



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, xxx  
SEC(2004) 376

COMMISSION STAFF WORKING PAPER

# **SERBIA AND MONTENEGRO**

**Stabilisation and Association Report 2004**

{COM(2004) 206 final}

# **SERBIA AND MONTENEGRO**

## **Stabilisation and Association Report\***

### **2004**

#### **TABLE OF CONTENTS**

<b>1. EXECUTIVE SUMMARY.....</b>	<b>1</b>
<b>2. POLITICAL SITUATION.....</b>	<b>2</b>
2.1. Democracy and rule of law.....	2
2.2. Human rights and protection of minorities.....	11
2.3. Regional and international co-operation/obligations.....	16
<b>3. ECONOMIC SITUATION.....</b>	<b>21</b>
3.1. Current economic situation.....	21
3.2. Existence of a free-market economy and structural reforms.....	25
3.3. Management of public finances.....	27
<b>4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS.....</b>	<b>28</b>
4.1. General evaluation.....	28
4.2. Internal market and trade.....	30
4.3. Sectoral policies.....	39
4.4. Co-operation in justice and home affairs.....	41
<b>5. EC FINANCIAL ASSISTANCE.....</b>	<b>46</b>
<b>6. PERCEPTIONS OF THE EU.....</b>	<b>48</b>
<b>* This report includes also a <u>section on Kosovo as defined by the United Nations Security Council Resolution 1244 of 10 June 1999</u>.....</b>	<b>50</b>

## 1. EXECUTIVE SUMMARY

Progress in Serbia and Montenegro since the last annual Report has been mixed. The adoption of the **Constitutional Charter** was an achievement in its own right, but its implementation is still incomplete. Continued disagreements about the interpretation and implementation of the new constitutional arrangements reflect the lack of overall consensus on the future of the State Union. This lack of consensus weakens the joint institutions and policies which are indispensable for progress with political and economic reforms and for developing Serbia and Montenegro's relations with the EU. The constitutional problems and protracted party political disputes in both republics have contributed to the slow pace of reforms in many key areas.

Republican institutions showed resilience and stability following the assassination of Serbian Prime Minister Djindjic. The ensuing **state of emergency**, while of great assistance to the Serbian government in combating the immediate threat posed by organised crime, affected, however, the respect for human rights and for the rule of law.

The level of progress in **political reforms** has varied: steady progress in army reform; further progress in the areas of minority rights and regional co-operation; slower than hoped-for reform of the police and judiciary. Efforts have been made to deal with the legacy of the past but this remains an outstanding challenge. Serbia and Montenegro is still failing to comply with its international obligations concerning co-operation with the International Criminal Tribunal for the former Yugoslavia (ICTY).

**Economic stability** has been preserved. However, the pace of structural reforms has slowed considerably, mainly due to the political disputes that have hampered the functioning of the institutions.

There was some progress on the European reform agenda in the framework of the **Stabilisation and Association Process (SAP)**. To speed up the reform process and to further deepen EU reform advice, an **Enhanced Permanent Dialogue** was established in July 2003, upon the Commission's suggestion, to build on the work of the previous Consultative Task Force meetings. The recommendations of both serve as reform guidelines and benchmarks.

Following the adoption of the Constitutional Charter and of the Internal Market and Trade Action Plan in August 2003, the Commission decided in September 2003 to commence work on its Stabilisation and Association Agreement **Feasibility Report**. The Feasibility Report looks into the possibility to open negotiations on a Stabilisation and Association Agreement on the basis of a number of criteria: the degree of compliance with SAP political and economic conditions, the overall functioning of the State Union, the existence of a single trade policy and a single market, progress on sectoral reforms and on those institutions at the state level necessary to implement an SAA.

The Feasibility Report was postponed in order to give the authorities more time to address the remaining key issues, including in particular political conditionality, constitutional issues and the Action Plan.

## 2. POLITICAL SITUATION

### 2.1. Democracy and rule of law

*The adoption of the Constitutional Charter in February 2003 was an achievement in itself that opened a new phase for the country. However, this was soon overshadowed by the tragic assassination of Serbian PM Djindjic on 12 March 2003. This was the most serious indication of the heavy legacy of the past and the continuing threat from elements linked with the former regime. Republican institutions showed resilience and stability following the assassination of Prime Minister Djindjic.*

*There has been a tendency to mark time in the key reform policy areas throughout 2003, the main reasons being the delays in the practical implementation of the new constitutional arrangement and fundamental political disputes within the republics. The establishment of the state level institutions has been delayed (notably the State Court), and those that have been set up do not yet fully function. The state of emergency in Serbia, introduced after the assassination of PM Djindjic, helped in facing the threat posed by organised crime but affected the respect for human rights and marked a step back in reform of the police and judiciary. Full respect for the rule of law has continued to be challenged in both republics. The persisting constitutional/legal uncertainty, coupled with political difficulty in both republics, has adversely affected the overall democratic functioning of the institutions.*

*On the positive side, military reform has taken resolutely the right direction and steady progress in regional cooperation has continued. Here, the recent apologies by the President of Serbia and Montenegro for acts committed during the previous decade have helped create a more conducive atmosphere. There have been mixed developments with regard to compliance with international obligations. Cooperation with ICTY is seriously deficient.*

#### 2.1.1. Assessment of democratic institutions and attitudes to the state

**Constitutional issues:** The Constitutional Charter came into force on 4 February 2003. It was accompanied by the Implementation Law, which provided detailed rules and transitional arrangements. In spite of the recommendations of the 2003 SAP Report, there was insufficient co-operation between the republics in implementing the constitutional reforms. The deadlines foreseen in the Constitutional Charter and Implementation Law for the adoption of the necessary legislation and establishment of the state institutions were not met, leading sometimes to an institutional vacuum - as in the case of the repeatedly postponed appointment of the judges in the State Court.

Furthermore, conflicting interpretations of the new arrangements (also due to discrepancies between the Charter and the Implementation Law) have led to a continuing lack of clarity as to the scope of the competencies of the state level institutions and the republican institutions, with the latter acting sometimes in areas of state level jurisdiction. In areas such as justice and home affairs, where the Constitutional Charter transferred the main competences to the republican level, insufficient cooperation between the republics affected the effectiveness of the policies. In this regard, while a positive development occurred in December 2003 with the signing of the Memorandum of co-operation between the two republican Ministries of Interior, inter-republican co-operation has often taken place on an *ad hoc* basis rather than in a structured manner.

The commitment undertaken in the Constitutional Charter to adjust the republican Constitutions within six months from the entry into force of the Constitutional Charter was not met. In *Montenegro*, the parliamentary crisis, provoked by the opposition boycott, has blocked any significant activity in this respect. In *Serbia*, the process of constitutional reform,

where the key outstanding issues concerned decentralisation and the mode of election of the President, was suspended as a result of the dissolution of the Parliament. The new Parliament is expected to carry out the reform of the republican Constitution by June 2004.

**Parliament:** At the state level, the Constitutional Charter provides for indirect election of members of the State Parliament for the first two years. The two republican Parliaments adopted legislation for the nomination of the respective members of the State Parliament in mid-February 2003 and subsequently appointed these MPs. After the Serbian parliamentary elections of December 2003, the Serbian Parliament elected the new Serbian members of the State Parliament in February 2004.

The State Parliament engaged in very limited legislative activity, mainly related to the adoption of laws on the establishment and functioning of other state institutions, as well as the ratification of international agreements. There have been delays in implementing this agenda, as in the case of the approval of the Trade and Internal Market Action Plan. The role of the State Parliament is also limited by the fact that it has no budgetary competencies: the financing of State Union institutions and functions is not done through own resources, but depends wholly on funding by the republics according to criteria that are agreed between them. The State Parliament cannot even decide the sectoral allocation of these funds. The financial viability of the state remains therefore precarious.

The State Parliament has been operating under provisional rules of procedure. The committee system has not been fully established. A step forward was made with the establishment in April 2003 of the Committee for parliamentary oversight of the military security service, but this committee has not become fully operational. New rules of procedure that envisage significant changes to provide for greater efficiency are pending. Positive steps have been taken concerning technical modernisation (including increasing computerisation).

In *Serbia*, the special conditions under the state of emergency, political disputes and the drawn-out debate on no confidence motions against the Speaker of the Parliament and the Government (October-November 2003) slowed down significantly the legislative activity of the Parliament.

The functioning of the Serbian Parliament was affected by serious cases of non-respect of the rule of law. The Parliament failed to enforce the ruling of the Constitutional Court which declared provisions allowing party/coalition control of seats unconstitutional, as they violate the independent mandate of individual MPs. There was substantiated evidence of irregular voting on the occasion of the appointment of the Central Bank Governor. In addition, when appointing the members of the Broadcasting Council, the Parliament did not respect the procedural requirements foreseen by the Broadcasting Law.

The protracted institutional crisis and political instability in Serbia resulted in the dissolution of the Parliament in mid-November 2003 and early parliamentary elections in December 2003. As regards the electoral legislation and procedures, progress has been made in updating voters' registers in co-operation with OSCE; this work needs to be completed and requires further efforts. As recommended by the 2003 SAP Report, there has been some progress in revising the legislation on parliamentary elections in line with the recommendations of ODIHR and of the Council of Europe. In particular, one of the first measures taken by the new Parliament in early 2004 was to abolish the threshold for parliamentary representation in the case of parties representing ethnic minorities.

In July 2003, the Serbian Parliament adopted a new Law on Financing of Political Parties, an important piece of legislation for the transparent conduct of elections. As this law entered into force in January 2004 it did not cover the November 2003 presidential elections nor the

December 2003 parliamentary elections. Implementation has now started. However, other related legislative reforms on Political Parties are still blocked. An important step was the setting-up of a Committee for European Integration in the Serbian Parliament in May 2003.

In *Montenegro* a draft law amending the legislation on financing of political parties to ban anonymous donations, control party funding and limit private financing is in parliamentary procedure.

Legislative activity in the Montenegrin Parliament was intense. However, its democratic functioning was affected by events which are a cause of concern. The post of Speaker remained vacant from May 2003 until the end of July 2003 because of a lack of agreement in the ruling coalition. In September 2003 the opposition parties decided to withdraw permanently from the Parliament. The move was initially triggered by the decision of the new Managing Board of the public TV network - on the basis of the new media legislation - to stop live broadcasts of parliamentary sessions. However, the opposition subsequently added a new set of conditions for its return to the Parliament, including early parliamentary elections, and continues to boycott all parliamentary work.

**Government:** At state level, in line with the Constitutional Charter, the Council of Ministers comprises only five portfolios, namely: foreign affairs, defence, international economic relations, internal economic relations and human and minority rights. The Council of Ministers was constituted in March 2003 and the legislation regulating the organisation and work of the Council of Ministers was adopted in mid May 2003. The division of competencies in some critical instances has remained unclear (e.g. in the area of asylum). The functioning of ministries and agencies was affected by insufficient resources. In particular, the Human and Minority Rights Ministry, although performing well under these circumstances, was given new competencies without the equivalent transfer of resources. The individual performance of ministries varied significantly. Due to these problems, there has been little decision-making in the Council of Ministers.

In *Serbia* the authorities managed to preserve the stability of the institutions after the assassination of PM Djindjic. The new PM was appointed just six days later on 18 March 2003.

A new Law on Ministries was adopted in April 2003, accompanied by a decision on the status of former federal institutions, now transferred to the republican level. This implied the formal transformation of some institutions into republican ones (such as customs), and also a widening of the competencies of existing ministries (e.g. the Finance Ministry was assigned anti-money laundering competencies).

The opposition made serious allegations against some ministers and top officials concerning cases of corruption, fraud, money-laundering and conflict of interests. In some instances, dismissals and resignations ensued, followed by the start of legal action, but overall the authorities reacted with delays.

The Government was slow to propose some key bills (e.g. conflict of interests; election laws; freedom of association), while some legal changes (notably in the judicial sector) were drafted in a non-transparent manner. A positive step was the decision (from September 2003) that all draft legislation prepared by ministries should provide a statement of its compliance with the *acquis*.

In *Montenegro*, the Government which had been constituted in January 2003 continued to be in place (despite the resignations of some ministers). However, some of the newly-formed Ministries, such as the one in charge of European integration, lack infrastructure and resources. The administration showed considerable transparency and wide consultation (of

both local and international experts) in preparing new legislation. Some initiatives, such as those in the area of anti-corruption, involved NGOs to a certain extent. Serious allegations about possible government involvement or at least negligence concerning a human trafficking case led to major political disputes. The government took some steps to follow-up the OSCE/Council of Europe report on this case, notably by proposing major reform in the criminal legislation, and the adoption of anti-trafficking strategy (in November 2003) which needs to be implemented effectively.

**President:** At the state level, the President was elected by the State Parliament in early March. In line with the new constitutional arrangement, the President of the State Union also chairs the Council of Ministers and the Supreme Defence Council. Both institutions have a key role in streamlining the reforms at the state level. The State President is in addition the head of a new body, the Council for European Integration, a high-level political institution supposed to discuss and oversee all EU-related issues. In spite of limited competencies and heavy dependence upon cooperation by the republics, the State President showed commendable commitment in trying to make the existing and agreed solutions work. His exchange of apologies with the Croatian President and apology to the people of Bosnia and Herzegovina were acts of courage promoting reconciliation and further cooperation in the region and raising domestically the painful issue of facing the past.

In *Serbia*, the post of President has been vacant since December 2002, and the Speaker has been the Acting President. The series of failed presidential elections in 2002 led to legislative amendments, resulting in the removal of the controversial threshold (50%+1) for the second but not the first round. Furthermore, ambiguous provisions concerning the timeframe for calling repeat elections resulted in the long-standing postponement of presidential elections. The Speaker's decision of February 2003 to delay the presidential elections until November 2003 was later declared unconstitutional by the Constitutional Court. The elections on 16 November 2003 failed to achieve the threshold required and protracted the institutional vacuum. The new Parliament abolished the threshold in February 2004 and the Speaker has indicated that the date of the presidential election will be announced in early April 2004.

In *Montenegro*, problems with repeated failures of the presidential elections (in December 2002 and February 2003) were resolved with the legislative changes of February 2003 (abolition of the turnout requirement for both election rounds) which led to the election of Filip Vujanovic in May 2003.

**Local government:** In both republics, there was some progress in the decentralisation and establishment of local government, but the problems of lack of efficiency, resources and transparency persisted. The recommendations of the 2003 SAP Report were thus only partly met.

In *Serbia*, the implementation of the 2002 Law on Local Government continued. It was accompanied by welcome steps to improve financial autonomy. However, municipal administrations are still weak. The new Ministry for Public Administration and Local Government (established in 2002) took several initiatives, including improving voters' registers at the local level. However, its capacities remained limited in terms of human resources and infrastructure.

As regards Vojvodina, the Serbian Parliament transferred some administrative competencies to the regional authorities, but no regional self-government has been established.

As regards Southern Serbia, while improvements occurred in the past two years, the situation has remained volatile. The lack of confidence among the ethnic communities made difficult the establishment of the municipal authorities (in particular in Presevo and Bujanovac). The

situation in Bujanovac has been resolved and the municipal assembly functions; whereas the continuing problems (inability to meet for a period of more than three months) in the functioning of Presevo municipal assembly led the Serbian Government to dissolve the assembly in December 2003. In accordance with the law, a provisional council has been established. The Serbian Government has been making credible efforts to improve the overall situation, in particular the poor economy and infrastructure, and received significant international support. The security situation deteriorated in summer 2003. In spite of several armed incidents and attacks against the police and army units, the authorities showed restraint and managed to keep the situation under control.

In *Montenegro*, the key development was the adoption of a set of laws in July 2003, notably the Law on Local Government, Law on Financing of Local Government and Law on Election of Mayors. The new legislation provided for genuine municipal competencies and some own resources (through municipal taxes and other charges). However, financial means remain inadequate, which makes implementation of this reform particularly problematic.

**Public administration:** As regards the state level, problems of financing of the state functions seriously impeded their performance. The principle of financing for 2004 based on the territorial principle was agreed between the republics (after an initial split based on GDP figures), but different interpretations on how to implement this continue, with severe consequences for the functioning of the state level institutions. Against this background, there was little progress in the necessary reforms to state administration, including downsizing and complementary social programmes. The state administration, with isolated exceptions (such as in the area of defence or human rights) did not take major initiatives and was strongly dependent upon the republics, even in the implementation of competencies under its jurisdiction. Some valuable training initiatives (initiated, for example, by the state European Integration Office) were, however, a good signal.

In *Serbia*, some awareness of the need for streamlining of the existing institutions emerged in 2003. However, the strategy for public administration reform is still delayed. Some key regulations to provide for public accountability of elected officials and civil servants, and tackle corruption (such as the code of conduct for civil servants, law on prevention of conflict of interests, ombudsman law) are still in preparation. Spill-over of party interests into the administrative machinery, poor equipment, lack of training for civil servants and insufficient accountability persist and need to be tackled.

In *Montenegro*, on the basis of the Public Administration reform strategy adopted in May 2003, the Parliament adopted a new Law on Public Administration in June 2003. Regulations governing the status of civil servants are in preparation. The ombudsman office was established, based on a law adopted in summer 2003, but at the very outset faced the issue of lack of resources. New procedural legislation (administrative litigation) is in preparation, as well as a Code of Conduct for civil servants. All drafts undergo a wide public consultation (including with trade unions), and envisage major changes to the obsolete system, to affect the status of civil servants at all levels. The objective is to introduce professionalism and more transparency (through obligatory public competition for all posts apart from ministerial and very limited number of personal advisers). A separate organisational unit for human resources management will be established (2004 budgetary allocation has been ensured), and a new salary system introduced. The whole system should be in place as of January 2005. The real challenge will be its implementation, as the changes do introduce major new developments and will affect a large number of civil servants.

**Civil society:** Civil society in Serbia and Montenegro has been developing rapidly in the past decade. NGOs, students' and women organisations have been largely instrumental in bringing

about the democratic changes, with the core of their work being devoted to issues related to anti-war activities and human rights violations. Although, in view of this, they are still largely perceived as human rights organisations, their role has evolved, and they have been taking an active part in promoting economic and social reforms and human development. This is a demanding task, in view of their rather weak capacities and infrastructure, notably at the local level. However, some steps forward were made during the elaboration of the Strategy for Poverty Reduction, where NGOs were involved. There is a dispersed network of NGOs in Serbia and Montenegro (around 20,000), but only a limited number perform genuine NGO activities. There is a growing number of NGOs dealing with environmental issues, but with limited impact.

There is a large number of trade union organisations, but only a few are genuinely active and representative (three major ones in the country). Employers' organisations also exist, but are generally weak. Social dialogue is institutionalised, but is marked by a lack of trust between participants, weak organisational capacities and diverging views concerning the sequence of reforms. In both republics tri-partite Social and Economic Councils were established, which have so far shown little practical result. Collective bargaining is provided for in the law, but remains at rudimentary level. Churches, notably the Orthodox one, have increasing public prominence, but the extent of its public engagement and occasional politicisations remain an issue of social divide.

Some positive steps have been taken to enhance formal co-operation with NGOs and take their views on board. The special circumstances under the state of emergency in *Serbia* adversely affected the monitoring role of NGOs, but most of them resumed this activity after the return of normality. In *Montenegro*, the Government is preparing legislation on co-operation with the NGO sector, which should formalise the *ad hoc* relations. It should also better regulate procedures for financial support. In both Serbia and Montenegro the NGO sector largely remains dependent on donor assistance; hence there is need to tackle the issues of self-sustainability and capacity building.

**Armed Forces:** There has been important progress in the reform of the sector which is a state level competence. This is a very welcome step in meeting the recommendation of the 2003 SAP Report.

A comprehensive legislative reform was set in train. Drafting takes place with an unprecedented transparency and wide public consultation. This should result in the preparation of the new defence strategy and military doctrine (to be adopted at state level) coupled with the national security strategies, which under the Constitutional Charter will be the competence of the republican Parliaments. This complex architecture will require good co-operation between the republics and the state and republican level. Once adopted, the above strategies should allow for the necessary revision in the existing defence and army laws.

With major legislative changes in preparation, important practical steps have been taken. Organisational changes were introduced to allow for civilian control over the Army; however, these changes will need time to become fully effective. Financial control has been entirely taken over by the civilian institutions. Important new legislation concerning trade in weapons and military equipment has been drafted to ensure full transparency and reduce the possibility of abuse. Progress was made in introducing transparency in military procurement with the establishment of the Public Procurement Agency.

Significant personnel changes were made, with the retirement or dismissal of a considerable number of high-ranking officers, some of whom had had close ties with the former regime, or

were indicted by ICTY. On the latter, the Ministry also took important steps, notably by disbanding in April 2003 the Army commission for co-operation with ICTY which was in reality obstructing co-operation. In addition, the Ministry issued an order instructing all Army personnel to report any information they may have on the whereabouts of ICTY indictees, and to participate in their arrests, should the indictees be in military locations.

The civilian control of the army needs to be extended to the defence industry. Also, necessary legal clarifications as to military property still need to be undertaken.

Additional positive steps include the start of border demilitarisation, albeit partially (on the Montenegrin part of the border only) and the entry into force of a decree allowing civilian service in institutions – such as social facilities and hospitals.

The authorities also engaged in intense international co-operation and Serbia and Montenegro formally applied to participate in the NATO Partnership for Peace programme. In August 2003, the Supreme Defence Council agreed to allow Army personnel to take part in UN peacekeeping operations; on a voluntary and professional basis (the relevant legislation is in preparation).

According to the Ministry of Defence, the military reform will lead to downsizing the Army probably from almost 80,000 to between 45-50,000 personnel. In this regard, the adequate socio-economic measures will be needed to deal with the redundancies. The foreseen downsizing would help to reduce the burden of defence expenditure down from the current level of around 5% of GDP. This would allow the government to reallocate budgetary resources to key priorities in other sectors.

### ***2.1.2. Assessment of judicial system, law enforcement and respect for rule of law***

**Judicial system:** At the state level, the State Court (which has constitutional control functions) has not started operating yet. The Law on the State Court was adopted in June 2003, but the State Parliament has not yet appointed the judges, and disagreement as to its competencies persists. The Court is the only state institution having its seat in Podgorica and according to the inter-republican arrangement on the financing of state institutions it should be funded by Montenegro. However, the Montenegrin Government argues that it faces financial difficulties in providing adequate premises and infrastructure.

Despite provisions in the Constitutional Charter, military courts continue to function, with an unclear timeframe for the adoption of the legislation concerning the full transfer of jurisdiction to the civilian courts. The relevant recommendation of the 2003 SAP Report has thus not been met.

In *Serbia*, the situation of the judiciary was affected by the introduction of the state of emergency. While it enabled the government to investigate individual cases of misconduct or corruption of judges and prosecutors, the state of emergency also led to wider, more structural measures including legislative and personnel changes, based on irregular procedures. The initial order establishing the state of emergency was followed by additional measures allowing for suspension of court presidents and prosecutors outside the usual legal procedures. Replacements were appointed and their tenure subsequently confirmed as permanent. In March 2003, the Serbian Parliament decided to retire 35 judges (including one from the Supreme Court), without the legally required involvement of the Supreme Court. Legislative changes were also made under the state of emergency, but remained in force after its lifting on 22 April 2003. These changes affected the status of prosecutors: by replacing permanent tenure for deputy prosecutors with an 8 year mandate and increasing the role of the executive in the appointments procedure. The independence of court presidents was

undermined through the establishment of an administrative body – the Council for Court Administration – in charge of their appointment and dismissal.

The implementation of the Council of Europe post-accession commitments was the subject of a Protocol on Co-operation, signed in June 2003 with the Council of Europe and envisaging major amendments in the set of judiciary laws, criminal legislation and legislation regulating execution of criminal sanctions. Little progress has taken place as regards the implementation of this Protocol.

The establishment of new, administrative and appellate courts was planned for 1 January 2004. These courts would take over some functions of existing district and municipal courts. However, since the necessary parliamentary decision on the appointment of judges to the new courts was not taken due to the parliamentary crisis, the Serbian Constitutional Court decided to postpone the implementation of the law to avoid a legal vacuum.

