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Executive summary

Serbia and Montenegro (S&M) is the Union of these two states that has emerged from the Federal Republic of Yugoslavia. That is only the beginning of the constitutional development that may take some time to be finished. The final outcome is most likely to be two independent states. It is probably the European Union (EU) that is the most interested in the preservation of S&M – partly because it wants to minimize the number of small states as future members and partly because it is not ready to address the issue of Kosovo, which, it is believed, would immediately follow once S&M dissolves. Thus, at the moment, S&M has been given a trial period of about three years to build up a functional state-like union. Chances for success are slim.

The additional reason that S&M has little chance to survive is the pressing need to speed up the process of state- and institution-building. This mainly means the introduction of the rule of law. The urgency of this task has become evident after the assassination of the prime minister of Serbia, Mr. Zoran Djindjic. In its aftermath, it became clear that Serbia is a captured state. This is the inheritance from the Miloševic era. However, the post-Miloševic governments in Yugoslavia and Serbia chose the strategy of appeasement in many crucial areas, including that of dealing with the organized crime. They apparently believed that the progress of reforms and transition would take care of organized crime. In other words, they seem to have believed that transition with organized crime is possible. In that, they were brutally proved wrong.

The situation in Montenegro is different, though the problems with organized crime are quite serious. It seems, however, that those are dealt with through corruption rather than through partnership. That does not mean that the problems with the introduction of the rule of law are not daunting there, too – especially because of the high level of informal economic activities or, rather, of the dependence of a large number of people on informal activities for their income. This problem is aggravated by the fact that the process of transition has still a long way to go and it will take some time before the country moves to the path of sustainable growth.

Reforms in Serbia and Montenegro have been implemented separately, are at different stages, and are quite possibly incompatible. Montenegro relies, at least in principle, on liberalization, as this is a very small economy and can hardly grow if it is not increasingly opened. Serbia, however, relies on a strategy which sees a significant role for the state. This difference in strategies, though not necessarily in the actual economic situation, has led to probably insurmountable differences in trade policies. Montenegro aims at very low tariff protection, unlike Serbia, which wants to rely on a certain level of protectionism for a longer period of time. This disagreement is the major stumbling block standing in the way of the harmonization of their economic systems, which is a precondition for negotiations with the EU on the Stabilization and Association Agreement.

Both reform strategies have led to a disappointing supply-side response. Serbia has entered into what appears as a transitional recession, at least when it comes to growth of industry, while Montenegro is stagnating at best. In addition, macroeconomic disequilibria – external, fiscal and labour market imbalances – are increasing. Those coincide with the decrease of foreign financial support and investment; and also with the prolongation of the prospects for EU accession despite the promises given at the EU-Western Balkans summit in Thessaloniki held at the end of June 2003.

After the initial strong response by the government to the assassination of the Serbian prime minister Zoran Djindjic, the anti-organized-crime campaign is losing its momentum. With that, political instability is increasing. Some of it is due to the approaching elections, with early elections possible in autumn 2003 or regular elections in autumn 2004 at the latest. The recent conflict between the ministry of finance and the central bank in Serbia should be seen in that light. These conflicts are bound to escalate as the elections come closer in time.

The current economic developments are not sustainable, especially in Serbia. Changes in the economic policy can be expected to turn around the negative trends in Serbia. Those are seen as necessary by the governing coalition which wants to stay in power after the elections. Thus, some relaxation of the monetary policy can be expected with the change in the central bank of Serbia. In Montenegro, due to the use of the euro and the need to continue with the fiscal consolidation, there is no room for a policy change and thus for short-term recovery.

The crisis in Serbia cannot be overcome without democratization. That means elections. It is, however, not to be expected that one round of elections will bring speedy improvement. It will probably take another round for political stability to be achieved and economic development to be put on a sustainable path. Similar political developments should be expected in Montenegro too.

Keywords: Serbia and Montenegro, transition, macroeconomic stability, organized crime

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1 Introduction

After the political change in October 2000 and a few months of confusion, Yugoslavia (Serbia and Montenegro) embarked on a path of reform and transition. Two years later, the country has changed its name to Serbia and Montenegro as part of a major constitutional reform. This reform is far from finished, as it has to be followed up by constitutional changes in its two constituent states, Serbia and Montenegro. These changes will be impacted by, and will in turn impact, political developments, both internal and external. Together, constitutional and political changes will have consequences for the process of reforms and in particular for economic developments.

These changes were expected to bring the long-awaited stability to the country. These hopes were dashed by the assassination of the Serbian prime minister Dr. Zoran Djindjic on 12 March 2003. In its aftermath, the Serbian government introduced the state of emergency. Extraordinary powers were given to the army and to the police to go after the assassins and organized crime in general. Though the state of emergency has since been lifted, a vast security operation is still in progress. It has uncovered the extraordinary extent to which Serbia has been criminalized. The state was to a very large extent captured by organized crime. The crackdown that is still in progress has gained support in the public – but it has also intensified some of the existing political tensions. Because of the extent of the influence of organized crime and the level of political divisions, it is still difficult to assess the state of political stability at the moment. Indeed, as elections are approaching, both the action against organized crime is losing momentum and political conflicts are increasing.

In this report, a description of Serbia as a captured state will be followed by a brief overview aimed at clarifying some of the basic facts about Serbia and Montenegro. Then, constitutional issues will be taken up, followed by a discussion of the political developments. After an analysis of the state of reforms and economic developments, some selected macro- and microeconomic issues are discussed. Some comments will be made on the role of organized crime and the importance of the informal economy. The report concludes with remarks on the prospects for political and economic developments especially in view of the risks to political, economic and social stability after the assassination of the Serbian prime minister. The significance of and the prospects for international aid and assistance will also be discussed, particularly in view of the process of European Union (EU) integration, after the EU-Western Balkans summit in Thessaloniki held in late June 2003. The report ends with some conclusions.

2 Serbia: a captured state?

In the aftermath of the assassination of the Serbian prime minister Zoran Djindjic, Serbia emerges as a captured state trying to liberate itself from the grip of the coalition of organized crime, remnants of the former regime, nationalists and populists. Those have been controlling the security forces, the administration and much of the informal economy. Whether or not the government was aware of that, it certainly decided to deal with other issues first and turn to the dismantling of these structures later. Once the prime minister was assassinated, the government turned with full force against these structures that can perhaps be called a parallel state or government. In a matter of weeks, some of the alleged assassins of the prime minister have been arrested and a number of other political assassinations have apparently been clarified, most importantly that of the former Serbian president Ivan Stambolic, assassinated on the eve of the presidential elections in 2000. All in all, over 10,000 people have been detained in connection with various criminal activities However, only a very small number of them have been charged so far and are awaiting trial.

The government has adopted changes in the criminal law which enabled it to terminate the state of emergency (at the end of April) but at the same time to continue with the dismantling of the criminal elements in the state. At the moment, the support of the public for these activities is still quite high. There is clearly the feeling that the time to take on the criminal elements has come. There is no doubt that the public demands it. Whether there is the necessary enduring political support remains to be seen.

Apart from the criminal elements, the state has been captured by the ideology of nationalism. The government did not take on nationalism. Indeed, in many ways it adopted a defensive posture – especially in three main areas: cooperation with the Hague tribunal for war crimes in former Yugoslavia, the recognition of the responsibility of the Serbian state for the violent break-up of former Yugoslavia, and the radical change in the policy towards Bosnia and Herzegovina and Kosovo. The strategy, if there was one, was to sideline nationalism with reforms. It was, in a sense, a strategy of appeasement. It did not work and the nationalistic rhetoric became quite aggressive. Also, pressure from abroad intensified, partly because the government was losing credibility as it also adopted some of the nationalistic slogans and even programmes. Thus, though the government was concentrating power, it was losing political space.

Apparently, that seems to have led the assassins to conclude that they could profit from the increased political instability once they had taken out the prime minister. That turned out to be a miscalculation. The government and the public turned decisively against them. This assassination, however, does reveal that there are deep divisions within the Serbian society. These are ideological, social and regional. Ideologically, the majority remains deeply suspicious of the whole reform process and especially of the foreign interests. In the two failed presidential elections in the autumn of 2002, the significant majority voted for conservative or nationalist candidates. The government tried to satisfy some of those political sentiments, but all it ended up with was exchanging concessions for an increase in unpopularity.

Two years of transition have also deepened the social divide. Though the average welfare has been on the increase, inequality has also been growing. The government was sensitive to social problems. It allowed a rapid increase in wages and accompanying increases in pensions. It used and continues to use the cap on some of the administered prices, e.g., of electricity, as a tool for social policy. It also relied on various instruments of the social safety net in order to help those who were being sacked during the process of privatization and restructuring.

Regional differences increased as well. Vojvodina, the northern more prosperous province of Serbia, and Belgrade, the capital city, did better than central Serbia. In the latter some of the worst examples of socialist industrialization can be found. Many firms have to be downsized or shut down. In some cases, a whole city would depend on a plant or a factory. That would lead to a concentration of social problems and thus of political dissatisfaction. The government relied on fiscal centralization in order to redistribute resources towards the lagging regions. That, however, made both regions, the more prosperous as well as the less developed one, unhappy.

The government's social policy was also mostly one of appeasement, if not of outright buying of political support. The same strategy seems to have been followed in the case of ideological and regional interests and divisions. Indeed, in a number of instances, the government even attempted to appease the security forces and may have gone the same way when it came to the informal sector and even to some of the criminal elements. This strategy (if it was one) was sometimes justified as one that should basically buy time for the government. The expectations were that reforms would be successful and that then the government would be able to build on these successes to deal with the deep political divisions in the Serbian society.

Thus, Serbia remained a captured state two years after the ouster of the Milosevic regime. How can a captured state be defined? It is a state with a distorted relationship between principals and agents: rather than working for the public, the government has to make compromises with the influential lobby groups. This inverted relationship arose from three sources.

First, the government had limited legitimacy. It was not at all clear whether the government that took office after the December 2000 parliamentary elections in Serbia was the one that the electorate voted for. In any case, the governing coalition soon broke up, with the strongest party, that of the then federal president Koštunica, pulling out. Thus, the government had constantly to fight calls for early elections (which it would have lost had they been held), and had to work with the inherited structures and institutions because any change would have given Koštunica's party levers of power. This inheritance included not only the president of Serbia, who was indicted for war crimes, but also the administration and, most importantly, the security services. These services were at the heart of the inherited regime, as Milosevic's was a police state. For a variety of reasons, the Serbian government chose to co-operate with these services. As it turned out, the security services were running the organized crime activities too. Thus, the overall reform process was presumed on the reform, or rather on dismantling these services. As the latter was not done decisively, that proved fatal not only for the prime minister but for the whole reform process as well.

Second, the Serbian government could influence the army only indirectly, because the latter is a federal institution. Thus, the government was constantly worrying about the possible role that the army could decide to take up. Though the fear of an army *coup d'etat* was almost certainly exaggerated, it did play a role in the government's behaviour. Again, as in the case of the security services, the reform of the army was delayed and is still in its infancy.

Third, the government was under constant pressure from both the losers in the transition and from the business community, much of which emerged and got established during Miloševic's reign. Initially, the government tried to distance itself from the latter, but then changed track and increasingly tried to work with them. This, however, led to the growing perception of corruption, which did not contribute to the authority and legitimacy of public governance.

Thus, in sum, the Serbian government was quite limited in its ability to act. Indeed, it was more of an unwilling agent of these organizations and vested interests than a principal of decision-making and reforms. In the aftermath of the assassination of prime minister Djindjic, the Serbian government has been trying to radically reverse that relationship at least when it comes to some parts of organized crime, but it is still unclear how successful it will be in the end The growing feeling in the public is that the initial hopes and expectations will most probably be disappointed. That may prove to have a profound and long-term influence on the institutional and also economic development of Serbia. It will also affect significantly the prospects for EU integration, on which most probably the whole process of stability and modernization depends. Already these prospects are worse than they were only half a year ago. This is because the outside partners increasingly see organized crime as the most important problem that Serbia faces, more important than development even.

3 And what about Montenegro?

Montenegro too has been described as a captured state. Indeed, while Serbia was perceived as captured by nationalists, who, it turned out, had had strong interest in criminal activities, Montenegro was often portrayed as being run by smugglers and criminal groups of all types. The whole political structure has been rumoured to have been very much connected at least with the informal economy. Continuously, the prime minister (formerly president) of Montenegro, Mr. Milo Djukanovic, has been implicated with widespread smuggling of cigarettes. Quite recently a scandal involving prostitution and human trafficking has made headlines and aroused interest internationally. Montenegro is also much smaller than Serbia and the possibilities of capture by organized crime are therefore much higher.

