debt and fiscal management strategy on structural and other government reforms, and (3) need for capacity building at the Securities Commission.
Local/Domestic Support ("Buy-in")	Ministry of Finance planning to issue up to one-year securities. Securities Commission seeks USAID support.	Agreement with Ministry of Finance on debt management and issuance strategies would need to be agreed. This may be risky, as the fiscal deficit is rising, and sound budget management will require significant reforms. The Securities Commission is benefiting from current SEGA support and would like it to continue.
Global Development Alliance	Potential for partnership more likely with other USG or other regulatory institutions.	Uncertain if GDA is optimal for this initiative. Alliance is more likely with UST re budget management.
Further Questions: • How strategic a fit is support for securities market development, apart from the potential contribution it can make as a catalyst for financial stability?		

- Are medium-term results achievable with only short-term TA? If permanent advisor(s) is/are needed, is this the best method of allocating resources?
- Is the general concept too complex or ambitious, particularly as it depends on accounting reform as well?
- Is the objective of using this project as a catalyst for needed government reform (e.g., expenditure management and planning, tax administration and collection, PAYG pension reform) unrealistic or overly ambitious?
- What are the prospects for success given low levels of capacity at the Securities Commission?
- Even if the Ministry of Finance initially agrees to pursue prudent debt and fiscal management policies, is there a risk that such a project would be reversed with a new election and/or a worsening of the economy, triggering requirements for a soft fiscal policy as largely currently exists (as reflected in very low tax collections and revenue-to-GDP ratios)?

Initiative #3: Support to Ministry of Finance and NBS for AML/CFT: USAID assistance would involve short-term (and possibly) long-term TA to (1) tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and assist with the organizational structure and requirements for effective implementation of FATF principles and requirements; (2) increase training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors; (3) strengthen capacity and systems to monitor suspicious transactions; and (4) coordinate closely with NBS, law enforcement agencies, and other international counterparts to strengthen AML/CFT capacity. Capacity-building efforts would be linked with assistance to the NBS under Initiative #1 to ensure coordination via NBS operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with its effort to monitor the payment/settlement system. Specific outputs would include (1) demonstrated enhancement of capacity to identify, contain and prosecute suspicious transactions and those responsible for such financial crimes; (2) better public awareness of the costs and penalties associated with such activity; and (3) narrowing of gaps in institutional capacity relative to regional peers. Partners would be a prime contractor, Ministry of Finance, and NBS, with significant coordination envisioned with the IMF and World Bank. USAID should also explore partnerships with UST on this. If feasible, USAID should consider utilizing the same advisor for AML/CFT to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.		
Strategic Consideration	**Prospects for Success**	**Considerations**
Strategic Fit with USAID	Consistent with support for Euro-Atlantic institutions.	AML/CFT capacity is essential for a sound financial system, and for the national reputation of the Serbian market and business environment. Capacity is also a strategy priority for Euro-Atlantic institutions.
Comparative Advantage for USAID	Strong prospects for success. USAID/USG is uniquely positioned to provide assistance.	Donor assistance has been limited, although assistance received from SEGA has been well utilized. Relations are good between NBS and USAID, and USAID is uniquely positioned in this regard to assist with coordination and capacity building between Ministry of Finance and NBS.
Achievable Medium-term Results	Much is achievable in the medium term, although prevalence of tax evasion and criminal elements creates challenges.	All assistance objectives are achievable in the medium term. This is a recommended intervention to help Serbia make up for its late establishment of a financial intelligence unit.
Sustained Long-term Impact	Building additional capacity at Ministry of Finance and NBS will have significant impact in the long term.	Capacity enhancement in this area will strengthen Serbia's overall reputation, helping to create long-lasting benefits to the economy.
Major Results from Budgetary Resources	Results will exceed budgetary resources and strengthen coordination between Ministry of Finance and NBS, as well as with international counterparts.	AML/CFT TA provided by USAID could be spread across multiple institutions, providing some resource leveraging. This is particularly the case regarding NBS. It is possible that ST advisory assistance in AML/CFT could involve someone who would assist NBS with some of their IT assessment needs of the banks, an explicit need for the coming years. Meanwhile, that same advisor may be positioned to assist with the specific AML/CFT tasks of the Ministry of Finance.
Scaled re Available Budget	Scaled according to needs, with anticipated benefits greater than direct costs.	TA linkage to both AML/CFT and supervisory capacity at the NBS will generate significant systemic benefits.
Measurable Performance Indicators	There are numerous indicators that can be compiled, although these may be more judgmental re capacity.	Specific performance indicators to be determined. To be driven by FATF principles in a manner similar to BCPs for banking supervision and guidelines from the Financial