Court efficiency needs to be improved significantly. Court statistics are managed by their respective supreme courts. According to a report presented by the Serbian Supreme Court in March 2003, a total of 451,817 cases remained unsolved, or 29% of the total number of cases dealt with by all courts in 2002.

In both republics, new Civil Procedure Codes are still awaiting adoption. Due to the still applicable obsolete procedures, civil proceedings on average take up to 4-5 years, some even up to 10 years. A new Serbian law on judges (from 2001) made an attempt to address the issue and improve efficiency (introducing mandatory regular deadlines for a judge to report on the status of a case), but this has produced few concrete results.

Despite certain improvements, much remains to be done. The authorities are tackling the problem of backlog of cases by initiating a revision of procedural laws (notably civil codes and executive acts), as well as by improving infrastructure and resources. The establishment of administrative and appeals courts, envisaged in both republics, is also important in this respect, notably in view of relieving the Supreme Courts of some of its workload (such as acting upon appeals) which will be transferred to new courts.

There is still a considerable lack of public confidence in the judicial system, as a legacy of the past decade and structural weaknesses of the system. According to the *Montenegrin* Ministry of Justice, based upon the information from the republican Prosecution Office, in 2003 no cases were recorded involving charges against judges or prosecutors on the grounds of corruption-related acts.

The financial position of courts has improved, including salaries; infrastructure (new buildings, renovation of existing premises; new cars; IT equipment). As for prosecutors, the situation is much less favourable. Training is undertaken, notably with the involvement of the Judicial Training Centre (with, however, still insufficient participation by the court administration). There have also been some improvements in court computerisation. As for war crime trials, Serbia has adopted specific legislation and appointed in July 2003 a special prosecutor. Specialised judicial bodies were set up to deal with organised crime.

The enforcement of civil decisions is a major problem in both republics, with an average delay in Serbia being 3 years. Bailiffs as such do not exist; there are court officials who, escorted by the police, are charged with enforcement on the ground, but they have limited capacities and in practice prove to be inefficient.

In *Montenegro*, some progress has taken place with the adoption in December 2003 of the Criminal Code, Criminal Procedure Code and Law on the Public Prosecutor's Office which establishes also a specialised prosecutor for organised crime, who is appointed by the

republican prosecutor. Adequate resources are, however, still required for the proper implementation of the new legislation. The 2002 legislation on courts foresaw the establishment of the administrative court and of the court of appeal and reinforced the safeguards of the independence of judges, including the appointment and dismissal procedure where the main role is reserved to the High Judicial Council, a body composed of practitioners and without the involvement of the executive. However, the implementation is still insufficient. Judicial accountability in practice continued to be subject to politicisation rather than legal procedure. The establishment of new courts – appeals as well as administrative – is now scheduled in June 2004. The financial independence of the court system remains a problem.

Judicial training has continued, but will have to include initial and vocational training for the implementation of the newly adopted criminal legislation as well as training in ethics in order to combat corruption. Short term measures are needed to improve the efficiency and reduce the backlog (new legislation on civil and executive proceedings, now in preparation, is important in this respect, and, at last, considerably improved training), as well as to enhance transparency in court proceedings and general legal awareness.

**Penal/Prison system:** In *Serbia* the state of emergency introduced significant restrictions (such as prolonged police detention, up to 60 days incommunicado detention, suspension of judicial review, etc), some of which were declared unconstitutional by the Serbian Constitutional Court in June 2003. The restrictions were then repealed in July 2003. An OSCE/UN monitoring mission (April 2003) came up with findings concerning the overall conditions in prisons, notably in detention facilities (in particular overcrowded cells, inadequate health care, etc.) which are a serious cause for concern. The Serbian Ministry of Interior reported that additional steps were taken to improve health care, but also general living conditions (correspondence, leisure time, provision of clothing, etc). International Organisations and NGOs reported cases of ill treatment and even serious allegations of torture, notably during Operation *Sabre*. So far, there has been no clear evidence that those claims have been fully investigated. Meanwhile, preparations for comprehensive reform of the prison system have continued. The training of inmates and rehabilitation of prisoners should be improved, together with particular attention to vulnerable groups such as juvenile offenders.

In *Montenegro*, the Parliament amended the law on the enforcement of criminal sanctions. This law provides for additional (court) protection of offenders, more explicit provisions concerning protection of basic human rights and the prohibition of all torture and similar acts. The situation in Montenegrin penal institutions is difficult, due to the lack of adequate resources and infrastructure. However, the treatment of prisoners is improving, and there are ongoing prison staff training projects. Nevertheless, special attention should be paid to further improving prison conditions of vulnerable groups, such as juveniles, but also drug addicts.

**Respect for rule of law:** Continuing differences in the interpretation of the Constitutional Charter, followed by delays and obstruction in its enforcement, and the still unclear distribution of powers – de jure and de facto – between the various levels added to the constitutional and legal uncertainty. The delayed establishment of the State Court has created an institutional and legal vacuum, resulting in denial of justice at the state level. The failure of the republics to adjust their Constitutions to the Constitutional Charter has led to the parallel existence of different constitutional and legal systems. The problem of the coexistence of new legislation and obsolete laws continued. All this seriously affects the rule of law in Serbia and Montenegro. The constitutional re-structuring led to the abolition of all former federal structures in charge of police and justice issues. Improved, institutionalised co-operation

between the relevant republican instances is necessary in order to achieve nationwide law enforcement, as well as efficient international police co-operation.

In *Serbia*, the introduction of the state of emergency (12 March 2003) temporarily suspended full implementation of the rule of law and of human rights. There was a tendency to adopt or amend important systemic laws (notably on the judiciary, criminal law and media) during the state of emergency, with insufficient transparency.

In addition, the authorities (both the Parliament and Government) showed a tendency towards non-enforcement of the rulings of the Serbian Constitutional Court and lack of respect for its independence. This is a source of serious concern.

In *Montenegro*, personnel changes in the judicial sector (notably in the Prosecution office) were subject to political interference, rather than to due legal procedure. There was a continuation of the practice of interfering with judicial decisions, and even alleged threats to some judges.

Corruption is an area of major concern. Some legislative progress was achieved with the adoption of the Law on Financing of Political Parties in *Serbia* in July 2003, and the Anti Money Laundering Law in *Montenegro* in September 2003. They still need to be fully enforced, as other key anti-corruption laws, such as codes of conduct for public servants or laws on prevention of conflict of interest in both republics, still need to be adopted. This legal vacuum has in practice led to a failure to react to some serious allegations, involving top government officials and ministers. Comprehensive anti-corruption strategies are still lacking. The existing institutions in the anti-corruption field lack political support and in their view are sometimes obstructed even by the government.

On the positive side, Serbia and Montenegro ratified in October 2003 the European Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime. It joined the Council of Europe's GRECO initiative (Group of States against Corruption). No evaluation mission has yet taken place. In December 2003, Serbia and Montenegro acceded to the UN Convention for the Fight Against Corruption.

## **2.2. Human rights and protection of minorities**

*There was some progress in the field of human rights. The accession to the Council of Europe in April 2003 and the Ratification of the European Convention for Human Rights and of the European Convention on the Prevention of Torture (in March 2004) were important positive developments. The authorities now need to ensure the effective implementation of these conventions. On the other hand, the state of emergency in Serbia affected the respect for human rights.*

*There has been steady progress in the implementation of minority rights. However, the lack of clarity of the new constitutional arrangement and a lack of coordination with the parallel Montenegrin institutions impeded efforts in these fields, affecting compliance with some of Serbia and Montenegro's international obligations.*

The basic human and minority rights are enshrined in the new Charter on Human and Minority Rights, adopted on in February 2003. The Charter has the force of a constitutional law. A good state Law regulating minority rights from 2002 exists, but *de facto* only applies in Serbia –as Montenegro is preparing its own legislation. Whereas for most of 2003 there had been almost no cooperation between the state and Montenegrin authorities, a positive change took place in October 2003, with the establishment of a sub-office of the State Ministry for Human and Minorities Rights in Podgorica, headed by a Deputy Minister appointed by Montenegro.

The complex division of competencies has led to difficulties in coordination and affects the implementation of the state's international obligations. Reporting under the UN international treaties was late, due to the different pace of preparation of the respective republican contributions.

The ratification in March 2004 of the European Convention for Human Rights (ECHR) and of the European Convention on the Prevention of Torture was an important development. It is essential that the ECHR is properly implemented by the competent authorities. In addition, as the State Court to be established is competent to treat the cases before they reach the European Court of Human Rights, the fact that this State Court is not yet established undermines the implementation of the Convention. The ratification of other key conventions, notably the European Charter on Regional and Minority Languages, should also take place soon, in line with the Council of Europe recommendations.

The State Ministry for Human and Minorities Rights continued doing good work, despite the fact that the new constitutional arrangements resulted in the transfer of additional competencies (related to readmission, migration issues, etc.) without an equivalent transfer of resources. In addition to excellent cooperation with the civil sector, the Ministry established a legal aid office to address concrete cases of human rights violations, accompanied by a media campaign to raise public awareness. Republican legislation has not yet been fully aligned with the applicable human rights standards and discriminatory provisions and practices (especially concerning women, Roma and other vulnerable groups) persist. An Anti-Discrimination act is in preparation by the Ministry.

### **2.2.1. Civil, political, economic, social and cultural rights**

**Lustration:** The *Serbian* Parliament in May 2003 adopted the Law on Accountability for Human Rights Violations. Its implementation, however, has not started, as the relevant Committee is not fully constituted and operational. In July 2003, eight out of nine members were appointed by the Parliament, but the parties of the former regime refuse to take part in the lustration committee as they see the Law as an act of political revenge. The Law targets human rights violations committed since 1976 (the year of entry into force of the International Covenant on Civil and Political Rights) and serves to screen all stakeholders and candidates for top positions (including at local level) in the parliaments, governments, judiciary, law enforcement agencies, diplomacy, army, and economic and financial institutions. In addition to the procedural problems, enforcement is affected by the lack of relevant legislation concerning access to state security files.

**Access to court and fair trial:** In line with the Constitutional Charter the whole criminal justice system, including the procedural laws - previously a federal competence, was transferred to the republics.

In *Serbia*, in addition to the new Criminal Procedure Code (adopted as a federal law in 2002, now applied as a republican act in Serbia) there is separate legislation on competencies and procedures in fighting organised crime. This legislation was significantly amended during the state of emergency, suspending some basic rights in the pre-trial procedure and giving wider powers to the police.

The *Montenegrin* parliament adopted the Criminal Code and Criminal Procedure Code in December 2003. The Codes were prepared with wide public consultation and international expertise.

In order to ensure coherence in the legal system, it is essential that the two republics adopt the relevant legislation as soon as possible, including the new police laws.

**Freedom of association:** In *Serbia* there has been no progress on the legal status of both domestic NGOs and foreign associations (which have no legal basis). The Ministry for Public Administration and Local Government is preparing a new draft, in cooperation with the civil society. The tax regime remains unfavourable, hindering NGO's work and independence.

In *Montenegro*, NGOs status is guaranteed by the legislation, but NGOs have requested amendments to the current Law, notably concerning full tax exemption of all genuine NGO activities, but also fiscal incentives for private donors.

**Torture:** The issue of torture and abuse of notably prisoners' rights has long been a concern in both Serbia and Montenegro, although international organisations report that there has been a declining trend. The state of emergency in *Serbia* however highlighted a number of points of concern, such as the need to tackle both torture as such as well as other grave abuses of human rights. Regarding reports of abuses, notably in the Amnesty International report of 2003, the administration tended to fall back on the specific denial of torture while remaining far more circumspect on the broader issue of abuse of human rights.

There were serious allegations of torture and ill-treatment of detainees and prisoners in *Serbia* during the state of emergency. The Serbian police initially dismissed the allegations, subsequently insisting that an internal investigation (by the Inspector General) was ongoing. However, so far there has been little information as to its progress.

Many of the allegations relate to pre-trial detention. This has thrown up a clear distinction in the actions of Ministries. The Serbian Ministry of Justice indicated on a number of occasions that this is not a matter within its responsibility while the Serbian Ministry of Interior noted that complaints have been investigated and have been found to be groundless. The opaque investigative process within the Ministry of Interior does not however enable justice to be seen to be done and further fuels concerns raised in particular by local human rights organisations that there is no effective independent investigation of complaints. Similar concerns have also been voiced about investigative procedures in place in Montenegro which are characterised by a similar lack of transparency. Serbia and Montenegro is a signatory to the relevant UN instruments and has ratified the European Convention for the Prevention of Torture. However the issue of torture remains a source of concern. While the new Montenegrin Criminal Code includes torture as a specific offence, in Serbia the legislation has still not been amended.

An increase in cases of police torture in *Montenegro* is quoted by the Council of Europe. These cases are rarely addressed and punished, notably due to the fact that the prosecution has to rely upon the cooperation of the police, which often leads to obstruction. Pressure upon victims not to press charges is also reported.

**War crimes:** *Serbia* adopted specific legislation in July 2003 on the organisation and jurisdiction of the republican institutions in prosecuting war crimes. The Special Prosecutor was appointed in July 2003, special police units and detention facilities are in the process of establishment. The domestic judiciary held two trials dealing with war crimes, which did not target any high-ranking police or Army officers and did not investigate higher-level command responsibility. An OSCE monitoring assessment (October 2003), while acknowledging the government's commitment and efforts, noted legislative and procedural deficiencies which would not allow the efficient conduct of domestic war crimes trials at this time. For instance, command responsibility for war crimes is currently not laid down as a formal offence in its own right; there are legal shortcomings and practical problems related to witness protection mechanisms, and the independence of the Special Prosecutor for War Crimes and of the War Crimes Chambers is not yet adequate. Most fundamentally, there is a lack of the political will

and the proper environment for fair and comprehensive trials. Furthermore, there has been lack of progress in the investigation of mass graves identified in 2001 (Batajnica).

**Freedom of expression and media:** Legal and practical impediments to the free operation of media persist. In *Serbia*, the Parliament violated some procedural requirements foreseen by the Broadcasting Law for the appointment of the Broadcasting Council. No action has been taken to remedy the situation. This is a source of concern also with a view to the allocation of the broadcasting licences.

The Serbian Parliament also adopted a Law on Public Information. However, the too broad definitions of exceptions allow for additional restrictions of freedom of expression to be introduced. The depenalisation of slander and libel is pending in Serbia.

A positive development was the conduct of the media and the lack of political interference during the presidential election campaign and of the parliamentary election campaign in November and December 2003.

In *Montenegro*, the implementation of the 2002 set of media laws has continued, albeit with difficulties. Notably, the cancellation of previous live broadcasts of parliamentary sessions triggered a parliamentary crisis involving a long-term opposition boycott.

The provisions on prison sentences for slander and libel were removed from the Criminal Code in December 2003. Fines now replace prison sentences. A draft law on free access to public information has been prepared and should be adopted in line with the recommendations of the Council of Europe.

**Ombudsman:** The establishment of an Ombudsman office at the state level is not foreseen by the Constitutional Charter. In *Serbia* the adoption of the Ombudsman law is pending; meanwhile the Provincial Assembly of Vojvodina established an ombudsman office at the provincial level. *Montenegro* adopted its own legislation and subsequently in October 2003 appointed an Ombudsman, but the establishment and functioning of the Office is confronted with financial and infrastructure problems.

**Property rights:** The problems concerning the restitution of private property in *Serbia* persist. No legislation has been adopted, including on restitution of property to churches and religious communities. The authorities are confronted with an increasing number of claims for property return. This basic lack of legal certainty may also adversely affect the process of economic reform.

*Montenegro* is preparing a new Restitution Law, following the constitutional appeal, which the Government lodged against the act adopted in 2002. Meanwhile, the authorities claim that significant property was returned.

**Labour rights:** The legal framework has improved in both republics, through the adoption of new employment laws. In *Montenegro* a Law on strikes was adopted in July 2003, while *Serbia* is currently preparing its new law. However, implementation of legislation is often difficult. The functioning of labour inspectorates should be strengthened.

**Gender equality:** Serbia and Montenegro is a signatory to the UN Convention of Elimination of all Forms of Discrimination against Women (CEDAW) and its accompanying Protocols. The national legislation is also mostly in accordance with international standards, but the adoption of an Anti-Discrimination Act is necessary as a further guarantee and protection mechanism. In spite of the fact that there are no legal restrictions, the representation of women in public life remains poor, as is their practical access to job opportunities.

**Academic freedom:** Serbia and Montenegro is a signatory to all the relevant UN treaties that include guarantees of equal access to education and academic freedoms, and signed the Bologna Declaration in September 2003. Furthermore, there are solid guarantees in the national constitutional and legislative acts, including towards minorities.

**Religious freedom:** There have been no developments in the adoption of new legislation, although drafts were prepared earlier (at the then federal level). Generally, the situation in this field is positive.

### ***2.2.2. Minority rights and refugees***

There has been steady progress in the implementation of minority rights, but problems in ensuring full and adequate cooperation between different levels of government persisted, affecting compliance with some of Serbia and Montenegro's international obligations.

Work has continued on Roma integration and a special directorate was established in the Ministry in April 2003. The NGO community was fully involved and valuable cooperation with the media also began. In coordination with the Serbian authorities, several actions to support the Roma community were taken, including free distribution of school textbooks and support in secondary and high education. In spite of these valuable efforts, the vulnerable situation of the Roma community persists and it continues to face discrimination and practical problems notably concerning housing.

The establishment of National Councils under the 2002 minorities act has continued, albeit with apparent problems concerning the issue of representation within the national groups. There has been progress in the use of minority languages, including in southern Serbia<sup>1</sup> with the official use of Albanian. The multi-ethnic police project continued successfully, and was complemented by a welcome step by the Serbian Ministry of Interior which provided for the translation of the new Code of Conduct into minority languages. The Provincial Assembly of Vojvodina adopted a Decision in May 2003 regulating the use of minority languages and alphabets, including in the public administration.

International agreements on minority rights have been signed with countries in the region (Hungary and Romania), and agreements are pending with Croatia and Albania.

*Montenegro* has been preparing its own legislation. Steps have been taken to improve the situation of the Albanian community. The adoption of the Ombudsman Law is a positive development, but the Ombudsman Office needs adequate resources to allow independent and unhindered operation.

In both republics, an outstanding issue is the under-representation of minorities in public services and in Parliament. In *Serbia* the election legislation which affected the position of minority parties in December 2003 elections was amended by the new Parliament: in case of parties representing ethnic minorities, the threshold for parliamentary representation was abolished. *Montenegro's* legislation includes some affirmative provisions for the Albanian minority, such as set-aside seats. Widening these provisions to other minority groups needs to be considered.

The high number of refugees and internally displaced persons (IDPs) continued to burden the difficult economic and social situation in both republics. According to the *Serbian* authorities, there are currently 278,000 refugees and 207,000 registered IDPs. The authorities are making efforts to address the issue, in cooperation with countries in the region and with UNMIK. The implementation of the 2002 National Strategy continued, but with difficulties. Integration is reliant upon scarce financial resources.

---

<sup>1</sup> The State Ministry for Human and Minority Rights has a sub-office in this region.

The implementation of the new legal provision allowing dual citizenship in practice resulted in the decrease – in legal terms - of the number of refugees, as some of them lost that status by getting Serbia and Montenegro citizenship. The enforcement of the October 2003 Agreement on the return of refugees with Bosnia and Herzegovina is expected to facilitate safe return. The issue of refugee status and deregistration is one which should receive greater attention in the coming year. There are legislative difficulties, notably the obsolete (1992) Refugee law in Serbia, and also problems on the ground. These in particular concern administrative practices and bureaucratic procedures, affecting the ability to obtain personal documents, establish residence and access social and health services.

### **2.3. Regional and international co-operation/obligations**

#### **2.3.1. Regional co-operation**

*Serbia and Montenegro's steady progress in regional cooperation has continued, although some outstanding issues persist, notably border demarcation (with Croatia and Bosnia and Herzegovina) and these countries' lawsuits against Serbia and Montenegro before the International Court of Justice. Keynote events were the exchange of apologies between Serbia and Montenegro and Croatia for crimes committed in the recent past, and the unilateral Serbia and Montenegro apology to the Bosnian people. Political dialogue continued, coupled with the signing of some important agreements (concerning refugee return, visa suspension, fight against organised crime and terrorism). There was a successful dialogue with Hungary over the introduction of its visa regime, but differences with Romania on the same issue. Intensive multilateral cooperation also continued. After major delays due to Montenegro's refusal to apply the state's international obligations and Serbian attempts to renegotiate parts of the treaties, the Free Trade Agreements with partners in the region were eventually finalised at the end of 2003 and were submitted for assent to the State Union Parliament in March 2004.*

Serbia and Montenegro continued its active participation in **regional initiatives**, notably as a very active and successful chair of the South East Europe Cooperation Process (**SEEC**), which held its summit in Belgrade in 9 April 2003, concluding the Serbia and Montenegro tenure.

Serbia and Montenegro also joined the **Black Sea Economic Cooperation Council** in April 2003 and the International Commission for the Protection of the **Danube River** in August 2003, and the final conference of the Working Union of Danube countries took place in Belgrade in October 2003. A framework agreement was also signed on the regulation of the **Sava River**.

A regional meeting of prosecutors took place in Belgrade in December 2003, involving participating countries of the **South East Europe Cooperation Initiative (SEECI)**.

Regional **cooperation in the transport and energy fields** was improved with regard to the SEE Transport Core Network and the Regional Energy Market (signature of a revised MoU on 8 December 2003)<sup>2</sup>. Serbia and Montenegro have complied with a number of provisions of the first MoU, but need to speed up work to meet the July 2005 deadline.

Serbia and Montenegro undertook intensive activity concerning military cooperation: in June 2003 the country applied for accession to the NATO **Partnership for Peace (PfP)**.

Although there are no major outstanding issues in Serbia and Montenegro bilateral relations with **Albania**, a deterioration occurred in August/September 2003. Concerning the status of

---

<sup>2</sup> Cf. section 4.4 "Co-operation in other sectors" of the Strategy Paper.

Kosovo, the Serbian Parliament adopted a Declaration confirming Serbian sovereignty over Kosovo. The Albanian Parliament dismissed such a reference in the Serbian document. In turn, the Serbia and Montenegro authorities reacted by lodging a formal demarche.

Additional controversy briefly occurred over the signing of an FTA between Albania and UNMIK, but did not impede final agreement on a Serbia and Montenegro-Albania FTA.

There is an ongoing political dialogue and 4 agreements were signed. A new border crossing was opened August 2003 (on the Montenegrin section of the Serbia and Montenegro borderline). An agreement on mutual protection of minorities is being negotiated.

Overall, there is good level of co-operation with **Bosnia and Herzegovina**. During his visit to Bosnia and Herzegovina, the Serbia and Montenegro President unilaterally apologised to the people of Bosnia and Herzegovina for any crimes committed by Serbia and Montenegro citizens, a further step towards regional reconciliation. There are currently 12 agreements and protocols signed. The two countries signed an agreement allowing their citizens to cross the border on the basis of ID cards only (by this act, Serbia and Montenegro is now treating all BiH citizens in an equal manner, previously only citizens of Republika Srpska benefited from this privilege). An important agreement on the return of refugees was signed in October 2003. This should help alleviate the difficult circumstances that Serbia and Montenegro faces with the high number of refugees from Bosnia and Herzegovina as the agreement is intended to contribute to the safety of return. The two key outstanding issues in Serbia and Montenegro relations with the Bosnia and Herzegovina are the suit against Serbia and Montenegro for genocide before the International Court of Justice and the demarcation of the borders. Also, Bosnia and Herzegovina is currently delaying the final phase of trade liberalization under the bilateral FTA with Serbia and Montenegro.

Relations with **Croatia** continued to progress. In September 2003 the Croatian President paid his first visit to Belgrade since 1991. The event was marked by an important exchange of apologies between the two Heads of State for any crimes that their citizens had committed against each other in the recent past. The decision in June 2003 was taken by the Croatian Government to suspend its visa regime for Serbia and Montenegro citizens until the end of 2003. There are currently 19 agreements and protocols signed between the two states (including on readmission and co-operation in the fight against organised crime), while 6 are in the pipeline (including on the border along the Danube and the protection of minorities). In parallel with the high-level contacts between the State Union and Croatian leaderships, Montenegro also developed its own bilateral co-operation.

