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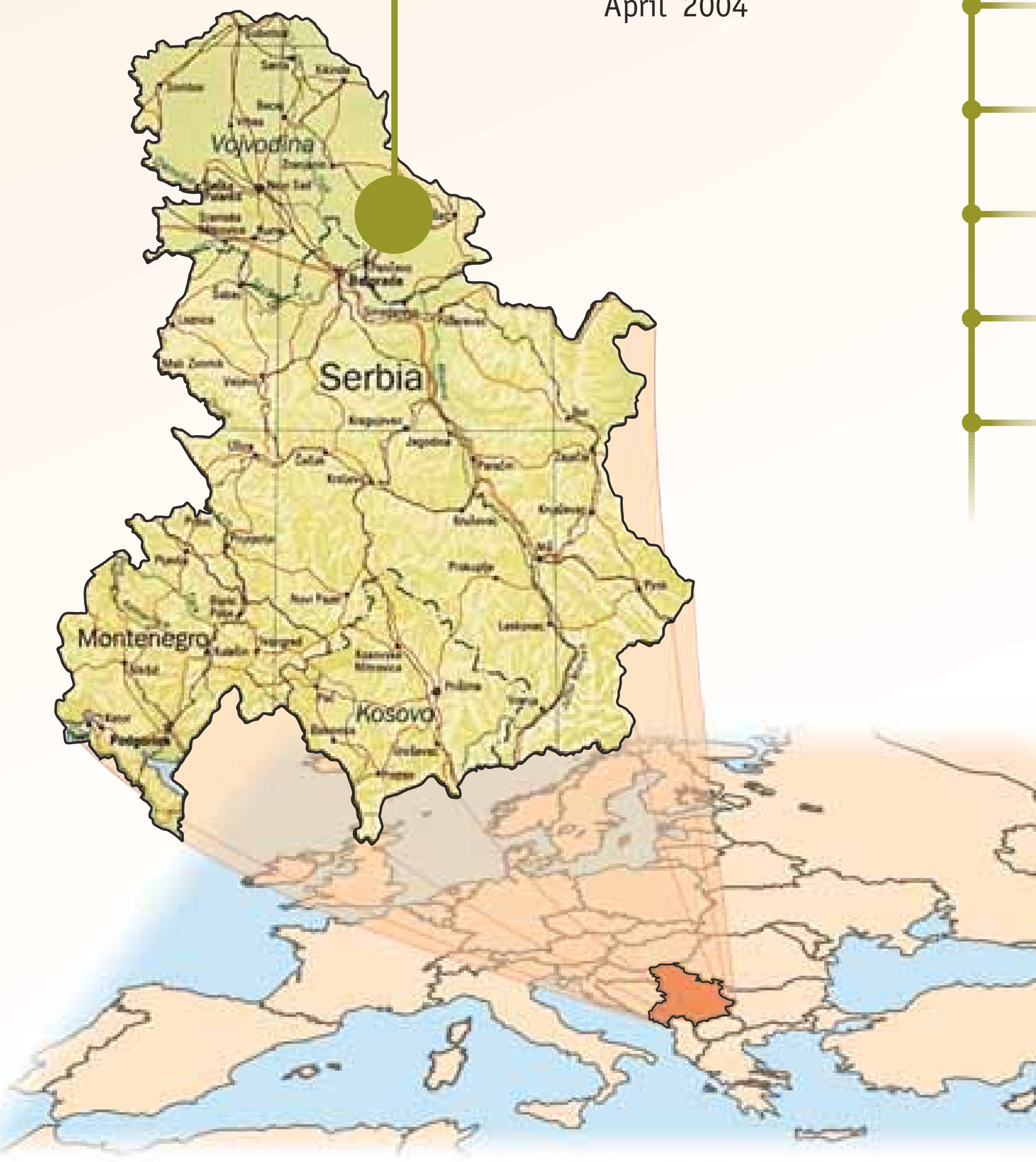
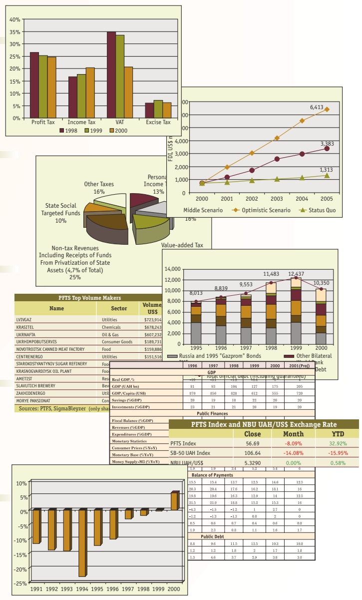
Serbia: Country Overview

April 2004





THE BLEYZER FOUNDATION

SERBIA: COUNTRY OVERVIEW

Background Information

Serbia is one of the largest Balkan countries

Serbia is one of the largest countries in the Balkan Peninsula, with an area of 88,412 square kilometers. The population of the country is approximately 11 million people. The capital of Serbia is Belgrade. Its largest cities are Novi Sad, Nis, Bor, and Subotica. Serbia borders a number of the Balkan countries, including Croatia, Hungary, Bosnia and Herzegovina Romania, Bulgaria, Macedonia, and Albania. The Danube, an important traffic river for Europe, flows through the territory of the country.

Historical reference

Serbia took shape as a country in the twelfth century. Since the mid-fifteenth century, Serbia was under control of the Ottoman (Turkish) Empire. After World War I, a number of Balkan countries-former colonies of the Austro-Hungarian and Ottoman Empires-including Serbia, united to become Yugoslavia. Over 1991-1992, practically all the republics separated to become independent countries; the two remaining republics, Serbia and Montenegro, are presently a formal union.

Serbia's natural resources are coal and copper

Serbia is rich in some natural resources, primarily coal (low-calorie coals provide for 65% of the country's electricity) and copper (which is one of Serbia's main export resources.) In addition, Serbia produces construction materials, namely building stones, cement, and bricks. There are confirmed and partly developed deposits of boron, phosphates, zeolites, ilmenite, zircon, and other natural resources.

EXECUTIVE SUMMARY

Serbia is one of the largest countries of the Balkan Peninsula, with borders on seven countries. Until 2003, it was a part of Yugoslavia. Today, it is officially a republic and a part of the State of Serbia and Montenegro. However, Serbia and Montenegro only have a common market and mutually agreed-upon international policy until 2006. It is expected that in 2006, Serbia and Montenegro will have independence referendums and become independent states.

The Serbian legislature is composed of the National Assembly of the Serbian Republic — a one-chamber Parliament that includes 250 deputies. The National Assembly approves the Prime Minister, who is appointed by the Serbian President. The President of Serbia is elected by direct secret vote for a term of five years. Today, Serbia does not have a legitimate President, for since October 2002, Presidential elections were three times declared invalid due to poor turnout (less than 50%).

The current political situation in the country can be considered difficult due to the assassination of Serbia's Prime Minister, Zoran Djindjic, in early March 2003. His assassination was followed by mass arrests, and a state of emergency was introduced. In November 2003, Presidential elections were again declared invalid due to low turnout. On December 28, 2003, Parliamentary elections were held, as a result of which half of the seats in Parliament were taken by three parties: the Democratic Party, Serbian Democratic Party, and the G17 Plus Group. About a third of all seats were won by the Serbian Radical Party, the largest single party to attract votes.