It is difficult to judge the extent to which organized crime is important in Montenegro. There is no doubt that the informal economy plays a very significant role. There is also little doubt that an informal economy of that scale cannot exist without intimate and diverse relationship with the government, security forces and the administration in general. It is, however, difficult to assess two things: One is how organized the crime is, and the other is whether it runs the government or it survives through means of corruption only. Data being largely unavailable, it is difficult to answer these questions. There is no doubt, however, that the answer will emerge as the reforms proceed there and especially as the rule of law starts to get hold. In any case, it does seem that the principal-agent relations are more straightforward in Montenegro than in Serbia for two reasons. First, there is no ideological conflict in Montenegro of the type and intensity that is to be found in Serbia. Second, it seems that the coexistence between the government and the informal economy is mediated more through corruption than by organized crime either running or trying to run the government. The informal business lobby does not seem to want to take over the government, as it appears to have been the case with organized crime in Serbia.

There is, however, no doubt that the non-existence of the rule of law is a problem in Montenegro as much as it is in Serbia. Indeed, this may prove to be the main obstacle to the Montenegrin aim to create an open and integrated economy based mostly on tourism, foreign investments in small and medium-size enterprises and financial services. It will also constitute a constant problem for the country's political stability and thus will make it all but impossible for Montenegro to decide on the strategic issues that it faces, especially those of its independence from the union with Serbia and on the urgent need to speed up reforms of the public sector and of public governance in general. Essentially, as long as the issue of the corruption of the government is not resolved, it is difficult to see the rule of law taking hold in Montenegro.

4 From Yugoslavia to Serbia and Montenegro

Serbia and Montenegro were republics, member states, of former Yugoslavia, which until 1991 also included Slovenia, Croatia, Bosnia and Herzegovina, and Macedonia. The latter four became independent states in 1991-1992, while Serbia and Montenegro formed a new Federal Republic of Yugoslavia. After the war in Kosovo in 1999, that autonomous province of Serbia was put under UN protection. From 1997 on, Serbia and Montenegro started drifting apart. First came fiscal devolution, then Montenegro introduced the German mark as a parallel currency and then it adopted the euro as its sole legal tender. Laws on foreign trade and tariffs, banking, privatization and in many other areas followed. By October 2000, when the change of regime occurred in Serbia, the two states not only did not have a functioning common federal government or any other common institution, but were *de facto* operating under two separate legal systems.

In the presidential elections in September 2000, Vojislav Koštunica was elected president of Yugoslavia. The governing Montenegrin parties boycotted these elections as well as the federal parliamentary elections that were held at the same time. Thus, the opposition parties from Montenegro won all the Montenegrin seats in the federal parliament. As a consequence, the majority of the population in Montenegro was not represented in the federation. This created political instability in the federation and in Montenegro. To resolve the problem, political pressure was building up in Montenegro to call for a referendum on independence. At the beginning of 2002, the European Union forged an agreement, called the Belgrade Agreement, that required the adoption of a new Constitutional Charter that would create a loose union of Serbia and Montenegro. During 2002, a series of elections were held in Montenegro, which confirmed that the majority of the population supported the governing coalition of pro-independence parties. With that, the text of the Constitutional Charter was agreed on mainly between the governments of Serbia and Montenegro, and the new Union of Serbia and Montenegro came into being.

5 Future constitutional developments

The adoption of the Constitutional Charter and the creation of the new Union of Serbia and Montenegro (S&M) open up the process of further constitutional changes in both Serbia and Montenegro. There are also some unfinished issues connected with the constitutionality of the Union itself. More importantly, there is the question of the functionality of this new Union especially in view of the fact that the Constitutional Charter provides for the possibility that the member states may opt for independence three years after the Union has come into existence.

The Union

The future of the Union of S&M depends on two sets of issues. The first contains the leftovers from the Constitutional Charter. The three most important issues are:

– First, the adoption of a charter on human and minority rights. The document was adopted in early March 2003, but its implementation will be mostly taken up by the constitutions of Serbia and Montenegro. Also a Union Court needs to be set up and become operational. It remains to be seen whether any real power will be delegated to it and how its decisions will be implemented.

– Second, an agreement on the assets of the former federation. The most important are the military assets. This issue has already proved contentious. The principle adopted in the Charter, and in the law that implements it, is that the Union has no assets. Everything belongs to either Serbia or Montenegro. That means that the existing assets will have to be divided. The principle itself is still contentious and the actual division will be even more so. It will have to be connected with the reform and reorganization of the military, which will take some time even if no additional problems appear.

– The third and certainly most important issue is that of the harmonization of the economic systems of Serbia and Montenegro. The necessity for that springs from the fact that Serbia and Montenegro are internally sovereign states, but are externally represented by their Union. Therefore, the Union enters into contractual relations, for instance with the European Union (EU) and the World Trade Organization (WTO). Both the EU and the WTO require Serbia and Montenegro to be at least a customs union in order to proceed with the negotiation of an association agreement with the EU or membership in the WTO. Though these issues are in principle under the jurisdiction of the Union, the discussions on harmonization of the tariffs and of the economic systems in general will be carried out mostly between the governments of Serbia and Montenegro, with little contribution from the government of the Union. One reason for that is that the Union will have no budget and as a consequence all the fiscal implications of the harmonized laws and of the contractual relations with the EU and the WTO will fall on the budgets of the member states.

One particularly urgent issue was that of the so-called fiscal agent that would take over the financial obligations with the IMF and The World Bank. As the Union will not have a central bank and a ministry of finance, it cannot take any responsibility for the loans that the Union is securing from these international financial institutions. But as the member states do not have external sovereignty, they cannot take over these obligations either. The impasse was handled by a compromise, with the National Bank of Serbia entrusted to perform that function in the IMF and the Central Bank of Montenegro was decided to have the same responsibility in the World Bank. It remains to be seen how this arrangement will work. It is hard to find a permanent solution to problems such as this one within the new constitutional arrangement. The reason is not technical, but political. Any institution representing the Union should have legitimacy in both states, but that is impossible because there are no such Union-wide institutions.

Even if these problems were to be solved, there would remain the more basic question of the usefulness and the functionality of the Union. The two member states differ very much not least in size. Serbia has close to 8 million inhabitants, while Montenegro has less than 7 hundred thousand.[1] Their economic structure is also different. Serbia is landlocked and relying on agriculture and industry, while Montenegro's main comparative advantage is in tourism, as it has a beautiful coast. Thus, Serbia and Montenegro do not form an optimal customs and currency area. This is so apart from the fact that Montenegro has adopted the euro as its legal tender. In addition, though Montenegro is much smaller than Serbia and is to contribute to the Union's budget in proportion to its size, the posts and generally the power in the Union is to be divided equally. Thus, either the Union will have quite restricted powers, or it will be a source of constant tensions.

Therefore, the usefulness and the functionality of the Union are rather questionable – especially because the complete fiscal devolution will be maintained and no explicit transfers of funds are to take place.

Serbia

The Constitutional Charter of the Union of Serbia and Montenegro requires that the constitutions of the member states be changed to conform to the Charter. The Serbian constitution would have to be changed anyway because it dates from 1990, that is from the time of former, socialist, Yugoslavia. It is in many ways inapplicable and in some ways an obstacle. Because of that, it has to be implemented selectively, which always raises questions about the use and abuse of discretionary power. Also, the procedure for constitutional amendments as written in the constitution was deemed to be somewhat too hard to implement. It requires a two-thirds majority in the parliament and a majority in a referendum with more than fifty per cent of registered voters casting a supporting vote. The Serbian parliament passed a law that only simple majority in the parliament is needed to change the constitution. The referendum requirement has however been retained.

Still, the major obstacles to the adoption of the new constitution are not procedural, but substantive. One has to do with the definition of the territory of Serbia. As Kosovo has been exempted and put under the protection of the UN, its constitutional status will be difficult to define. If it is mentioned in the constitution at all, it will create problems for the

[1] The census was conducted in Serbia in 2002, but is yet to be held in Montenegro.

relations between Serbia and Kosovo. It is, however, politically hardly possible that it will not be mentioned as being part of Serbia.[2]

Apart from the problem with Kosovo, the most difficult issue is that of decentralization of power. Serbia has an autonomous province, Vojvodina, which has expressed an interest to increase its autonomy. That would basically mean the federalization of Serbia. It is, however, rather difficult to envisage the transformation of Serbia into a symmetrical federation, i.e., a federation with a number of federal states or provinces. Though that is not inconceivable, in theory, it may however not be politically feasible. As a consequence, there are proposals for one variant or another of an asymmetrical decentralization, where other regions besides Vojvodina would not have the same level of autonomy. There have been a number of proposals, but it is still unclear what the final outcome will look like.

The structural aspect of this problem is not difficult to understand. Central Serbia has an interest in fiscal centralization because it expects to benefit from the transfers. The city of Belgrade can live with that, because it can always influence the government's decisions in its favour. Vojvodina, however, is a net contributor to the budget and has an obvious interest in fiscal devolution. Thus, the question is how to design the proper system of fiscal federalization. This is a political issue because the majority of the votes are in Central Serbia. Because of that, Vojvodina is interested in achieving political autonomy rather than just a change in the level of transfers.

Another important issue will be that of sovereignty of Serbia. Though it is apparently assumed that the Union with Montenegro is a long-term constitutional arrangement, the functionality of the Union's constitutional arrangement is not assured and would be greatly strengthened if it were supported by a Serbian constitution that would be compatible with it. That means that the Serbian constitution would have to defer significant sovereign rights to the Union. It is unlikely that there will be great enthusiasm for that. Once the constitutional process starts, the pressure for full sovereignty of Serbia may increase and become overwhelming. This will almost certainly be the case if the aim will be to adopt a constitution that should not be changed too soon. In any case, this will certainly be one of the key issues that the constitution should solve.

These are just the most fundamental dilemmas. There will be other, less significant dilemmas to solve, including the ethnic or civic character of the state, the role if any for the royal family, the role of the churches and of religion in general, and the role of checks and balances between different functions and levels of government. Though these dilemmas will eventually be solved, their existence probably means that the constitutional process

[2] This is already a problem, because Kosovo and Metohija (the name used in the Serbian constitution) is mentioned in the Constitutional Charter as part of Serbia, and that is unacceptable to the political public and the government of Kosovo.

may take a rather longer period of time. At the moment, the aim is to have the whole process finished by early 2004.

Montenegro

The change of Montenegro's constitution may also prove to be difficult. Though there are no territorial problems to solve, there is the paramount issue of sovereignty. As the citizens of Montenegro are divided over the issue of independence of their state (the pro-independence majority is slim, though perhaps growing), some compromise formula will have to be found. The content of the compromise is hard to predict. It is quite possible that the Montenegrin constitution will only be amended and the adoption of the new one will be delayed until the referendum on independence is held. Even in that case, the process of constitution-building will not be easy because of the unresolved issue of sovereignty of Montenegro.

Though Montenegro is a very small country, the regional differences are quite significant, not only between the coastal and the continental regions, but also between the region closer to the Serbian border and others that are more distant form it. As a consequence, decentralization may prove to be an issue when the new constitution is discussed. Other problems may emerge, some having to do with the symbols of national identity, such as the name of the language and a number of others. Those may not seem as much of a problem, but they are in fact quite sensitive and may prove to be quite important for the political public in Montenegro.

Constitutional prospects

This round of constitution-making will most probably be a transitional one. The Constitutional Charter of Serbia and Montenegro is not a very clear and functional legal framework. Serbia may eventually settle for a constitution that will leave some of the crucial issues open (e.g., Kosovo, the sovereignty of Serbia) and Montenegro may also decide to go through some interim constitutional changes that will eventually have to be superseded by a new constitution once the decision on whether or not Montenegro will be an independent state is taken. There are other possibilities, but as the constitutional debate has not even started in Montenegro, it is hard to judge what the preferred outcome for the Montenegrin political public will be.

How the Union will function in this interim period and how long it will last is not easy to tell at this moment. Its main immediate task will be the reform of the military. Once that process is started, it will be easier to see where the Union is going. It is difficult to see the military becoming accountable in the democratic sense of that word and still remaining under the jurisdiction of the Union. And once that becomes clear, it will be difficult to see what the point of the Union remaining in existence will be.