The state authorities also made significant efforts to facilitate the voting of Croatian citizens, residing in Serbia and Montenegro and wishing to vote in the Croatian parliamentary elections in November 2003.

The main outstanding issues between Serbia and Montenegro and Croatia continue to be the full border delimitation, refugee return and the Croatian genocide lawsuit against Serbia and Montenegro before the International Court of Justice. In addition, an FTA between the two countries, tabled for ratification in the State Union Parliament of Serbia and Montenegro in early March 2004, is not in force yet. Rapid implementation of this FTA is important to further strengthen the commercial ties between the two states.

Overall relations with **FYROM** are good, with no major unresolved issues. FYROM is indeed the only former SFRY-Republic with which Serbia and Montenegro has an agreement on border delimitation and demarcation. Implementation is progressing. In 2003, there was an intensive political dialogue and a number of high-level visits by the FYROM leadership. The two countries have concluded 25 agreements and protocols. In July 2003, a Memorandum on

co-operation in fighting terrorism and organised crime was signed between the Serbian and FYROM Ministries of Interior.

Steady progress continued in relations with **Slovenia**, including the liberalisation of the transit visa regime for Serbia and Montenegro citizens (by the decision of June 2003, whereas Serbia and Montenegro had previously unilaterally abolished visas for Slovenian citizens). There is growing economic co-operation, and there are in total 18 agreements and protocols signed (including on readmission and co-operation in fighting organised crime). An agreement on military co-operation is being negotiated.

Very good co-operation continued with **Hungary**, including the successful outcome of talks concerning the introduction of the visa regime by Hungary in force as of November 2003. An agreement was signed on the mutual protection of minorities. This is being followed by talks concerning the conditions of dual (*i.e.* Hungarian) citizenship for the Hungarian national community in Serbia (Vojvodina). An FTA is in force, but will be abrogated once Hungary accedes to the EU.

No bilateral problems exist with **Bulgaria**. An FTA was signed, although belatedly, at the end of 2003 and submitted to parliamentary ratification in March 2004.

Difficulties have occurred in Serbia and Montenegro relations with **Romania**, following the decision by the latter to end the visa free regime for citizens of Serbia and Montenegro as of 16 January 2004. Problems regarding the FTA between the countries, due to both Montenegrin and Serbian demands for renegotiation, were finally solved at the end of 2003 and the FTA was submitted to parliamentary ratification in March 2004.

**Free Trade Agreements (FTAs)** in general posed a specific challenge to Serbia and Montenegro. The country has now finalised bilateral FTAs with all the Western Balkans countries, plus Bulgaria, Romania and Moldova, under the auspices of the Stability Pact. The constitutional debate considerably hampered the finalisation and implementation of these agreements. Serbia and Montenegro undertook to ratify its FTAs with Albania, Bulgaria, Croatia, Moldova and Romania only with significant delay (in March 2004) as compared to its neighbouring countries and after partial second-guessing of already agreed commitments, notably by Montenegro. Eventually, Montenegro agreed to reduce its wish-list of additional sensitive items to the absolute minimum. Moreover, some technical adjustments were necessary because of the adoption of the Action Plan<sup>3</sup>.

This issue illustrates both the poor functioning of the State Parliament, which has to give its assent to these treaties, and, more fundamentally, Serbia and Montenegro's problems in implementing its international commitments, which risks affecting the country's political and economic credibility.

An additional issue was linked to Kosovo. On the basis of UNSCR 1244, UNMIK committed itself to implement the Stability Pact MoU in February 2003, including the conclusion of FTAs in the region with interested parties. Partners in the relevant Stability Pact working group took good note of UNMIK's intention, to make sure that there are no gaps in the free trade venture in South Eastern Europe. Serbia and Montenegro initially contested this as prejudicial to Kosovo's final status and even threatened to block its FTAs with those countries which intend to sign an FTA with UNMIK (Albania has already signed one), but eventually proceeded to the ratification of its own agreement with Albania. Clearly, the successful liberalisation of regional trade must not be politicised.

---

<sup>3</sup> In this context, it is important to note that the Action Plan, which re-establishes the state's *erga omnes* trade regime for the future, cannot per se serve as an argument for ex-post revisions of the *preferential* free trade arrangements that Serbia and Montenegro has agreed bilaterally with its neighbours.

### 2.3.2. International co-operation and obligations

*Serbia and Montenegro's compliance with its international obligations varied. Accession to the Council of Europe was the key foreign policy development, and led to the ratification of ECHR. In spite of repeated commitment to full cooperation with ICTY, and some positive steps taken after the constitution of the new state institutions, overall cooperation remains seriously deficient, in particular due to the authorities' negative attitude when new indictments were announced in October 2003. The dialogue between Belgrade and Pristina commenced but the March 2004 events in Kosovo risk seriously undermining the encouraging developments in this field. There are no major problems in respect of the Dayton Agreement.*

**Council of Europe:** In April 2003, under the difficult circumstances of the state of emergency in Serbia, Serbia and Montenegro joined the Council of Europe, thus fulfilling one of its key foreign policy objectives. A series of other commitments was undertaken, including the signature and ratification of key Council of Europe conventions, but also the pursuit of important internal reforms and compliance with international obligations. Progress is under way concerning the signing of the Charter on Regional and Minority Languages, as well as with the signing of some anti-corruption instruments. Serbia and Montenegro also became a member of the Council of Europe's initiative GRECO (Group of States against Corruption).

A Protocol was signed with the Council of Europe in June 2003 on the reform of key pieces of criminal legislation and judiciary laws in Serbia; implementation is ongoing. However, there are difficulties concerning police legislation. On the positive side, valuable co-operation with the Council of Europe was established in the education of judges, prosecutors and prison staff, and teacher training. More commitments from the various authorities are necessary for Serbia and Montenegro to fully benefit from Council of Europe assistance.

**International Criminal Tribunal for the former Yugoslavia:** Serbia and Montenegro is still failing to comply with its international obligations concerning co-operation with the International Criminal Tribunal for the former Yugoslavia (ICTY). The October 2003 report to the UNSC by the Chief Prosecutor still saw cooperation as "difficult and heavily politicised".

In the course of 2003, there were some positive developments, such as changes in the State Law on Co-operation in April 2003, repealing the controversial provision allowing for handovers of only those already indicted before the law entered into force (2002). The composition of the National Council for ICTY Co-operation was completed, to reflect the full participation of both republics. The Ministry of Defence also made important steps with the disbanding of the obstructive Army commission and a binding order to all members of the Army to fully co-operate in arrests. However, these actions fall short of the required level of co-operation. Since March 2003, there has been the arrest and handover of one indictee and a number of voluntary surrenders.

The October 2003 report of the ICTY Chief Prosecutor noted the lack of real commitment to co-operation or readiness to take difficult steps. It also noted that about half of the indictees who are still at large, including Mladic, are in Serbia and Montenegro. There was little action to follow up the intelligence provided by ICTY in these cases which could have permitted arrests. The Prosecution also faces great difficulties regarding the access to archives, which is granted selectively and mostly only after the issuing of binding orders by the Tribunal. The modalities proposed by the Prosecution in February 2003 to provide access to the key documents, while at the same time taking into account Serbia and Montenegro's due concerns over confidentiality, have met with obstruction. Serbia and Montenegro's proposal would in

practice imply a ban on access to key documents before 1996 (thus with clear implications for the ICTY trials concerning crimes in Croatia and Bosnia). Further difficulties persist in relation to those files which Serbia and Montenegro authorities feel may point to the then involvement of the Serbian regime in the crimes committed in Bosnia and Herzegovina, and thus be used by the country in its current suit against Serbia and Montenegro before the International Court of Justice. The Prosecution also reports that the process of issuing waivers for witnesses remains slow and difficult, directly affecting the length of the procedure before the Tribunal. Decisions are still pending in about 70 such cases.

Since the publication of the above-mentioned report, there were further negative developments regarding co-operation with ICTY. The publication of the four latest indictments (20 October 2003) against high ranking officers of the Serbia and Montenegro Army and Serbian police, one of whom was then a serving officer and Deputy Minister of Interior, led to a negative reaction by the Serbian authorities and initially some open refusals to co-operate (by the Minister of Interior). These indictees were not arrested and transferred by the government which argued that in this particular case the trials should be held domestically. This option was dismissed by ICTY as Serbia and Montenegro does not have the capacity to properly conduct such trials domestically yet.

Finally, the participation of some indictees including former President Milosevic in the Serbian parliamentary election, although legally possible, was a sign of the political role and influence of the indictees.

**International Criminal Court (ICC):** Serbia and Montenegro has been taking a positive attitude towards the International Criminal Court. It is one of the founding members of the ICC and ratified the Rome Statute (in 2002). Specific legislation for co-operation with the ICC is being drafted (although both at the state level and in Montenegro, whereas this is clearly an area under state responsibility). Serbia and Montenegro has been consistent so far in its policy not to sign the bilateral agreements to allow an exemption from ICC jurisdiction, as proposed by the US.

**United Nations Security Council Resolution (UNSCR) 1244:** The end of 2003 saw the start – amidst difficulties - of the dialogue between Belgrade and Pristina and the inaugural meeting in Vienna on 14 October. The meeting resulted in the understanding that dialogue should initially take place in four working groups, focussing on issues of missing persons, returns, energy and transport and telecommunications. The Working Group on Energy and the Working Group on Missing Persons met in March 2004 for the first time. However, the March 2004 violent incidents in Kosovo risk seriously undermining the encouraging developments in this field.

Belgrade has not dismantled parallel institutions, which persist in a number of sectors (justice, education, health etc.), claiming that, in the overall climate of insecurity and the increasing number of violent attacks, they are the only way for the Serbian community to have access to these services. The Serbian authorities also continue to contest UNMIK competence to sign FTAs on behalf of Kosovo.

The violence against Kosovo Serbs that occurred in March 2004 had repercussions in Serbia. By and large, people expressed their frustration and shock through peaceful demonstrations although there were deplorable attacks on two mosques. Faced with this situation the Belgrade authorities acted with swiftness in condemning the violence in Kosovo and the attacks against the mosques in Serbia and actively preventing the escalation of the tension.

**Dayton Agreement:** There were no major issues concerning Serbia and Montenegro compliance with the Dayton Agreement, with the exception of co-operation with ICTY. However, the overall level of legal and police co-operation should be strengthened, in particular concerning the arrests and handovers of ICTY fugitives, and also in fighting organised crime. It is essential to ensure that no conditions exist for them to find refuge in either of the two neighbouring countries.

### 3. ECONOMIC SITUATION

#### 3.1. Current Economic Situation

*In 2003, the third year of transition, stability-oriented macro-economic policies continued. The process of privatisation gained momentum in the course of the year with some important privatisation deals being successfully concluded. The overall pace of structural reforms slowed down considerably as a result of the internal political context, leading to rather modest economic results. Much remains to be done in order to improve fundamentally the economic environment so as to allow for a rise in production and the creation of new jobs. Recorded real GDP continued to grow, but reached only 56% of its 1990 level. Annual inflation was reduced in both Serbia and Montenegro to single digit levels for the first time. Fiscal deficits remained rather high in 2003 and future fiscal burdens point to the need for further fiscal streamlining. After two years of nominal exchange rate stability, the dinar started to depreciate gradually against the euro as a result of a more flexible exchange rate policy that also takes into account aspects of international competitiveness. Though the trade deficit grew steadily, hard currency reserves continued to rise owing to an important inflow of net external resources, such as remittances from abroad, high revenues from privatisation and the continuation of external assistance.*

In 2003, **growth performance** in the country worsened with a reported 1.5% increase of real GDP (down from 4% in 2002), compared to the initial target range of 3.5 to 4.5%. As in the previous year, growth in Serbia was mainly driven by a good performance of the service sector (telecommunications, trade, financial services and construction). Agricultural output is estimated to have dropped by 6% compared to 2002 due to an extended Spring-Summer drought and industrial production reportedly fell by 3%. The main sources of growth in Montenegro are industrial production and tourism with annual increases of 6% and 9% respectively in the first nine months of 2003 compared to the same period in 2002. However, economic data on output are highly unreliable as they include only statistics based on the large socially owned and state owned companies, thus excluding a rapidly emerging private sector whose share in total output is constantly growing<sup>4</sup>.

Annual retail **inflation** in Serbia (end of period) in 2002 came down from 39% (end 2001) to below 15%. It was further reduced to 7.8% by end of 2003, despite an increase of electricity prices in July 2003 (by 15% on average) in line with the IMF programme, and higher food prices as a result of the spring drought. Montenegro recorded an end-of-year inflation rate of around 9.4% in 2002, lower than in Serbia, but still very high for a euro economy. In 2003, annual inflation was further reduced and amounted to 6.7% at the end of 2003 (projected 9%). This is still a relatively high inflation for a euro-ised economy, partly driven by the introduction of VAT in April 2003 and an increase in electricity prices by 23% on average,

---

<sup>4</sup> Though the private sector share in overall output is arguably still low and therefore non-inclusion in the official statistics does not distort the picture substantially (e.g. SMEs with less than 20 employees, which represent over 80% of all companies in Serbia, do not provide regular data on production, but have only an estimated 11% share in total production: under these circumstances, their growth needs to be almost double-digit to have an overall 1% impact).

which brought tariffs closer to cost recovery levels. The lack of competition in some sectors, such as trade, may also play a role.

**Wage developments** in Serbia may negatively impact on macro-economic stability as average dinar wages have increased substantially by some 16% in real terms in 2003. In Montenegro, the official data on wage developments have not been published since summer 2002, but it seems that real wages have not substantially changed over the last few years.

**Unemployment** also continues to persist as a structural problem in both republics, but official data are incomplete and unreliable (officially over 30% in Serbia and over 35% in Montenegro of the workforce are unemployed), and the real figures may in fact be considerably lower. Survey data for Serbia suggest a more realistic level of 15% if the non-recorded official private sector and the grey economy are included (thus registering as unemployed only those who are really in search of a job). In Montenegro, the programme of legalisation of existing jobs and the creation of new ones that was introduced in April 2003 (with a substantial reduction in obligatory taxes and contributions by employers) resulted in a rise of the number of employed persons by almost 20,000 (simultaneously the number of unemployed fell to below 70,000) in the first three months of the application of the programme.

**Poverty** rose dramatically in the country during the 1990s when GDP per capita fell by 50-60% and is considered as one of the major challenges for policy-makers. According to the World Bank, material poverty affected 10% of the population in Serbia and Montenegro in mid-2002 (defined as the population with consumption below the country-specific absolute poverty line of €60 per month). Moreover, Serbia experienced also extreme poverty with 2% of the population unable to afford even the basic food basket.

### **Fiscal performance**

In the context of the current IMF programme (a three-year Extended Arrangement), the consolidated fiscal deficit of the country for 2003 was initially programmed to be maintained at 4.5% of GDP of Serbia and Montenegro (4.1% for Serbia and 0.4% for Montenegro), while the overall level of spending was planned to be reduced by 2 percent of GDP to make room for a lower tax burden, in particular in Serbia.

In Serbia, the consolidated general government deficit<sup>5</sup> was revised downwards to 3.5% of GDP, planned to be financed by foreign financing (€445 million), receipts from privatisation (€200 million) and domestic borrowing (€110 million). According to the data on budget execution in the first nine months, revenues were in line with the plan, while expenditures were held at the allocated levels (with only transfers to social funds falling short of the budgeted amounts). With regard to the sources of deficit financing, execution of domestic borrowing and foreign loans were as planned, grants were somewhat lower, but privatisation revenues were much higher than planned leading to an over-financing of the budget by 2% of GDP, allowing for an equivalent reduction of net public debt. The 2004 budget for Serbia was adopted by Parliament in March 2004.

Montenegro remained under fiscal pressure in 2003. The introduction of VAT in April 2003, after initial problems, contributed to an increase in budget revenues. For the year as a whole, the fiscal stance is still difficult to assess, also due to the lack of reliable data. Uncertainties remain with respect to the actual financing of an expected deficit of 4% of Montenegrin GDP. In particular, it appears that foreign financing, programmed at some 3.3% of GDP in 2003,

---

<sup>5</sup> The revision was carried out in April in order to encompass also the costs of the newly established state in which the two republics had agreed to jointly participate. The total financial framework of the state was projected at €660 million (cf. infra 3.3.).

turned out to be lower, and might have been compensated for by higher domestic public borrowing or accumulation of arrears.

The National Bank of Serbia (NBS), in spite of a change of management, continued its stability-oriented **monetary policy** in 2003. In early 2003, the NBS temporarily tightened monetary policy through an increase in reserve requirements on deposits to absorb an increase in commercial banks' liquidity that resulted from a shift of government deposits to banks in the context of the payment reform. The tight stance of monetary policy continued during the state of emergency in early spring to stabilise financial markets and inflation expectations. Since May 2003, monetary policy was somewhat relaxed through subsequent reductions of the compulsory reserve rate in line with the ongoing shift of government deposits from commercial banks to the NBS treasury single account.

Throughout 2001 and 2002, the **exchange rate policy** was geared at stabilising the nominal exchange rate of the Dinar, which significantly facilitated a process of disinflation in Serbia. Since early 2003, the National Bank of Serbia conducted a more flexible approach taking also into account real exchange rate developments and aspects of international competitiveness. As a result, from end-December 2002 to end-December 2003, the dinar/euro exchange rate depreciated by around 10% in nominal terms. In real effective terms, the exchange rate has been kept roughly constant during the same period. Prospects for an increase in exports however, remain somewhat constrained by relatively low quality and technical standards in most segments of the country's production.

In the context of the IMF programme, the **current account** deficit of Serbia and Montenegro for 2003 is expected to be lowered to 11% of GDP before grants (after reaching 12.8% of GDP in 2002), as a result of a somewhat lower import demand and continued export recovery. According to IMF projections, actual imports of goods and services grew by 25.6% in 2003 (in USD-terms, compared to +30.7% in 2002) due to some credit tightening. Expressed in Euro-terms, however, import growth in 2003 was lower at around 10%. Exports continued to increase (+32.0% in 2003 vs. +20.4% in 2002 in USD-terms), despite weaker demand in the EU and on world markets in general. They were, however, facilitated by a real depreciation of the dinar/euro exchange rate; hence export growth in Euro-terms is only slightly positive in 2003. As a result, the export/import ratio is still very low and the trade deficit is expected to have increased to approximately 30% of GDP. Trade with the EU, Serbia and Montenegro's biggest trading partner, accounts for more than 40% of the total trade deficit. Net current transfers, mostly in the form of remittances, increased by 37% (in the first eight months of 2003) and have helped financing a substantial part of the trade deficit.

The **capital and financial account** balance came under some pressure in the first quarter of 2003, due to a number of factors, such as the re-purchase of Serbian Telecom shares from Telecom Italia, delays in obtaining external assistance and in March 2003 a temporary decline in confidence following the assassination of the Serbian Prime Minister. However, these negative trends were reversed in the remainder of the year, with important net financial inflows, especially resulting from FDI. As a result, foreign exchange reserves continued to rise and are reported to have reached more than €3 billion (equivalent to 4.5 months of projected imports). This is mainly due to the results of the privatisation process in Serbia (see below), which significantly contributed to a large net inflow of foreign direct investment (FDI) at €1,060 million compared to an initially projected level of €550 million. However, it is expected that the inflow of FDI will be substantially lower in the following years and it will become increasingly important that the reform process in Serbia and Montenegro attracts more green-field FDI to ensure the external sustainability of Serbia and Montenegro.

Despite a substantial debt relief that is being provided by Paris Club creditors (a phased reduction of the net present value of outstanding debt by 66%), the **external debt** (estimated at €11.5 billion, end-September) remains relatively high. After an overall agreement with the Paris Club had been reached in 2001, bilateral agreements with the main Paris Club members (except Italy, Japan and Finland) were concluded. Moreover, in November 2003, important agreements on debt relief were signed with China and the Russian Federation. Despite a renewal of negotiations and efforts on the part of the authorities, Serbia and Montenegro has not yet reached an agreement with the London Club of commercial creditors, which have been reluctant to accommodate the authorities' objective to be granted generous terms similar to those of the Paris Club. An important near-term priority identified in last year's SAP Report has thus not been implemented. Therefore, obtaining substantial write-offs shall remain an important objective of the authorities as it is a *conditio sine qua non* for improving the external sustainability of the economy which remains a major challenge in the coming years. Important financing requirements will continue to put a heavy strain on the country's balance of payments. Notably debt service payments are expected to rise considerably from 2.2% of GDP and 10% of exports of goods and services in 2003 to 4.1% and 16.1% respectively, in 2005 – which is clearly a reason for concern. These ratios are likely to deteriorate further over the rest of the decade as a result of the expiration of grace periods on restructured debt. Moreover, financing needs will result from the real sector restructuring which also implies huge investment needs and imports, and from a further strengthening of official foreign exchange reserves. At the same time, prospects for private capital inflows remain rather uncertain, and the level of net FDI inflows will largely be determined by the pace of privatisation, as greenfield and equity investments are expected to remain low. Thus, the country is still likely to require substantial inflows of official financing over the medium term, including of a concessional nature.

**Relations with IFIs.** The *IMF* is supporting economic reform and stabilisation in the country through a three-year Extended Arrangement approved in May 2002. The first and second reviews were successfully completed in January and July 2003, respectively. In October 2003, the Fund reached a preliminary agreement with the outgoing government on most aspects of the economic and fiscal framework for 2004. However, in the light of early elections in Serbia in late December 2003, the completion of the third review is expected to be delayed, with discussions on policies for 2004 expected to resume once a new Serbian government is in place. Total funds that have been provided under this programme so far amount to some USD 420 million. The EC is providing macro-financial assistance in the context of the IMF-supported programme (see below section 5).

*World Bank* lending to Serbia and Montenegro is based on the Transitional Support Strategy adopted in May 2001 and updated in August 2002, which contains a three-year exceptional and temporary IDA envelope of USD 540 million. In 2002, the World Bank disbursed two structural adjustment credits (SACs) of USD 70 million and USD 85 million, respectively, to support reform measures in Serbia in the area of public expenditure management, health and education as well as in support of privatisation, enterprise development and sound financial systems. In 2003, two SACs for Serbia to support social programmes (USD70 million) and to back privatisation and financial sector development (USD 80 million), as well as a first structural adjustment credit for Montenegro to support the implementation of the reform agenda in public finance, energy and labour market (USD 15 million) were approved. For the year 2004, the Bank envisages lending in the order of some USD 150 million.

As of mid-October 2003, the *European Investment Bank* has signed projects in Serbia and Montenegro for a total of €426 million (€162 million in 2003), that are concentrated in the

area of electricity, transport – in particular road and railway rehabilitation – and small and medium enterprise financing.

As of end of 2002, the *European Bank for Reconstruction and Development* had signed 15 projects, reaching a cumulative investment of around € 370 million in sectors such as telecommunications, transport, energy, and municipal infrastructure.

### 3.2. Existence of a free market economy and structural reform

*Structural reforms towards establishing a market economy successfully started in 2001/ 2002 but advanced at a slower pace, or even stalled in 2003. Though privatisation of socially-owned enterprises gained some momentum in the course of the year, the restructuring of large enterprises and the process of bank privatisation have been delayed. Important legislation aimed at improving the overall business environment, encouraging investment and laying the foundation for growth led by private sector development has been prepared and adopted by the government. Its enactment and enforcement has however been delayed, in particular in Serbia where the protracted parliamentary crisis culminated in early elections in late 2003.*

In the course of price liberalisation that took place in previous years most price categories were liberalised except for some public utilities. No further **price liberalisation** occurred in 2003. However, electricity prices were further increased by 15% on average in Serbia and by 23% in Montenegro. While previous increases in 2001 and 2002 were substantially higher, the continued price adjustment in 2003 is estimated to have further reduced the need for subsidies to the electricity companies.

In Serbia, a number of laws, which aim to improve the legal and regulatory framework for private sector development, have been prepared or adopted in 2003 by the government, also in line with last year's SAP report recommendations. However, these laws have not yet come into force due to the protracted parliamentary crisis culminating in early elections in late 2003. New draft legislation includes amendments to the Serbian Privatisation Law, a new Bankruptcy Law, as well as laws on enterprises, competition, executive procedures, company registration, and procurement. These laws are partly based on recommendations of the Foreign Investors Council that was established in July 2002. Some new laws came into force, including a new Accounting Law (February 2003), as well as a number of laws that broaden the scope for secured lending (August 2003). It is now important that these laws are fully implemented and applied in order to facilitate financing and investment in the economy.