After World War II, Serbia developed very rapidly as a part of the Socialist Federative Republic of Yugoslavia (SFRY); the Serbian economy was one of the most developed in the region. From 1992 to 1999, the Serbian economy was affected by Yugoslavia's break-up, civil war between the newly-founded states, and entailing economic sanctions. Once Slobodan Milosevic, the former Yugoslavian President, resigned and western-oriented political forces came to power in Serbia and Yugoslavia, the Serbian economy started recovering.

After 1999, Serbia shows high rates of economic growth. The Serbian government expects that the average GDP growth rate will be at least 5% in the coming years. Over the last several years, the country's monetary indices have changed considerably. Inflation declined from 116% in 2000 to 7.6% in 2003. Over the same period, the weighted average lending rate of commercial banks decreased from 78% to 14%, and the National Bank gross international reserves increased form $516 million to $3.55 billion. For 2004, inflation is expected to drop further, the national currency is expected to remain stable, and gross international reserves are expected to grow.

Serbian Macroeconomic Indices

Index	2001	2002	2003P
GDP, $ billion	11.6	15.7	19.8
Retail Price Inflation, % yoy, at year end	39.0%	14.2%	7.6%
Gross International Reserves, $ billion	1.17	2.28	3.55
Current Account Deficit (% of GDP)	–4.6%	–8.8%	–8.7%
Total External Debt, $ billion	11.94	11.84	13.80
Fiscal Deficit (% of GDP)	–1.4%	–5.0%	–4.5%

The adoption of a new foreign investment law created favorable conditions for the operation of foreign investors in Serbia. The law gives foreign investors the right of free profit repatriation, duty free equipment import, and simplifies procedure of employment for foreign experts. As a result of the government's energetic efforts, the inflow of foreign direct investments to the country increased sharply from $25 million in 2000 to about 1.4 billion in 2003. At the same time, foreign trade became more active with both exports and imports growing rapidly.

Privatization, which began in 1991, is one of the key factors attracting foreign investment to Serbia. Initially, it was aimed at transferring state and public property to employees, and foreign investors could buy stakes up to 10%. In 2001, new privatization laws were adopted in Serbia. According to these laws, during the privatization of Serbian enterprises 70% of the company shares could be offered for sale and 30% of shares could be transferred cost free to the enterprise employees and Serbian residents. 4,500 enterprises will be privatized this way. Privatization is expected to be complete by 2005.

There are two privatization methods in Serbia: open tender and auction. Tender is used for the privatization of large and medium companies, for which it is possible to find a strategic investor. In 2003, over 50 companies were put up for tender. Auctions are set to sell small and medium-sized companies. They are mostly aimed at domestic investors. In 2003, 1,200 companies were sold at open auctions. Shares can also be sold through the stock market. Sometimes before a tender or auction, restructuring takes place.

In 2003, the total privatization revenues in Serbia reached about EUR 1.3 billion. New laws planned for adoption and those recently approved are expected to become a considerable stimulus for privatization. These are the laws on bankruptcy, companies, amendments to privatization law, and other important legislation.

EU accession is one of the strategic objectives of Serbian leaders. For 2005, the Serbian government plans active measures on bringing national legislation in conformity with EU requirements so that Serbia will be able to become a full member of the EU in 2007.

Despite the positive macroeconomic dynamics, the situation in Serbian industrial sectors is complicated. The leading industrial sectors (food industry, tobacco industry, mining industry, and chemical industry) suffer great losses. This is due to the fact that Serbian industry still feels the consequences of a decade of wars and economic sanctions. It is one of major risks of investing in Serbia. An unstable political situation, which could lead to a change in the country's economic policy, is another substantial risk.

At the same time, Serbia has created favorable investment opportunities. First of all, it has legislation focused on attracting foreign investors. The ongoing privatization process is another important opportunity. Finally, low competition among portfolio funds creates a favorable environment for investing in the country within the next several years.

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POLITICAL SITUATION

Serbia is the political successor of Yugoslavia

From 1929, Serbia was a part of Yugoslavia, which united several Balkan republics. In 1992, four of the six Yugoslav republics (Bosnia and Herzegovina, Slovenia, Croatia, and Macedonia) became independent. Until 2003, Serbia and Montenegro were in the Yugoslav state; in mid-2002, they started negotiations on creating a new state that would come to replace Yugoslavia.

Serbia and Montenegro form one independent state

In February 2003, the Parliament of Yugoslavia dissolved the Yugoslavian Federation and proclaimed creation of a new state, Serbia and Montenegro. The republics became practically independent, yet they have a common market and common defense and international policies. Serbia and Montenegro have the right to hold a referendum on independence in three years.

Serbian legislature

Serbia's Parliament, the National Assembly of the Serbian Republic, is a one-chamber legislative body with 250 seats. The National Assembly approves the Prime Minister and the Council of Ministers. The deputies are elected by direct vote for a term of 4 years. On December 28, 2003, Parliamentary elections were held. The Serbian Radical Party received the most seats.

Deputy Groups in the Serbian Parliament

Deputy Group	Seats in Parliament
Serbian Radical Party	82
Serbian Democratic Party	53
Democratic Party	37
17 Plus Group	34
New Serbia — Serbian Renovation Movement	23
Serbian Socialist Party	21
TOTAL:	**250**

Source: Republic of Serbia National Assembly

Serbia failed to elect a President

The President of Serbia is elected by direct popular vote. The term of presidency is 5 years. The President appoints the Prime Minister to be approved by the National Assembly. In early 2003, the term of presidency of Milan Milutinovic expired; however, since October 2002, three Presidential elections failed because of insufficient turnout. The most recent Presidential elections were held in November 2003. Until the last Parliamentary elections, Natasa Mitic, Speaker of Parliament, was acting head of the Serbian state.

Serbian executive

The government of Serbia consists of the Prime Minister, deputy prime minister, and other ministers. The candidate for Prime Minister should present his/her program to the National Assembly and propose a list of ministers for the government. The government is considered elected if approved by the majority in Parliament. The Prime Minister is appointed by the President and approved by the Parliament.

Serbia faces political difficulties

The political situation in Serbia has been marred by instability. The main reason for the difficulties is the conflict between two large political forces: those headed by Vojislav Kostunica, the President of Yugoslavia, and those whose leader was the former-Serbian Prime Minister Zoran Djindjic. Kostunica and Djindjic were at the head of Serbian opposition to Slobodan Milosevic, ex-President of Yugoslavia. In the year after Milosevic's overthrow, the opposing bloc, the Democratic Opposition of Serbia (DOS), started to fall apart. The largest party in the DOS, the Serbian Democratic Party, supported Kostunica, while smaller parties in the DOS supported Djindjic.

Djindjic's place taken by ex Defense Minister

The complex political situation in Serbia became even more tense after Zoran Djindjic was shot and killed at the government building in Belgrade on March 12th of 2003. After the assassination, Serbia introduced a state of emergency in the country (which was canceled on April 22nd.) Zoran Zivcovic, former Defense Minister and a close supporter of Djindjic, became the new Prime Minister of Serbia. 128 Parliament Deputies voted for Zivcovic, and 100 deputies against.