6 Political developments

Serbia and Montenegro are at the very beginning of the process of democratization. In Serbia, anti-authoritarian elections were held in 2000. Since then, two rounds of presidential elections were held, in the second half of 2002, which proved to be unsuccessful. This is because the law requires the winner to secure more than fifty per cent of votes of more than fifty per cent of registered voters at least in the first round (in fact, in the first elections in both rounds and in the second only in the first round). In both cases, the turnout was below fifty per cent, in the first elections in the second round and in the second elections already in the first round. The presidential elections in Montenegro, held in December 2002 and February 2003 with the same fifty per cent requirement, were also unsuccessful. The reasons, however, were different.

In Serbia, the presidential elections were unsuccessful because the number of registered voters was probably inflated and because they were boycotted by parties that either had no candidate in the elections or whose candidate lost in the first round. In Montenegro, the opposition parties boycotted the elections and both times the turnout was below fifty per cent. In both states, the candidate that won both times with the overwhelming majority of votes cast was prevented from taking office. In Montenegro, the electoral law was changed and the threshold requirement removed, so that the elections held on 11 May 2003 finally produced the desired result: Mr. Filip Vujanovic, the candidate of the ruling party, was elected. In Serbia, however, the presidential elections have been postponed until after the adoption of the new constitution or until 1 October 2003 at the latest.[3]

Parliamentary elections can be expected in Serbia in the second half of 2003 if the new constitution is adopted in time, which means six months after the adoption of the Constitutional Charter, and that means sometime after September. If the adoption of the constitution is delayed, as has already been announced, or the government decides that early elections are unnecessary even after the new constitution has been adopted, the parliamentary elections cannot be expected before the end of 2004. Early elections can only be expected if the current government coalition loses the support it has in the parliament or if it assesses that its popularity has increased and that it can win or, as seems most likely, it comes to the conclusion that it has lost the ability to run the day-to-day affairs and decides to cut its losses.

In Montenegro, parliamentary elections were held in the autumn of 2002, giving clear majority to the government coalition. Thus, barring unforeseen developments, early elections should not be expected in Montenegro. In fact, at this moment, there is no viable opposition that could present an alternative to the governing coalition in Montenegro. The

3 This date looks rather unrealistic at this moment because the preparations have not yet started. On the prospects for elections more below.

coalition may not be ironclad, but the lack of an alternative will in all probability keep it together for the rest of this term.

Thus, the process of democratization in both Serbia and Montenegro has been slow if not stalled. That has already had negative consequences for state- and institution-building in both states.

State-building

Apart from the constitutional issues, in both Serbia and Montenegro the process of state-building is still in its infancy. By state-building mainly the introduction and the strengthening of the rule of law is meant. In both states, there are still quite significant legal lacunas. There are also pervasive legal inconsistencies, which are supportive of the existence of the huge scope for discretionary decision-making. Finally, the implementation of laws is weak, because the judiciary system is still either very much under the control of the government or is still unreformed and is very much obstructing the implementations of reforms.

These deficiencies in the rule of law have to be connected with the widespread corruption. The latter is to be expected given the existence of the large informal sector, which in many ways is the dominant economic sector. Indeed, the two main sources of income are the budget and the informal sector. Both, though for different reasons, do not have much use for the rule of law. The authorities are becoming aware that they have to strengthen the legal system if they are to continue to receive foreign financial support. However, that process is slow and in any case is only at the very beginning.

Institution-building

Because of the lack of rule of law and because of the non-standard post-socialist institutional development, both Serbia and Montenegro have rather poor institutional environments. Though, for instance, the civil sector, especially when it comes to the contribution of the NGO's, is rather developed, its contribution to institutional development is rather limited. Their influence is even decreasing because the foreign sources of financing are drying up. Thus, NGO's are increasingly dependent on the official sources of financing and thus have decreasing influence on the public and on the government. Other social actors – e.g., trade unions, professional associations and voluntary groups – have seen their role diminished in the pre-transitional period and have not managed to recover at this early stage of democratization.

An added problem for institution-building is the non-existence of contractual relations with the EU. Once the association process starts, the process of state-building and institution-building can be expected to speed up. As of this moment, the process should start sometime by the end of this year, 2003. How it will progress will depend on how the new

S&M Union manages to function. At this moment, again, it does not look as if the process will move very fast. Strangely enough, it seems that speed is even more important for the EU than for S&M because the latter keeps failing to meet all the dates that would lead to a start of the negotiations with the EU on an association agreement.

Democratization

Usually, countries in transition, at least the more successful ones, undergo rather fast democratization. Indeed, transition in Europe is characterized by a process that can be summarized as: democracy first, reforms later.[4] Democratization does not just mean the emergence from authoritarian rule, but also a speedy rise of the importance of parliaments and a regular change in the governing parties or coalitions. Thus, quite quickly, the electorate starts to play a significant role, thus stabilizing democracy in the sense that the proper principal–agent relationship between the citizens and their representatives is established and is reaffirmed with every new round of elections.

In Serbia and Montenegro the process of democratization is still in its initial phase. In Serbia, the authoritarian government was overthrown, but the incoming governing coalition is yet to submit itself to the judgement of the electorate. Indeed, it is quite clear that such an early test would be called for, because the coalition in government does not command the support of the large majority of the people.[5] In Montenegro, the governing coalition has been tested in a number of elections, but there it is the failure of a successful opposition to emerge that is worrisome from the point of view of democratization. Indeed, the same post-communist party has been in power for more than a decade now. Its main opposition is another faction of the same post-communist party.

Thus, further democratization in Serbia and Montenegro will depend on the process of transformation of their party systems and on the regularity of the future elections and generally on the functioning of the system of representation. In the end, nothing will work more for the process of democratization than a succession of free and fair elections that have an impact on the constitution of the government. As long as the public has not exercised its power to change the party in government, the process of democratization is in its infancy. This is a more acute problem in Serbia where the issue of early elections has become perhaps the most important one. Indeed, most political conflicts and developments have to be seen in the context of pre-election campaigning of the major political parties and other organizations.

4 On that see Roland (2000).

5 This has changed immediately after the assassination of the prime minister, but whether this high level of support is just temporary or will carry over into support in the elections will depend on the stability of the governing coalition and on its overall success. More on that can be found in the prospects part of this report below.

7 Reform programmes and accomplishments

Reforms have been on the agenda of former Yugoslavia and thus Serbia and Montenegro for a very long time. Some of those were intended to introduce partial changes, some were more ambitious, but did not succeed. The latest attempt in Serbia was that of the then central bank governor Avramovic that was attempted after the hyperinflation in 1993-1994, and was terminated with the removal of Avramovic from his post in 1996. All the previous reforms were attempted in adverse political circumstances, indeed mostly against the political will of the government or leading political forces. Thus, the current reforms are essentially the first ones that are an expression of the political will of the respective governments of Serbia and Montenegro.

Montenegro

Montenegro's transition started before Serbia's. It went parallel with the process of state-building or independence-building. The two key elements of the reform programme were: fiscal and monetary independence and privatization. First, fiscal independence was secured. Transfers to the federal government were discontinued and then new tariff and tax systems were introduced. The guiding idea was that both tariffs and taxes should be low. That was deemed possible because it was assumed that Montenegro's state should not be very costly, as the country is so small. That, however, implied a significant restructuring of public expenditures, which proved very difficult to do. Thus, the shortfall in revenues, as a rule quite significant, has to be supplemented by reliance on aid and donations. Privatization revenues have also started to play an increasingly important fiscal role.

Thus, fiscal independence led to the persistence of high fiscal deficits.[6]

In 1999, in order to protect itself against the highly inflationary policy of the Yugoslav central bank, Montenegro introduced the German mark as the parallel official currency. A year later, it adopted the German mark as its sole legal tender. It now uses the euro. Montenegro has established its own central bank, the Central Bank of Montenegro, which regulates and supervises the banking sector. It does influence the banks' credit activity by setting their reserve requirement, but cannot conduct a monetary policy in its usual sense. Indeed, inflation has been running at quite a speed. Only lately it has dived into single digits.

Thus, the introduction of the euro has not yet brought inflation under control.

[6] For a more detailed discussion of fiscal developments see below.

Privatization started in earnest only in late 2001, early 2002. Montenegro opted for a voucher privatization. After long preparations, the programme was implemented in early 2002. Vouchers were distributed and then exchanged for shares. The whole process was completed within a few months. The government set aside some assets for sale to strategic investors. Some attempts proved to be unsuccessful. However, in mid-2002 a gasoline company was sold to a Greek firm. That had the desired positive effect on the budget and may be the first in a number of similar sales in the future. Still, as in the case of other transition economies, there are a number of problematic non-privately owned companies which are yet to be restructured and privatized. In addition, privatization, up to now, has not led to a significant improvement in economic circumstances, partly because the most dynamic sector is already the private one, but one that is largely informal.

Thus, privatization has yet to lead to improved allocation of resources and an acceleration of growth as that depends very much on market access and on the legal environment.

With these reforms in place, the government has vied to speed up further the reforms and transition in the next couple of years. It has promised an aggressive programme in the next few months.[7] It clearly needs to use the next few years to get the reforms on the track of irreversibility and to lay the grounds for a referendum on independence.

Serbia

Transition in Serbia concentrated on securing macroeconomic stability. The two key elements were: a pegged exchange rate and fiscal solvency. Parallel to that, markets and prices were liberalized and a programme of privatization was adopted. That programme had run out of steam by the end of 2002 and a debate emerged about what should be the next steps both from the macroeconomic and the microeconomic points of view.

From November 2000, the German mark was exchanged for 30 dinars. After the introduction of the euro, the euro was being exchanged for 60 dinars or slightly more until the beginning of 2003. Thus, in over two years, the dinar has depreciated by not much more than 5%. Inflation has registered more than 100%, thus the real appreciation of the dinar has been quite significant. Currently, inflation is running at somewhat less than 1% per month, so the real appreciation of the dinar is continuing.[8]

Thus, nominal pegging of the dinar has helped the disinflation of the economy, albeit slowly. That has led to continuous real appreciation of the dinar.

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7 The goals and tasks have been set in the 'Agenda of Economic Reforms' that was adopted by the government in April 2003.

8 Recently, i.e. in the first half of 2003, this has changed, with the dinar depreciating to about 65 dinars for one euro. On current developments more below.

The key to macroeconomic stability has been the improved fiscal situation. This has been a consequence of the improved collection of revenues mainly. The best performing revenue sources have been sales taxes, excises and tariffs, to which aid and cheap loans should be added. However, the collection of revenues has in all probability reached its upper limit. Once public debt has to be serviced, or rather serviced more fully, expenditures will have to be cut. Otherwise, the whole fiscal stance will become unsustainable.

Thus, the fiscal balance has been maintained by increases in revenues, but long-term sustainability has not been secured. This was mainly a consequence of the fact that increased public expenditures have not translated into a significant acceleration of growth, except that of imports.

The liberalization of prices has been extensive. The initial freeing of prices in late 2000 led to a sharp acceleration of inflation. Thereafter, inflation was mainly driven by the successive increases in administered prices. These inflationary pressures will continue. However, prices are also pushed by large increases in wages. Though it is difficult to determine how much of the average wage increase has been compensated by the decrease in employment, there is no doubt that wages have been growing much faster than production. There have been attempts to liberalize the labour market, but with the large share of public employment, this liberalization has had limited success.

Thus, as in many other cases, liberalization has been successful, though the competition in the markets has to be increased so that they can start to allocate resources efficiently.

The new law on privatization was passed in mid-2001. The guiding idea was that assets should not be distributed or given away, but sold. It was also decided that the two methods of sale chosen – tenders and auctions – would be implemented once the necessary institutional structure has been established. As a consequence, privatization has proceeded rather slowly. In 2001 there was practically no action, except for the failed attempt to sell one cement company to a foreign firm – the sale was eventually completed in early 2002. Auction sales have gained some speed in the second half of 2002, but the pace is still not altogether impressive. The plan is to sell all firms in social ownership within four years, which means by mid-2005. For this goal to be achieved, the whole process will still have to be speeded up.

Thus, privatization has proved to be slow, though the process now seems irreversible.