In Serbia, the **privatisation process** gained some momentum with the sale of some important companies, such as two tobacco factories, the second largest oil company, a steel mill and a brewery. By end-2003, some 900 enterprises had been sold by auction (of which 206 in 2002), 32 by tender (of which 12 in 2002) and 103 through the Share Fund (of which 48 in 2002). As a result, revenues from privatisation reached more than €900 million in 2003 (€ 345 million in 2002). On top of this, around €450 million was committed in investment and social programmes. In Montenegro, the process of privatisation of the largest Montenegrin company, Aluminium Factory KAP-Podgorica, started with the selection of the financial advisor, but as the sale is also related to some strategic decisions (imports of electricity) the process is not expected to be finalised soon. The privatisation of the Nikšić steel-mill and Podgorica tobacco factory are at an advanced stage. Towards the end of 2003, the Montenegrin Government also announced an accelerated privatisation of 20 smaller and less attractive factories.

The process of **restructuring** of some 50 large insolvent companies which were identified by the Serbian Privatisation Agency has not much advanced. Although restructuring plans have

been adopted for some of these companies by the authorities, it seems that creditors (including the government) have not been willing to offer a restructuring of outstanding liabilities of these companies. In an attempt to accelerate the restructuring process, the authorities have developed a new approach of “conditional tendering”. This would imply to offer the companies for sale with the un-restructured debts while the bidders would be asked to provide an offer on how much debt they would be ready to accept. It still remains to be seen whether this new strategy will be more successful. So far the results are still lacking and the whole process is far behind schedule.

In Serbia, the new Law on Pensions and Disability Insurance was adopted on 1 April 2003. The law stipulates that the calculation of the **pension** is based on the entire period of service (and not the best 10 years as in the past). The law has also introduced more stringent criteria for invalidity pension to discourage fraudulent retirement on disability (as the country had in the past an enormously high proportion of disabled pensioners) and increases the minimum retirement age by 5 years in a phased manner.

In Montenegro, the new Pension and Disabled Insurance Law was adopted on 24 September 2003, following intensive public discussions on the financial viability of the pension system. The law introduced a three-pillar system: a first pillar based on several new reform measures (extended working period, inclusion of the entire working period in the calculation of the pension base and the introduction of the Swiss formula for calculation), a new second pillar (insurance based on individual capitalised savings) and a third pillar (voluntary insurance).

In the **financial sector**, the Serbian authorities<sup>6</sup> strengthened the regulatory and supervisory control over the local banking system by adopting the new Law on the National Bank in July 2003 together with the amendments to the Banking Law. In the new regulations, a wider range of tasks is envisaged for the central bank in the event of the failure of a bank, while some new provisions for bankruptcy procedure and a new role for the Bank Rehabilitation Agency (BRA) were discussed. The process of privatisation of the 15 banks in which the Serbian government acquired shares through a debt-for-equity swap in 2002 (in 9 banks, the Republic of Serbia became a majority shareholder) was delayed. So far, the BRA has only engaged an international financial advisor –for the privatisation of four banks in which the state is a majority stakeholder. However, the actual privatisation has been postponed, also due to institutional problems, i.e. a change in the top management of the BRA. The privatisation of the first banks is not expected to occur before mid-2004. Thus, an important near-term priority identified in last year’s SAP report (“either privatise or liquidate banks in which the government has taken majority stakes”) has not been met. The banking sector is still burdened with the unresolved problem of claims on heavily indebted companies. A strategic decision concerning non-performing loans in the portfolios of the banks will have to be made as this blocks privatisation of both banks and indebted companies and may cause additional delays. However, the rise in deposits<sup>7</sup> continued in 2003 though at a somewhat slower pace compared to the previous year.

In Montenegro, the institutional framework for banking supervision has been strengthened over the past year with the introduction of new regulations on licensing, minimal capital, asset classification and provisioning and large exposures. The authorities also adopted an anti-money laundering law in September 2003. The finalisation of the privatisation of the

---

<sup>6</sup> The competencies of the former National Bank of Yugoslavia, though de facto limited to Serbia already for years before the Constitutional Charter was adopted on 4 February 2003, were thus *de jure* limited to Serbia only and as of that date the new National Bank of Serbia came into existence.

<sup>7</sup> The sharp rise in previous years should be attributed to the fact that they started literally from a zero level in 2000.

Montenegro Bank (sold in July 2003), formerly the largest bank in the republic, only contributed to this confidence. The privatisation of the last bank with majority public ownership, Podgorica Banka, is currently under way. Another important development in 2003 was the decision of the Ministry of Finance to revoke all licences given to the offshore banks registered in Montenegro. After the sale of Montenegro Banka and the closure of some smaller banks, all banks operating in Montenegro are now considered to be liquid and to comply with capital requirements. A continued growth in deposits through 2003 confirms strengthened confidence in the banking sector.

### 3.3. Management of public finances

*As in previous years, tax policy and administration as well as expenditure control remain a priority, not least because of the scarcity of fiscal resources and the state's reliance on donors to finance a significant share of fiscal deficits. In Serbia, the speed of public finance reforms somewhat slowed down in 2003 and the restructuring of public administration, an important element in overall reforms, appears still to be insufficient. The planned introduction of VAT should play an important role in establishing a sound basis for the future. In Montenegro, the introduction of VAT, as well as pension reform, were encouraging steps towards the improvement in the management of public finances. However, the lack of co-ordination of reforms among the two republics remains a concern.*

The **financing of the State Union** which does not have fiscal resources of its own (and no state level power to collect taxes, thus depending entirely on funding from the two republics) was already identified as an important issue in the 2003 report. Originally, the republics had agreed to fund state level expenditure (projected at €660 million for 2003) on the basis of GDP-shares (i.e. 93.3% paid by Serbia and 6.7% by Montenegro). The viability of the state level was put in question by several delays in these contributions in the course of the year. As of 2004, “territorial financing” is being introduced, meaning that the republics will finance only those institutions located on their respective territory. Consequently, Montenegro will fund the State Court<sup>8</sup> (the only state institution having its seat in this republic) and army units stationed there. The financing of Serbia and Montenegro’s foreign service remains unclear.

In Serbia, further progress was made to enhance expenditure control. Following the establishment of an intermediate Treasury system with cash and debt management functions and a central accounting division in the Ministry of Finance in late 2002, the introduction of a Single Treasury Account in the NBS for budget execution is moving forward and progressing well. Most ministries and other direct spending units have been progressively transferred to the Treasury during 2003. However, the management and control of extra-budgetary funds and budgets of local government, accounting for 25% and 15% of consolidated government spending in Serbia, respectively, need to be further enhanced. Also, more progress is still needed in budget formulation and internal audit.

Following the adoption by the Serbian Parliament of a new Law on Tax Procedures and Administration in November 2002, the re-organisation and modernisation of the Public Revenue Agency progressed in the first half of 2003. A new computerised system has been established and large taxpayers units have become operational in Belgrade and three other towns in Serbia. The transfer of tax collecting functions for payroll and income taxes as well as social security contributions from the old payments bureau (ZOP) to the PRA took place with effect from 1<sup>st</sup> January 2003. To improve revenue collection, new tax identification numbers for all taxpayers have been created which constitute a precondition for the opening of bank accounts. The new Law on Tax Administration was also designed to deal with tax

<sup>8</sup> Still, the Montenegrin authorities claim that they do not have adequate financial resources.

frauds. It envisages that all citizens are obliged to register their property worth more than € 300,000. By 31 October 2003, only about 1,200 persons had declared their properties, while, according to some unofficial estimates, there are between 40,000 and 80,000 persons whose property is over the threshold. It remains to be seen how the new Serbian Government will deal with this problem in a year when income declarations and property evaluations have to be produced.

**Tax policy reform** was supposed to continue in 2003, as the Serbian Government adopted a new set of important laws and submitted it to the Parliament in September. However, due to the blockage in the work of the Parliament and the fact that it was dissolved later in the year, the laws have not been adopted. The incoming government has decided to review some of these drafts, including the Law on VAT. The target date for the entry into force of the latter is now 1 January 2005. The other laws are related to excise duties, income taxation and the harmonisation of the base for profit taxation in line with international standards.

In Montenegro, following the introduction of a Treasury in the Ministry of Finance, the authorities have embarked on further reforms to contain public spending. In March 2003, the government adopted an employment and wage policy action plan. It foresees a reduction of redundant public employees, in particular by 3,000 in the education sector, as well as a larger differentiation of salaries to increase incentives for qualified staff to remain in or enter the public administration. A new Pension Law, which shifts the indexation of pensions from wage changes to a weighted average of price and wage changes and raises the minimum retirement age by 5 years in a phased manner, was adopted by the government in September 2003. The introduction of VAT in Montenegro in April 2003 marked a major reform step despite some temporary difficulties in revenue collection. Concerns have been expressed as to the adequacy of controls at the Serbia-Montenegro administrative border line, which need to be addressed to safeguard a free flow of goods within the territory of the country. This will become increasingly critical with the introduction of (a different rate of) VAT in Serbia, implying two different VAT systems operating in the two republics.

A Montenegrin Law on Public Administration which provides the policy and legal framework for reforms in the public administration was adopted in July 2003. The Government also announced a plan to reduce employment in the public sector by 3,500 (1,000 in 2003), mainly among the police (initial steps taken in August 2003 when some police officers were laid off) and in the education sector.

Both republics still lack a Supreme Audit Institution.

#### **4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS**

##### **4.1. General evaluation**

*Following the adoption of the Constitutional Charter in February 2003 and of the Internal Market and Trade Action Plan in August 2003, two logical preconditions for a substantial study, the Commission decided to prepare its report on the feasibility of opening negotiations for a Stabilisation and Association Agreement. However, the non-respect of the Constitutional Charter, the poor functioning of institutions on all levels and stalemate on remaining parts of the Action Plan have fundamentally affected progress in the SAP. A specific, recurrent theme that has affected Serbia and Montenegro's rapprochement with the EU is the lack of a single, functioning trade regime and of a single market, contrary to its constitutional provisions, which impacts on a great variety of policy areas. Secondly, while progress on sectoral*

*reforms has continued in 2003, the political crisis in Serbia has stalled an important number of reform laws and policies.*

#### **4.1.1. Current position**

There are currently **no contractual relations** between the EU and Serbia and Montenegro. The pre-conditions for the beginning of the work on a Feasibility Report, namely the Constitutional Charter and the Internal Market and Trade Action Plan, were met at a late stage, after serious delays, in February and August 2003 respectively.

Based on the commitments undertaken at the EU-Western Balkans Summit held in Thessaloniki on 21 June 2003, a Joint Declaration on Political Dialogue between the European Union and Serbia and Montenegro was adopted by the Council in September 2003. Furthermore, the EU-Western Balkans Justice and Home Affairs Ministerial meeting took place in Brussels on 28 November 2003 and the EU-Western Balkans Foreign Affairs Ministerial Meeting took place in Brussels on 9 December 2003 (both within the framework of the EU-Western Balkans Forum).

Meanwhile, the technical and policy dialogue has been intensified with the start of the **Enhanced Permanent Dialogue (EPD)**, which succeeded and builds on the EU-FRY Consultative Task Force (CTF) of the years 2001-2002. So far three sessions of this technical working group have taken place focusing on political conditionality, justice and home affairs, economic and structural issues, especially the establishment of a single market, and infrastructure issues. After the pause in the CTF meetings which Serbia and Montenegro had chosen due to its constitutional restructuring, the EPD now serves as a useful tool to monitor and deepen sectoral reforms in an EU-context, in the interest of Serbia and Montenegro's policymakers and experts.

#### **4.1.2. General assessment of administrative capacity**

A positive step towards giving the necessary political impetus for European integration within the state was the creation of the high level **Council for European Integration** in 2003. This Council has nine members: three from the state level (President, Minister for International Economic Relations, and Minister of Foreign Affairs), three from Serbia (Serbian Prime Minister, Deputy Prime Minister for European Integration and Minister for International Economic Relations) and three from Montenegro (Prime Minister, Minister of Foreign Economic Relations and European Integrations and Minister of Finance). It deals with issues related to the integration of Serbia and Montenegro in the EU, and monitors and guides the integration process. However, it has only held one substantial meeting so far.

The **state level European Integration Office (EIO)** acts as the secretariat of the European Integration Council, although its work is limited to organisational, not really substantial tasks. Cooperation between the three EIOs (state and republican) has improved. The administrative capacity at the Montenegrin level, which has had a European Integration Ministry only since January 2003, has started improving. The Serbian European Integration Office has started to assert its role as a coordinator of EU affairs in the Serbian administration at the heart of a network of EU contacts in all line-ministries. It has also initiated regular checks of Serbian draft legislation on their EU compatibility.

Another informal structure has been created to deal more specifically with economic issues that are also relevant for relations with the EU. The **Forum "5+2"** gathers the two republican Finance Ministers, the three Ministers for International Economic Relations and the two central bank Governors.

**Administrative capacity**, which is a key condition for success towards European integration, is still quite weak, although it differs considerably between the various levels and sectors of government. Therefore, the authorities should make sure that the proper administrative structure and capacity is in place at all levels. This will require from the authorities a comprehensive, coherent and prioritised analysis of the functions that the state should bear, an assessment of the human and financial resources that the state and the republics will have to dedicate to that end and a clear timetable for their development.

#### **4.1.3. Impact of the prospect of an SAA on reform**

There is a lack of a strategic planning and consensus at the state level, which renders any assessment of the current position of Serbia and Montenegro and its prospects in the SAP difficult. The country's clear EU perspective in the context of the SAP has not yet become the determining framework of reference for many decision-makers both at state and republican level. This is further exacerbated by the continuing uncertainty over the future of the state. Moreover, in terms of substance, there is little co-ordination between the two parallel reform processes in Serbia and in Montenegro. Serbia is more advanced in structuring its European ambitions and has adopted a very welcome *acquis* approximation plan, which has, however, not been coordinated with Montenegro.

## **4.2. Internal market and trade**

*To create the internal market provided in its Constitutional Charter and a single external trade policy, Serbia and Montenegro drafted an Internal Market and Trade Action Plan (AP), with detailed advice provided by the European Commission. After more than a year of negotiations between the two republics, the AP was eventually adopted by the state Parliament in August 2003. The AP's main aim was to re-establish progressively a single trade policy in Serbia and Montenegro by setting up a precise self-executing schedule with targets and dates for the harmonized tariffs. It has succeeded in clarifying a number of key issues, such as the harmonisation of a majority of tariffs. However, serious lacunae persist and some of the AP's deadlines have already been missed. In particular, agricultural tariff harmonization, the alignment of additional import levies and the abolition of internal obstacles to the single market have not been accomplished.*

*Consequently, Serbia and Montenegro has not yet made sufficient progress towards a single market and a single external trade policy. The existence of two sets of economic legislation, trade policy instruments and customs territories, for the time being, remains a fundamental impediment to the free movement of goods, capital, services and (to a lesser extent) persons within Serbia and Montenegro and with third partners including the EU. Full agreement on the details of the AP and its rapid implementation is essential for the negotiation, conclusion and implementation of a potential SAA, the core of which is reciprocal trade liberalisation. In some areas, measures beyond the AP will be required to ensure that Serbia and Montenegro can assume the obligations arising from a potential SAA.*

*Serbia and Montenegro also continued to pursue World Trade Organisation (WTO) membership, for which a functioning single trade regime is equally critical.*

### **4.2.1. Free Movement of Goods:**

Free movement of goods, as the other economic freedoms, has two dimensions for Serbia and Montenegro, one external and one internal. Achieving a single external commercial policy is consequently not sufficient to deepen its relations with the EU as long as obstacles remain *within* the state, as these obstacles would also constitute barriers to market access for foreign goods, capital, services and persons.

### Tariff harmonisation

In 2003, Serbia and Montenegro has made progress on the reintegration of its foreign trade regime under its Internal Market / Trade Action Plan. 90.3% of all tariff lines, mainly for non-sensitive products, have been harmonised as of August 2003. An important number of quantitative restrictions in Montenegro that existed before and had a major impact on the structure of trade and import and retail prices in that republic were abolished in parallel. For a further group of products, a common external tariff has already been successfully fixed in the Action Plan, but will only be applied after a transition period of 18 months (for a further 1% of industrial products) and 24 months (8% of lines, both industrial and agricultural) respectively. As a result, harmonisation for these items will be in force in February and August 2005 respectively.

Under this transitional regime, controls would still be undertaken along the administrative boundary line between the two republics. Clearly, these controls, which currently hamper state-wide market access for foreign goods, must be abolished entirely at the end of the transition phase of 18/24 months. During their limited existence they must only cover those goods the tariffs of which are being phased in, as far as that is possible, to avoid negative effects for trade on all other products.

Finally however, for the remaining, significant group of strategic agricultural products, which account for a substantial share of Serbia and Montenegro's imports (e.g. practically all cereals, some meat and dairy products and refined sugar, etc.), common tariffs have not been agreed yet. A long transitional phasing-in period for these (still entirely unknown) tariffs of three years (extendable for another two years) has already been agreed upon by the two republics in the Action Plan. The disagreement on these strategic tariffs means that a single foreign trade regime has not been achieved yet. Given the lack of a harmonisation schedule in the crucial agricultural sector, Serbia and Montenegro is currently not capable of tabling a common negotiating position internationally.

It is important to note that Serbia and Montenegro has already taken commitments for far-reaching regional trade liberalisation. This will inevitably lead to a significant reduction in current Serbian rates, especially for agricultural and other sensitive products<sup>9</sup>. Secondly, the already agreed, long transitional period for agricultural harmonisation (i.e. the extendable three years phase mentioned above) should give both republics sufficient breathing space to restructure the farm sector. Harmonisation at the end of such a long transition period is therefore possible if coupled with structural agricultural reforms which are necessary in any event. Consequently, the present stalemate can be overcome with sufficient political will. However, there is a recent rebound of a protectionist tendency in Serbia which is inconsistent with the further liberalisation needed to support competition and create the foundations for export-led growth.

### Harmonisation of other import charges and measures having equivalent effect

The harmonisation of import levies and charges, including all import-related measures having the equivalent effect of tariffs, must follow the very same harmonisation calendar as the corresponding import tariffs per product to achieve a single trade regime. Single tariffs as

---

<sup>9</sup> It is also worth noting that the tariff harmonisation for some vital imports has so far, according to local data, not led to an increase in consumer prices in Montenegro. As a matter of fact, prices of these products in Montenegro were mostly equal or even higher than in Serbia, despite lower tariffs, due to significant quantitative restrictions, discriminatory licensing systems etc. which had artificially increased profit margins for traders and importers to the detriment of local consumers. The abolition of these quantitative restrictions under the Action Plan will therefore increase transparency.

such do not yet constitute a state-wide foreign trade regime since they are entirely differentiated by divergent additional charges on sub-state level.

However, Serbia and Montenegro have found no agreement yet as to the creation of a single regime on these levies and charges. Work on this critical issue has stalled. Hundreds of items are still covered by two republican sets of import levies<sup>10</sup>. As these republican product groups are not mutually congruent (and even if so have different levy rates) and do not match the groups of items with harmonised tariffs, the total number of products for which there is no single trade regime is very high, including most agricultural products<sup>11</sup>. Due to these diverging levies on a variety of items, coupled with not fully harmonised import tariffs, there is no harmonised trade regime yet. All levies need to be harmonised on state level.

Serbia has increased levies on a variety of predominantly agricultural products by significant amounts in 2003, partly multiplying levies by ten. A further increase in import charges on EU sugar took place in February 2004. These increases undermine the remarkable trade liberalisation that the Federal Republic of Yugoslavia undertook in an earlier phase of transition. The economic rationale behind these levies is not entirely clear either. More fundamentally, the significant increases, taken against the explicit advice of the European Commission, are in breach of the standstill clause under the Community's autonomous trade preferences<sup>12</sup>. Serbia and Montenegro's entitlement to this preferential arrangement depends on abstaining from the introduction of any new trade barriers for Community goods. The Commission is currently evaluating the impact of these levies on EC trade and will then consider whether appropriate measures should be taken.

#### Further trade policy issues<sup>13</sup>

The republics recently introduced an **import licensing system** for 160 steel and iron products for an undefined transitional period (on Montenegro's demand, to protect a non-competitive steel mill in Niksic). The republican lists of products concerned are not entirely congruent. The application of this system, which the authorities report will be phased out next year, appears to amount to a de facto quota system, i.e. the discretionary licences have the equivalent effect of a quantitative restriction, which would be in breach of the standstill clause under the Community's autonomous trade preferences. Furthermore, this system affects the creation of a single trade policy and a single market in the sector of steel and iron.

While export quotas have in principle been abolished in both republics, Serbia has introduced a **de facto export ban** on cereals and rawhide, allegedly to prevent shortages after the 2003 drought. This ban also applies to Montenegro, which obviously undermines the trade policy harmonisation process and the single market. Furthermore, new Serbia and Montenegro **export duties** of 15% and 20% respectively apply to some ferrous and non-ferrous metal products and rawhide, reportedly to safeguard the supply of domestic processing industries. Serbia and Montenegro has not provided a clear indication of the date by which these would be phased-out. Finally, the remaining lacunae in the state's single trade policy have affected and delayed the implementation of the free trade agreements that Serbia and Montenegro has entered into.

#### Trade relations with the EU

The European Union is by far Serbia and Montenegro's most important commercial partner. Serbia and Montenegro's bilateral trade with the EU accounts for approx. 43% of the

---

<sup>10</sup> 202 products in Serbia and 127 in Montenegro are concerned.

<sup>11</sup> At the time of writing, this concerns 259 products.

<sup>12</sup> Cf. Article 2(1) of Council Regulation (EC) No. 2007/2000 of 18 September 2000.

<sup>13</sup> For customs issues as raised by trade in sugar, cf. infra section 4.2.4.

country's total. Trade relations with the EU continue to be based on the Community's autonomous trade measures (ATMs), allowing basically all imports originating in Serbia and Montenegro to enter the EC without quantitative restrictions and exempt from customs duties. The ATMs continue to play a vital role for Serbia and Montenegro's trade performance: Serbia and Montenegro's exports to the EC grew from €763 million in 2000 to a projected value of around €1 billion in 2003. However, in 2003 exports to the EU, expressed in Euro-terms, grew only by 0.7%. This performance is still considerable as it has to be seen in the light of weak import demand in the EU and the suspension of trade preferences for sugar (cf. infra, section 4.2.4.). Given that the ATMs will also apply to the ten new EU Member States, important trading partners for Serbia and Montenegro, as of 1 May 2004, their role will further increase. However, as Serbia and Montenegro's imports from the EU have also remained at a high level (despite a drop of approx. 10% in 2003), its bilateral trade deficit with the EU is still important, standing at approx. 40% of the country's total. On a sectoral level, agricultural, food and textile products dominate EU imports from Serbia and Montenegro, whereas the EU exports to this country consist mainly of machinery, transport equipment and chemical products.

The opportunities offered by the ATMs are far from being fully exploited yet. While liberal market access as such remains a key element to assist Serbia and Montenegro, improvements in its export performance are evidently dependent on a variety of other, more structural factors<sup>14</sup>. For instance, the narrow product base and the low quality level of many products, exacerbated by years of underinvestment, currently still hamper the full use of these preferences. In addition, delays in the restructuring of enterprises in Serbia and Montenegro have also hindered the development of export potential. High product standards, both regulatory and economic, in developed export markets have also been difficult to meet in some areas, notably in parts of the agricultural sector. EC assistance in this field has shown the first positive results, enabling Serbia and Montenegro to re-start exports (e.g. of meat products). Moreover, the Serbian Investment and Export Promotion Agency (funded by the EAR) will also address the issue by granting specific support to companies.

Consequently, giving in to calls by Serbian exporters for devaluation would probably lead to further upward pressure on prices, depending on pass-through effects. In the first place it would however increase the costs of imports, including those of capital goods important for the ongoing restructuring of the economy. Moreover, it is questionable whether the exchange rate is the most efficient instrument to render Serbia and Montenegro exports more competitive since the quality and the level of processing of traded goods are evidently more relevant.