Three presidential elections ended without a new President

A particularly acute manifestation of the political crisis in Serbia was the triple failure of Presidential elections in 2002 and 2003. The vote failed to reach the 50% turnout threshold necessary for the election to be considered valid. In elections held in October and December 2002, more than half of votes were cast for Vojislav Kostunica. In the most recent Presidential election held in November 2003, a candidate of the Serbian Radical Party received the largest number of votes.

New Parliament creates new opportunities

Despite the fact that the most votes were cast for the Serbian Radical Party in the Parliamentary elections of December 28, 2003, Dragan Marsicanin of the Democratic Party of Serbia was officially elected as the Speaker of the Legislature in 2004 by just two votes. Mr. Marsicanin automatically becomes the acting President as well. It is expected that the Democratic Party, Serbian Democratic Party, 17 plus Group, and others will begin to form a cabinet.

MACROECONOMIC SITUATION

Background

Serbia, formerly a dominant part of the Socialist Federal Republic of Yugoslavia, lived through a shocking final decade of the twentieth century. Through the late 1980s, the country enjoyed a more developed economy and higher living standards than in any other Central and Eastern European state. Yugoslavia was among the first transition economies of the region to succeed in reaching economic stabilization, liberalize the economy, and launch a privatization program.

However, these promising initial actions fell victim to the unfolding political conflict that plunged the country into a decade of war, economic sanctions, disintegration, and economic decline. A long period of macroeconomic instability, including hyperinflation in 1993 and a freefall of the national currency (the dinar), led to a 50% drop in the country's GDP and a sharp rise in unemployment and poverty (see table in Annex.)

The first Balkan war of 1991 and the resulting international sanctions distorted production and deprived the economy of capital, and made the country default on its foreign debt. The informal sector of the economy flourished, fuelled by the central government's increasing regulation of the economy. The government continued to employ various non-market practices, including implicit subsidies. These were administered through banking and payment systems and energy companies, and led to mounting budgetary, bank and enterprise arrears.

By the mid-1990s, the economy started a slow recovery assisted by a decision to fix the national currency to the German Mark. Foreign trade expansion was enabled by the lifting of sanctions in 1996. However, the government's policies lacked consistency and thus brought further instability.

The Kosovo war of 1999 had an immensely negative effect on the country. Disruption of normal business activities was exacerbated by destruction of the physical infrastructure (including roads, bridges, communication lines, power stations, etc.) leading to a sharp contraction (by 18%) of GDP. Also, the need to provide social care for hundreds of thousands of refugees has put big pressure on the economy. At the same time, the country once again became isolated from the world economy due to continued rule of the Milosevic regime.

Unlike other former socialist economies, Yugoslavia ended the 1990s with significantly weaker market institutions than it boasted a decade earlier. It required strong political will along with sound economic decisions of the new government to improve the situation.

The fall of the old regime and the coming to power of the new government in 2001 marked a turning point in macroeconomic policies. The government committed to reverse the negative trends of the 1990s by adopting a program of transition to market economy and improving relations with the international community. Most importantly, the new government realized the need to restructure and liberalize the economy. The change of direction in economic policymaking already had positive effects: sound monetary and fiscal policies resulted in reduced inflationary pressures and a stabilized exchange rate. Restructuring of sovereign debt with the Paris Club in November 2001 signified a warming of the relationships with foreign creditors.

Economic Growth

The Serbian economy saw rapid recovery of its economic output in 2000 after a large contraction a year earlier; GDP grew by 5% after a steep decline of 18% in 1999. In 2000, economic growth was driven mainly by expansion of industrial production, which rose by 11%, while agriculture was badly affected by severe weather conditions. In contrast to 2000, the economic growth of 5.5% in 2001 can be attributed almost entirely to a recovery in agriculture. Many industrial sectors that witnessed strong signs of rebound in 2000 started to contract in 2001 and continued their decline through 2002. In 2002, GDP grew by 4.0%, again mostly thanks to agriculture while industrial production experienced a modest growth of 1.7%.

2003 was another difficult year for the Serbian economy. Sluggish performance of the domestic industries, along with low demand of the world economy resulted in lower than expected GDP growth of about 3% versus 4.5% expected. While industrial production saw modest expansion of about 2%, agriculture was hit severely by unfavorable weather conditions.

The economic decline that plagued Serbia in the 1990s resulted in changes in the country's output structure. The share of manufacturing and mining dropped from about half of GDP in 1989 to just one third of GDP in 1998. Agricultural output exhibited more stability while increasing its share of GDP from 15% to 22% over the same period. The Serbian economy has also become more reliant on services and trade.

Serbian Macroeconomic Indices

Index	1998	1999	2000	2001	2002	2003P
GDP, $ billion	13.89	10.16	8.60	11.58	15.68	19.77
Real GDP Growth, %	6.7%	−18.0%	5.0%	5.5%	4.0%	3.0%
GDP per capita, $ thousand	1.31	0.96	0.81	1.08	1.47	1.85
Industrial Production Growth	4.4	−24.4	11.1%	0.0%	1.7%	2.0%

Sources: IMF, World Bank, SB staff estimates

The relatively poor performance of Serbia's industry is particularly surprising considering the continued growth of incomes, consumption, imports, and retail trade since 2001. Strong import growth in Serbia (see below) resulted not only from a more liberal trade regime and inflows of official aid, but also from a recovery in real wages and incomes since 1999. According to official estimates, average real wages in the country grew by 13% in 2001 and by 25% in 2002. Notably, consumer goods accounted for about two thirds of additional Serbian imports during the same period. The recorded increase in retail trade turnover (17% in 2001 and 15% in 2002) can thus be mainly attributed to a growth in imports. Therefore, there is a notable discrepancy between rising domestic demand and retail trade on the one hand, and the mostly stagnating industrial production (including consumer industries) on the other.

Employment has been following a path similar to that of output. The registered unemployment rate saw steady growth and reached 29% in 2002. The numbers are surprisingly high even compared to other transition economies of the region. In fact, labor market surveys conducted according to International Labor Organization methodology measured the unemployment to be about half of the official registered rate. The situation can be explained by generous social benefits to the officially unemployed that encourage the informally employed population to register as unemployed.

Fiscal Policy

Since 2001, fiscal budgetary policies in Serbia have come under tighter control. That year, the country implemented necessary structural changes that enabled it to run a balanced fiscal budget. Currently, Serbia is facing the hard task of controlling its public finances in the midst of low tax receipts and a heavy burden of social payments and extensive government expenditures.

Serbia's fiscal system in the 90s was characterized by poorly controlled expenditures. It was also plagued by abundant off-budget funds, loan guarantees, directed credits and bank refinancing on soft terms used to subsidize state-owned enterprises. All payments and transfers were made through an underdeveloped clearing and payments system (the "ZOP"). The primary source of the above quasi-fiscal activities was the Central Bank. Also, the government used accumulation of arrears to achieve fiscal budget balance.