Unlike Montenegro, where the government is promising a new beginning when it comes to reforms, the Serbian government leaves the impression that it has run out of ideas. It intends to tackle the large state-owned enterprises and firms, especially in utilities, in 2003. That will be rather difficult to do, but even more difficult will be the reforms of the labour market and public governance. On top of that, macroeconomic problems are re-emerging, with the exchange rate policy being contested and with the fiscal constraints starting to bite rather harder than before. In addition, international financial support is decreasing with the doubts about the path of Serbian transition increasing.

Incompatible reforms?

Whatever the actual accomplishments, the strategies of reforms followed in Serbia and Montenegro are rather different. This can be seen in the basic approach and in the instruments chosen.

In Montenegro, liberalization is considered the key. This is because this is a small state and the reliance on the market is regarded as the best economic policy. It is not believed that Montenegro is an optimal currency area, thus the euro has been adopted and reliance on monetary policy, at least in the traditional sense of that word, has been abandoned. Also, tariffs have been set low as there is very little that needs protecting. Finally, the public sector is seen as being very small once the transition is accomplished. Reality is far from this vision, of course. It is also possible that it will be the vision that will give. Still, it should be expected that this approach to reforms will be guiding some of the policies of the Montenegrin government in the near future.

In Serbia, a rather traditional approach to reforms has been adopted. The state is not only seen as the main agent of change, but also as playing a major role as an entrepreneur, a manager and an employer. Also, monetary policy is still considered quite useful, though at the moment it is not being used in an active sense because it is mainly supportive of the exchange rate stability. Fiscal policy has a strong social function, not least in the sense that it provides for a lot of jobs, but also because it doles out significant subsidies and transfers. Finally, an active trade policy is advocated, as it is believed that Serbia has a lot to protect, especially in agriculture and in industry.

The reality in the two states is not much different, though, as will be pointed out below. But the approaches to reforms are certainly different, and those differences are causing problems not only when it comes to the process of harmonization of the various regimes and policy instruments, but also when is comes to the negotiations with the European Union and with the IFIs. Indeed, this has led to a situation in which almost nothing can be agreed between Serbia and Montenegro and certainly not in a short period of time. With political instability persisting in both states and with the economic developments being rather negative, at least in the short run, the differences in approaches to reforms and in interests are bound to increase.

8 Transition with disequilibria

Both transitions, in Serbia and Montenegro, have been proceeding under significant political pressure. In Montenegro, the government was under constant pressure from Miloševic and afterwards from the opposition, which consists mostly of the remaining pro-Miloševic parties. Only since the last elections, in late 2002, have they had the necessary majority and the mandate to speed up the reforms. However, because of the still existing democratic deficit as well as a number of unsolved institutional issues and issues connected with the rule of law and the widespread informal economy, they have been very slow in exercising their mandate.

In Serbia, the government has lost popular support almost immediately after taking office in late January 2001. They have been banking on regaining support with the success of the reforms. However, improvements have been slow and have mostly been perceived as temporary or uncertain. Thus, with the elections approaching, it was becoming questionable whether the government had the necessary reform determination and capacity. This has now changed significantly after the recent political developments in Serbia. At the moment, the reform agenda has changed. The establishment of the rule of law has become of paramount importance at least rhetorically. How the whole agenda will eventually look like is yet to be seen once the current crisis is over.

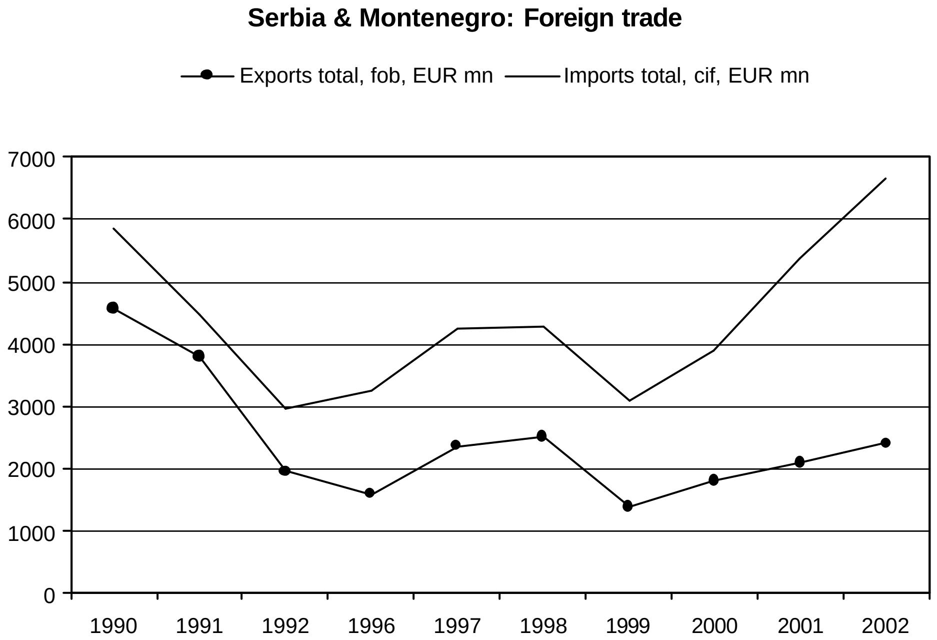
Both transitions being under serious political pressure, the governments have not shied away from populist measures. As a consequence, large macroeconomic disequilibria have appeared. The trade deficit has surged, though it was traditionally high. Still, and especially after 2000, the growth of imports has sharply outpaced that of exports. Though there is some doubt about the validity of foreign trade data, the trend is unmistakable.

Also, fiscal deficits have been significant, though they are much larger in Montenegro than in Serbia. In the latter country, however, the fiscal deficit is bound to increase in the future because of the high burden of the debt service. Finally, unemployment has stayed at a very high level and indeed labour shedding has intensified in the last two years, though the data have to be used with caution as the size of the informal economy is not really known.

External sector

Serbia and Montenegro are similar in the sense that they have large current account deficits. They are also similar when it comes to surpluses in services trade and on the income account. But the causes of the imbalances and possible remedies are different. Figure 1 illustrates the persistent foreign trade deficit that has also been increasing in the past two to three years.

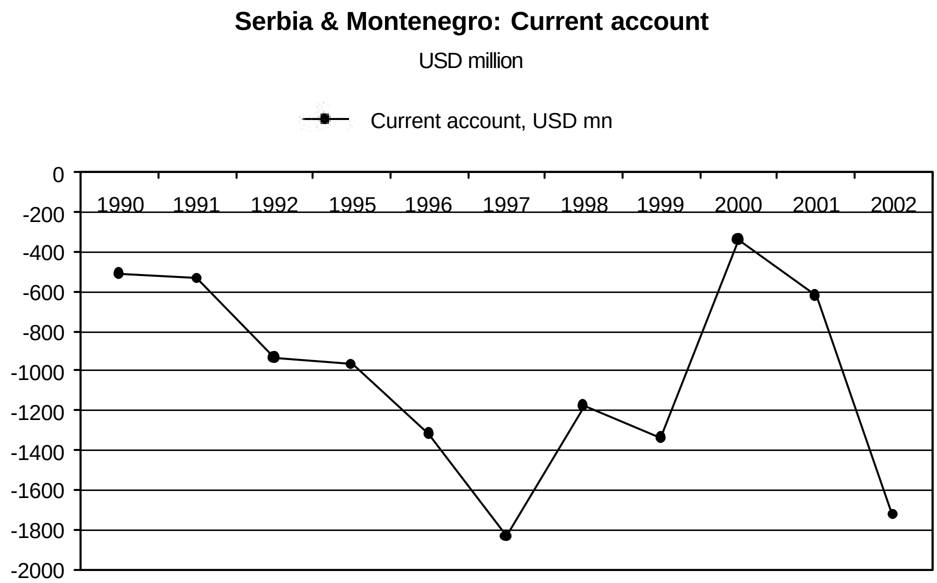
Figure 1



Source: **wiiw** Database.

The high trade deficit is the main cause of the high and persistent current account deficit. Figure 2 gives the development of the current account.

Figure 2



Source: **wiiw** Database.

Unlike Montenegro, Serbia cannot rely on services to close the current account gap in the future. Montenegro is potentially a tourist economy. Serbia runs surpluses in services trade, but mainly on account of being a transit country. Its main foreign trade potential is in exports of goods.

Again, probably more than Montenegro, Serbia relies very much on private transfers from abroad, i.e., on remittances. There are limits to how much those can contribute in the future, because the population of both Serbia and Montenegro is rather old and further outward migration, which is a precondition for future flows of remittances, are not only undesirable but cannot really be maintained.

Both countries, of course, depend on inflows of capital. Currently, aid and concessionary loans are the major sources of foreign finances. In the near future, those will be substituted for by privatization receipts. Thereafter, however, access to green-field investments and financial markets will become crucial. This is because the external imbalances can be reduced only gradually, though, again, Montenegro faces a smaller problem if it invests aggressively in its tourist industry.

Fiscal imbalances

The data on various budgets and extra-budgetary funds are getting better, but are still far from being satisfactory. Some general comments can anyway be made. Generally, public expenditures are high, as a share of GDP, though significantly higher in Montenegro than in Serbia (except in 2002). As a consequence, tax burdens are also high, all the aid and soft loans notwithstanding. A further consequence is the high incentive for tax evasion, which partly explains the existence of large informal sectors.

These fiscal imbalances are structural in the sense that they cannot be addressed adequately without reforms that would lead to a rather radical redistribution both on the revenue and on the expenditure sides. The situation in Serbia is somewhat better in so far as significant savings can still be achieved through the reduction, for instance, of expenditures on the military. Other savings will have to come at the expense of the social security system and the system of education. Many of the responsibilities for the old and the young that are now centred in the state will have to be 'privatized'. Contrary to that, the new Union of Serbia and Montenegro will be costly for the Montenegrin budget because it will have to start contributing to the payments of its expenses.

Table 1 shows the state of the general government in terms of revenues, expenditures and the overall balance.

Reforms so far have concentrated more on increasing revenues by broadening the tax base and by reliance on those taxes that most efficiently bring in revenues, i.e., indirect taxes and contributions from wages and salaries. Those increase the costs of trading and

Table 1

General government: total revenue and grants

per cent of GDP

	2001	2002	2003
Serbia and Montenegro	42.0	44.0	43.5
Serbia	41.5	44.0	43.5
Montenegro	48.5	48.0	.
General government: expenditures per cent of GDP			
Serbia and Montenegro	43.6	48.4	47.6
Serbia	43.2	48.0	47.5
Montenegro	50.9	45.7	.
Fiscal balance			
Serbia and Montenegro	-1.6	-4.4	-4.1
Serbia	-1.7	-4.0	-4.0
Montenegro	-2.4	2.3	.

Source: IMF (2003).

employing. Some rationalization will be achieved with the introduction of the value added tax (VAT) in Montenegro on 1 April and in Serbia by the end of 2003. But, the burden will have to remain high as long as public expenditures are high.

In both countries the primary balance is negative, i.e., public expenditures net of interest payments on the public debt are higher than public revenues including grants. The pressure from servicing the public debt will increase in the coming years because the debt service will increase sharply. The revenues from privatization will provide some relief, but fiscal sustainability cannot be assured without significant restructuring of public expenditures.

Unemployment

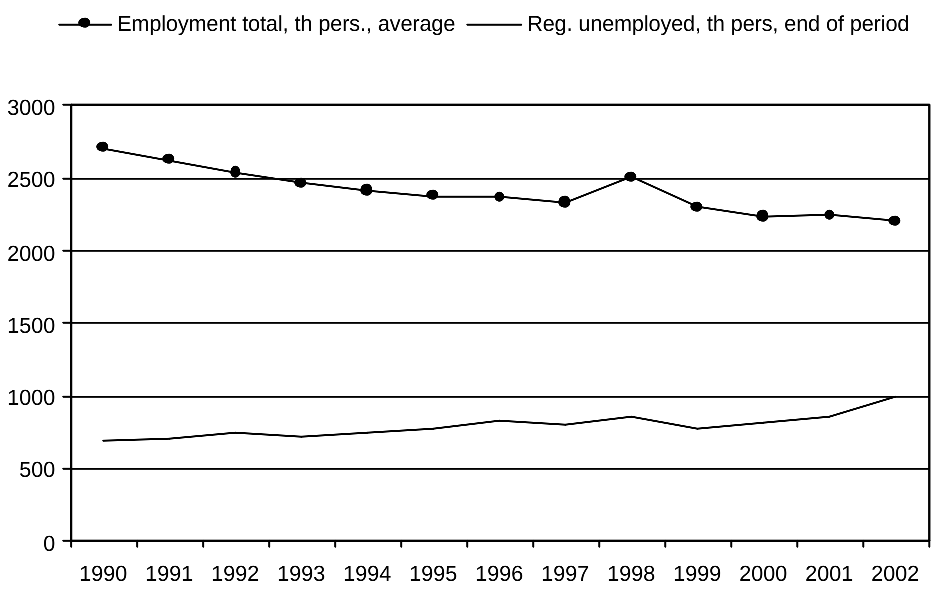
Because of the large informal sector, the data on employment and unemployment are not at all reliable. Registered employment is low, as a share of the labour force, while unemployment is very high. Labour surveys, however, register much lower unemployment. The difference between the two figures is indeed very large, in the neighbourhood of twenty per cent of the labour force. That is still below the estimate of the share of the informal economy, because those employed do not necessarily work or do not work full time. Thus, there are at least three types of imbalances in the labour market.