Talks on a bilateral textiles agreement between Serbia and Montenegro and the Community commenced in November 2003 and are ongoing. The conclusion of negotiations is conditional upon Serbia and Montenegro fulfilling a number of basic requirements concerning, in particular, enforcement structures and powers.

#### Single market issues concerning the free movement of goods

Despite the adoption of the Action Plan, there are still a number of important issues relating to the free movement of goods in the state's single market, in addition to the aforementioned controls at the administrative boundary line. A good imported into Serbia and Montenegro must not face further obstacles of any kind *within* the country. Such obstacles would jeopardise a single economic space within Serbia and Montenegro. Serbia and Montenegro has clarified that goods, both domestic and foreign, entering the market in one republic will

---

<sup>14</sup> Cf. the Strategy Paper for a more detailed analysis of the impact of the EC trade measures.

not face discriminatory treatment in the other. It also suggests that duplicate technical controls and market authorizations are in principle excluded. However, it remains to be seen whether this principle is observed in practice as an increasing number of products are regulated by separate republican laws that replace former FRY laws. There is thus still a **risk of new non-tariff barriers** between the republics.

State level bodies have undertaken substantial reforms, with EC assistance, on **technical standards and regulations**. Still, a variety of product-related norms are regulated by the republics. There is thus a substantial risk of increasing regulatory complexity and non-tariff barriers for both domestic and foreign products due to the fact that there are currently no horizontal mechanisms for consultation, internal screening or notification of draft technical regulations prior to their adoption.

**Veterinary, sanitary and phyto-sanitary controls** pose a specific challenge. Currently, both republics still exercise separate controls within the country at the administrative boundary line. However, they have made progress in resolving this issue and have agreed to abolish this obstacle to free trade within a year from the adoption of the Action Plan, thus paving the way for a single, mutually recognised entry authorisation for all products concerned based on EU-compatible rules and procedures. Two Liaison Offices for veterinary, sanitary and phyto-sanitary matters were created on state level on the Commission's suggestion in late 2003. They will oversee this joint approach.

Both the different **value added taxes and excise taxes** in the two republics pose an additional risk for the functioning of the single market. In the future, differing VAT rates and, more fundamentally, the current lack of a reliable clearing system between the republics may create challenges. Positively, action has started to deal with these issues, which is imperative for Serbia and Montenegro, both in its own internal market and in view of an SAA, as double taxation would clearly constitute a breach of the free movement of goods rules.

Taking the aforementioned factors into account, Serbia and Montenegro currently does not respect the single market principle enshrined in its Constitutional Charter. Overlapping legislation and administrative practices on republican level additionally hinder the proper functioning of a single economic space. This is worsened by the still weak institutional framework framing the single market, as both the responsible state level Ministry and the state's Parliament have not become active in this field with a view to implement the Charter's principle.

In practice, the introduction of a horizontal mutual recognition clause in Serbia and Montenegro's legal order may be the most appropriate and efficient means to progress towards free movement of goods.

Moreover, the lack of coordination on draft republican legislation means that attempts to create a level playing field are constantly confronted with moving goalposts.

#### ***4.2.2. Movement of persons, services and right to establishment***

Both Serbia and Montenegro have made progress in amending their **service legislation**, thus opening up their economy to foreign service providers. While there are thus partial improvements as to the access to the two republican markets separately, the different and uncoordinated sets of services-related legislation in both republics still hampers the single market access and the free operation of service providers throughout Serbia and Montenegro. In particular, service providers established in one republic (including foreign operators) are generally subject to duplicate licensing or authorisation requirements before they can provide services in the other. In some cases, establishment of a branch or subsidiary is required.

Regarding financial services, the National Bank of Serbia and the Central Bank of Montenegro, the banking supervisory authorities in the republics, have concluded a cooperation agreement under the Action Plan. However, there has been limited progress towards the full implementation of this agreement. Moreover, the cooperation agreement covers only supervision after the award of a licence by the relevant republican authority. The provision of banking services throughout Serbia and Montenegro by both domestic and foreign financial institutions is therefore still hampered by the existence of two separate licensing regimes, meaning that banks need two distinct licenses and must respect two minimum capital requirements to operate throughout Serbia and Montenegro.

A similar situation prevails for other financial sectors. In addition, new laws under preparation at republican level plan to perpetuate the separation of the two markets, for instance in the insurance sector. Consequently, the Action Plan does not lead to a fully functioning single economic space in relation to financial services.

While the barriers to state-wide market access are particularly obvious in the financial sector, similar problems affect a broad range of other service activities. This lack of a single market for services in Serbia and Montenegro could be resolved by the mutual recognition of republican licenses under the principle of home control. Service providers would thus only require a single license to access Serbia and Montenegro's entire market. Obviously, continued restrictions in this field would also hamper the economic benefits of an integrated market. The principle of mutual recognition has already been agreed for accountant and auditor licenses.

The framework governing the **right to establishment** is set on the level of the republics. Formally, both Serbia and Montenegro operate a liberal regime, granting foreign investors national treatment. However, the fact that the rules on the right to establishment diverge between the republics affects the single market and amounts to an investment barrier.

The same holds for company registration rules as such. The registration and incorporation process has been significantly eased in both republics. A law transferring the business register from the commercial courts to an independent agency is pending in the Serbian Parliament. In Montenegro a central registry exists as an independent agency within the commercial court.

More fundamentally however, the fact that two different authorisations have to be obtained in order to operate throughout the state, instead of having a single one-stop system ensuring state-wide market access, still poses problems for the efficient functioning of the country's internal market and would be incompatible with an SAA. Currently, there is no link between the corporate registers of both republics. Again, a policy of mutual recognition would alleviate the problem. More positively, as regards market exits, both civil and criminal court decisions are automatically recognised and enforceable throughout the state despite the existence of two republican judicial systems. This includes bankruptcy decisions, i.e. assets of an insolvent company can be seized in the other republic.

Finally, whilst both urgently needed and crucial for the establishment of a proper system of registries as well as for co-operation with EUROPOL, appropriate **data protection legislation** in line with EU standards has not been adopted yet.

#### ***4.2.3. Movement of capital***

Serbia and Montenegro have made substantial progress regarding the overall liberalisation of capital movements including foreign direct investment, which is basically granted national treatment. The repatriation of profits is also liberalised. These rules constitute a major

economic and regulatory accomplishment and should in the long run help to attract the vital capital needed for economic growth.

The comprehensive law regulating foreign investments adopted earlier on FRY-level now only applies to Serbia proper, with a separate albeit similarly liberal framework being in force in Montenegro. This means that there is no uniform regime on the inflow of foreign capital. While the inflow of capital into each republic as such is largely liberalised, this split regime could amount to an obstacle for investors under an SAA given the remaining obstacles to the free movement of capital within the state.

In order to ensure the particular free flow of payments within Serbia and Montenegro, the two republican central banks have found basic agreement on a system of correspondent accounts, meaning that operators are free to choose either the Dinar or the Euro for financial transactions between the republics. This system should be fully operational by the end of 2004. A clearing system is currently in the making, as the two currencies remain the sole legal tender in their respective republic.

The free flow of both legal tenders throughout Serbia and Montenegro is thus assured in theory, and very basic agreement has been found under the Action Plan. It is vital that this system is now fully implemented to permit the unhindered flow of capital throughout Serbia and Montenegro, as foreseen in the Constitutional Charter, and to avoid economically harmful transaction costs which would also backfire on the free movement of goods, the free provision of services (as payments for these goods and services would be hampered) and foreign investments. In any event, the co-existence of two currencies cannot serve as an argument to delay the creation of a single capital market.

Generally, the Internal Market / Trade Action Plan provides a joint harmonisation strategy for the capital sector as such by end 2004. This would include a harmonised approach to liberalised money markets and cooperation on liberalised securities markets which is evidently important to attract investment.

#### **4.2.4. Customs**

The set-up of customs services in Serbia and Montenegro remains complex. While the republics have started to create a single trade regime under the Action Plan, customs powers have been formally transferred to the republican level by the Constitutional Charter's Implementing Law in February 2003. Both republics thus have separate customs administrations, two separate customs codes (although EU-compatibility has been aimed at) and different IT systems. Montenegro has been enacting a new customs law since April 2003 (deleting a provocative mention of Serbia as a "foreign territory" at the last moment, following a strong recommendation from the Commission). Serbia applies a revised law as of 2004.

In order to manage and enforce a preferential relationship with the EU, Serbia and Montenegro need to ensure a minimum of state level customs functions, both for daily coordination and clear single enforcement. The Internal Market / Trade Action Plan established a Joint Customs Office (JCO) in Serbia and Montenegro's Ministry of Foreign Economic Relations. Staffed on a parity-basis by six members of the republican administrations, it is responsible for the coordination and control of the procedure for the issue of certificates of origin, authenticity checks and the coordination of enforcement. The JCO's rules of procedure, drafted with the help of the EC-funded Customs and Fiscal Assistance Office (CAFAO) in Serbia and Montenegro, provide for the power to issue executive orders, binding upon the two republics, which subsequently have to implement them on the ground. The JCO may also undertake on the spot checks. These powers enable

the JCO to act as a single interlocutor, supervisor and guarantor of Serbia and Montenegro's commitments in this field, notably as an interface with the EU.

Furthermore, administrative reform of both customs services, supported continuously by CAFAO, has progressed but still needs to be deepened, especially in Montenegro. In particular, the enforcement powers of customs agents in both republics have been strengthened substantially, which is critical to implement the rules of trade.

The problems relating to trade in sugar reflect the critical importance of the two customs main issues mentioned above, i.e. administrative capacity and the lack of a state level policy. Given the systemic problems in certifying and controlling the preferential origin, established through fact-finding missions by Commission services, and the initial lack of serious action by all levels of the state on the issues it had repeatedly raised, the Commission had to resort to a suspension of preferences for sugar imported from Serbia and Montenegro in May 2003 to protect the financial interests of the European Community. This suspension applied for an initial period of three months and was extended for additional periods of six months in August 2003 and February 2004 respectively, as the ongoing efforts by the authorities to tackle the customs deficiencies had not fully born fruit yet. A notice to importers covering imports from Serbia and Montenegro was published in January 2004 as a precautionary measure. Continued investigations by the European Anti-Fraud Office eventually revealed specific cases of false certifications of origin concerning sugar (exports of sugar not produced in Serbia and Montenegro and thus illegally benefiting from EC preferences), which still need to be followed up by the authorities. At the same time, Serbia and Montenegro made considerable progress regarding its customs legislation, institutional set-up and operational practice in reaction to the suspension of sugar preferences, supported by CAFAO. The Commission took good note of these improvements. This good progress now needs to become fully sustainable and a settlement for the past cases of irregular origin certification needs to be found, so that the trade preferences in force can function fully.

#### ***4.2.5. Competition (including State aid)***

The development of a competition policy in Serbia and Montenegro remains at its initial stage. The current lack of a legal basis and a functioning administrative structure for competition policy, after the non-replacement of the federal Anti-Monopoly Commission as enforcement body, is a cause for concern, both in view of the functioning of Serbia and Montenegro's internal market and in the perspective of bilateral trade with the EU.

A draft competition law covering restrictive agreements, the abuse of dominant position and merger control has been prepared on the Serbian republican level, with the help of Commission comments. However, Serbia and Montenegro will not adopt this draft as an anti-trust law with state-wide scope, but has instead opted for preparing two separate albeit largely congruent laws on republican level. It is important that under this complex set-up a comprehensive anti-trust regime is enforced throughout the country, applicable to all anti-competitive effects both within and between the republics of Serbia and Montenegro, as well as to effects on bilateral trade between the EU and Serbia and Montenegro.

It has recently been decided to set up a state level Joint Competition Commission, located in the Ministry for Internal Economic Relations, as envisaged in the Action Plan. It is vital that this body becomes operational as an independent and efficient competition authority throughout the state. It is foreseen that this body, while having a wide scope of responsibilities, would still rely on the respective agencies in the republics for competition law enforcement on the ground, which means that such independent bodies would also still need to be set up in the republics in a manner that ensures the efficient enforcement of the

competition rules. In addition, Serbia and Montenegro needs to strengthen cross-sectoral competition advocacy, i.e. a horizontal policy to promote competition policy through screening of draft legislation regarding competition aspects, fostering liberalisation, improving public procurement practices, ensuring a pro-competitive approach to privatisation and an overall strengthening of the rule of law. In fact, a number of sectoral laws already govern aspects of competition policy, but insufficiently.

As to the control of State aid, the first steps still need to be taken towards a basic framework, starting with an administrative structure for coordination and the setting up of a transparent State aid inventory based on a proper State aid definition.

In conclusion, fundamental efforts, both in the legislative and the executive realm, will be necessary if Serbia and Montenegro is to be able to take on and implement obligations under an SAA.

#### ***4.2.6. Public procurement***

The basic legislative framework for Public Procurement, including Public Procurement Agencies, has been established through laws adopted in both republics. However, a basic harmonisation of procedures within Serbia and Montenegro is still necessary to avoid the situation where operators would face different hurdles. Serbia's Public Procurement Agency drafted amendments to the republican law in late 2003 which are however stuck in Parliament. The draft legislation should be made compatible with the *acquis*. Montenegro is also working to improve its law's provisions, including approximation with the Serbian law as well as full harmonisation with the *acquis*. Generally, the administrative capacity of both republican agencies needs to be further improved.

#### ***4.2.7. Intellectual, industrial and commercial property rights***

There has been further progress on Serbia and Montenegro's intellectual property legislation, which is currently being harmonised with the international conventions in this field, including the relevant TRIPS standards, and the EU *acquis*. These amendments, concerning copyrights and related rights, patents, trademarks designs and the design of integrated circuits, are scheduled for adoption. This should be achieved rapidly, as in the framework of its accession to WTO, Serbia and Montenegro will have to undertake to implement TRIPS fully.

The Serbian Criminal Code was amended to improve IPR enforcement, notably by introducing *ex officio* prosecution of piracy and counterfeiting, the strengthening of the position of rightholders as civil parties and through provisions on the seizure and physical destruction of illegal goods and their production devices. Temporary protective measures will henceforth also be applicable upon the request of third-party rightholders. Furthermore, Serbia's new Customs Law foresees increased border measures to prevent the import of counterfeit and pirated goods. On the other hand, Montenegro's Customs Code lacks such provisions and the necessary by-law has not been passed yet.

Consequently, while the material reform legislation is about to be passed on state level and overall policy input is provided by the state level IPR Office, diverging enforcement rules in the republics are still a cause for concern. The coherent legal protection of intellectual property rights is therefore not yet fully ensured throughout the state.

Both republics have set up Anti-Piracy Commissions. It remains to be seen whether this will improve the coordination between the administrative bodies involved. In addition, the administrative resources of all agencies concerned, despite better cooperation, appear not to be sufficient, which leads to a persistent enforcement deficit.

### **4.3. Sectoral policies**

#### **4.3.1. Industry and SMEs**

While traditional industry still suffers from chronic under-investment and insufficient commercial banking capacity and is still undergoing ownership transformation through privatisation, governments are trying to create a user-friendly environment for the development of SMEs by simplifying administrative procedures and reducing related costs. At the Thessaloniki Summit, Serbia and Montenegro signed the European Charter for Small and Medium-Sized Enterprises, committing itself to respect key principles and best practices to achieve growth and development.

In *Serbia*, the Government adopted in January 2003 a strategy for development of SMEs in the period 2003-2008. With regard to the legislative activities, three important laws have been drafted (Business Registration Law, Law on the Agency for Business Registers, Bankruptcy Law) and submitted to the parliament, but are currently blocked there.

Serbia is advancing with a pilot project on entrepreneurship in secondary education and has staged an awareness campaign in the whole country to create a positive image for creating and running companies. The banking sector is not fully geared to SME's but various banks are now setting up separate SME departments. A microfinance bank has been established and in May 2003 a guarantee fund was created which started issuing first guarantees in October 2003. The Chamber of Commerce movement is characterised by a very complex organisation which needs reform and rationalisation.

In *Montenegro*, a set of new laws related to business registration and operation (including SMEs) has been adopted by which the registration procedure is shortened and costs reduced. However, there are still problems with obtaining an operating licence.

Six new regional/local business centres are increasingly operational and a seventh one is planned. In Montenegro there are various pilot schemes on entrepreneurship education and skills development in small companies but there is a need for mainstreaming and rationalisation. Montenegro has started looking seriously at opening up an initial series of clusters, technology parks and incubators, confirmed in the targets set under the European Charter for Small Enterprises.

#### **4.3.2. Agriculture and fisheries**

Agriculture in *Serbia*, where it represents 23.8% of the GDP, suffered from a long drought in spring/summer 2003. As a result of that, production of some of the major agricultural products like wheat and some other cereals was substantially lower than expected (the average yields of wheat and maize were 30% lower than the 3-year average). As a result of the drought, Serbia decided on the emergency import of 100.000 tons of commercial wheat to ensure domestic supplies. Overall estimates for the 2003 agricultural output show a 10-15% decrease in comparison with 2002.

In spite of the problems, the sector still significantly contributes to exports. However, the problem of low value added (most exports are unprocessed products) persists. In order to overcome the existing problems, the Ministry of Agriculture is currently working on the national agricultural development strategy until 2010. Other laws are drafted (law on veterinary services, law on rural development agency that will focus on the problems of small farmers etc.).

As far as the state level is concerned, the ministries of agriculture of Serbia and Montenegro signed an agreement on the establishment of one office at the State level (Veterinary Phyto-Sanitary Liaison Office) that will be in charge of harmonisation of legislation in the field,

coordination and control of procedures applied as well as the consistent implementation of regulations in both republics.

However, Serbia has recently seen a protectionist backlash, culminating in the massive increase in special import charges for a great number of agricultural products (cf. supra, section 4.2.1.).

#### **4.3.3. Environment**

Given that environmental protection is a republican competence in Serbia and Montenegro, it is all the more important to coordinate efforts to combat environmental degradation jointly and take a common stance in international organisations. The pragmatic approach taken by both republican ministries in this regard has been helpful. Serbia and Montenegro has also been an active participant in the work on the International Convention for the Protection of the Danube River Basin, which it ratified in August 2003.

In Serbia, the recently established (2002) Ministry of Natural Resources and Environmental Protection engaged in further capacity-building activities in the course of 2003. The Ministry completed the draft Law on Environmental Protection, which was then submitted to the parliament. Other important activities (creation of the Agency for Environment Protection and establishment of links with the European Environmental Agency) are also underway.

In *Montenegro*, institution building is also identified as a priority and this has been done through participation in various activities of the Regional Environmental Reconstruction Program for South Eastern Europe (REReP).

Significant regional developments have occurred in the context of the REReP<sup>15</sup>.

#### **4.3.4. Transport**

In both Serbia and Montenegro, new laws were drafted in the area of road, rail and air transport. In *Serbia*, the Law on Railways, the key document for restructuring and reorganisation of the railway sector, is pending. Important investment activities are going on related to reconstruction of the road network in both Serbia and Montenegro. The reconstruction of Niš Airport has been completed, while the reconstruction of Belgrade Airport started in autumn and is ongoing.

#### **4.3.5. Energy**

Reconstruction and further development of the energy sector, heavily dependent on support from the EU and other donors, are among the top priorities. The overhaul of the energy generation and distribution infrastructure has led to a further improvement in electricity supply. This was due to the mild 2002/03 winter and lower consumption because of the substantial rise in the price of electricity. The collection rate in Serbia improved reaching 90%. As of April 2003, the crude oil import regime has been liberalised. As far as legislative activities are concerned, a Serbian Law on Energy envisaging major reforms in the sector was passed by the Government in June 2003 but has since been blocked in the parliament.

In *Serbia*, the adoption of the new Energy Law is still pending. The draft does not provide detail regarding the scope of the Energy Regulatory Body (ERA) monitoring powers which will reportedly be developed through secondary legislation.

In *Montenegro*, the new Law on Energy was adopted in July 2003. The law requires the establishment of market and competition rules within two years after the law comes into force. At the same time, the Government decided to establish the Energy Regulatory Agency,

---

<sup>15</sup> More information can be found in the section 4.4 “Co-operation in other sectors” of the Strategy Paper.

an independent regulatory body responsible for the development and competitiveness of the electricity market.

#### **4.3.6. Telecommunications**

The Law on Telecommunications was passed by the *Serbian* Parliament in April 2003. The law envisages the establishment of a Regulatory Agency for Telecommunications, which is underway. In *Montenegro*, a Regulatory Agency for Telecommunications was established in line with the republican Law on telecommunications from 2000. Currently there are two mobile operators in each of the two republics.

#### **4.4. Co-operation in justice and home affairs**

*The adoption of the new constitutional arrangement introduced major changes, by transferring all competencies in this field to the republican level, with the exception of visas, integrated border management, asylum and migration (the explicit power for which is however questioned by the republics). Difficulties persist regarding the division of competences. Coordinating mechanisms have not been established, with the valuable exception of readmission, where a joint working body was set up. Border demilitarisation has begun, although only on the Montenegrin part of the territory. Differences in visa policy persist, although efforts are being made towards further harmonisation. Inter-agency cooperation seems to be improving, but coordination between the republics requires formalisation. Specific measures were prepared for the fight against organised crime. Regional and international police cooperation has further improved, but the outstanding issue of the National Bureau for cooperation with Interpol remains.*

##### **4.4.1. Visa, border control, asylum and migration**

**Visa:** Differences in the **visa regime**, as applied by the republics, still exist in contradiction to the Constitutional Charter, which stipulates that the state is competent to adopt legislation concerning visa policy.

A positive step was the decision of the Council of Ministers of May 2003, which provided for the repeal of the visa regime for around 40 European and non-European countries, including all EU Member States. However, some exceptions were provided for Montenegro, thus preventing full harmonisation. Notably, an exceptional visa free regime was kept in Montenegro for 3 countries (Albania, Russian Federation and Ukraine), and different entry procedures were allowed for citizens of former Yugoslav republics, (Slovenia, FYROM, Croatia, and Bosnia and Herzegovina), who can enter Montenegro, but not Serbia, with IDs only (for tourist purposes). A comprehensive solution must be found to provide for effective establishment of a fully harmonised and unified visa regime throughout Serbia and Montenegro's territory, and the abolition of all internal check points (including at airports), which have a negative impact on the free movement of citizens and visitors alike.

Serbia and Montenegro took other steps towards alignment with the Schengen requirements, by introducing visas for several African and Asian countries. Steps were also taken to improve the security of travel documents and of visa stickers, together with stricter rules on the issuance of diplomatic and official passports, to prevent abuses, which often took place in the past. Efforts are also ongoing to modernise consular services and shorten procedures. Where it continues, the practice of issuing visas/tourist passes at the borders should be repealed.

Visa procedures were made stricter for source countries for human trafficking. Serbia and Montenegro has a reciprocal visa free regime with all former Yugoslav republics, except Slovenia.

**Border management:** Following the Ohrid Conference on Border Security in May 2003 Serbia and Montenegro presented further concrete measures at the EU-Western Balkan Justice and Home Affairs ministerial meeting in November. These will be implemented in the short term under monitoring by the Commission.

Integrated border management in practice continues to be obstructed by different interpretations of the Constitutional Charter. A Memorandum of Understanding was signed in July 2003 between the two republican Ministers of Interior and the state level, (as a precondition for the start of CARDS border projects in the two republics). However, there has been no evidence to date of any practical inter-republican coordination concerning border issues. Inter-agency cooperation within the republics is also insufficient. However, one positive step was the announcement in Serbia of an agreement on cooperation to facilitate coordination between different services (border police, customs, transport, phyto-sanitary) involved in border management.

There has also been a significant delay in the adoption of new, comprehensive border legislation. Some steps have already been taken, notably the demilitarisation along the Montenegrin part of the state border, including the administrative boundary line with Kosovo. A decision was adopted by the Supreme Defence Council (10 June), providing for the provisional takeover of the border by the Montenegrin police, pending the final adoption of the new legislation on the state border. The Montenegrin Ministry of Interior reported that the demilitarisation was completed by end 2003). Good contacts are reported with UNMIK (with which the Montenegrin Ministry signed a protocol on cooperation). Preparations are underway for a similar transfer on the Serbian part of the border, but the Serbian Ministry of Interior claims it is still not ready and lacks the necessary resources. Meanwhile, both Ministries have been engaged in training and educating their staff, together with the reconstruction of border crossings.