With the help of international financial organizations, the country managed to reform its public finance system and adopt sound fiscal policies. This was done by halting quasi-fiscal activities of the Central Bank, eliminating numerous extra-budgetary funds, and developing the treasury system based on transparency and accountability.

The country finished 2002 with a fiscal deficit of 4.5% of GDP, up from 1.4% of GDP in 2001 when the deficit had been constrained by a shortfall in foreign financing and privatization proceeds. The share of fiscal revenues to GDP has grown from 38.9% in 2001 to 42.8% in 2002, reflecting the impact of tax reform and the effects of increasing domestic demand on sales tax and customs receipts. Fiscal expenditures rose by 7 percentage points to 47.3% of GDP in 2002, reflecting higher capital spending as well as transfers and subsidies, in part to support bank and enterprise restructuring.

For 2003, the government had initially set a target fiscal deficit of 3.8% of GDP. However, preliminary data suggests that it failed to meet the target with the fiscal deficit rising to 4.5% of GDP. During the year, the Serbian government was facing significant challenges. On the one hand, it tackled large external debt repayments, as well as some overdue social payments, topped with the desperately-needed expenditures on capital investments and government procurement. On the other hand, there was a need to reduce the tax burden to improve competitiveness of the country's businesses. With the country's tax system being reformed, and since over 90% of fiscal revenues come from taxes, the government failed to cut expenditures sufficiently to offset falling revenues.

Monetary Policies

2001 represented a big turnaround in the monetary policy of the Serbian government. The Central Bank dropped the quasi-fiscal function it used to perform through loan policies and guarantees to select banks and enterprises. Instead, it concentrated on containing inflation, maintaining exchange rate stability and improving regulation of commercial banking. By adopting an exchange rate anchor, the central bank succeeded in substantially reducing inflation and stabilizing expectations about prices and the exchange rate.

The monetary activity of the central bank in 2001 and 2002 mainly included interventions on the foreign exchange market to ensure exchange rate stability. During that period, the value of the

Dinar, pegged to the Euro, remained relatively stable at close to 60 dinars per US Dollar. In 2003, the central bank has allowed the Dinar to depreciate slightly against the Dollar, and to a greater extent against the Euro (down by some 10% yoy). The authorities were acting more cautiously to strike a balance between the external and internal stability (i.e., some depreciation of the local currency is an important element for improving the country's competitiveness, while a stable exchange rate contributes greatly to price stability.)

Due to the restored demand for dinars and significant capital inflows from abroad, the central bank managed to increase its gross international reserves. Purchases of foreign exchange accounted for about half of the $653 million accumulation in the Central Bank's gross international reserves in 2001, with the remaining part coming from international loans and aid. Each year since 2001, the Central Bank's gross international reserves doubled in size to reach $3.55 billion by the end of 2003.

Pursuing a rather loose monetary policy, the Serbian government more than doubled the money supply in 2001 and increased it by 80% in 2002. However, the money supply was allowed to increase along with the rising demand for dinars to accommodate the growing needs of the recovering businesses. Despite substantial growth of the money supply, the level of monetization in Serbia remained quite low at about 8% of the country's GDP by the end of 2001.

Serbia succeeded in reducing retail price inflation from 113.5% (end of period, yoy) in 2000 to 39% in 2001 and to 14.2% in 2002, despite the growth in money supply. The country registered a record-low 7.6% retail price inflation as of end 2003, a significant achievement of the relatively tight monetary and exchange rate policies, as well as slower public-sector wage growth than in 2002.

Interest rates in Serbia have fallen along with the inflationary expectations, but remain comparatively high at about 1.5% per month for short-term credits. With the dinar pegged to the Euro, this is effectively a Euro interest rate, and remains excessively high for most enterprises.

Retail price inflation is expected to fall slightly in 2004 to a projected 7% at year-end.. An important part of inflation in Serbia will be associated with price liberalization and increases in prices that remain administratively fixed (especially energy and utilities.) At the same time, lower than expected agricultural yields in 2003 are likely to maintain upward pressure on food prices.

Serbian Monetary Indices

Index	1998	1999	2000	2001	2002	2003P
Retail Price Inflation, % yoy, at year end	44.5%	49.9%	113.5%	39.0%	14.2%	9.0%
YUD/$ Exchange Rate, at year end	10.031	11.661	63.166	67.670	58.985	55.000
Weighted Average Commercial Banks Lending Rate, at year end	60.3%	45.4%	77.9%	32.5%	19.2%	14.2%
National Bank Discount Rate, at year end	33.7%	26.3%	26.3%	16.4%	9.5%	9.0%

Source: IMF, World Bank, SB staff estimates

International Trade and Capital

Serbia's international trade was hit severely by the Kosovo war in 1999. Exports dropped by nearly half from $3 billion in 1998 to $1.7 billion in 1999. Imports saw a smaller but still significant reduction of 32% over the same period, from $4.8 billion to $3.3 billion. Thereafter, both exports and imports experienced growth, although at a different pace. The rate of growth of imports considerably outstripped that of exports: 30% versus 4% in 2001, and 31% versus 20% in 2002. Even though early 2003 saw the reversal of the widening trend of the trade balance deficit, the second half of the year saw it return. In the period of January through November 2003, imports rose by 27% while exports gained 20%, bringing the trade deficit to about $4.7 billion, or about 24% of GDP by the end of 2003. As mentioned above, overall macroeconomic trends in the country in the period of 2000-2003, particularly the recession in domestic production at a time of increasing demand and retail trade, contributed to a big surge in imports.

Despite rapid expansion of international trade in the post-war period, the country still did not reach the level of exports it enjoyed in 1998, but is expected to approach that target in 2004. Imports, on the other hand, had recovered to pre-war levels by the end of 2001.

Despite the widening current account deficit, capital account inflows (and strengthening local demand for dinars) have more than compensated for the negative current account. Apart from the typical capital inflows, such as foreign loans and foreign direct investments (FDI), the capital account saw large amounts of private inflows. The latter included capital transfers from workers living abroad, reverse currency substitution, and placement of foreign banknotes with local banks. In total, private capital inflows have contributed considerably ($629 million in 2001 and $892 million in 2002) to the capital account surplus in recent years.