There are those who work both in the formal and in the informal economy. Their number may be quite high. There is also a significant number of those who are registered as employed, but are in fact working in the informal economy. Some of those are joining the ranks of registered unemployed as their firms and enterprises are being restructured. And, there is an unknown number of informally employed, who are in fact only working from time to time, i.e., are entering and exiting the labour market practically constantly.

With these imbalances, it is rather difficult to assess both the state of the labour market and its future development. Clearly, both the formal and the informal sectors will undergo significant restructuring, which will lead to a series of shocks to the labour market. At the moment, the formal economy is under pressure, both from the markets and from the fiscal needs of the state, while the informal market is subsidized through tax evasion. With the recovery of the formal economy that will change, but the timing and the pace of the expected recovery is still rather uncertain.

Figure 3

Serbia & Montenegro: Employment and unemployment



Source: **wiiw** Database.

9 Reforms and the supply response

In the two years since the political change in Serbia, production has undergone a mild transitional recession. In Montenegro, that recession may have been more severe, primarily because its causes have been different. While in Serbia the recession has been a consequence of the transition, in Montenegro it has been due to the increasingly hardened budget constraint of the state. Thus, some of the causes for the Serbian recession are yet to arrive to Montenegro, while some of the Montenegrin causes are yet awaiting Serbia.

Serbia

Transitional recession has been subdued in Serbia because of the significant temporary inflow of financial aid, channelled mainly through the increase in public expenditures. In addition, there has been a significant expansion of bank loans as a consequence of the increased liquidity mainly due to the euro conversion. These increased financial resources have spilled over into increased consumption that has especially boosted imports. On the other hand, industrial and agricultural production has stagnated while construction has even declined.[9] Investment has not recovered either.

Though GDP has indeed grown, albeit at decreasing speed in both years, it is still appropriate to speak of a transitional recession because the near-stagnation in industrial activity has been caused by typical transitional causes: credit crunch, increased foreign competition and institutional change.

Immediately after the takeover in late 2000, the central bank discontinued its credit activities with the commercial banks. Thus, the banking system, or what was left of it, redirected its loans to the consumers. The enterprise sector, both the state and the private one, had to face not only very high interest rates, but also credit rationing because of increased risk aversion among the banks and because of the impossibility to come up with the necessary collateral. That sapped not only investments, but also the ongoing activities.

The inflow of foreign finances and the slow response on the part of the domestic industry have led to a sharp increase in imports that in turn have created a more competitive environment on domestic markets. In itself, increased competition should bring in a positive stimulus to the uncompetitive domestic producers. This positive response, however, can be delayed because of the need to restructure large parts of the existing industry and because of the effects of disorganization.

Finally, transition involves a radical institutional change, and that does divert resources from current activities to institution-building. This refers especially to the process of privatization, which in Serbia has been designed to be slow. The idea was to maximize the value of the assets to be privatized. However, there are costs to this delay, because the assets to be privatized may not be used in the meantime and may in fact deteriorate during that time. In any case, the uncertainty as to what will happen to the firms that are to be

9 In recent years, agricultural production has been quite volatile, posting a big fall in 2000 due to the drought, and a rebound in 2001, only to shrink again in 2002. Over a number of years, however, it has basically been stagnant.

privatized does not allow them to be restructured in the meantime. And that, in most cases, means that there will be no investments and no expansion of activity.

The strategy in Serbia seems to have been that the period of high inflow of foreign assistance should be used to privatize and restructure the economy, and then the public sector would be restructured in favour of the private one. Thus, once the Montenegrin problem appears, i.e., a fall in public expenditures occurs, the economy would take over. Indeed, it was believed that in the first phase transitional recession could be avoided, while in the second phase the adjustment recession should not appear. Both expectations seem to stand to be disappointed, at least as things appear now.

Montenegro

The decline in GDP growth in Montenegro is not so much a consequence of problems connected with transition but mostly with the decline of foreign financial support. Unlike in Serbia, where public expenditure has expanded, it has been shrinking in Montenegro. The diminishing supply of aid has been partly compensated with the increased inflow of privatization receipts and this trend will continue. It is also expected that tourism will prove to be the engine of growth in the future.[10] However, in the meantime, the restructuring of public expenditures will have to be speeded up. This will prove to be rather difficult in Montenegro where almost everybody depends on public money in one way or another.

There is some way to go to absorb the adjustment recession in Montenegro. As its economy is not really restructured, some kind of transitional recession may yet happen there. It may affect both the formal and the informal sectors – for different reasons, though. The formal sector will have to restructure and it is not clear at the moment what part of it will be able to survive. The informal sector, however, will see its tax burden increased once tax evasion becomes more difficult, and some of the activities will have to be outlawed altogether. Thus, transitional recession may yet arrive to Montenegro after the current adjustment recession is over.

10 Developments in some sectors

Though the overall supply response has been rather disappointing, there are differences across sectors. Especially important are developments in foreign trade, industry and in the new private sector. In this section some structural aspect will be connected with the recent developments in these sectors. Those considerations should lead to an overall judgement about whether Serbia and Montenegro are experiencing a transitional recession and what are the short- and medium-term prospects for recovery. Afterwards, some conclusions

[10] The recovery of tourism, however, has constantly been delayed for a variety of reasons. The main one is political risk, both local and regional. More on that below.

about the contribution of the current economic policy to the developments in these sectors will be drawn.

Serbia

In the past two years, imports have grown sharply while exports have recovered much more slowly. Though there are some doubts about the quality of the foreign trade statistics, the trends are clear. Serbia now imports almost three times as much as it exports. Imports are dominated by consumer and intermediate goods while imports of equipment are lagging. Raw materials and food and food products dominate exports. The trade deficit is highest with the EU countries, where exports are growing more slowly, while exports to the Balkan region have expanded, mostly to Bosnia and Herzegovina and to Macedonia.

Imports have probably reached their limit, from the balance of payments point of view. They may continue to grow, but at a slower pace, because financing that is available now will not continue to be so in the future. This, however, may not lead to a switch towards domestic supply because the growth of income is expected to slow down as well. The main unknown variable is investment, which has failed to increase significantly for transitional reasons and because of the high political risk.

Exports may have reached their limit too. Their expansion to the regional market can hardly continue, because growth in the region is rather sluggish. Growth of exports to the EU will depend on the competitiveness of the Serbian economy. That, in turn, depends on product quality upgrading and on cost reduction. In most transition countries, upgrades in quality have come as a consequence of increased penetration of foreign companies and from the new private sector. The former state or social sector has shown scant ability to move up the quality ladder. In some cases, as for instance in Slovenia, where competitive firms have already existed, they have been able to remain competitive. But in the case of Serbia, the competitive firms have gone through a retrograde development during the long period when the economy was closed to foreign competition and was experiencing decay overall. In addition to the poor quality of the products, the costs structure is also a barrier to increased competitiveness. Production in Serbia is backward in terms of technology and is thus lagging in productivity. Also, the sharp real appreciation of the dinar has not helped. An increase in productivity is possible and is happening, as employees are being laid off. However, technological improvements are yet to come about and the adjustment in the exchange rate policy will be gradual.

In the first half of 2003, both exports and imports have not grown if the depreciation of the dollar is taken into account. In Serbia, the slowdown of the growth of exports is more pronounced than that of imports. Assuming that these trends will continue, exports in euros (rather than dollars) will be just higher than last year, while imports and the trade deficit will increase by about 10%. In dollar terms, the trade deficit is headed to more than USD 4.5 billion in 2003. That is well above 20% of GDP.

Industrial production has been practically stagnant in the past two years. A slight increase of 1.7% was recorded in 2002. Initially, much faster recovery had been expected. It was believed that stabilization and liberalization, both domestic and foreign, would quickly lead to an expansion. This expectation was based on the assessment that there was significant capacity under-utilization. In 2001, industrial production was less than 40% of what it had been in 1989. So, room for recovery was seen to exist. However, the degradation turned out to have been much higher than originally believed. Indeed, in a number of cases, it turned out that there was some room for further downward restructuring, because the explicit or implicit protection was removed.

In the first half of 2003, industrial production has recorded negative growth of close to 4%. The statistics do not cover the private sector properly, but it is not likely that there is some significant unaccounted growth happening there. Thus, industrial production is in recession. The reasons are essentially transitional. There are no credits, there is increased competition from abroad and there is the expectation of privatization and restructuring. The prospects for the year as a whole are not very encouraging. Though some recovery is expected in the second half, chances are that the decline may continue for a while.

Thus, the opening up of domestic and foreign markets did not prove to provide a push for recovery, but quite to the opposite, it exposed the weaknesses of the existing industrial structures. The need for fast restructuring to adjust to the new conditions on the markets proved difficult or impossible due to the bad corporate governance structure and because of the rising expectations of privatization. All these factors contributed to the very slow and in many cases defensive adjustment of the manufacturing firms to growing market competition.

If the state or socially owned firms showed significant rigidity, the new small and medium-size firms should have proved to be more aggressive in exploiting the newly opening market opportunities. This reaction, however, did not materialize and is only slowly emerging two years after the start of the transition. The reason why the small and medium-size sector has not been performing strongly is mainly the consequence of the large share of informal economic activities. Thus, the informal sector has absorbed significant entrepreneurial resources and now also represents a strong competitive barrier to new entrants into a number of activities that are especially conducive to small and medium-size firms.

In addition, the government has done little in the area of competition policy and has, in some cases, strengthened or even introduced state monopolies. That has put added barriers to entry into a number of industrial sectors. Finally, the new fiscal system has redistributed some of the fiscal burden in a way that is not favourable to the private sector. Thus, it has probably strengthened the competitive position of the informal sector. That sector still provides a cushion for laid-off employees. Their number is not easy to determine, but there is no doubt that it is growing.

Thus, in Serbia, in the first two years of transition, the new private sector has not shown a lot of dynamism even among small and medium-size enterprises.

Montenegro

Once Montenegro took over the control of the customs, it passed a law on tariffs that brought the average tariff rate down to about 3%. It retained, however, a rather elaborate system of import quotas. Those were justified on protectionist grounds, but must have served mostly fiscal or quasi-fiscal purposes. This foreign trade regime did not sap the growth of imports very much and, thus, Montenegrin imports are about four times higher than exports.

Data on Montenegrin foreign trade are only recently becoming more reliable. In the first half of 2003, the trade deficit has also widened, in dollar terms. More important is the negative balance in the trade of services. That will change during the tourist season, but the foreign trade deficit is bound to increase anyway for the year as a whole. An additional problem is the fact that almost half of the exports come from the aluminium plant that has traditionally been subsidized through a lower price for electricity. Once that becomes a problem, the problems with the sustainability of Montenegro's external balance will increase.

Exports of services are the anticipated comparative advantage of Montenegro. The Montenegrin coast is as good for tourism as the Croatian or the Albanian, if not better. Three airports – in Podgorica, Tivat and Cilipi (in Croatia) – can be used for access to the holiday resorts. The Montenegrin coast, being further south than the Croatian one, has a longer holiday season. It yet suffers from poor infrastructure, especially in water supply. Because of the lack of investment and due to political risks, tourism in Montenegro is yet to start to grow.