**Asylum:** Preparations for new legislation, at the state and the republican levels, are still at an early stage. In the absence of progress the current situation is characterized by obsolete legislation and procedures, coupled with inadequate infrastructure and human resources. No internal coordination efforts or mechanisms have been initiated so far. The outdated refugee legislation also makes it difficult to implement obligations under the 1951 Geneva Convention and 1967 New York Protocol. Progress in this area is essential and is also part of the Council of Europe post-accession commitments.

**Migration:** Illegal migration continues to be a serious problem, although credible efforts have been taken at different levels. Inter-agency cooperation within the republics seems to be improving, although there is little evidence of the coordination of efforts between the republics.

There have been positive developments in the area of **readmission**, where a joint working group, comprising the relevant state and republican institutions, was reported to have been established. Serbia and Montenegro has so far signed readmission agreements with a large number of countries, with negotiations ongoing with a number of other countries. However, there may be significant practical problems (social and economic) with the implementation and return of large numbers of Serbia and Montenegro's citizens, for whom adequate living conditions will have to be secured, with scarce resources.

#### **4.4.2. Money laundering**

At the state level, a positive development was the ratification in October 2003 of the European Convention on Laundering, Search, Seizure and Confiscation of Proceeds from Crime.

*Serbia* is implementing the former federal anti Money Laundering Law (in force as of July 2002), and the formerly federal Commission (which used to be part of the Yugoslav Central Bank) was subsumed to the Serbian Ministry of Finance and Economy. Its establishment as an independent administrative body is envisaged.

Changes to the current Law are being prepared, to bring all the procedures, including those related to asset confiscation, in line with international standards. *Serbia* also became a full-fledged member of the Egmont group (July 2003).

*Montenegro* adopted its own legislation in September 2003, stipulating identification of all transactions beyond 15,000 euros. The procedure of setting up specialised bodies is ongoing. The adoption of the Law is a welcome step, but there are some flaws in the scope of the Law (e.g. level of fines; exclusion of sport associations and – interestingly - tobacco companies; furthermore various aspects of the practical implementation – registration of cases, co-operation with banks etc).

Overall, despite progress in setting up legal and institutional mechanisms in both republics, the practical enforcement and investigation of cases allegedly involving money laundering has proven to be difficult. Training of the police, prosecutors and judges should be further improved. Fight against money laundering would benefit from increased cooperation between the Serbian and Montenegrin anti-money laundering agencies.

In the follow up to the Thessaloniki commitments the country adopted specific measures of a regional nature to exchange information on suspicious financial transaction. This measure has been presented at the EU Western Balkans JAI ministerial meeting on 28 November 2003 in the framework of the Thessaloniki forum.

#### **4.4.3. Drugs**

Drug trafficking continues to be a serious problem in *Serbia* and *Montenegro* is an important transit route. Actions were taken in *Serbia* during Operation *Sabre*, within the overall activities against organised crime groups. Actions against key channels of trafficking in narcotics were taken but efforts were not sustained. A reorganisation of the Serbian Customs Office took place in August 2003, and together with the announced initiative on signing an inter-agency cooperation agreement, could lead to further results in fighting drug trafficking. Stricter penalties were also introduced by changes in the criminal legislation.

In *Montenegro*, a special department on drugs trafficking for the fight against organised crime was established in the Ministry of Interior, but it currently lacks human and other resources. The Government adopted in June 2003 an Action Plan for the prevention of drug abuse by children and youngsters. However, implementation was hampered by scarce financial resources (the Government was only able to secure 35% of the necessary funds). The new Law on Tobacco in force as of March 2003 provides penalties for illegal production. A strategy for fighting tobacco smuggling is in preparation. The Montenegrin leadership is burdened with persisting allegations by some foreign judicial services claiming the involvement of some top officials in activities linked with organised crime, notably tobacco smuggling. The Montenegrin authorities will have to take firmer action in this respect.

A national drugs strategy in line with the EU Drugs Strategy and Action Plan on Drugs should be developed.

#### **4.4.4. Police**

In December 2003 the two republican Ministries of Interior signed a comprehensive Memorandum on police co-operation. This positive development should allow the establishment of a Joint Commission for co-ordination of all police related activities.

In July 2003, the two Ministries of Interior, together with the state Ministry for International Economic Relations, signed a Memorandum of Understanding on border police co-operation. However, there has been little follow-up in terms of practical implementation. An outstanding issue concerns international police co-operation, notably with Interpol: Montenegro maintains its request for separate membership and contests the current institutional situation whereby the Interpol National Bureau is integrated into the Serbian Ministry of Interior.

In both republics, the reform of the republican police forces has continued. However, in spite of the recommendation of the 2003 SAP Report the core police laws have still to be adopted.

In *Montenegro*, the draft law on Montenegrin Police and the draft law on establishing the National Security Agency have been blocked in the parliamentary procedure since July 2003, due to divergent views inside the ruling coalition over the appointment of the Agency's director. This led to the resignation of the then Minister of Interior in November 2003. Furthermore, the current deadlock delays the envisaged establishment of new bodies to enhance transparency and internal and external accountability (code of ethics, civilian oversight, etc.).

In *Serbia*, the police law is also pending. The state Security Law was adopted in 2002, but there are concerns due to the lack of adequate human rights safeguards and too wide competencies of the State Security Agency. In April 2003 the Serbian Ministry of Interior presented a comprehensive document on police reform, but the key prerequisite remains the adoption of the new police legislation. The code of police conduct in Serbia came into force in April 2003. In addition, the General Inspector Office was set up in June 2003, to provide internal accountability. However, there was little information and evidence available on the outcome of the work of this Office.

Both Ministries of Interior have specialised directorates for fighting organised crime, but they lack (especially in Montenegro) human resources, infrastructure and equipment.

In *Serbia* the police achieved results in the aftermath of PM Djindjic's assassination (Operation *Sabre*) in actions against several organised crime channels, and resolving some high-profile political murders (e.g. Stambolic case). The legal basis for the action was amended during the state of emergency, introducing controversial changes undermining human rights and giving wider powers to the police. These were later repealed, but the allegations of misconduct and torture do not seem to have been fully investigated.

A major step forward was made with the disbanding of the Special Forces ("Red Berets")<sup>16</sup> in March 2003. However it is not clear to what extent the police in general was cleared of elements potentially linked with organised crime.

Police training continued in both republics, as well as the implementation of the community policing projects. A noteworthy development in *Montenegro* was the start in October 2003 of training for women police officers on domestic violence and human trafficking. The Montenegrin police will need enhanced training for the implementation of the new criminal laws.

Steady progress has continued with regard to regional and international police co-operation. In particular Montenegro signed an Agreement on police co-operation with UNMIK (in October 2003), as Serbia had done in 2002. The Agreement establishing the Inter-

---

<sup>16</sup> Their deputy commander was charged with the assassination of PM Djindjic.

governmental Council for Co-operation between Serbia and Montenegro and Bosnia and Herzegovina was also signed in October 2003.

#### **4.4.5. *Fighting organised crime and terrorism***

In the follow up to the Thessaloniki commitments the country adopted several specific measures against organised crime. All these measures have been presented on 28 November 2003 at the ministerial meeting on Justice and Home Affairs within the framework of the EU-Western Balkans Forum. The country will implement these measures in the coming years under monitoring by the Commission.

The inter-ministerial cooperation that was established for the preparation of the above action-oriented measures against organised crime was a very welcome development. A set of important operations has been prepared in both republics, including regional cooperation in the areas of anti-money laundering and witness protection. The real test will be their implementation, and in particular the improved cooperation of the respective republican services (police, courts, and financial investigative units).

Otherwise, there was limited progress in setting up comprehensive and harmonised legal and institutional mechanisms for fighting corruption and organised crime. The key anti-corruption legislation is still pending. Criminal legislation is amended or completely changed, but the implementation remains impeded by insufficient resources (infrastructure, staff, funding). In addition, the basic systemic laws concerning the police remain to be adopted in both republics. This is seriously delaying the restructuring and re-organisation of the police in line with modern, European, standards.

PM Djindjic's murder was by far the most serious indication of the pervasiveness of organised crime and the connection between organised crime and war crimes. Both are a heavy legacy from the past, which having penetrated the official structures of the former regime continue to burden the new, democratic, authorities. In spite of this, there has been only sporadic evidence (such as the disbanding of the *Red Berets*) of comprehensive action inside the security structures to remove obstructive elements from the past.

In *Serbia* the police managed to achieve some significant results following the PM's assassination. Positive changes were made in the Criminal Code in April introducing new offences (such as human trafficking, computer crimes, child pornography) and stricter penalties (e.g. for drug abuses). Operation *Sabre* (March-April 2003) led to results in breaking up key organised crime channels and in resolving previously unsolved high profile cases, including murders, abductions and political assassinations. However, some of the practices during this operation are legally questionable and could possibly have adverse implications for the admissibility of evidence at the forthcoming trials. The trials against 45 indicted persons charged with involvement in the PM's assassination started in December 2003. A comprehensive system is being established under the specialised legislation for the fight against organised crime, adopted in 2002, but its practical operation is problematic, due to insufficient resources. The Special Prosecutor for the fight against organised crime was appointed in March 2003, a new building for the specialised court to try cases of organised crime and war crimes was opened in October 2003; there is a separate police directorate and penitentiary/prison units in preparation. The existing police directorate has been additionally assigned the investigation of war crimes. This will place a considerable burden on its already limited staff. The necessary security measures for future trials will also entail significant costs.

No comprehensive action had been taken to investigate financial crime.

*Montenegro* adopted in December 2003 a whole new set of criminal legislation. The new act setting up the republican Prosecutor will also establish a specialised prosecutor for fighting organised crime. There is a specialised police directorate, but it is at a very rudimentary level, lacking basic equipment and human resources.

Changes were made in the criminal legislation to include **human trafficking** as a specific offence (July 2002 in Montenegro and April 2003 in Serbia). These need to be accompanied by adequate procedural provisions, including comprehensive witness protection, improved inter-agency cooperation, and regional cooperation. Some of these issues were addressed during the preparation of action-oriented measures for fighting organised crime (presented at the Ministerial meeting with the EU on 28 November 2003). The national team for anti-trafficking and a coordinator exist in Serbia, as well as a special inter-departmental police team.

In *Montenegro* special police teams were subsumed to the organised crime directorate of the Ministry of Interior, which currently seems to be short of all necessary resources. Public awareness campaigns, with wide NGO participation, have been initiated in both republics, but further activities in raising the level of awareness of media, elected officials and of the general public are essential.

Several operations have been carried out both in *Serbia* (especially during the police operation *Sabre*) and Montenegro, resulting in the cutting of some major trafficking channels. A number of criminal charges were pressed against perpetrators but these are still relatively few compared to the size of the problem. Moreover, there is no available information on any convictions for offences related to trafficking. Shelters for victims exist in both republics. Regional police cooperation is good, as are international contacts. However, Montenegro's application for a separate National Bureau appears to be having an impact on the efficiency of police actions.

Serbia and Montenegro continues to face serious challenges, as a country of origin, transit and destination. Further measures are needed to ensure effective border protection and control, training of border police and regular cooperation at all levels. The ongoing high-profile human trafficking case in Montenegro was an indication of the outstanding problems in dealing efficiently with trafficking: inadequate legislation, deficient legal procedures, lack of political will to prosecute perpetrators, lack of political accountability<sup>17</sup>, alleged pressure (even threats) on the judiciary and intimidation of victims/witnesses. The implementation of the Government strategy to fight against human trafficking, which was adopted in November 2003 aimed at bringing about solutions to some of the above-mentioned systemic problems. Equally, the goodwill demonstrated by the Government to allow an independent, international review of the case was a welcome step and should be followed by duly taking on board the experts' recommendations.

## 5. EC FINANCIAL ASSISTANCE

Overall, between 2000 and 2003 (included), Serbia and Montenegro benefited from a total of more than €1.6 billion in EC assistance.<sup>18</sup> Besides the CARDS assistance, the EC provided balance-of-payments support in the context of IMF stabilisation programmes, as well as humanitarian support (ECHO) and democratisation assistance.

---

<sup>17</sup> For example the Republican prosecutor, despite serious charges pressed against his deputy, only resigned after protracted political bargaining inside the ruling coalition.

<sup>18</sup> Excluding EC assistance to Kosovo, which in the same period amounted to some €993 million.

**CARDS** assistance allocated to Serbia and Montenegro between 2000 and 2003 totals €898 million. Initially CARDS assistance focused on reconstruction with significant assistance with infrastructure, especially rehabilitation of the energy and transportation sectors. The emphasis of the assistance has shifted and is now more concentrated on institution building, economic reform, and support for civil society and media. Assistance also takes due consideration of past and ongoing programmes, and provides support for structural reforms in the targeted sectors, paving the way for IFI intervention.

The bulk of all CARDS assistance is implemented by the European Agency for Reconstruction. Programmes in the areas of customs and taxation and higher education continued to be centrally implemented by the Commission. Implementation continued to be speedy and efficient. Of the 2000-2003 programmes, 89 % has been contracted and 63% has been disbursed by December 2003<sup>19</sup>.

In 2003, some €255 million were allocated for implementation in Serbia and Montenegro, of which €15 million for Montenegro and €240 million for Serbia and the State Union. The assistance was focused on governance (public administration reform with particular focus on public finance reform, justice and home affairs and customs and taxation), economic recovery and reform (energy, transport, environment, enterprise and municipal development) and social development and civil society (university and professional education and civil society and media).

In the 2004 programmes, the gradual shift to longer-term development assistance and to support institutional reform continues, with packages of €214 million for Serbia/state level and €15 million for Montenegro. This includes the additional €19 million that was allocated to Serbia and Montenegro in accordance with the Council conclusions of 16 June 2003 on the Western Balkans endorsed by the Thessaloniki European Council of 19 June 2003. The programmes are in line with overall SAP priorities as reflected in the European Partnership. The key sectors in 2004 are Justice and Home Affairs, Public Administration Reform (including state level institutions of Serbia and Montenegro), energy, environment and economic development, as well as the return and integration of IDPs and refugees.

The CARDS programmes continue to facilitate IFI investment in particular EIB, EBRD and WB, especially in the sectors transport, energy, health, education, SME and local government.

In early November 2002, the Council decided to provide the country with Community **macro-financial assistance** of up to €130 million, following a first €345 million package of EC macro-financial support already implemented in 2001/2002. The objective of this assistance is to underpin economic policies in the context of a three-year IMF programme (2002-2005) approved in May 2002, and in particular to support the balance of payments and strengthen the country's foreign exchange position. Two tranches of this assistance amounting to €40 million and €65 million were disbursed in 2003<sup>20</sup>. In October 2003, a Commission staff mission reviewed the fulfilment of conditionality for the third tranche under this assistance, and concluded that substantial additional progress was necessary before the third tranche could be disbursed. In November 2003, the Council decided to increase the current EC macro-financial assistance by €70 million to up to €200 million to help addressing additional financing needs identified by the IMF in the context of the current stabilisation programme. **EC humanitarian assistance** to Serbia and Montenegro since 1999 totals over €165 million.

---

<sup>19</sup> Contracting and paid figures exclude the additional €16.3 million committed to Kosovo at the end of December 2003.

<sup>20</sup> The size of the second tranche was relatively big as it had been decided to frontload EC macro-financial assistance to address potential financial strains following the assassination of PM Djindjic.

ECHO concluded its operations in Montenegro in 2002 and in Serbia in 2003. Its final project provides heating to collective centres in Serbia during the 2003-2004 winter. ECHO's and other relief agencies exit from Serbia signals that the worst of the humanitarian crisis is indeed over. The Commission organised a workshop in Belgrade in September 2003 to identify areas on which both the authorities and the donors need to work, in order to ensure that the end of humanitarian assistance does not create too many unmet needs for vulnerable segments of society.

Democratisation assistance continues to be provided under the **European Initiative for Democracy and Human Rights**, with specific projects for the state worth €4.6 million in 2001 and €2.78 million in 2002 and €2.2 million in 2003. Serbia and Montenegro also benefits from EIDHR regional activities.

A **Donor Coordination Meeting** for Serbia and Montenegro was organised by the European Commission and the World Bank on November 18<sup>th</sup> 2003, two and a half years after the successful donor conference of June 2001. The objective of the donor meeting was to assess the progress achieved in stabilising the political and economic situation and the challenges ahead in sustaining a viable reform path. It was announced that during 2004 overall donor commitments in support of Serbia and Montenegro could reach €1.1 billion, which would meet the overall target set in 2001.

## 6. EU PERCEPTION

European integration has been an important element of the political debate in Serbia and Montenegro throughout the reporting period and has been featuring in the political objectives of almost all political parties. One of the most significant expressions of the partnership between the EU and the country came through a joint visit by Commissioner Patten and High Representative /Secretary General Solana on the day following the assassination of Serbian PM Djindjic, which gave a strong message to the country that the EU regards Serbia and Montenegro as an important partner and that it strongly cares about its stability and democratic development.

The local opinion polls that appeared over the year continuously recorded a 70-or-so percent of the public in favour of joining the EU. However, there are still discrepancies in results when the same respondents in favour of EU integration are asked about their opinions on some of the conditions (co-operation with ICTY being the most controversial).

Serbia and Montenegro's media continue to show significant interest in EU affairs. Still, topics are mainly locally focused and concentrate on activities of EU players (Delegation, EAR) in the country.

The Stabilisation and Association Process is seen as a process that in the end will result in EU membership of the country. The media have paid significant attention to the process, focusing, however, more on problematic moments in the relationship (such as the suspension of preferential sugar export regime) than trying to focus on the actual process and its continuous benefits as such. Consequently, there is a continued need for more information about the EU and the European integration process both as regards the policy-makers, public administration and the public opinion.

The EU generated peaks of coverage on the occasion of high profile events such as the signing of the Accession Treaty between the EU and the ten Acceding Countries in Athens in April 2003 and the EU - WB Summit in Thessaloniki in June 2003 which were all perceived in a positive context. But headline peaks were also related to controversies such as in the case

of the suspension of the preferential export regime for Serbia and Montenegro sugar to the EU market.

In order to overcome the noted shortfalls in proper understanding of the European integration process, the EU actors in the country need to continue and even increase EU and, more specifically, SAP visibility and understanding. The complementary roles of the EU actors and national/local authorities and opinion makers/opinion leaders (media, civil society organisations, academia, business, etc.) need to be strengthened. It is important that the country takes leadership and ownership of the process.

**SECTION ON KOSOVO**  
**as defined by the United Nations Security Council Resolution 1244**

**TABLE OF CONTENTS**

<b>1. EXECUTIVE SUMMARY.....</b>	<b>51</b>
<b>2. POLITICAL SITUATION.....</b>	<b>52</b>
2.1. Democracy and rule of law.....	52
2.2. Human rights and protection of minorities.....	57
2.3. Regional and international co-operation/obligations.....	59
<b>3. ECONOMIC SITUATION.....</b>	<b>59</b>
3.1. Current economic situation.....	59
3.2. Existence of a free-market economy and structural reforms.....	61
3.3. Management of public finances.....	62
<b>4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS.....</b>	<b>62</b>
4.1. General evaluation.....	62
4.2. Internal market and trade.....	63
4.3. Sectoral policies.....	64
4.4. Co-operation in justice and home affairs.....	65
<b>5. EC FINANCIAL ASSISTANCE.....</b>	<b>65</b>
<b>6. PERCEPTIONS OF THE EU.....</b>	<b>67</b>

## **1. EXECUTIVE SUMMARY**

The UN key decision to operationalise the Standards for Kosovo, and the launch – although amidst difficulties – of the Dialogue between Pristina and Belgrade on issues of common concern, were the main developments over the reporting period.

Just at the time when the direct dialogue between Pristina and Belgrade seemed to be finally on track and the Kosovo standards implementation plan was about to be finalised, the ethnically motivated violent incidents that occurred in March 2004 marked a serious setback to the establishment of a secure, democratic and multi-ethnic Kosovo.

Over the reporting period, the performance of the Provisional Institutions of Self-Government (PISG) and public administration has started to improve, but significant deficiencies still need to be addressed with determination. The transfer of non-reserved competencies from the United Nations Interim Administration Mission in Kosovo (UNMIK) to the PISG was completed by the end of 2003. Now the PISG need to make full use of the transferred competencies to take greater responsibility for the reforms and their implementation under the ultimate responsibility of UNMIK, which in addition holds the reserved powers. The late and inadequate reaction of the PISG to the events of March 2004 raises serious concerns. The rule of law needs to be strengthened, in particular as regards effective implementation and enforcement of the legislation.

While some efforts were made notably in the second half of 2003, substantial and sustainable return of displaced persons to Kosovo was hampered by the unfavourable socio-economic conditions and precarious security situation. The March 2004 violent incidents have led to the forced displacement of members of minority communities and have exacerbated the climate of insecurity with a very adverse impact on the overall process of returns.

Despite some improvements, the economic situation remains a major cause for concern: Kosovo's economy is still heavily dependent on foreign aid and remittances and is far from being viable. Unemployment is high and likely to increase, thus creating fertile soil for social and political unrest. Privatisation of socially owned enterprises and restructuring of public utilities have not advanced satisfactorily. The management of public finances need to be more efficient and transparent.

Over the reporting period, progress has taken place in setting Kosovo's European perspective through the implementation of the Stabilisation and Association Process Tracking Mechanism (STM). The Commission has provided to the Kosovo authorities policy advice on a number of sectors with a view to supporting EU compatible reforms. At the same time, the STM process reinforces and strengthens the work being done on the Standards for Kosovo.

The European perspective means that Kosovo people will be able to benefit from the peace and prosperity that the process of European integration has secured in a free and democratic manner throughout most of the continent. To achieve this aim, Kosovo needs to be firmly anchored in the Stabilisation and Association Process. However, the March 2004 incidents shows that Kosovo people and the PISG need to engage seriously in the process.

## **2. POLITICAL SITUATION**

### **2.1 Democracy and rule of law**

**Constitutional Framework** - The process of transfer of non-reserved competencies - listed in chapter 5 of the Constitutional Framework - to the Provisional Institutions of Self Government was completed by December 2003. In some areas, enabling legislation needs to be adopted for the newly transferred competencies to become operational.

The Standards for Kosovo document was presented in December 2003 by the UN Special Representative of the Secretary General (SRSG) and representatives of the PISG and was endorsed by the UN Security Council which invited all parties to cooperate in its implementation. UN Mission in Kosovo (UNMIK) and the PISG have been jointly devising a work plan which outlines the concrete actions needed to achieve individual standards. Once this work plan is finalised, it will be of key importance that the Kosovo institutions carry out the actions outlined in it.

Belgrade authorities consider the Standards document unacceptable since they believe that their concerns were not sufficiently taken into account and because they believe it undermines UN Security Council Resolution 1244 (1999). Kosovo Serbs have been invited to participate in work on the preparation of the standards implementation work plan but they have chosen to abstain. As Kosovo's future, no matter under which specific institutional arrangement, is firmly rooted in a European context, it is critical that the standards and the implementation work plan have a strong European dimension and reflect the long term European perspective of Kosovo.

**The Provisional Institutions of Self Government** - The PISG (Assembly, Government, President, and Courts) have improved their overall performance compared to the poor performance of 2002 when they were established. However, the late and inadequate reaction of the PISG to the events of March 2004 raises serious concerns. The PISG must take all necessary steps as required by the United Nations Interim Administration in Kosovo to overcome the consequences and address the causes of the March 2004 events, notably by explicitly condemning violence against minority communities, fully co-operating with UNMIK-KFOR to bring those responsible to justice, encouraging witnesses, restoring and rebuilding properties and allowing return of displaced persons.

In general, the still fragile democratic culture and inter and intra party struggles continue to affect the effective functioning of the PISG and the independence of the public administration. Furthermore, the PISG are hindered by a weak administrative capacity. The PISG need to improve their functioning and effectiveness in the transferred areas. This will require better co-operation and coordination at all levels, and between the central and municipal authorities.