Serbian Foreign Trade Turnover

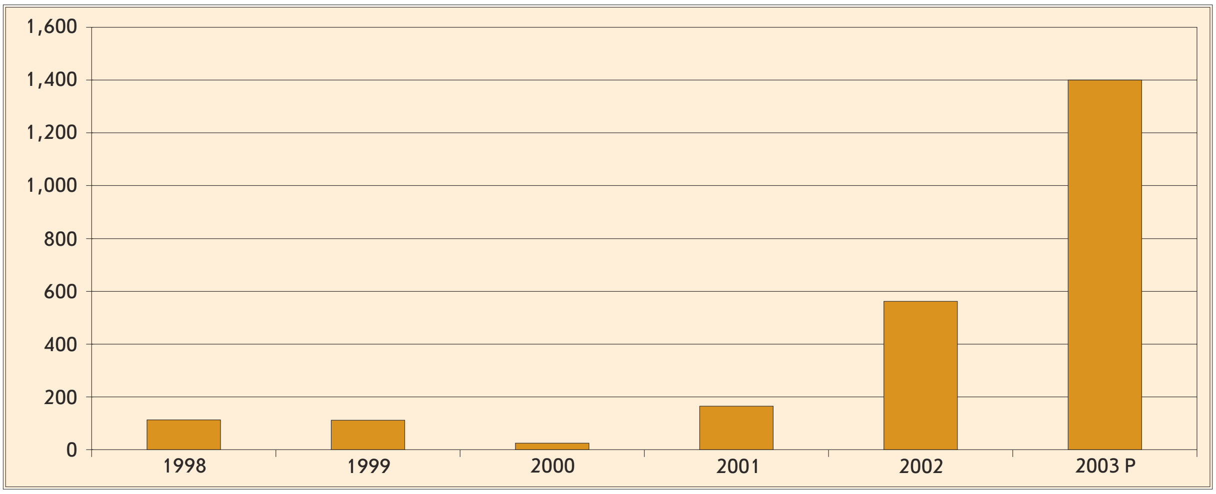
	1999	2000	2001	2002	2003P
Export, $ billion	1.68	1.92	2.0	2.41	3.19
Import, $ billion	3.30	3.71	4.84	6.32	7.94
Foreign Trade Balance, $ billion	–1.62	–1.79	–2.83	–3.91	–4.75
Current Account Balance , $ billion	–0.76	–0.34	–0.53	–1.38	–1.70
Current Account Deficit, % of GDP	–7.5%	–3.9%	–4.6%	–8.8%	–8.7%

Source: IMF, World Bank, SB staff estimates

Geographically, Serbia's main trading partners are the neighboring European countries. Serbia is exporting to Italy, Bosnia and Herzegovina, and Germany, and importing from Germany, Italy, Bulgaria and Russia. Machines and vehicles are the major import items, closely followed by energy, and account for about 21% of imports each. In 2002, the main exported goods were food, copper, and textile products.

Net Foreign Direct Investments (FDI) more than tripled in 2002 to reach $562 million. About 40% of the FDI inflow went into Greenfield investments, mainly related to retail trade. The remaining part was accounted for by privatization receipts (through both tender privatization and purchase of shares.) In 2003, FDI inflows received a further boost that came primarily from the three largest privatization deals, which essentially doubled the previous year's results. The deals brought a total of EUR 812 million from international tobacco giants Philip Morris and BAT for purchases of large tobacco plants in Serbia, and from the sale of a leading oil retailer to Lukoil. The year-end FDI inflows are estimated at about $1.4 billion.

Net Foreign Direct Investments in Serbia, USD million



Source: IMF, World Bank, SB staff estimates

Debt

Years of economic disruption and the accompanying efforts to rebuild the economy with the help of the international community have resulted in accumulation of vast debt. The total debt to GDP ratio peaked in 2000 at 133%, while total debt to exports ratio reached 500% in 1999. Although the ratios tended to decline over subsequent years (down to 75% and 365% by the end of 2002, respectively), total debt continued to grow and reached $13.8 billion by the end of 2003. Since the beginning of 2003, Serbia and Montenegro's debt demonstrated a rapid expansion, which resulted in the accumulation of about $2 billion in new loans (growth of about 17% yoy.) The bulk of the reported increase in 2003 can be accounted for by the depreciation of the Dollar. Despite such a significant increase in debt stock, debt to GDP ratio declined in 2003 to about 69%. The reason for Serbia's recent surge in international borrowing is that the country is making a transition from entirely emergency financing programs meant to introduce economic stabilization, to long-run development assistance.

The Serbian government succeeded in restructuring its external debt with the Paris Club in late 2001. According to the agreement, the Paris Club creditors wrote off 51% of Serbia's outstanding debt, accompanied by an additional write-off of 16%, contingent upon satisfactory performance of the IMF program. A similar agreement is expected to be reached with the London Club creditors. However, the negotiations have recently stalled because Serbia insisted on terms similar to those of the Paris Club agreement. The London Club remains the largest creditor of Serbia with outstanding debt estimated at $2.5 billion.

Taking into account both write-offs (should the London Club agreement be reached), Serbia will reduce its external debt to about $11 billion. However, questions have been raised about the sustainability of the current level of debt and the ability of the government to meet debt service payments. In 2002, only $150 million out of $350 million of due payments was paid back on a regular basis, while the rest was accumulated as debt arrears. Foreign debt service is projected to increase from $433 million in 2003 (2.1% of GDP) to $946 million in 2005 (4.1% of projected GDP), and is expected to peak in 2009 with $1,850 million, or 6.4% of projected GDP, when the grace period on the new loans will be over. To serve this debt, the country will need to show broader economic recovery, with a larger reduction in its current account deficit and greater attraction of foreign capital inflows. Achieving these goals will be a major challenge. It will require a major improvement in the country's investment climate, as discussed below.

Budget Indicators and External Debt

Indicator	1998	1999	2000	2001	2002	2003P
Budget Revenues, $ billion	n/a	n/a	3.16	4.50	6.71	8.02
Expenditures, $ billion	n/a	n/a	3.23	4.67	7.42	8.93
Balance, $ billion	n/a	n/a	–0.08	–0.17	–0.71	–0.91
Fiscal Deficit, % of GDP	n/a	n/a	–0.9%	–1.4%	–4.5%	–4.5%
Total External Debt, $ billion	10.54	10.74	11.40	11.95	11.84	13.80
Total Debt Service, $ billion	0.07	0.10	0.06	0.11	0.18	0.43
Debt, % of GDP	75.9%	104.8%	132.5%	103.2%	75.4%	69.0%

Sources: IMF, World Bank, SB staff estimates

INVESTMENT CLIMATE

The macroeconomic policies pursued by the new government since 2001 have had a very positive effect. However, as indicated in the previous chapters, the country is still deeply in need of economic restructuring to ensure sustainable economic growth. The capital inflows necessary to finance the rebound may come from increased investments by the private sector. To attract domestic and foreign investments, the government needs to further improve the country's business environment.

A study by SigmaBleyzer identified the most important measures that a government can take to improve the business environment and attract foreign direct investments. The study reviewed 50 countries around the world and carried out statistical analyses to identify the policy measures that have the greatest impact on the flow of FDI. Through benchmarking, it also identified best practices in economic reforms in a number of successful developing countries. Also, a model was built to predict the flows of foreign direct investments that a country could receive based on the implementation of these key "policy" investment drivers. The study concluded that "first generation" reforms-macroeconomic stabilization, achieved by sound fiscal and monetary policies-are essential pre-conditions to achieving a favorable business climate and attracting foreign direct investments. But they alone are not sufficient to improve the business environment and achieve increases in international capital inflows. Within this macroeconomic framework, a number of "second generation" reforms are needed. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in the group of 50 developing countries can be explained by nine economic policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flows of FDI, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g., geographical location, country size, population, etc.)