		Stability Forum for financial stability issues.
Fill Major Economic Development Gaps	TA serves as a key contributor to financial stability and a sound reputation, which is required for investment, long-term growth and convergence with EU requirements.	A stable financial system requires capacity to identify, contain and manage risks related to criminal financial activity. Support for AML/CFT capacity will help achieve this, and will boost confidence in Serbia re the investment climate, rule of law, etc. It will also help to close gaps between Serbia and its neighbors as well as with the larger gaps re EU. This is important as Serbia is a relatively late entrant re the establishment of a financial intelligence unit.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to existing capacity at NBS, relationship of USAID, and earlier successful collaboration between SEGA and the financial intelligence unit. Risks are the degree of criminality in the system.
Local/Domestic Support ("Buy-in")	Ministry of Finance would like USAID support for this initiative.	Counterpart cooperation and support can be expected.
Global Development Alliance	Potential for partnership more likely with UST.	Uncertain if GDA is optimal for this activity. Alliances are more likely with UST, or possibly to include FTAF-type assistance for AML/CFT which is sometimes coordinated via the UN.
Further Questions: • To what extent will an increased crackdown on criminal activity impact resistance to TA delivery? • Will there be any resistance within Ministry of Finance, or difficulties in coordinating with NBS? • Can an AML/CFT advisor also double as someone who could work with NBS on operational risk issues, etc. as part of Initiative #1?		

Initiative #4: Establish the American-Serbian Management Institute: USAID assistance would effectively provide start-up capital, along with other partners, to establish a US-styled and certified program that would provide needed professional training and development in financial management and other needed disciplines. Direct involvement from USAID would require (1) a general mapping of needs as these relate to enterprise, financial sector, and government management; (2) general outline and framework for coursework priorities, staffing and other requirements, and preliminary costing; (3) methods of oversight, management and coordination among other partners and stakeholders; and (4) formalization of agreement with and commitment from Serbian institutions (government, financial sector, professional associations, universities, etc.) to support, participate, and sustain the Institute. Specific outputs would include (1) introduction of core accounting, audit and financial coursework according to international standards (e.g., IFRS, ISA); (2) narrowing of gaps in business and financial management education relative to regional peers and the EU; and (3) certification to award MBAs, MPAs, and other master's-level education degrees. Partners would be a US university or consortium of universities, the government (e.g., Ministry of Education or Finance or Economy), NBS, professional associations (e.g., Bankers, Chamber of Auditors, AmCham, SAM, Foreign Investor Council), and universities and think tanks (e.g., University of Belgrade, FREM, CLDS). USAID would need to explore GDA possibilities, as well as potentially consider linkage to existing programs in the region (e.g., MBA program with University of Delaware at the University of Sarajevo, EU-oriented programs).		
Strategic Consideration	**Prospects for Success**	**Considerations**
Strategic Fit with USAID	Consistent with support for Euro-Atlantic institutions.	Financial management expertise and practical skills are needed for institutional strengthening throughout the economy. These are also essential for a better understanding of governance standards and requirements.
Comparative Advantage for USAID	Strong prospects for success. USAID is well positioned to provide assistance in conjunction with others.	There is widespread need, and no systemic or strategically coordinated effort to remedy these business education weaknesses.
Achievable Medium-term Results	Much is achievable in the medium term, although full development of a comprehensive MBA and/or MPA program may not be achievable by 2015.	Significant progress can be made in developing a curriculum, training professors, and moving towards the award of a class of MBAs or MPAs by 2015. Alternatively, one-year management degrees may also be feasible..
Sustained Long-term Impact	Addressing these needs will have a will have significant impact in the long term.	Capacity enhancement in this area will strengthen Serbia's capacity to introduce modern management and financial management techniques throughout the economy. This will have significant and long-lasting benefits to the economy, as well as assist with progress towards convergence with EU standards.
Major Results from Budgetary Resources	Results will exceed budgetary resources.	USAID assistance would achieve results well in excess of direct financial contributions due to the pooling of resources from other partners. ASMI should be structured to be a legacy institution.
Scaled re Available Budget	Scaled according to needs, with anticipated benefits greater than direct costs.	There is recognition that this is an investment that requires agreement with multiple parties. A specific business plan with a strategy and budget would need to be developed. Resource commitments would then shape the phasing and build-up of capacity. In this regard, the project would be scaled.
Measurable Performance Indicators	There are numerous indicators that can be compiled with ease once operations commence.	Specific performance indicators to be determined. Simple measures would include numbers of Serbians trained to deliver course work, numbers of students attending,

		numbers of students receiving certificates and degrees, numbers of institutions sending employees to attend coursework, etc.
Fill Major Economic Development Gaps	The absence of trained management personnel is a considerable weakness in the economy. ASMI would help fill that gap.	A market-based economy that is well managed, balanced, and with sustainable growth prospects requires sound financial management. ASMI would address these gaps, with benefits in all sectors of the economy.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to existing capacity within Serbia that simply needs training for more practical applications. USAID can continue to build on successes, like actuarial training under SEGA, to make this a permanent offering that helps to build needed quantitative modeling and risk management capacity in the economy.
Local/Domestic Support ("Buy-in")	Likelihood of broad-based support for this—from government, the private sector, and the financial sector.	Counterpart cooperation and support can be expected.
Global Development Alliance	Partnership required for implementation and funding.	GDA is optimal for this activity. Alliances with one or more US universities will be essential. Serbian-American benefactors are potentially willing to establish a legacy institution like ASMI. AmCham members may also be able to obtain commitments from parent companies to endow chairs, etc. This includes the Big 4.