Cooperation between UNMIK and the PISG has been complicated by the PISG's calls for the transfer of competencies to be accelerated and even to include areas that the Constitutional Framework reserves to UNMIK. The PISG have challenged UNMIK authority on various occasions and have taken a confrontational and unconstructive approach to privatisation, which is also a reserved power. In the areas where there are links between the transferred and the reserved competencies, co-operation between PISG and UNMIK needs to be improved. Nevertheless, the operationalisation of the standards policy opens the door to such increased co-operation.

**Parliament** - The functioning of the Assembly has started to improve, through better planning of its work and a more active role of the Assembly committees. This has allowed

some progress as regards law-making. During 2003, 28 Assembly laws were promulgated by the SRSG. However, the Assembly's capacity to initiate legislation still remains very limited.

On a number of occasions, the Assembly acted beyond its mandate and legislated on reserved areas or in contradiction to UNSC Resolution 1244, for instance, by "abrogating" Socialist Federal Republic of Yugoslavia acts after 22 March 1989 (this resolution was declared null and void by the SRSG) and by failing to address all UNMIK comments on its rules of procedure, which are still not agreed. On the positive side, Assembly debates with UNMIK participation such as those organised on the judiciary, returns and security issues have contributed to better cooperation between the Assembly and UNMIK. A very serious cause of concern is that on the occasion of the incidents of March 2004, the Assembly adopted a statement that failed to call, in an immediate and unequivocal manner, for the end of the violence.

The participation of the Kosovo Serb members in the work of the Assembly has improved. After having withdrawn in November 2002, Coalition Return (KP), the party of Kosovo Serbs, returned to the Assembly in February 2003. Since then, KP has been making regular use of the special procedure under the Constitutional Framework which provides safeguards for the key interests of minorities. In sensitive cases, the recommendations made in the context of this special procedure were not taken into account by the Assembly. On the positive side, there have also been instances in which the KP has supported legislation proposed by Kosovo Albanians, for example, the law concerning agricultural co-operatives. Overall, more effective participation of minority community members in the legislative process should be encouraged.

The quality and timeliness of legal translations continues to represent an impediment to the effectiveness of the Assembly. Draft legislation is available only in English, Albanian, and Serbian, although Serbian versions are frequently produced late in the legislative process making it difficult for Serb members effectively to contribute to the debate and drafting. Legislation that has been promulgated is published with great delay in the Official Gazette which is available only electronically on the UNMIK website. Not even key pieces of legislation such as the Constitutional Framework are translated into Bosniac or Turkish. The Commission recommendation that legislation be available in local languages has thus been met only partly.

**President** – The President of Kosovo has used his representation functions in a constructive way, notably by participating in the launch of the Pristina-Belgrade Dialogue in Vienna in October 2003. In 2003, in order to increase cooperation among the PISG, the President appeared before the Assembly for the first time.

**Government** - The government has taken steps to improve its organisation and functioning. The recently established position of Secretary of the Government within the Office of the Prime Minister (OPM) and permanent secretaries of the Ministries should work to improve the coordination of the government. The government has also appointed a Liaison officer to the Office of the SRSG and the joint UNMIK-PISG working groups have begun preparing the implementation of the Standards for Kosovo. Efforts to improve intra and inter-ministerial coordination, policy formulation, and legal drafting should be continued.

The Government has stepped up its legislative capabilities in 2003. Importantly, a "Harmonisation Cell" was established in the OPM with EU support to prepare legislation in compliance with the *acquis*. The government needs to fully institutionalise the Harmonisation Cell within the OPM and to more consistently take into account the recommendations of the Cell. The government should also increase its capacity to assess the impact, including

budgetary, of proposed legislation and to ensure the consistency of proposed legislation with their overall legislative program. Consideration should also be given to include other ministries in EU harmonisation efforts.

**Local government** - Some measures have been taken in the field of local governance to improve the effectiveness and responsiveness of municipal administrations to the needs of the local population. In most municipalities, however, the civil service shows a general lack of professionalism in implementing transparent, non-politicised and ethnically balanced procedures in areas such as recruitment and procurement. Furthermore, municipal regulations, once adopted, are often not implemented. Local officials need to respect the competences of the central government and UNMIK. At the request of the SRSG, the Council of Europe has presented a report on decentralisation which is under review.

**Public Administration** - The legal and administrative framework for the Kosovo Civil Service has been improved in 2003, although provisions for the basic requirements for becoming a civil servant, categories or positions of civil servants and a unified salary system are still lacking. The law only provides for employment contracts limited to a three year period. Although the contracts can be extended, the conditions for such extension are not included in the law. Overall, there continues to be a disparity between what happens in practice and what is prescribed under the various regulations.

Politicisation of the civil service has continued to increase. Political appointees are pressured to act on the basis of political directives that undermine the procedures established in the Civil Service Code of Conduct. The establishment in late 2003 of an Independent Oversight Board and the joint UNMIK-PISG Steering Board on Public Administration should at least partially counter this trend. The Kosovo Institute of Public Administration offers training to civil servants which needs to be continued and enhanced for civil servants at all levels.

As of July 2003, the government implemented a hiring freeze of civil servants (except for the education and health sectors) for the remainder of the year to limit the public wage bill, while at the same time working to streamline public administration. Efforts have thus been made to address the 2003 SAP recommendation on controlling the wage bill and streamlining public employment. This reform needs to be pursued to liberate the resources necessary to attract and retain qualified personnel in the civil service.

Efforts to increase minority participation in government continued with varying degrees of success. With respect to the judicial system, six judges and one prosecutor from the Kosovo Serb community were appointed in December 2003, raising the Serb representation to 5%, whereas Kosovo Albanians make up 90% and other minorities 5% of judges and prosecutors. In the Kosovo Police Service (KPS), the presence of minority communities has increased to 15% of the total KPS strength by the end of 2003. In north Mitrovicë/Mitrovica, significant progress has been made in the recruitment of Kosovo Serb officers from the Serbian Ministry of Interior into the KPS. While efforts to increase the number of members from minority communities in the Kosovo Protection Corps continued, their recruitment falls far short of goals and is not satisfactory.

**Judiciary** - The new Criminal and Criminal Procedure Codes were promulgated and will enter into force as of April 2004, and represent an improvement in the legal framework for prosecuting criminal cases.

The role of local judges and prosecutors increased over the last year. They dealt with almost all criminal cases and with all civil cases. Recruitment of qualified legal staff remains difficult, particularly with respect to the Kosovo Serb community because of *parallel courts*. Importantly, the ability of local judges or prosecutors to deal with sensitive cases improved.

By the end of 2003 there were 13 international judges and the same number of international prosecutors. In increased co-operation with local judges and prosecutors, the international judges and prosecutors dealt with cases of war crimes, terrorism and organised crime.

Steps have been taken to improve the functioning of the courts in 2003. However, the Supreme Court Chamber dealing with constitutional matters and the administrative courts have not yet been established. Courts are still weak, understaffed and undermined by the overall lack of clarity in the legal framework, all of which results in lengthy delays in resolving cases. Problems remain in translation of court proceedings, timely access to recently promulgated legislation and work of bailiffs. Training for judges and prosecutors continued in 2003 under the responsibility of the Kosovo Judicial Institute (KJI). The Institute implemented a comprehensive yearly training program for all judges and prosecutors covering criminal and civil law, UNMIK Regulations, as well as other areas such as ethics and international human rights standards. Steps should be taken to institutionalise this important judicial training.

**Police** - Further progress has been made in developing the Kosovo Police Service, through new recruitments and training. During 2003 the transfer of responsibilities from UNMIK Police to KPS continued, particularly in the area of investigations of crimes. The KPS still lacks sufficient equipment to properly carry out investigations which in turn makes it difficult to prosecute cases through the courts. Another serious impediment to the preparation of court cases by the police is the unwillingness of witnesses to testify. Authorities have been reluctant to investigate serious crimes, including cases involving violence against non-Albanian communities. In particular, it is a very serious cause of concern the fact that on the occasion of the incidents of March 2004 the KPS failed to a large extent to comply with its duty of enforcing the law.

**Prison system** - The Kosovo Correctional Service has been reinforced through the recruitment of additional staff (notably from minorities) and training. There has been improvement as regards the access to detainees in Pristina prison as recommended in SAP 2003. The prison officials have managed to improve conditions and stabilize the situation in Dubrava Prison as well as at the other prison facilities, but the situation remains tense due to crowded conditions throughout the penitentiary system. The number of prisoners will decrease to some extent with the recent establishment of a probation service. Prisoners now have the possibility to forward their human rights concerns to the Ombudsperson Institution in Kosovo.

**Kosovo Protection Corps (KPC)** - The KPC continued to progress in restructuring its organization and in training its members under its mandate as a civil emergency agency. The commitment of KPC leaders to acknowledge UNMIK authority is positive, but some actions belie this commitment and show that command and control over KPC personnel is not at the expected and desired level. A new oath has been introduced to enhance the individual responsibility of KPC members. In December 2003, the SRSG ordered the suspension of 12 KPC officers following a joint KFOR/UNMIK enquiry into allegations of association with organised crime, abuse of function and other illegal activities. The role of members of KPC in the March 2004 events needs to be thoroughly investigated and assessed. KPC needs to condemn violence unambiguously. The plan for the reduction of one-third of the KPC sites is ongoing. Lack of resources, however, could seriously hinder further progress in KPC reform, particularly with respect to equipment, training and completion of the relocation plan.

**Parallel Structures**<sup>21</sup> - Belgrade-sponsored parallel administrative structures continued to operate in most predominantly Kosovo-Serb municipalities notably in sectors such as courts, property rights, education and healthcare. In addition to structures in Kosovo, there are other administrative structures and courts in the Republic of Serbia assuming jurisdiction over every municipality and district of Kosovo. Belgrade considers these parallel structures are needed due to unavailability of other official structures offering the relevant services in conditions of security and non-discrimination. Overall, the recommendation of the 2003 SAP Report concerning the dismantling of the parallel structures has not been fulfilled. This issue requires careful follow-up.

With respect to courts, Belgrade has yet to implement provisions of the Joint Declaration made in July 2002 to facilitate the integration of Kosovo Serbs into the Kosovo judicial and prosecutorial system. It is difficult to attract qualified Kosovo Serb judges and prosecutors because of the higher salaries paid by Serbia to judges and prosecutors serving under the parallel structures. Furthermore, the parallel courts do not recognize rulings of the Kosovo court system and consequently individuals may be tried for crimes for which they have already been tried by a Kosovo court.

Regarding property rights, there are also administrative parallel structures in the Republic of Serbia that take decisions on the basis of Kosovo cadastral records that have been taken to Serbia. This has also a negative impact on the privatisation process.

As for education and healthcare, there is no cooperation and no information sharing between the two parallel systems. For instance, there is no recognition by the Serb-run schools of certificates or diplomas issued by Kosovo schools, and vice versa.

Serbian Ministry of Internal Affairs Offices issue passports, drivers' licences, identification cards and vehicle registration plates. Many Kosovo residents of all ethnicities have relied on these services, especially those who need to travel to Serbia and other countries in the region, since UNMIK documents are not recognised.

**Rule of law** – Respect for the rule of law is not adequate. The legal framework in Kosovo is complicated and there continue to be difficulties regarding timely publication and access to new laws. The law is sometimes applied arbitrarily which undermines the credibility of the legal system as a whole. Court decisions are sometimes ignored by authorities if they are not considered expedient. The intimidation of witnesses and the fact that the perpetrators of ethnically motivated crimes are not brought to justice contribute to create a climate of impunity and insecurity which is a fertile soil for mistrust and violence.

The Ombudsperson Institution in Kosovo has played an important role in promoting the rule of law and respect for human rights. The Ombudsperson investigated cases concerning property issues, fair trials, abuses of authority, employment complaints and impunity issues. The Ombudsperson facilitates the proper functioning of the nascent institutions in Kosovo and acts as a check on power of the authorities. In this context, it is important that the Ombudsperson is given access to the necessary information and documents by the Kosovo institution.

**Corruption** - Corruption is a pervasive problem in Kosovo that undermines the functioning of democratic institutions and the development of a democratic society and impedes the

---

<sup>21</sup> The general term parallel structures is used to define bodies that have been or still are operational in Kosovo after 10 June 1999 and that are not mandated for under UN Security Council Resolution 1244. These parallel structures operate contemporaneously with, or under the same roof as the UNMIK-recognised bodies. OSCE has examined this subject in the areas of security, courts, property rights, education, health care and issuance of the documentation that exists in Kosovo.

functioning of a market economy. There are important links between corruption and organised crime in Kosovo and the region. There is a need to increase awareness of the problem and to take measures to combat it at all levels, including prevention, effective use of audits, and enforcement. In this regard, the recent promulgation of an UNMIK regulation on money laundering is a welcome development. Efforts to develop and implement a comprehensive corruption strategy should continue.

## **2.2 Human rights and protection of minorities**

The European Convention on Human Rights and Fundamental Freedoms (ECHR) binds the PISG under the Constitutional Framework. Ongoing work undertaken by the Council of Europe and UNMIK needs to be sustained to ensure effective compliance particularly with respect to review and recourse mechanisms.

**Minority rights and refugees** – The rights of minorities are protected under Chapter 4 of the Constitutional Framework and protection of minorities is a reserved power of the SRSG. The main challenges are to promote returns and ensure the sustainability of all the minority communities already living in Kosovo. The Office of the PM has set up a specific Task Force, together with Ministerial Return Coordinator and including working groups on the municipal level. It is also worth noting that the establishment of minority Community Offices in all mixed municipalities was finalised in 2003.

In the second half of 2003 there was increased engagement in, and support for, the return process by key Kosovo leaders. In July 2003, the Kosovo Assembly adopted a resolution supporting returns. Furthermore, the Government has allocated €7 million for return activities from the Kosovo Consolidated Budget (KCB) surplus.

Despite these efforts, substantial and sustainable return of displaced persons to Kosovo was hampered by a number of factors: the unfavourable socio-economic conditions, the fact that freedom of movement and access to services of public utilities remained problematic for members of minority communities, and the precarious security situation, characterised by a number of attacks on minorities and several murders. The March 2004 violent incidents have led to the forced displacement of members of minority communities and have exacerbated the climate of insecurity with a very adverse impact on the overall process of returns.

**Freedom of expression** - The ability of the minority communities to use their own language freely has somewhat improved. Most municipalities have now translation staff although overall the provision of standardised language services to members of minority communities continues to be unsatisfactory.

The media remains divided along ethnic lines. The draft Law on an Independent Media Commission (IMC) is still pending. The key issues are the means of financing of the public broadcaster Radio and Television Kosovo (RTK) and the independence of the IMC. Utmost attention should be paid to the long-term viability of RTK and its ability to perform as a public service broadcaster, particularly provision of services to minority communities.

There is a need to de-criminalise slander in line with the Council of Europe standards.

**Property rights** – The Housing and Property Directorate (HPD) has improved its functioning. Since the July 2003 deadline for submission of property claims, the HPD has notified 97 percent of all claims and resolved 44 percent. The clarification of property rights is also hindered by Belgrade's failures to transfer the cadastral registers to UNMIK. Regarding enforcement, some 1000 eviction cases were undertaken in the past year. There

have been instances of courts issuing decisions outside of their authority in providing property settlements.

**Gender equality** – Despite progress, women are still not adequately represented in the PISG. The presence of women in executive and legislative bodies reflects only legal requirements for gender representation in electoral lists, with 33 out of 120 seats in the Kosovo assembly and 28% of all municipal assembly seats being occupied by women. Women make up 15% of the Kosovo Police Service. An anti discrimination law was approved which is substantially in line with the EC Race Equality Directive. A Gender Equality Law drafted by one of Assembly committees is being finalized.

**Vulnerable Groups** – Twelve percent of the population lives in extreme poverty and the government has taken some steps to protect the most vulnerable. For example, the laws on Social Assistance and on Disability Pensions were approved and promulgated by the SRSG. A system of professional monitoring through the Institute of Social Policy was set up, and Child Protection Manual and Foster Care Training Manual were published setting standards and norms in social service. Ministry of Labour and Social Welfare (MLSW) operates institutions such as for the mentally disabled and the elderly which are closely monitored by International Community.

**Labour rights** – The PISG is starting to develop policies and measures to promote labour rights and address the unacceptably high level of unemployment. For instance, the MLSW provides Labour Market Services through its network of Employment Offices and Vocational Training Centres. Kosovo Essential Labour Law was promulgated as well as the Law on the Labour Inspectorate of Kosovo and Law on Occupational safety, Health and the Working Environment. Enforcement of these laws is difficult, however, because labour courts are weak and in general, labour cases are not given serious consideration.

**War Crimes** – In October 2003, police arrested five Kosovo Albanians on charges relating to war crimes committed in 1999.

### **Dialogue with Belgrade**

Direct dialogue with Belgrade authorities<sup>22</sup> on practical issues of mutual concern was launched at a meeting in Vienna in October 2003, in the presence of high-level international representatives. The Kosovo government failed to take part in the meeting due to the lack of a clear mandate by the Assembly of Kosovo and PISG delegation consisted only of Kosovo President and Assembly of Kosovo Chairman. The decision of the government to abstain from the inaugural meeting of the Dialogue with Belgrade in October resulted in tense relations between UNMIK and PISG.

The meeting resulted in the understanding that dialogue should initially take place in four working groups, focussing on issues of missing persons, returns, energy and transport and telecommunications. The Working Group on Energy and the Working Group on Missing Persons met in March 2003 for the first time. However, this encouraging development risks being seriously undermined by the March 2004 events.

---

<sup>22</sup> Dialogue with Belgrade is one of the Standards for Kosovo and a requirement under that process.

### **2.3 Regional and international co-operation/obligations**

**Regional Cooperation** was significantly enhanced in relation to the previous year; the most notable progress was reached through cooperation under the Stability Pact. UNMIK and the PISG have increased their participation in a wide array of Stability Pact initiatives which benefit Kosovo and promote regional integration. UNMIK has signed a Free Trade Agreement with Albania and is in the process of negotiating with further partners. The fact that an increased number of states recognise documents and license plates issued by UNMIK facilitates regional cooperation. The acceptance of these documents and plates by Serbia is necessary.

There have also been some difficulties with Belgrade in terms of UNMIK/PISG participation in regional initiatives. In particular, there is a need to ensure that UNMIK/PISG is properly participating in the different fora established under the 2003 Athens Memorandum of Understanding (MOU) on the Regional Electricity Market and the MoU on the development of the Southeast Europe Core Regional Transport Network which were signed by Serbia and Montenegro and by UNMIK on behalf of Kosovo.

As regards **ICTY**, the general environment is currently not conducive to the carrying out of the necessary investigations. There is a lack of a political commitment to raise the public awareness about the importance of prosecuting war crimes. Witnesses are systematically threatened and subject to harassment. Measures to provide protection to witnesses are needed. The Law on Cooperation with The International Crime Tribunal has been sent to the Assembly by the Government.

## **3. ECONOMIC SITUATION**

### **3.1. Current Economic Situation**

After the post-conflict and reconstruction driven boom, with growth of 21% in 2001, Kosovo's **GDP growth** has slowed down substantially to 3.9% in 2002 and an estimated 4.7% in 2003. GDP per capita remains low at about €700 euro per year (the lowest in the Western Balkans), while GNP per head is higher resulting from remittances and foreign assistance. Private sector activities continued to be dominated by reconstruction and trade as well as service related businesses. **Unemployment** is high – notably among the minorities - and likely to increase. Even though the registered unemployment rate – 47% of the labour force in 2002 – is exaggerating the actual level due to the sizeable grey economy, the labour market is confronted with an increasing inflow of job-searchers, in particular young people. **CPI inflation** declined to 3.6% in 2002 and further to zero in 2003 reflecting the combination of improving distribution channels and lower margins in the face of weak consumer demand.

The mid-year review of the 2003 budget was delayed with the last appropriations agreed only in December. It is estimated that the accumulated budget surplus at the end of 2003 is €75 million, which is lower than anticipated. However, Kosovo's immediate investment needs for energy and KPC reform easily outstrip the surplus. UNMIK and the PISG estimate that there is a funding gap of about €8 million.

The 2004 budget was adopted on 31 December 2003 foreseeing an increase of 6% in revenues and a slight decrease of expenditure (-3%). Given the high investment needs, UNMIK and the PISG urgently need to elaborate a long-term framework integrating the budgets. This requires a consensus on the economic strategy including the priorities of the medium- and long-term public investment programme. Therefore spending policies in the short-term need to be carried out in a prudent way so as to avoid the possible waste of funds, to take into account

the uncertainty of future tax revenues as well as donor contributions and not to destabilise the macroeconomic balance. This is even more important given the number of future challenges for the Kosovo budget including taking over tasks carried out by UNMIK and so far funded by the UN or other donors.

Kosovo does not carry out an independent **monetary or exchange rate policy**. The economy is *de facto* euroised, since the free use of foreign currency beside the dinar was permitted in September 1999. Notwithstanding price stability, the interest rates of commercial banks for loans remained high, averaging around 14% in 2003, as well as the spread over deposit rates, which were in the order of 12%. Some 82% of outstanding loans have been granted to private non-financial enterprises (of which more than 80% to firms in the trade and service sector) and only some 16% to households, which has however grown rapidly in 2003.

The **external position** remains precarious: the deficit of the trade balance corresponded almost to GDP and the deficit of goods and services was still at around 90% of GDP in 2003. Most of the "exports" recorded in the trade balance (IMF data and methodology) relate to the expenditure and consumption of expatriate staff and not to exports of goods. Foreign assistance, albeit declining, and workers' remittances (equivalent to some 43% of GDP in 2002 and 2003) continued to be important in partly reducing the trade deficit but they highlight the high dependence of the economy on external financing flows. The 2003 deficit of the current account balance after grants is estimated to have been approximately at the level of 2002 (33% of GDP).

**Relations with IFIs.** Given declining donor assistance, Kosovo needs to develop other sources of financing of investment projects. Preparation of the legal framework which would allow international financial obligations against the Kosovo Consolidated Budget have begun and first steps have been taken to identify possible bankable projects and these efforts should continue.

Under the current status, Kosovo cannot become a member of the IMF and the World Bank. However, the *IMF* has been providing significant technical assistance since 1999. At the request of donors, IMF staff is assisting the authorities to design a macroeconomic policy programme, including selective quantitative and structural targets that staff could monitor subsequently. This would not only underpin the credibility of the envisaged programme but also facilitate the availability of financial support from donors.

In July 2002, the *World Bank* adopted a second 18-month Transitional Support Strategy (TSS) making available US\$ 15 million in budget support, which was fully committed by the end of 2003. A third TSS for the period 2004-June 2005 is under preparation. The Bank continued its analytical work and plans to produce a comprehensive economic study on the sources of growth in the second quarter of 2004. The *European Bank for Reconstruction and Development (EBRD)* is active in Kosovo through an equity fund and is exploring possible engagements in infrastructure projects.

With the legal base allowing for *European Investment Bank (EIB)* lending in Kosovo clarified in April 2003<sup>23</sup>, a Framework Agreement between UNMIK and the EIB has been under discussion and should be concluded as soon as possible. In addition, a draft law on international financial agreements which would provide for borrowing from IFIs should be adopted by the Assembly. The practical identification of bankable projects also needs to be speeded up. Therefore, UNMIK and PISG should indicate up to six priority sectors (like transport, energy and telecommunications) within which the EIB, in close co-operation with

---

<sup>23</sup> 2501<sup>st</sup> meeting of the Council of the European Union (General Affairs and External Relations), held in Luxembourg on 14 April 2003.

the European Agency for Reconstruction, will define and elaborate projects with the aim of supporting them by loans. It is expected that the finalisation of the agreement with the EIB will encourage other IFIs to lend to Kosovo.