These key investment drivers were the following, in order of priority:

- (i) **Business liberalization and de-regulation policies** to permit firms to operate freely by removing barriers to market entry, barriers to operations and barriers to exit.
- (ii) Policies to **create a stable and predictable legal environment** with well-defined "rules of the game" for all businesses, without discrimination or preferential treatment and with capacity to enforce business contracts.
- (iii) Policies to develop sound **Corporate and Public Governance** that would protect ownership rights and shareholders, and avoid excesses of power by Government agencies.
- (iv) Policies to **liberalize foreign trade and international capital movements** to facilitate the exports and imports of goods and the transfer of capital internationally.
- (v) Policies to **create a healthy financial sector** capable of meeting the financing needs of growing businesses.
- (vi) Actions to **minimize corruption** and protect businesses from abuse of power by government officials.
- (vii) Actions to minimize the effects of **political uncertainties** on business activities.
- (viii) Actions to **promote and inform investors** about business opportunities in the country.
- (ix) Actions to avoid distortions in incentives by **eliminating preferential targeted investment incentives** to companies, regions or sectors.

The performance of Serbia regarding the above nine investment drivers is discussed below.

(i) Liberalization and Deregulation of Business Activities

Since 2001, Serbia has made significant progress in the liberalization of its business environment. The country, known for a big role of the government in regulation of the economy, started to break with the past by adopting laws and implementing policies to reduce the regulatory burden on the private sector. The country is now making rapid and significant progress towards deregulation of its business environment.

The government has already implemented a regulatory reform providing opportunities for fast business start-up, and lowering the cost of business operations through reduction in the number of inspections. The reform simplified company registration procedure by introducing a "one-stop shop" — an office where all the information, permits and documents can be obtained. Also, a principle of "silence is consent" has been enacted, meaning that if a decision on a claim is not issued by the authorities within the determined period, a positive reply is implied. The self-certification principle, also introduced by the reform, implies that the authenticity of the submitted documents is guaranteed by the person submitting them. The establishment of a business ombudsman, an independent body that will work to guarantee better responsibility of public administration, was another step in ensuring a more competitive and non-intrusive environment for businesses.

Tax legislation was radically improved during the tax reform implemented in June 2001, and now boasts the most favorable terms among other transition economies in the region. Personal income tax is calculated using the brackets from 10% to a maximum of 20%. At the same time, foreign nationals employed in Serbia enjoy exemption from taxes on their fringe benefits; also, their non-taxable level of annual income is nearly five times the level of non-taxable income earned by a Serbian national. Corporate profits are taxed at a uniform rate of 14%. The country plans to introduce value-added tax (VAT) in mid-2004. Currently, sales tax of 20% is levied on the turnover of goods and services.

The Serbian taxation system includes the following basic taxes and duties:

- **Personal income tax — 14%.** Resident taxpayers pay income tax from income received both in Serbia and abroad. Employment income is subject to a withholding tax at a flat rate of 14%. Taxes on income from royalties, investment, immovable property, etc. are levied at the flat rate of 20%. Income tax for foreign income and other types of income has a floating rate of 10%–20%.
- **Corporate income tax — 14%.** All forms of business are subject to the company income tax. The tax rate is 14% of income received.
- **Sales tax — 20%.** Tax on sales of goods and services is 20%. In 2004, the sales tax is expected to be replaced by VAT.
- **Excise duty.** Excise duty is levied on producers and importers of the following goods: petrochemicals, tobacco products, alcoholic beverages, coffee, and luxury products (furs, jewelry, etc.)
- **Property tax — 0.25%–0.40%.** Property tax is levied on immovable property, shares, inheritance, and on transfers of property titles. The property tax rate is 0.4% of the real estate value. Tax on shares is 0.25% of their value.

- **Tax on financial transactions — 0.22%–0.41%.** All financial transactions within the payment operations, such as transfer order payments, barter trade, and other payments.
- **Tax on use of goods.** Tax on use of goods is paid for the use of certain goods, such as cell phones, vessels, aircraft, and weapons.

(ii) Stability and Predictability of the Legal Environment

The Serbian government fully realizes the need for a legislative framework that would create a level playing field and ensure sufficient protection for all economic agents. The basic legislation needed for a functioning market economy has been largely created in the past couple of years. This legislation is there not only to remove obstacles for efficient business environment, but also to create investment incentives. The country now has thorough legislation in the areas of foreign investments (the law ensures national treatment for foreign investors and allows for easy repatriation of profits), company law (based on OECD principles), public procurements (ensures transparent and accessible tender procedures), labor regulation, privatization, money laundering, bankruptcy and liquidation, stock market, and taxation.

Serbian lawmakers are currently developing some important legislation to regulate international commercial arbitration, concessions, and leasing. Also, the government is preparing regulations of certain economic sectors (energy, telecommunications, railways, construction) that will create opportunities for private sector investments in these fields.

Serbian authorities have taken steps to make the law-enforcement process more transparent and inclusive. Achievements in this area include amendments to the Criminal Procedure Code in line with European and international standards, and amendments to the Criminal Code to introduce new types of crimes especially related to corruption. Initial steps have also been taken to implement comprehensive judicial reform including adoption of five new laws on the organization of courts, the status of judges and the prosecutor's office, and the establishment of a judicial training center.

The major challenge for the Serbian government in creating a stable and predictable legal environment is now the implementation and continuous enforcement of the newly adopted legislation. In this sense, local authorities (from municipalities to law-enforcement to tax police) will play a decisive role.

Overall, Serbia has made striking progress in the creation of a sound legal basis for the development of a market economy, but it is still challenged with implementation of the new laws.

(iii) Corporate and Public Governance

Corporate Governance

A great advance in the development of up-to-date corporate governance came with the adoption of the Company Law. The new legislation has been created in line with the basic OECD principles in the field of corporate governance. In particular, the new law ensures equal shareholder treatment as well as adequate protection of property rights, including those of minority shareholders.

To make operations of its economic agents more transparent, Serbia has required International Accounting Standards (IAS) to be used by banks starting in 2003, and by enterprises as of 2004. The country has also passed new legislation to ensure development of a competitive business environment, including laws on securities, competition, bankruptcy, secured transactions, insurance, etc.

Public Governance

In the 1990s, Serbia saw a high centralization of power, revenues collection and spending authority. The government intervened directly in economic activities (e.g., with price and exchange controls) as a way of managing the country in times of sanctions and deep economic crisis. This centralization weakened the civil service and local governments and provided substantial opportunities for rent-seeking. The new government has taken extensive measures to reverse the government's role by liberalizing prices and exchange rates, among other reforms. There are high expectations on the part of local governments for a return to the more decentralized fiscal and political structure the country used to enjoy until 1990.

The government is committed to efforts to build capacity (at federal, republic and municipal levels, and in non-government civil groups), address sources of corruption, build public confidence in government, and develop rule-based public governance. A Public Administration Council has been established and is in charge of developing the strategy for public administration reform and overseeing its implementation. The government is making progress in raising the professional level of the civil service by reforming its structure and improving recruitment and remuneration. These measures are based on a recent law on government in Serbia that cuts the number of ministries in half. Accountability of public governance has been further increased by external monitoring of public sector performance. Recently, Serbian government adopted amendments to public procurement act aiming to improve supervision over public tenders and introduce more efficient registration system.