Industrial production in Montenegro consists of a relatively small number of large firms and a large number of small and medium-size enterprises. The two biggest firms, apart from utilities, are the Aluminium Company in Podgorica and the Nikšic steel-mill. The former is a major exporter and a major loss-maker. Its importance for Montenegrin industrial production and exports is such that its survival is not in doubt, though restructuring is unavoidable. Other industrial capacities include food processing and consumer durables. Some of those have been sold and restructured, e.g., the breweries, while some are yet to undergo that process. In the first four months of 2003, industrial production in Montenegro grew, but this will probably not be sustained throughout the year. The sector is struggling, very much as it is in Serbia.

The new private sector is in a similar situation as in Serbia. There is some increase of activity on the coast, though the real transformation of the tourist sector is yet to happen. Otherwise, the transformation of the informal sector, if and when it happens, will provide for more opportunities for the growth of the new private sector.

11 Overall prospects

Serbia and Montenegro are at different stages in their transition, mainly as a consequence of the differences in their political development. In Montenegro, the newly elected government is facing a new window of opportunity to push for reforms. In Serbia, however, the reforms are slowing down because the government had a rather slim popularity and legitimacy and is now turning its attention to organized crime and the building up of the rule of law. Despite these differences, it is difficult to predict what the two governments will in fact do. They will also have to allocate some time to the process of constitution-building, though, again, Serbia is more constrained than Montenegro by that process, as that could in Serbia lead to new parliamentary elections and to a change in government, while in Montenegro that is unlikely.

Even when the process of constitution-building is finished, the Union of S&M together with its constituent states of Serbia and Montenegro will emerge as a rather non-standard political arrangement. In itself, the S&M Union will be more of a burden and a barrier to economic and institutional development than anything else – especially when it comes to the all-important negotiations with the European Union and with the International Financial Institutions. If nothing else, every agreement will take more time to reach and to implement.

Putting constitutional and other institutional and political issues aside, the economic prospects are also rather uncertain. They will significantly depend on the way the current political crisis in Serbia is resolved. The political challenges will be discussed later.

Serbia

Two main economic factors will decisively influence developments in the medium term.

On the one hand, the macroeconomic constraints will become tougher in the coming years. Public expenditures, which are mostly targeting consumption, will have to be cut and that will leave very little room for an increase in public investments. Though the government plans to borrow money for infrastructure development, this will have to be seen in the light of growing concerns about the servicing of public debt. The growth of imports will also have to be sapped, which will make it difficult for increased investment activities to occur. Altogether, considering the rather tight macroeconomic framework, the implied growth rate will be quite moderate.

On the other hand, microeconomic restructuring will have to gain pace and it is not altogether clear what form it will take. This is because, simultaneously, the state sector has to be restructured, the so-called social sector has to be privatized and the informal sector has to be legalized or put out of business. All these processes require significant tightening of the various budget constraints of enterprises and firms. Unless these processes are accompanied by radical measures of market liberalization – e.g., removal of monopolies, liberalization of financial markets, support for new entrants – the hardening of the budget constraints will lead to a restriction of economic activities. That would land the Serbian economy into a new transitional recession. In any case, the recovery of industry can prove to be slow, at least in the medium term.

Montenegro

Macroeconomic adjustment is already under way in Montenegro. It may become more severe due to the increase in the costs of the new union with Serbia. In the past several years, Montenegro did not contribute to the federal budget. Starting with 2003, its contribution will amount to some USD 50 million, which is above 3% of Montenegro's GDP. Though a number of Montenegrins will get to work for the Union's government and administration, there are few if any other benefits that they will get from this union with Serbia. And quite a number of current employees will lose their jobs in the federal administration and in the military and other security services.

From the microeconomic point of view, much depends on the development of tourism. There are projects that should improve the infrastructure on the coast, which should support a quite significant economic growth in that region. Other Montenegrin regions will depend on the economic development in the bordering Serbian and Bosnian regions. In Serbia, the bordering region of Sandžak is doing better than the rest of Serbia and will probably continue to do so. Thus, the prospects for the northern part of Montenegro are not so bad. Still, much will depend on the restructuring of the big enterprises and on the development of the small and medium-size enterprises. Both are facing the same or similar problems as their counterparts in Serbia.

12 Selected issues

Debt sustainability

Serbia and Montenegro inherited about USD 12 billion of debt in 2000. In the two years since then, the debt to International Financial Institutions has been refinanced, which opened up possibilities for new borrowing. Also, the debt to the Paris Club was restructured at the end of 2001. Two-thirds of that debt was written off, 50% in mid-2002, and another 15% will be written off after the fulfilment of the three-year IMF agreement, i.e., in mid-2005. The London Club debt has not yet been restructured because the Union of S&M is asking for a similar write-off, which the London Club has been unwilling to accept so far. In addition, there is some outstanding debt that is outside both the Paris and the London Club frameworks. All in all, S&M debt stood at around USD 11.5 billion at the beginning of 2003.[11] The government estimates the actual level of the debt at about USD 9 billions, once all conditional and expected write-offs are subtracted from the existing debt. This debt does not include the frozen foreign currency savings, a large part of which is also serviced by the government.

Only part of the interest is being serviced at this moment, but the grace period expires by 2005. Until then, new debt will be accumulated mostly from the IFI's and from sovereign creditors. The level of new borrowing is difficult to forecast, but there is hardly any doubt that debt will grow faster than GDP, thus raising the debt-to-GDP ratio. After 2005, a further rise in that ratio is almost inevitable, under realistic assumptions of the rate of interest at which S&M will be able to borrow and the real appreciation of the exchange rate. The reason is that the share of the current account deficit in GDP will continue to be higher than GDP growth. Part of the gap will be closed with foreign direct investments, but that will probably not be enough, and the inflows become rather uncertain after the privatization process comes to its end, which should happen, according to the plan, around 2005 or 2006.

Thus, it is realistic to expect that the debt-to-GDP ratio will not be stabilized even if all the write-offs are realized as planned.

One way to substantiate these expectations is to look at the development of the debt to GDP ratio in the Central European and Southeast European countries. Figures 4 and 5 show that in a number of cases where debts were restructured, the ratio fell initially only to start growing afterwards. It tends to stabilise only few years after the start of the transition. In the case of countries coming out of former Yugoslavia, here Slovenia and Croatia, the debt tends to grow almost continuously. Serbia can be expected to combine these two tendencies. On one hand, the debt will most probably be reduced once it is completely

[11] And at close to USD 13 billion at the end of May 2003. The increase is almost entirely due to the depreciation of the dollar.

consolidated and rescheduled. However, it will then continue to grow as some of the underlying characteristics of the current account are similar to those in Croatia. However, the scope for growth is much more limited because Serbia is not a tourist country.

Figure 4a

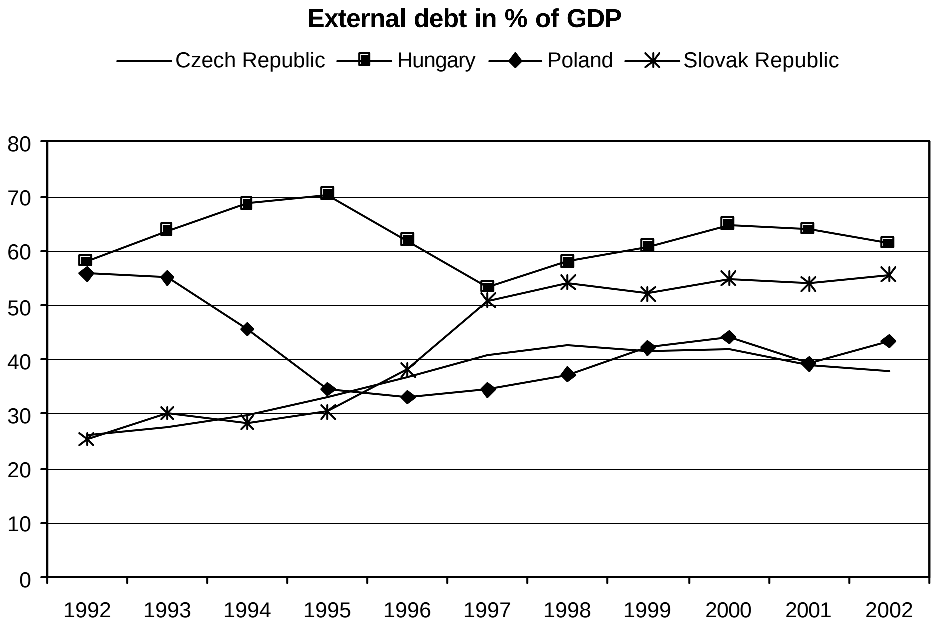
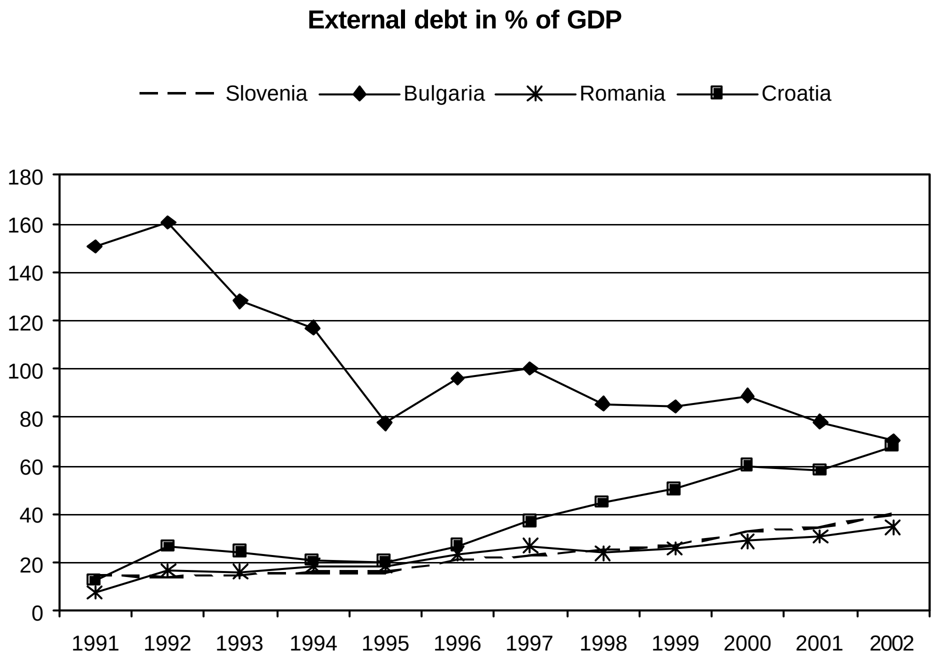


Figure 4b



Source: **wiiw** Database.

Thus, the prospects for the sustainability of the external debt are not very good – especially because Serbia would have to emulate the development that can be observed in Bulgaria, where the debt to GDP ratio has been going down almost constantly since the early 1990s and even after the external debt was consolidated in the mid-1990s.

A similar picture emerges when debt to export ratios are looked at. Again, in most cases, these ratios have tended to decline, except in former Yugoslavia countries. Thus, again, the prospect for stability of the external debt position of S&M are not very good, except if it manages to significantly increase its exports.