### **3.2. Existence of a free market economy and structural reform**

The **restructuring** plans for the public enterprises are being implemented by the *Kosovo Trust Agency (KTA)*. However, the process is still at a very early stage. Following an international tender, a decision for creating a designated air carrier (“Kosovo air transport”) was taken in 2003. Audits of the publicly owned enterprises finalised in spring of 2003 identified a number of shortcomings in terms of accountability, transparency and management. Investigations have been undertaken by OLAF and OIOS (the UN internal audit service). Results of these inquiries will serve as a basis for further restructuring of public utilities and other measures. They are likely to trigger a recurrent need for budgetary funds, in particular in the case of KEK, the Kosovo Electricity Company, which at the same time also needs to take urgent measures to improve collection rates. Incorporation of public utilities is a prerequisite for restructuring and attraction of investments and should go ahead as quickly as possible.

The first step towards restructuring of Water/Waste and Irrigation service providers was the unbundling of these utility companies from the municipal organizations. There was good progress on merging the municipal companies to regional business units. However, a great effort remains to be made in modernizing the legal and regulatory framework. The water utilities suffer from very low collection rates. While rates vary from municipality to municipality, overall collections are about one third of bills issued.

The KTA is also responsible for the **privatisation** process: the first tendering procedures for 23 socially owned enterprises (SOEs) were completed in July 2003, and attracted significant interest. Most sale receipts of some €26 million will be kept with a trust account so as to compensate for any claims. To this end a special chamber of the Kosovo Supreme Court was established by UNMIK in 2003 to adjudicate claims related to KTA activities. However, the privatisation process was temporarily suspended in autumn 2003 amid legal problems related to the process. More generally, the legal status of land use and ownership rights need to be clarified also for those SOEs which will not be privatised but liquidated. This would allow the economic use of land, which is probably the most valuable asset. UNMIK is currently trying to find acceptable solutions to the problems encountered to ensure that privatisation can proceed on a solid legal, economic and political basis.

A number of laws further developing the commercial law framework were promulgated in 2003, including laws on the transformation of the right of use of socially-owned immovable property, public finance and accountability, mortgages, the establishment of an immovable property registry, external trade activity and bankruptcy. But the current business environment is not yet conducive to free market entry and exit. The social assistance scheme was upgraded to come into force in December 2003 providing for a monthly support between €35-75 for eligible families.

The foundations for a sound **financial sector** have been laid. Within the Banking and Payments Authority of Kosovo (BPK) a strong and professional supervisory department has been strengthened in 2003. Seven banks have been licensed operating 139 offices (December 2003) in the province and providing basic financial products. In addition, there are 15 “micro-financial” institutions operating 41 offices, which provide small loans to the non-bankable sector. An inter-bank payments system has been established. Overall, financial intermediation

through the banking sector has improved but remains at a low level. The rapid credit expansion of the banks has to be monitored closely even though there are no indications yet of possible problems with the loan portfolio. This control is being executed by the BPK whose independence must be safeguarded to ensure the stability of the banking sector.

In the area of insurance, further progress was achieved in 2003. With seven companies licensed, the range of products widened to include property and personal liability insurance. There was also an application for a life insurance license. Additional business areas have been approved and the relevant regulations are being drafted (e.g. a draft regulation on life insurance already finalised). In spring 2003, a complaint system was introduced. The major concerns relate to compliance with existing BPK rules (there are 30 rules in place) and to the lack of product knowledge of agents.

### **3.3. Management of public finances**

The authorities continued in 2003 to develop the tax system and the administrative capacity to manage and collect funds. However, border taxes continue to represent roughly 75% of total revenues. As regards the institutional setting, the Central Fiscal Authority was dissolved by the end of 2002; all functions including the Treasury were moved to the Ministry of Finance and Economy of the PISG. Within the EU Pillar, a “Fiscal Affairs Office” was set up to provide the SRSG and the Deputy SRSG with analysis and advice on fiscal and other issues. In May 2003, an organic budget law was promulgated laying down the rules and procedures in budget management. The budget process is very complicated and should be simplified and streamlined. Special attention should be given to aligning budget management systems with European practice.

The review of the wage scale and job classification started in mid-2003. The objective is to decompress and equalise the wage scale across ministries as well as to identify surplus employment. A salary system which would rationalise and equalise treatment of civil servants across ministries should be implemented. Consideration should also be given to reducing the salary gap that exists between civil servants who work in the reserved areas and those who work in the transferred areas. Given the relatively large public sector wage bill, there is growing awareness in the PISG of the need to streamline the civil service.

## **4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS**

### **4.1 General evaluation**

The European perspective of the Western Balkans as confirmed in the Thessaloniki Declaration and the Agenda for the Western Balkans of June 2003 is also open to Kosovo. Just as in other parts of the region, it can also become a major factor in promoting reforms in Kosovo.

The Stabilisation and Association process Tracking Mechanism (STM) initiated by the European Commission in spring 2003 is designed to facilitate Kosovo’s progress in the SAP and thus bring Kosovo closer to the European family. Over the reporting period, the STM has become well established with both the Provisional Institutions and UNMIK, as guidance for EU compatible reforms. The Government has shown strong commitment to the exercise. The

STM complements and reinforces the parallel process of implementation of Standards for Kosovo, adding a longer-term perspective of European integration.

Following the official start of the Kosovo SAP Tracking Mechanism in November 2002, the PISG set up an internal co-ordination structure to be able to fully participate in the process. As part of this structure, an STM Office was set up within the Office of the Prime Minister to coordinate the work of the various ministries in the STM process.

In the STM context, three meetings took place in 2003. Discussions were covering a number of areas: democratisation, economic reform and energy; justice and home affairs, media policy, and telecommunications and transport policy; trade policy and customs issues, economic legislation and competition. Policy advice on all these sectors was given by the Commission with a view to supporting reforms. A fourth meeting planned for March 2004 had to be cancelled due to the security situation. Nevertheless, the STM will continue to help keeping Kosovo firmly anchored in the Stabilisation and Association Process.

#### **4.2 Internal market and trade**

**Trade Policy** - Kosovo's trade policy, as jointly developed by UNMIK and the PISG, is aiming at integrating Kosovo into the region and Europe, as well as providing additional incentives to investors and exporters. Presently, the most important trade flows of Kosovo are in the region. Kosovo has formally liberalised trade regimes with FYROM and Albania. Trade with Serbia and Montenegro is considered as intrastate trade, representing about 18% of total trade. Trade flows between Kosovo and the rest of the region, while gradually developing, are still partly hampered by non-tariff barriers.

In May 2003, UNMIK made a formal Statement of Intent to the Stability Pact, committing itself to the obligations set out in the Memorandum of Understanding (MoU) of 2001. UNMIK herewith declared its intention to sign Free Trade Agreements (FTAs) on behalf of Kosovo with the signatories of the MoU, and to undertake additional measures to liberalise and facilitate trade in the region. With the support of the joint UNMIK-PISG Trade Policy Working Group, a first Free Trade Agreement with Albania was successfully concluded in July and entered into force on 1 October 2003. Kosovo is thus participating in the process of trade liberalisation and facilitation in the region. An Agreement on the Reciprocal Promotion and Protection of Investments with Albania was signed in February 2004.

The autonomous trade preferences granted by the EU also apply to Kosovo. On this basis, trade with the EU is developing, but still slowly, as a result of the low quality of Kosovo products and issues in certifying the fulfilment of technical requirements.

**Public Procurement** - Currently public procurement is regulated by an UNMIK administrative instruction which is not in line with EC public procurement legislation. A Public Procurement law was adopted and promulgated. The draft law represents a major step forward in terms of EC compatibility, although there are concerns with respect to separation of executive and judicial functions and the provisions on exemptions. Public procurement procedures remain weak and need to be addressed urgently to ensure sound use of public resources and to limit the possibility of corruption. There should be a strong emphasis on increasing the administrative capacity of the staff of the relevant institutions and ensuring that these institutions are properly equipped and funded to carry out their mandate. It will also be necessary to reinforce auditing and financial control institutions and procedures.

**Customs** An EU-compatible Customs Code entered into force in March 2004. The new Code also contains key enforcement provisions, which can, however, not be applied in some key areas like intellectual property rights protection due to the lack of material legislation. The new legal framework also foresees an inward/outward processing regime and will thus help to foster trade and investment in Kosovo. The government should now focus on effective implementation of the new code, rather than on debating and drafting alternative customs legislation. In addition, inter-agency co-operation on integrated border/boundary management needs to be strengthened.

### **4.3 Sectoral policies**

**Agriculture** - Agriculture is the largest economic activity in rural areas in Kosovo. However, farms are small and semi-subsistence farming is widespread. Gradual improvements have been made, particularly by the Ministry of Agriculture Forestry and Rural Development, in the establishment of legal and policy frameworks to support the development of the rural economy sector. More effort is required to ensure the further development and effective implementation of such enabling legislation and policies and to strengthen the capacity of the responsible institutions. In particular, the PISG needs to give further attention to supporting (i) the establishment of an enabling policy, legal, infrastructure, and financial environment for private sector development in rural areas, including agro-processing enterprises, and (ii) the introduction of land reform and management/administration policies – crucial for the further development of viable commercial farming (iii) develop a regulatory framework to support food safety and phyto-sanitary controls

**Environment** - The Ministry of Environment and Spatial Planning (MESP) has drafted over the reporting period legislation on the long-term control of hazardous waste materials. The Department of Environment, within the Ministry of Environment and Spatial Planning, is in the process of establishing the Energy Efficiency Agency in Kosovo.

**Transport** – Under the transportation strategy developed in the context of REBIS (Regional Balkans Infrastructure Study), Kosovo authorities seek to strengthen further the road and telecommunications infrastructure of Kosovo in the regional transportation network. Bilateral agreements on road transport of passengers and goods have been signed with Albania and Montenegro. As regards air transport, the handover of the airport operation from KFOR Military Command to UNMIK Civil Aviation is scheduled for 1 April 2004. UNMIK is taking measures to ensure that the transfer of responsibility takes place in smooth manner, ensuring the required level of security and sound management. The UNMIK Railways has been reorganized, but further significant downsizing of its staff will be required if the company is to become viable. Capital investment in stock and infrastructure of railways is needed to upgrade the quality of the rail transport services to approach European standards

**Telecommunications** - The law on Telecommunications passed in spring of 2003 contains provisions for a clear separation of the policy-making functions from the licensing, regulating and supervising of the telecommunication services and their providers. The Board of Directors of the Regulatory Authority was appointed. The lack of an international dialling code remains a problem. The postal services and telecommunications utility (PTK), which is among the few profitable utilities, needs to be restructured and measures taken to ensure financial control and accountability.

**Energy/KEK** – KEK, the electric company in Kosovo, is suffering from serious managerial, financial and technical problems which must be addressed urgently by UNMIK with the

support of the PISG to ensure the continued provision of electricity and the viability of the massive EU investment in the KEK power plant since 1999. The lack of reliability of the electricity supply is a major deterrent to foreign investment and inhibits economic development.

The turnaround management project for KEK needs to be implemented so that the restructuring of the company can move forward. At the same time, the billing, metering and collection rates need to be improved substantially in line with the Standards for Kosovo. From the total energy supplied to the distribution system, over 40% is lost either through illegal connections or non-functioning meters. The recommendation of the 2003 SAP Report concerning the need to increase the collection rate for public utilities and improve their reliability has not been fulfilled.

#### **4.4 Co-operation in justice and home affairs**

There were noticeable improvements in fighting ordinary crime, where increasing numbers of detected shipments of narcotics and other illicit goods indicate growing levels of expertise and professional standards in the KPS and the UNMIK Customs. The Financial Investigation Unit, established within UNMIK in January 2003, has become fully operational to investigate and prosecute corruption and other economic crimes in public and publicly-funded entities.

However, there is a trend of increased attacks on police and judiciary facilities and personnel, which is an issue of serious concern. This trend has culminated with the attacks on UNMIK police and KFOR on the occasions of the March 2004 ethnic violence. Prominent witnesses in major trials were assassinated, prompting a number of potential witnesses to become more reluctant to cooperate with the prosecution. Also, the number of attacks on minorities has increased.

UNMIK is involved in the regional cooperation on justice and home affairs, including participation in the Ohrid conference in May 2003 and the EU – Western Balkans JHA Ministerial meeting in November 2003.

### **5. EC FINANCIAL ASSISTANCE**

The EU has provided significant support to Kosovo since 2000 under a variety of instruments including CARDS assistance, macro-financial support, humanitarian aid and by supporting the international civil administration. Overall, between 2000 and 2003 (included) this assistance amounted to €993 million.

CARDS assistance for Kosovo between 2000 and 2003 totals €826 million, of which 93 % has been contracted and 73% has been disbursed by December 2003. Initially CARDS assistance focused on reconstruction with significant assistance in infrastructure rehabilitation in the energy, housing and transportation sectors. The emphasis of the assistance has shifted and is now more concentrated on institution building, economic development and reform, and support for civil society in line with the STM recommendations and in an effort to support the implementation of the Standards.

In the 2003 program, major initiatives were launched to strengthen the role played by the Prime Minister's Office, the Ministry of Finance, the Assembly and the Supreme Audit Institution. Funding was also used for the refurbishment of three power substations and two sanitary landfills. New programs were carried out to tackle the difficult problem of

unemployment. At the end of 2003 an additional € 16.3 million was allocated to Kosovo, bringing the total for the year to € 69.3 million, to support implementation of the Standards for Kosovo. These additional funds will be used for infrastructure projects in municipalities that support returns as well as for the development of an initial sewage treatment and disposal programme.

In 2004, programs will continue to focus on support for implementation of the standards for Kosovo. The total allocation is € 55 million which includes the additional allocation to Kosovo in accordance with the Council conclusions of 16 June 2003 on the Western Balkans endorsed by the Thessaloniki European Council of 19 June 2003. Programs will emphasize increasing the effectiveness of the judicial system and on combating financial crime and corruption. Assistance will also promote the development of the private sector and restructuring of publicly owned enterprises, technical assistance for designing bankable projects is planned and further capacity building for the PISG.

In addition to CARDS assistance, the EU has supported the international civil administration by financing the operation of Pillar IV of UNMIK in charge of economic development which is at the heart of UN's mandate under UNSCR 1244. Pillar IV is an integral part of the UNMIK pillar structure and the head of the Pillar is a Deputy SRSG. Within the Pillar is the Europe Office which coordinates and supports the STM process and works with the PISG to follow up on STM recommendations. The Pillar also has responsibility for ensuring the EU perspective in the standards implementation plans. The Kosovo Trust Agency (KTA) which is responsible for privatisation and restructuring of publicly owned enterprises is a major component of the Pillar.

Assistance is coordinated with member states and other donors including USAID, the World Bank and the IMF through meetings of stakeholders on the ground in Kosovo as well as in headquarters.

## **6. EU PERCEPTION**

The idea of integration within the European structures has a strong appeal among Kosovo leaders, as shown by the positive reaction to the address of Commissioner Patten to the Kosovo Assembly in September 2003.

Through the European Agency for Reconstruction's interventions, the EU has a fair level of visibility on the ground and the SAP Tracking Mechanism has proved very useful as a means of familiarising Kosovo public administration with the EU. However, there is a need to enhance the knowledge of the general population about the EU to improve the understanding of the process towards the EU.

**STATISTICAL DATA AS OF <JANUARY 2004>  
<Serbia and Montenegro without Kosovo>**

	1998	1999	2000	2001	2002
<b>Basic data</b>	<b>in 1000</b>				
Population (as of 30th June)	8395	8373	8343	8326	8305p
	<b>in km<sup>2</sup></b>				
Total area (incl. Kosovo)	102200	102200	102200	102200	102200

<b>National accounts</b>	<b>1000 Mio Dinar</b>				
Gross domestic product at current prices	148,4	191,1	381,7	...	...
	<b>Mio ECU/euro</b>				
Gross domestic product at current prices	17395	10691	7986	...	...
	<b>ECU/euro</b>				
Gross domestic product per capita at current prices	1 639	1 277	953	...	...
	<b>% change over the previous year</b>				
Gross domestic product at constant prices (nat. currency)	2.5**	-17.7**	6.4**	5.5*	4.0*
Employment growth	-0,1	-8,2	-2,6	0,2	-1,6
Labour productivity growth	...	...	...	...	...
	<b>in Purchasing Power Standards</b>				
Gross domestic product per capita at current prices	...	...	...	...	...
	<b>% of Gross Value Added</b>				
Structure of production					
- Agriculture	18,4	20,6	21,1	...	...
- Industry (excluding construction)	31,5	30,3	28,2	...	...
- Construction	5,3	4,2	3,9	...	...
- Services	44,8	44,9	46,8	...	...
	<b>as % of Gross Domestic Product</b>				
Structure of expenditure					
- Final consumption expenditure	98,9	96,9	98,8	...	...
- household and NPISH	70,7	68,0	70,5	...	...
- general government	28,2	28,9	28,3	...	...
- Gross fixed capital formation	11,6	12,6	15,4	...	...
- Stock variation	-1,1	-0,5	-6,6	...	...
- Exports of goods and services	23,4	11,2	9,2	...	...
- Imports of goods and services	32,8	20,3	16,8	...	...

<b>Inflation rate</b>	<b>% change over the previous year</b>				
Consumer price index	29,8	42,4	75,7	88,9	19,2

<b>Balance of payments</b>	<b>Mio ECU/euro</b>				
-Current account (after grants)	-735	-814	-371	-589	-1463
-Trade balance	-2022	-1725	-1961	-3164	-4131
<i>Exports of goods</i>	3377	1786	2110	2236	2549
<i>Imports of goods</i>	-5399	-3511	-4071	-5400	-6680
-Net services	549	243	363	466	309
-Net income (net interest)	9	-44	-1	-29	-117
-Net current transfers (including official grants)	729	712	1228	2138	2476
- of which: government transfers (official grants)	0	0	297	660	660
- FDI (net) inflows	126	119	27	184	594

<b>Public finance</b>	<b>in % of Gross Domestic Product</b>				
General government deficit/surplus					
General government debt					
<b>Financial indicators</b>	<b>in % of Gross Domestic Product</b>				

Gross foreign debt of the whole economy	76,6	105,5	132,9	101,8	75,5
<b>as % of exports</b>					
Gross foreign debt of the whole economy	267,0	500,4	448,3	428,0	365,3
<b>1000 Mio ECU /euro</b>					
Monetary aggregates					
- M1	0,8515	1,2594	0,4610	0,9762	1,5280
- M2	1,1772	1,5911	0,5623	1,1423	1,8070
- M3	1,9904	2,1254	1,1129	2,1071	3,1309
Total credit	3,8453	4,5115	3,6163	4,0403	2,5358
<b>% per annum</b>					
Average short-term interest rates					
- Day-to-day money rate	.....	.....	.....	.....	.....
- Lending rate	84,62	48,53	63,32	51,39	24,18
- Deposit rate	72,98	38,11	29,43	37,55	17,27
<b>(1ECU/euro=DIN)</b>					
ECU/EUR exchange rates					
- Average of period		11,7350	15,0449	59,4482	60,6785
- End of period		11,7350	58,6750	59,7055	61,5152
<b>1995=100</b>					
- Effective exchange rate index					
<b>Mio ECU/euro</b>					
Reserve assets					
-Reserve assets (including gold)	278	296	564	1.325	2.186
-Reserve assets (excluding gold)	167	158	430	1.139	2.077

<b>External trade e)</b>					
<b>Mio ECU/euro</b>					
Trade balance	-2.022	-1.725	-1.961	-3.164	-4.131
Exports of goods	3.377	1.786	2.110	2.236	2.549
Imports of goods	-5.399	-3.511	-4.071	-5.400	-6.680
<b>previous year=100</b>					
Terms of trade	100	...	100,2	103,1	98,0
<b>as % of total</b>					
Exports with EU-15	38,6	36,4	38,2	43,1	40,8
Imports with EU-15	42,6	41,5	40,7	41,0	42,6

<b>Demography</b>					
<b>per 1000 of population</b>					
Natural growth rate	1,4	0,8	0,73	1,61	1,2
Net migration rate (including corrections)	...	...	...	...	...
<b>per 1000 live-births</b>					
Infant mortality rate	13,94	13,64	13,25	13,13	12,8
<b>at birth</b>					
Life expectancy :					
Males:	69,8	69,86	69,85	70,13	...
Females:	74,82	74,88	74,91	75,17	...

<b>Labour market (Labour Force Survey)</b>					
<b>% of population</b>					
Economic activity rate (15 - 64)	53,3	52,9	52,5	52,7	51,9
Employment rate (15-64), total	34,6	34,3	35,1	34,9	33,8
Employment rate (15-64), male	42,1	41,5	42,5	42,0	40,4
Employment rate (15-64), female	27,7	27,6	28,2	28,1	27,4
<b>in % of total</b>					
Average employment by NACE branches					
- Agriculture and forestry	...	...	...	...	...
- Industry (excluding construction)	43,1	42,7	42,2	41,8	...
- Construction	6,1	5,9	5,7	5,3	...
- Services	28,3	28,6	29,8	30,7	...
<b>% of labour force</b>					
Unemployment rate, total	13,2	13,7	12,6	12,9	13,8
Unemployment rate, males	11,6	11,7	10,6	11,2	12,4
Unemployment rate, females	15,3	16,2	15,2	15,1	15,8

Unemployment rate of persons < 25 years	51,5	53,1	49,6	46,8	46,5
	<b>as % of all unemployed</b>				
Long-term unemployment share	78,5	79,6	81,6	74,8	75,6

<b>Infrastructure</b>	<b>in km per 1000 km<sup>2</sup></b>				
Railway network	39,7	39,7	39,7	39,7	39,7
	<b>km</b>				
Length of motorways	3,7	3,7	3,7	3,7	3,7

<b>Industry and agriculture</b>	<b>previous year = 100</b>				
Industrial production volume indices	103,6	76,9	111,2	100,0	101,7
Gross agricultural production volume indices	97,0	99,0	87,0	117,0	98

<b>Standard of living</b>	<b>per 1000 inhabitants</b>				
Number of cars	164,7	159,1	131,0	139,1	138,2
Main telephone lines	190,1	211,8	222,6	236,9	233,1
Number of subscriptions to cellular mobile services	...	43,4	109,3	213,8	271,8
Number of Internet subscriptions	...	...	...	...	...

P=provisional figures

\*=estimate

\*\*= Based on Material Products System

**NB: DATA EXCLUDES KOSOVO&METOHIA**

GDP data has been converted according to the World Bank Atlas method by market prices

Balance of Payment data and the financial data covers only the Republic of Serbia

*CAVEAT: It should be noted that due to a variety of data collection methods, survey and calculation techniques, data presented in this Statistical Annex are not always fully comparable.*

**STATISTICAL DATA AS OF <29/01/2004>  
<Kosovo>**

	1998	1999	2000	2001	2002
<b>Regional accounts</b>					
<b>GDP per capita by NUTS II or NUTS III region</b>	<b>ECU/EURO</b>				
- Region 1	:	:	:	:	:
- Region 2	:	:	:	:	:
- Region X	:	:	:	:	:
<b>Unemployment rate by NUTS II or NUTS III region</b>	<b>% of labour force</b>				
- Region 1	:	:	:	:	:
- Region 2	:	:	:	:	:
- Region X	:	:	:	:	:
<b>Public expenditures</b>	<b>as % of Gross Domestic Product</b>				
Health	:	:	:	4,1	4,5
Social protection	:	:	:	3,8	5,2
Education	:	:	:	5,2	6,1
<b>Age Structure</b>	<b>as % of Total Population</b>				
- people aged under 15	:	:	31,5	32,3	32,8
- people aged between 15 and 64	:	:	63,0	61,2	61,0
- people aged 65 or over	:	:	5,5	6,5	6,2
<b>International migration</b>	<b>in 1000s</b>				
- Immigration, total	:	:	:	:	:
- Emigration, total	:	:	:	:	:
<b>Tertiary education</b>	<b>in % of total age group (18-24)</b>				
- participation rate for persons aged 18 to 24	:	:	:	:	5.0E

**Notes:**

NUTS regions do not at present exist in Kosovo

Source for Public Expenditures: 2002 budget p10 and 2003 budget p22

Source for Age Structure: Different household surveys

There are at present no reliable figures on international migration in Kosovo.

Source for Tertiary education: University of Pristina

There are about 300 000 persons in the age group 18-24 years of age and 19 100 students in 2000/01 and 21 200 in 2001/02 and 23 175 in 2002/2003 of which 65% is between 18 and 24: that is about 15 000, thus the estimate 5%