Privatization

The new Serbian government moved quickly in 2001 to halt privatization under the flawed framework adopted back in mid-1990s, which involved obscure procedures and favored insiders. Building on the experiences of other transition economies, it quickly developed a new legal framework for privatization. It allowed 70% of enterprise shares to be offered to strategic investors in a transparent way, with the goal of establishing clearly defined and dominant owners. The new Privatization Law, adopted in June 2001, was followed by the creation of a privatization agency and the adoption of secondary legal acts. The Serbian government launched the across-the-board privatization program in late 2001, aiming to change ownership of about 1,300 state- and publicly-owned companies. Most of these were planned for privatization using competitive bidding procedures. In the first 15 months of the privatization process, however, very few companies of those slated for privatization really changed ownership. In 2003, the government made considerable inroads in the privatization field; over 800 companies were sold, mainly through open tenders and auctions. Privatization proceeds reached EUR 1.3 billion, with the bulk of this amount coming from three major deals in tobacco and oil industries (see chapter above). Privatization is expected to complete by the end of 2004, yielding about EUR 200 million in the year.

Since 2001, Serbian authorities have gone a long way in creating privatization principles attractive for foreign investors. They include open, transparent and simple privatization procedures;

several privatization modes ensure freedom to choose acceptable way of participating in purchase of state-owned companies. The government now contracts some of the world's largest investment banks to lead in privatization deals to secure transparency. In general, the country managed to assure rather efficient and unbiased privatization management to create opportunities for successful investments.

(iv) Liberalization of Foreign Trade and Capital Movements

The amendments made to the Law on Foreign Trade in 2000 significantly contributed to deregulation and liberalization of the country's foreign trade. Further amendments were introduced to the Law on Customs Tariffs in June 2001, bringing the number of tariffs from 36 to 6: 1%, 5%, 10%, 15%, 20% and 30%. Half of all products are subject to 1% or 5% tariff rates, while nearly three quarters of products are subject to rates from 1% to 10%. The average tariff rate has been reduced from 14.4% to 9.4%. In an important step towards liberalization of foreign trade, the Serbian government eliminated all import quotas, while keeping a minimum level of export quotas, mainly for strategic agricultural products like wheat, corn, soybeans, and some others.

The country has entered into free trade agreements (FTA) with Hungary, the Russian Federation, Bulgaria, Macedonia, and Bosnia and Herzegovina. The FTA terms have been agreed in principle with Romania and Albania, and are being negotiated with Croatia, Slovenia, and Moldova. Serbia enjoys preferential treatment from the European Union-products originating in Serbia are generally admitted to the EU for import without quantitative restrictions and are exempt from customs duties and charges. A preliminary declaration of cooperation has been signed with EFTA in December 2000, pledging asymmetric preferential treatment of Serbian products on the markets of the four member countries. The US has recently restored normal trade relations with Serbia lifting most of the restrictions that had been applied against the Milosevic regime. This allows Serbian exporters to enter the US market with customs rates reduced by 20% from those in place until this decision.

Serbia is working to harmonize its foreign trade legislation and practices with those of the World Trade Organization and the EU, in which the country is aiming to have full membership.

With this in mind, the Serbian government has succeeded in building up regional cooperation with neighboring transition economies. The country is implementing joint projects with Romania (oil pipeline, modernization of hydro electric power plant, road and rail infrastructure), and Bulgaria (road and rail infrastructure.)

The new Foreign Investments Act that came into force in January 2002 introduced significant improvements in regulating foreign investments. Most importantly, foreign investors were granted full national treatment, meaning that a foreign investor enjoys the same status, rights, obligations, and legal protection as a domestic entity. The new legislation now allows for full repatriation of profits and free conversion of the national currency into a foreign currency. The latter condition has been enabled by the new foreign exchange legislation that considerably liberalized the foreign exchange market, and introduced full convertibility of the dinar according to Article 8 of the IMF.

Following international practice, the Serbian government has established the Serbian Investment and Export Promotion Agency (SIEPA)-a government institution in charge of attracting foreign direct investments into the country and promoting exports. The agency provides pre-investment services, which is mainly information support and consulting, as well as post-investment services, including assistance in dealing with bureaucracy, and establishing contacts in the country.

Since urban construction land is still state-owned and cannot be traded, both foreign and domestic investors may only lease the land for their use.

(v) Financial Sector Development

The financial sector remains one of the weakest sectors in Serbia's economy, a legacy of the decade of disruption, economic sanctions and mismanagement of the economy. In general, Serbia's banking system is still dominated by state-owned banks. Financial intermediation indicators suggest that Serbia is behind other economies of the SEE region, except Romania, with regards to deposit base (total deposits as percentage of GDP), credit expansion (total loans as percentage of GDP), and share of bank assets in GDP. Also, Serbia is the only country in the region that does not have a deposit insurance system in place.

However, the country can boast a lower degree of concentration in the banking sector than in its Southeastern European counterparts. The share of assets of the three largest banks in Serbia equals 36%, well below the SEE countries average of 56%, which leaves room for likely future consolidation in the sector through mergers and liquidations.

Over the past few years, the health and the performance of the Serbian banking system has improved. This was a result of the implementation of a common reform process, including the restructuring and privatization of state-owned banks, the closure of insolvent banks, the write-off of non-performing loans, the adoption of new prudential regulations and tighter supervision, and the entry of foreign banks.

As part of the restructuring, 19 inefficient and loss-making banks were closed down, along with four large banks that accounted for about 60% of the total book value of assets. The government has introduced modern banking standards, including minimum capital requirements, and allowed for entry of six foreign banks. The latter measure helped to improve competition in the banking sector and raised the general quality of banking services. However, the number of foreign-owned banks operating in Serbia is still critically low (6 out of 48), well below the average for the region.

At this stage of development, the quality of the financial sector in Serbia, although improving, remains very low in comparison with other transition economies of the SEE and CEE regions. Further improvement in financial intermediation is the key to financial sector development as well as being necessary to support the attainment of high and sustainable rates of economic growth in the country.

(vi) Corruption Level

Corruption is one of the gravest problems on the thorny road to a full-fledged market economy, and it remains a serious impediment to normal business activities in Serbia. However, the Serbian government is fully aware of the situation and is taking decisive measures to tackle it. In fact, the government has defined the fight against corruption as one of its top two priorities (along with living standards improvement.)

In its study of the problem, Transparency International identified the existence of a sound institutional framework in Serbia as a prerequisite to fight corruption. However, the main problem remains insufficient funding, which leads to technical incompetence along with a lack of qualified personnel.

The government has set up various bodies that oversee and manage the anti-corruption crackdown: the Anti-Corruption Commission, a high-level body comprised of ministers and heads of government agencies, oversees anti-corruption activities in the country; the Anti-Corruption Council, an independent body comprised of well-known professionals (lawyers, professors, journalists) advises the government on anticorruption strategy and tactics, and develops legislation; and the Anti-Corruption Unit, a division of the Ministry of Finance and Economy, coordinates all anti-corruption initiatives.