Figure 5a

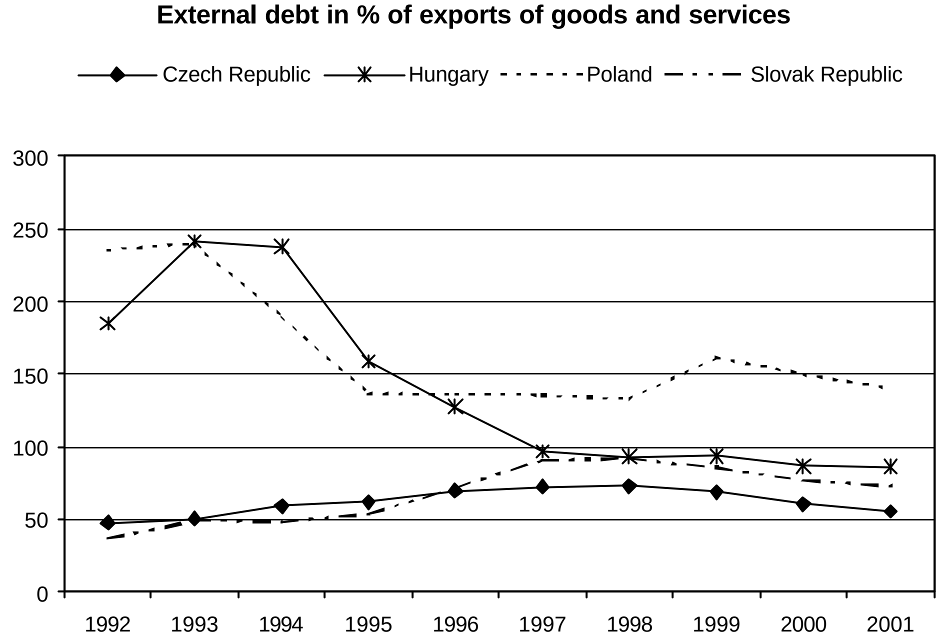
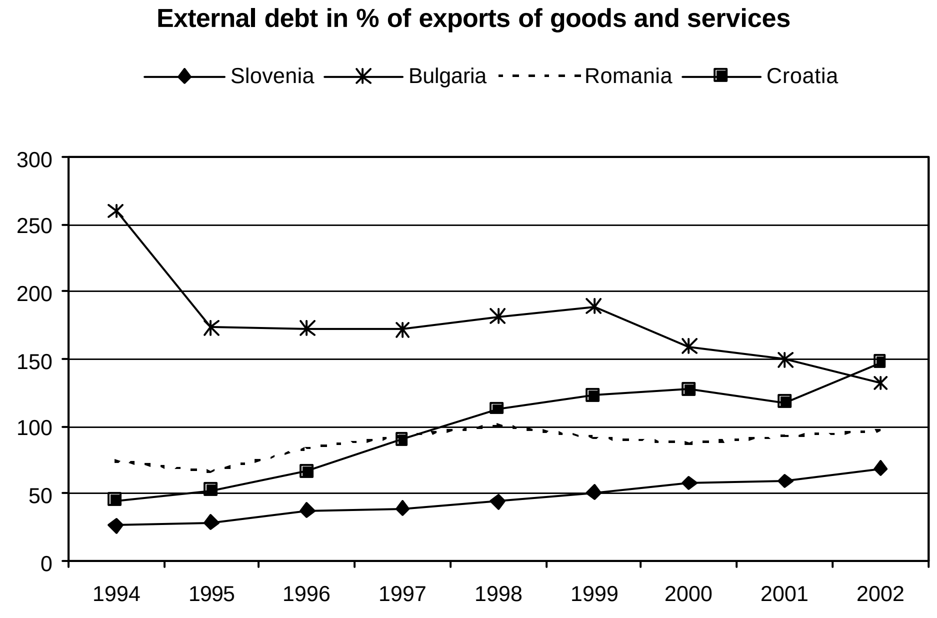


Figure 5b



Source: **wiiw** Database.

The situation in Montenegro is somewhat different from that in Serbia. The Montenegrin foreign debt is not known with certainty, but it has been put at EUR 512 million by the Central Bank of Montenegro. Of that, EUR 332.7 million is to multilateral creditors and EUR 167.1 million to the Paris Club of sovereign creditors. These figures do not include London Club debt. Also, they include the debt that Montenegro bought back in 1992 and also the debt that was taken over by former Yugoslavia and is yet to be allocated between Serbia and Montenegro. If the latter two positions are excluded, Montenegro's foreign debt goes down to EUR 345 million. As Montenegro's GDP was estimated at EUR 1221 million in 2002, that gives a foreign debt-to-GDP ratio of 42% or 28%, depending on which estimate of the foreign debt is adopted. To this debt, that to the London Club needs to be added. Apparently that debt is small, because Montenegro bought back most of that debt.

Montenegro has been accumulating new debt, however. Unlike Serbia, which is only now starting to issue domestic debt, Montenegro has been financing its budget deficit with domestic borrowing for a while now. In 2002 it paid over EUR 13 million in interest and almost EUR 50 million in repayments. That is about 5% of the GDP in that year. In the same year, the state borrowed about EUR 45 million, which is about 3.7% of GDP. Thus, it is borrowing as much as it is repaying, except for the interest payments, which amount to over 1% of GDP.

To assess the foreign debt sustainability, a look at the current account is necessary. Both Serbia and Montenegro run high current account deficits. Montenegro's balance of payments has only recently been produced and only for the last two years. It shows a current account deficit of about EUR 175 million in 2001 and about EUR 161 million in 2002. That is almost 17% and slightly more than 13% of GDP in 2001 and 2002 respectively. Obviously, if it were financed from loans, it would add significantly to the foreign debt or would run down the reserves. The deficit seems to have been financed only to a small extent with credits, however. Instead, the increasing inflow of foreign investments has been mostly relied on.

Fiscal sustainability

The current fiscal deficit is running at around 5% of GDP. As interest payments are rather small now, that is practically equivalent to the primary surplus. Once debt starts to be serviced in earnest after 2005, the deficit will reach unsustainable levels. Thus, fiscal restructuring will become urgent. The structure of the budget, however, makes this a rather difficult task.

As already mentioned, public expenditures are mostly targeted at consumption. Public investments are quite low, though their share is bound to increase. At the moment, much of what usually goes into public investments is covered from aid for reconstruction. That will change with credits and guarantees substituting for aid – which will necessitate a restructuring of public consumption. At the moment, it is not clear what cuts in public spending will be feasible. The obvious candidates are the expenditures on the army and other security services, but it is not altogether clear whether that is what will in fact be done.

The key to fiscal sustainability is the growth of the private sector. As soon as the private sector will be capable of increasing employment, both public expenditures will go down and public revenues will go up. At the moment, however, the growth of the private sector is rather sluggish. That should change once privatization and the restructuring of the public sector are completed.

The political business cycle may work against the more positive developments, however. The pressure on the state to take more financial responsibilities rather than less are persisting and will certainly grow as the elections approach. Indeed, over time it may become more rather than less difficult to restructure the public finances because of adverse effects that the cuts in public expenditures might have on the election prospects of incumbent parties and coalitions.

In 2002, Montenegro ran a general government surplus. This was mainly because it borrowed much more than initially intended, as foreign aid decreased. More importantly, it accumulated arrears in the contributions to the social security funds, at the same time increasing net wages. If all unpaid obligations are taken into account and if aid is excluded, Montenegro runs a significant fiscal deficit, perhaps above 10% of GDP. Clearly, that is not sustainable as debt will be growing faster than the GDP, under realistic assumptions of costs of borrowing.

Monetary policy

Both Serbia and Montenegro have chosen the nominal exchange rate as the main anchor for price stability. Montenegro uses the euro, while Serbia has relied on a fixed exchange rate with the euro, at least until quite recently. Thus, both have given up on an active monetary policy. The interesting question is, what is the consequence of that decision on the level of monetization of the economy and on currency substitution?

Looking at the monetary indicators of Serbia, it can be seen that there is almost no difference between M1 and M2 (the latter includes time deposits). Taking either the one or the other, the share of money in dinars in the GDP is about 10%. M3, which includes foreign currency deposits, is by about 70% larger than M2 and is less than 20% of GDP.

Foreign reserves of the central bank cover more than 100% of M2. Together with foreign currency reserves of the commercial banks they cover about 90% of M3. Thus, almost all money is covered by foreign currency reserves. As this has been the case for more than two years now, the behaviour of the central bank indicates that it does not feel that confident that it can support more dinar monetization beyond the amount that is actually more than covered by the foreign currency reserves. This goes together with the fact that deposits in dinars are much smaller (time deposits in dinars are practically non-existent) than those in foreign currency. That indicates that the trust in the central bank is still quite low.

The same conclusion can be reached by noticing that currency substitution, i.e. the share of foreign currency deposits in M3, is almost 50%. Of course, it can be assumed that significant amounts of foreign currency are being used for current transactions and are kept outside of the banking system. Thus, there are probably several times more foreign currency than dinars in Serbia.

A similar conclusion can be drawn for the structure of credits. At the end of April 2003, commercial banks' lending to enterprises accounted for slightly more than 80 billion dinars, while loans in foreign currencies for slightly more than 66 billion dinars. Loans to households were almost exclusively in dinars, but they were just above 19 billion dinars. Loans to the government were also almost exclusively in dinars. The central bank lends almost exclusively to the government, about 25 billion dinars at the end of April 2003. Thus, loans in foreign currencies are about 40% of all loans (loans to the government not included).

The growth of credits is quite slow. Indeed, in the first half of 2003 it either stagnated or decreased. Commercial credits, both in dinars and in foreign currency, practically equal M3. Thus, all outstanding loans are covered by cash or deposits. There are slightly more foreign currency deposits than foreign currency loans. In other words, there is a slight currency mismatch. All that pails in comparison to the low level of monetization and of crediting activity in the economy.

As mentioned above, the central bank lends almost exclusively to the government. Its interest rates cannot therefore influence the money market very much. Its lending to the government is also very limited. Thus, the main instruments of the central bank are reserve requirements and interventions at the foreign exchange market. These are crude instruments and tend to limit liquidity and the growth of credits.

As pointed out, the commercial banks do not face a significant currency mismatch. Thus, they are not vulnerable to variations in the exchange rate. There are certainly problems with the bad loans, the amount of which is not easy to determine. In most cases, however, those would not benefit or suffer very much either from changes in the exchange rate or in the interest rate. They are a cost to the banking sector, but are not a constraint on monetary policy.

The situation is different with the government debt, which is almost exclusively in foreign currencies. As the government borrows in foreign currencies and has to pay with dinars, its liquidity and solvency is very much affected by the movements of the exchange rate. This is the major constraint on the monetary policy.

Informal sector

Estimates of the informal sector in Serbia and Montenegro vary and are rather unreliable. There is no doubt that its share is significant. It is often suggested that about 500,000 people work informally. Quite a number of those legally employed work additionally in the informal sector. Given that the number of registered employed is about a million and a half, it would not be an exaggeration to assume that the informal economy is as large as one quarter or one third of the GDP.

It seems that informal activity has increased since 2000. That may be the consequence of two things. One is the rise of demand for goods and services supplied by the informal sector. Construction would be the obvious example, as would be services. In general, increased private consumption and investments, due to larger inflows of aid and transfers, support an increase in demand for services that are supplied through the informal economy. Initially, it could be assumed, the sector had some slack, due to the crises in the last years of Miloševic's rule. After a while, the sector may have started to employ more people, which would be consistent with the general feeling that more and more people are depending on it as the jobs in the legal sector become increasingly scarce.

The other reason for the growth of the informal sector is the increase in the fiscal burden. Again this is difficult to measure, but most business surveys suggest that, in a variety of ways, fiscal costs of doing business have increased and thus have the incentives to go underground.

As the informal economy is a subsidized activity, as long as it is motivated by tax evasion and is not outright criminal, its legalization can turn out to be hard to achieve. Certainly, at this moment, when the legal sector is still shedding labour, getting tough on the informal sector may prove to be unpopular and thus difficult to implement.

13 Conclusions

Two years after the momentous political change, Serbia and Montenegro are facing a new beginning. In a sense, true transition is yet to start. At the moment, political stability is not yet completely assured while the economy is yet to show signs of sustainable growth. The macroeconomic framework remains fragile, while the supply response has been disappointing. Both have to be reformed further for the turnaround to be achieved.

Economic developments depend very much on political stability. The latter, however, depends on the constitutional development and on democratization. Both are not proceeding fast and may in fact stall. At the moment, an end of the prolonged political crisis is not in sight. In Serbia, conflicts are proliferating and some stability can be expected only after the general elections have been held. In Montenegro, the government is not in danger of losing the support of the majority, but is not likely to stop losing its legitimacy. These two developments can go together for some time because the opposition is seen as an even worse alternative than the current government.

In both states, the situation may deteriorate more sharply in the short run if the foreign financial support continues to decline and investments do not pick up. Though social conflicts are not to be expected, increased political instability is likely.

Appendix: Getting out of the crisis in Serbia

The immediate danger after the assassination of the Serbian prime minister was the possibility that the country would slip into an Albanian type of crisis. In 1996, after the collapse of the widespread pyramid scheme, Albania's state institutions collapsed and the country found itself on the verge of civil war. This development was averted with the mediation of the European Union, which convinced all the various factions and parties to agree to early elections and then to a process of political stabilization.

The Serbian crisis did not develop in that direction. Though the state had been quite criminalized, it did not collapse. One of the reasons was that there was no panic and thus no run on the banks or anything similar to that. Another was that the institutional development of Serbia, however damaged and destroyed during more than ten years of Miloševic's rule, was still much more advanced than in Albania. Thus, the institutions reacted quite well to the introduction of the state of emergency. The final difference, of course, was that the public was outraged at the demonstration of political vandalism that the assassination of the prime minister represented. Indeed, at no time was there any serious threat to the government or to the regime.