Further Questions:

- How long would it take to develop fully certified programs like MBAs, MPAs, and specialized management certificates?
- Can USAID secure the commitments from a sufficient number of stakeholders to make this a feasible investment?
- How expensive would cost recovery be for unsubsidized start-up activities, and would students (or their sponsors) be in a position to fully pay the costs so that ASMI is commercially viable?

U.S. Agency for International Development
Mission to Serbia and Montenegro
U.S. Embassy
Kneza Milosa 50
11 000 Belgrade
Serbia and Montenegro

Tel: [+381-11-306-4675]
Fax [+381-11-361-8267]
www. serbia.usaid.gov

ANNEX 2: LIST OF MEETINGS

Prime Minister's Office
Bosko Zivkovic, Economic Team of Prime Minister's Office
Prof. Dejan Soskic, Economic Team of Prime Minister's Office
Prof. Jurij Bajec, Special Advisor to the Prime Minister for Macroeconomic Issues

National Bank of Serbia
Mira Eric – Jovic, Vice Governor

Ministry of Finance
Slobodan Ilic, State Secretary
Vuk Djokovic, State Secretary
Miodrag Didic, Advisor to the Minister

Ministry of Economy
Nebojsa Ciric, State Secretary
Bojana Todorovic, State Secretary
Andreja Marusic, Secretary of the Council for Regulatory Reform
Zorana Gajic, Deputy Head of Regulatory Review Unit
Nenad Ilic, Special Advisor

Securities Commission
Milko Stimac, Director

Banking and Finance Institutions
Zoran Petrovic, Treasury & Investment Banking Manager, Raiffeisen Bank
Aleksandar Jovic, Director, National Mortgage Insurance Corporation
Danijela, Legal and HR Division Head, National Mortgage Insurance Corporation
Sasa Jovanovic, Head of Loan Insurance and Risk Management, National Mortgage Insurance Corporation
Nikola Stefanovic, Director, SEAF South Balkan Fund
Rodger Voorhies, President of Executive Board, Opportunity Bank

Donors
Simon Gray, Country Director, World Bank
Milan Popovic, Operations Officer, World Bank
Bogdan Lissovolik, Resident Representative, IMF
William Infante, Resident Representative, UNDP

USAID
Michael Harvey, Mission Director
Marilynn Schmidt, Deputy Mission Director
Jim Stein, Economic Growth Office, Director
Mark Pickett, Director, Local Economic Growth Office

USAID Projects
Rosa Chiappe, Chief of Party, SEGA
Ana Delovic, Deputy Chief of Party, SEGA
Scott Calhoun, Senior Banking Advisor, SEGA
Nikola Altiparmakov, Senior Economist, SEGA
Peter Epstein, Chief of Party, MEGA
Bill Althaus, Evaluation Team, MEGA
Richard Allen, Evaluation Team, MEGA
Hugh Nichols, Evaluation Team, MEGA
Louis Faoro, Chief of Party, Agribusiness Project
James Herne, Deputy Chief of Party, Agribusiness Project
Goran Radojevic, Operations Director, Agribusiness Project
Brankica Obucina, Policy Specialists, Agribusiness Project
Nenad Popadic, Finance Advisor, Agribusiness Project
Vince Gamberale, Private Sector Development Director, Competitiveness Project
Sharon Valentine, Deputy Director, Competitiveness Project

US Embassy
Tanja Vecerka, Economic Specialist

Accounting/Audit
Nina Bulatovic, Senior Partner, KPMG
Milica Bisic, Head of Markets, KPMG

Civil Society and Business Associations
Boris Begovic, President, Center for Liberal Democratic Studies
Danica Popovic, Center for Liberal Democratic Studies
Marko Paunovic, Executive Director, Center for Liberal Democratic Studies
Ana Firtel Vlajic, Executive Director, Foreign Investment Council
Jelena Bulatovic, Deputy Executive Assistant of Serbian Association of Managers
Bojana Ristic, Executive Director, AmCham
Amalija Pavic, Regulatory Affairs Advisor, AmCham

ANNEX 3: BIBLIOGRAPHY

"Challenges of Introduction of the Mandatory Private Pension System in Serbia," CLDS, 2009.

Financial Stability Report, National Bank of Serbia, 2008.

"First Review Under the Stand-By Arrangement", IMF, May 2009.

"International Competitiveness and Economic Growth in Serbia," CEVES, November 2008.

International Financial Statistics, IMF, October 2008.

Lamaute, D., "Private Sector Development and Business Enabling Environment Assessment", Part I, May 2009.

Quarterly Monitor, Foundation for the Advancement of Economies, October-December 2008.

"Reforms in Serbia: Achievements and Challenges", CLDS, June 2008.

"Selected Issues", IMF, February 2008.

"Serbia 2008 Progress Report", European Union, November 5, 2008.

"Serbian Banking & Financial Sector—2009", www.allianceinternationalmedia.com , May 2009.

Statistical Bulletin, National Bank of Serbia, April 2009.

"Strategy Statement", USAID, December 2005.

www.belex.rs

www.bis.org

www.imf.org

www.nbs.rs

www.worldbank.org