This is not to say that there are no risks to political stability left. In fact, deep divisions remain present. Also, the government continues to have but a slim support in the parliament. Finally, the pace of reforms has yet to be speeded up. The key question will be whether the currently ruling coalition can stay together and whether it can remain in government after the elections, whenever they happen to take place. Or whether it can advance the reforms so much that they will become irreversible.

Much will depend on the upcoming trial of all those suspected in the numerous political assassinations and war crimes. If the trials are well executed and publicized, they could turn around the public opinion dramatically. There is no doubt that the political parties that used to support Miloševic will have a hard time adapting to the new situation, but that may not be the case with the largest opposition party, Koštunica's Democratic Party of Serbia. Thus, it will be quite important whether the current efforts could turn around radically the political debate in Serbia.

The chances for that happening, however, are decreasing with the level of political conflicts increasing. The latest conflict between the government and the central bank is a case in point. The governor of the central bank is also a vice-president of the newly established party called G17 Plus. They compete for votes with the governing coalition. Thus, the government has decided to sack the governor. This has only exacerbated the political instability. The consequences for the credibility of the central bank and the government can be serious too. Though the conflict over the control of the central bank is partly motivated by the worsening economic development and the desire of the finance ministry to have more easy access to the printing press, the political consequences will probably be more important than the economic ones. All that cannot be resolved in other ways than by general elections.

The Serbian crisis and the region

The developments in Serbia are already having significant consequences in the region. The anti-crime drive in Serbia has influenced the developments in Montenegro. The same is true for Bosnia and Herzegovina, especially for Republika Srpska. This was one large and connected security and criminal network that was operating throughout the region. Nothing more specific can be said at this moment, but there is no doubt that military and security forces throughout the region have been affected. There will also be a demonstration effect throughout the region if the effort is sustained. If Serbia is successful, that will set a new standard for the region as a whole, as organized crime is a problem throughout the region. However, if the effort fails, that will have consequences too. At the moment, the increase of political instability in Serbia signals a possibility that the state there will not be able to shake off the grip of organized crime. That will lead to the survival of the prominent role of organized crime throughout the region.

There will also be an effect in Kosovo. This effect is more difficult to judge. There have been some indications that security risks in southern Serbia, western Macedonia and in Kosovo may grow in the near future because of the planned and announced activities of the so-called Albanian Liberation Army. How they will assess the political developments in Serbia cannot be known. The tensions have increased anyway because of the UNMIK intention to transfer more power to the Kosovo authorities. The reaction by the Kosovo Serbs will be negative and the support for Serbian separatism in Kosovo will increase. That may increase the tensions throughout the region.

Serbia and EU integration

The EU announced that it would come out with a new initiative for the Western Balkans during the Greek presidency in the first half of 2003. Indeed, an EU–Western Balkans summit was held in Thessaloniki on 21 June. The expectations were running high, as they often had whenever a new international initiative had been announced. It would have been rather crucial that these expectations had not disappointed this time again. A clear signal that the EU intends to integrate the Balkans could contribute to a change of the political agenda in the region from Balkanization to Europeization. It is clear, however, that the Thessaloniki summit produced results that were below expectations. The EU promised that Western Balkan countries would eventually become members, but changed little in the mechanism of their integration. In that sense, the summit proved to be a missed opportunity. The existing strategy may be enriched during the current Italian presidency. The region badly needs more institutionalized and structured support and only the EU can provide that. It that were to happen, it would have a beneficial influence on the crisis in Serbia and then on the political and economic developments throughout the region.

Table 2

Montenegro: Macroeconomic indicators, 1992-2002

	GDP USD mn constant prices	GDP 1992=100	Population (000)	GDP p.c. USD constant prices	Industrial production 1992=100	Agricultural production 1992=100	Number of tourists (000)	Unemploy - ment rate	Number of employed	Number of unemployed	Inflation rate	Export of goods and services USD mn	Import of goods and services USD mn	Foreign trade balance USD mn
1992	1,027.4	100.0	624.0	1,646.5	100.0	100.0	413	23.6			20,293.2	112.6	195.1	-82.5
1993	655.3	63.8	631.9	1,037.0	66.0	91.8	423	22.4			n.a	146.8	159.4	-12.6
1994	686.6	66.8	635.3	1,080.7	60.6	97.4	603	21.8			n.a	94.3	101.1	-6.8
1995	701.8	68.3	638.6	1,099.0	59.0	102.4	625	22.2	178,868	55,436	111.80	79.1	126.0	-46.9
1996	939.6	91.5	643.0	1,461.3	89.6	105.8	658	21.9	183,483	56,477	47.20	177.2	272.9	-95.7
1997	953.8	92.8	647.4	1,473.3	90.8	116.0	663	23.5	178,562	57,342	16.20	249.5	322.0	-72.5
1998	982.5	95.6	651.3	1,508.5	90.5	116.8	622	25.7	180,365	50,693	42.00	239.9	360.2	-120.3
1999	908.9	88.5	655.2	1,387.2	83.3	122.0	298	27.3	184,832	53,340	128.40	211.5	383.8	-172.3
2000	1,022.1	99.5	658.3	1,552.6	86.2	115.9	448	27.8	181,762	54,949	24.80	293.6	545.4	-251.8
2001	1,032.0	100.4	661.6	1,559.9	85.0	124.0	555	24.8	175,242	57,536	28.00	345.3	695.2	-349.9
2002	1,041.2	101.3	663.0	1,570.4	86.1		541	23.3	177,617	57,688	9.40	471.4	777.7	-306.3

Source: National statistics.

Table 3

External debt indicators

		2001	2002*	2003*
Albania	External debt % GDP	28.7	24.7	25.5
	External debt % exports	140.7	138.8	141.9
	Short term debt % reserves	2.6	6.2	6.7
	Debt service % exports	3.9	7.8	7.1
Bosnia and Herzegovina	External debt % GDP	53.2	51.6	50.6
	External debt % exports	186.4	184.9	179.8
	External debt % reserves	207.0	224.3	231.9
	Debt service % exports	5.8	8.3	10
Bulgaria	External debt % GDP	78.3	70.3	64.8
	External debt % exports	140.9	137.1	131.5
	External debt % reserves	296.6	239.6	242.5
	Debt service % exports	20.1	18.8	15.1
Croatia	External debt % GDP	57.9	67.9	.
	External debt % exports	117.5	144.5	.
	External debt % reserves	240.6	259.0	.
	Debt service % exports	24.4	25.9	.
Macedonia	External debt % GDP	38	39	36.5
	External debt % exports	93..5	106.3	105
	External debt % reserves	186.6	191.4	215
	Debt service % exports	19.0	16.5	13.6
Romania	External debt % GDP	29.6	28.6	.
	External debt % exports	88.1	83.9	.
	External debt % reserves	240.6	190.8	.
	Debt service % exports	4.4	4.5	.
Serbia and Montenegro	External debt % GDP	113.7	76	52
	External debt % exports	441.4	365	259
	External debt % reserves	.	519.2	388.4
	Debt service % exports	3.9	6.2	12.2

Source: IMF.

Table 4

Serbia & Montenegro: Selected economic indicators *)

	1998	1999	2000	2001	2002 [1]	2002	2003	2003	2004
						1st quarter		forecast	
Population, th pers., mid-year	10616.9	8372.7	8342.5	8326.4	8304.7	.	.	.	.
Gross domestic product, USD mn, nom. [2]	15487	10090	8670	11545	15686	.	.	19500	20900
annual change in % (real) [3]	2.5	-21.9	6.4	5.1	3.0	.	.	2	4
GDP/capita (USD at exchange rate) [2]	1459	1205	1039	1307	1889	.	.	.	.
Gross industrial production [4]									
annual change in % (real)	3.6	-23.1	11.2	0.0	2.0	-4.1	-3.1	1	3
Gross agricultural production									
annual change in % (real)	-3.2	-1.0	-12.9	17.2	-2.1	.	.	.	.
Goods transport, mn t-kms	45601	30026	32878	17456	5480	.	.	.	.
annual change in %	19.5	.	9.5	-46.9	-68.6	.	.	.	.
Gross fixed investment, YUM mn, nom.	17893.2	24867.8	59315.5	65845.8	.	.	.	.	.
annual change in % (real)	-2.2	-26.3	13.3	.	.	.	.	.	.
Construction output, value of work done									
annual change in % (real)	-0.8	-9.9	.	.	.	.	.	.	.
Dwellings completed, units	13096	13123	12732	12156	12776	.	.	.	.
annual change in %	-11.3	.	-3.0	-4.5	5.1	.	.	.	.
Employment total, th pers., average [5]	2504	2298	2238	2243	2201	2214	.	.	.
annual change in %	-0.1	.	-2.6	0.2	-1.9	-0.4	.	.	.
Employees in industry, th pers., average	884.4	804.5	764.7	739.0	684.0	711.3	.	.	.
annual change in %	2.4	.	-5.0	-3.4	-7.4	-5.3	.	.	.
Reg. unemployed, th pers, end of period	849.4	774.3	812.4	860.5	980.8	881.0	.	.	.
Reg. unemployment rate in %, end of period [6]	25.4	25.5	26.7	27.9	31.2	28.5	.	30	30
LFS - unemployment rate in %, average	13.7	13.7	12.6	12.9	13.8	.	.	15	15
Average net monthly wages, YUM	1063	1309	2588	5545	9113	7779	.	.	.
annual change in % (real, net)	2.0	-15.0	6.5	13.3	24.6	40.2	.	.	.
Retail trade turnover, YUM mn	48748	57697	119522	250312	325855	32112	.	.	.
annual change in % (real, calc.)	3.9	-13.5	11.6	10.8	11.7	17.1	.	.	.
Consumer prices, % p.a.	29.9	44.9	85.6	89.0	16.5	29.1	11.6	15	10
Producer prices in industry, % p.a.	25.5	43.4	106.5	85.1	8.7	14.4	4.8	10	10
General government budget, YUM mn									
Revenues	61360	79321	138749	320475	507008	108641	.	.	.
Expenditures	70739	.	.	.	.	.	.	.	.
Deficit (-) / surplus (+)	-9379	.	.	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-6.1	.	.	.	.	.	.	.	.
Money supply, YUM mn, end of period									
M1, Money	10807.3	16332.0	26954.0	52686.0	88839.0	61745.0	82426	.	.
Broad money [7]	62352.0	75393.7	65522.0	107825.0	186966.0	134481.0	184561	.	.
Discount rate, % p.a., end of period	33.7	26.3	26.3	16.4	9.5	12.4	9.0	.	.
Current account, USD mn [8]	-1180	-1341	-339	-624	-1731	.	-614 [9]	-2000	-2000
Current account in % of GDP	-7.6	-13.3	-3.9	-5.4	-11.0	.	.	-10.3	-9.6
Forex reserves of NBY, USD mn	300	297	524	1169	2280	1477	2113	.	.
Gross external debt, USD mn	11500	12500	11418	11740	11839	.	12921 [V]	.	.
Exports total, fob, EUR mn [10]	2517.7	1391.1	1808.2	2097.0	2399.0	524.2	366.0 [I-II]	2500	2600
annual growth rate in %	6.7	-44.0	30.0	16.0	14.4	9.4	.	4	4
Imports total, cif, EUR mn [10]	4283.5	3080.8	3892.1	5390.7	6647.5	1511.3	904.0 [I-II]	6600	6600
annual growth rate in %	0.9	-26.4	26.3	38.5	23.3	9.1	.	-1	0
Average exchange rate YUM/USD	9.34	11.01	16.69	66.84	64.19	69.37	58.88	60	64
Average exchange rate YUM/EUR (ECU)	10.46	11.74	15.30	59.44	60.79	60.34	63.36	66	70

*) Note: From 1999 (GDP from 2000) excluding Kosovo and Metohia.

Notes: 1) Preliminary. - 2) Estimates based on World Bank method. From 1999 based on market exchange rate. - 3) Based on GMP in Dinar. - 4) Excluding private enterprises. - 5) Employees plus own account workers, excluding individual farmers. - 6) In % of unemployed plus employment. - 7) From 2000: at official exchange rate, excluding Montenegro, government deposits, household frozen foreign currency saving deposits. - 8) From 2000 including official grants. - 9) Serbia only. - 10) Converted from the national currency to EUR at the official exchange rate.

Source: **wiiw** Database incorporating national statistics; **wiiw** forecasts.

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