In its attempt to effectively fight corruption at different levels of society, the government has set up special anti-corruption teams staffed with the Ministry of the Interior and Prosecution Office personnel, which operate in 26 major cities throughout the country. The public is encouraged to report any instances of corruption to the designated hotline phone numbers. In the first 15 days of the teams' activities, they registered over 450 reports of corruption, which resulted in ten prosecutions against 13 individuals.

The wide-ranging anti-corruption campaign requires all ministries and government agencies to regularly report on their anti-corruption activities and suggest new measures that would help eradicate corruption within their structures. The measures currently being taken range from streamlining of regulations and procedures to minimize opportunities for rent-seeking behavior of government officials, to restructuring and re-staffing of some state agencies, to raising public awareness of the long-term damage to the economy and society from corruption activities. In a recent example, a training course for government officials, jointly financed by the Canadian International Development Agency, the OSCE Mission to Serbia and the Swiss government, was held in Belgrade. The course is part of the $15 million project to develop a strong public administration sector and reform the judiciary.

In recognition of Serbia's progress in combating corruption, the country has been recently admitted to the Council of Europe's Group of States against Corruption (GRECO), which pledged support for its future anti-corruption efforts.

(vii) Political Risks

Domestic political tensions over the future of the Federation peaked during 2002, raising concerns about their long-term impact on the pace of the reforms. However, the situation eased with the adoption of the constitutional charter by the joint Serbian and Montenegrin Constitutional Commission in December 2002. The document paved the way for greater autonomy of both Republics with the creation of a Union of Serbia and Montenegro (instead of the old Federal Republic of Yugoslavia). It also left room for the countries' complete independence in a few years should the population confirm this decision through national referendums.

The assassination of the Serbian Prime Minister in the spring of 2003 raised fears of the possible impact on the pace of reforms. However, the situation neither led to a change of government policy, nor caused an outburst of political confrontation.

Although reversal of the current market-oriented policies is highly unlikely, possible political tensions in this immature democracy contribute to a lesser degree of predictability of the political environment. However, being closely watched by all sorts of international political and financial organizations, and being heavily in need of financial assistance from the West, the Serbian government is expected to continue to move along the free-market path it started.

(viii) Country Promotion and Image

Serbian authorities are facing a formidable task of reshaping the country's international image after a decade of brutal conflicts and economic sanctions. Serbia is firmly resolved to implement democratic policies and institutions and build a market economy. However, fighting the legacy of the old regime is difficult and slow. Serbia was re-admitted to most international organizations soon after the new government came to power in 2001. It got involved in negotiations for new loans and restructuring of old debts, succeeding in many of these talks. International companies and banks have been entering the country ever since, aiming for long-term presence. Serbia has entered into regional cooperation with neighbor countries and renewed its political and economic relations with Slovenia, Bosnia-Herzegovina, and Croatia-former victims of the old regime.

The most challenging task for the Serbian authorities now is to create a stable and business-friendly investment climate that would encourage investments and further contribute to long-term sustainable growth. As part of these efforts, the Serbian government has been quite successful in presenting the drastic changes that have been happening in the country in the last few years to the international community.

(ix) Targeted Investment Incentives

The country has altogether discontinued using the quasi-fiscal and implicit subsidies it used to widely employ in the 1990s. At the same time, the existence and size of explicit subsidies is not known. However, as the country is striving to harmonize its domestic legislation with that of the EU, declaring its movement towards deeper involvement in the EU structure, one can expect the level of explicit subsidies, if any, to be in line with EU requirements.

On the other hand, the Serbian government is offering significant tax incentives to investors as follows:

- Tax credit of 20% of investments in fixed assets in a given year, and up to 50% of total tax (the rates for SMEs are 40% and up to 70%, respectively)
- Tax credit of 100% of total gross wages fund of newly employed persons for two years
- A 10-year tax break for "sizeable investments" (over $10 million and 100 employees)
- A 5-year tax break for investments in "regions of special interest" (over $100,000 and 5 employees)

The Serbian government is actively using free trade zones to stimulate investments and promote the development of certain regions. Currently, there are 14 free trade zones operating in Serbia. Import and re-export activities of the companies that operate in such zones are not subject to quotas, customs duties, charges or sales tax.

Targeted investment incentives are not perceived as a substantial distortion in favor of certain industries or economic agents, but rather as general motivation for further development of the business sector.

INVESTMENT MARKETS AND FUNDS

The competitive environment in Serbia's investment business is characterized by the fact that the country embarked on a peaceful development stage only in 2000. Fundamental economic reforms started in 2001–2002. Because of this, the number of foreign companies operating in Serbia is relatively low. Therefore, mostly Serbian companies operate in various sectors of the investment industry.

Investors

The European Bank for Reconstruction and Development is one of the largest foreign investors in Serbia. By mid-2002, EBRD had invested a total of €350 million in Yugoslavia. In 2002, EBRD investments were to reach €100 million. There were plans to invest €50 million in the mining industry and electricity sector, €10 million in banking, and €40 million in two private companies. In Serbia, EBRD invests both in private and government sectors. The EBRD privatization strategy is to purchase stakes of 20%–30%.

EBRD Commitments as of April 30, 2002

Project	Sector	Property	Type of Investment	EBRD Participation, € million	Date of Signing
EPS Emergency Power Sector Reconstruction	Electricity Sector	Government	Loan	€100.0	25.10.01
ZTP Belgrade Reconstruction	Transport	Government	Loan	€57.0	25.10.01
Belgrade Infrastructure reconstruction Program	Utilities	Government	Loan	€60.0	27.07.01
Micro Finance Bank of Yugoslavia	Finance	Private	Loan	€6.9	21.04.01
Micro Finance Bank of Yugoslavia	Finance	Private	Shares	€2.3	21.04.01
Micro Enterprise Bank (Kosovo)	Finance	Private	Shares	€1.3	18.09.01
Kosovo Reconstruction Equity Fund	Finance	Private	Shares	€2.0	06.11.01

Source: The European Bank for Reconstruction and Development

Soros Investment Capital (SIC) is a large investment fund operating in Serbia. The fund capital base totals $200 million. SIC invests in countries of South Europe and the Caucasian region (Albania, former Yugoslavia, Bulgaria, Romania, Turkey, Armenia, Azerbaijan, and Georgia). The fund invests in stakes in private and privatized companies. An investment ranges from $5 million to $25 million. Major sectors for investments are telecommunications, information technologies, and services. In Serbia, SIC invested in KDS (cable TV operator) and Eximbank (financial sector).

Black Sea Fund invests in countries of the Black Sea region. The fund started operation in 1998 with $62 million declared in investments. Initially, the Black Sea Fund focused on Bulgaria, Romania, Ukraine, Macedonia, Russia, Georgia, Armenia, Azerbaijan, and Moldova. In 2002, the fund's capital increased to $100 million, and its operation was extended to Bosnia and Herzegovina, Yugoslavia, and Croatia. Black Sea Fund investments in Serbia total $7.7 million.

In addition, a number of investment funds cover Serbia, but currently do not invest in Serbian projects. These funds include The Central European Equity Fund and GSIL-European Equity Portfolio. Assets of these funds range from $100 million to $200 million. In case risks in Serbia recede, these funds could invest in the country.

Apart from private investment funds, government funds also invest in Serbia. The Overseas Private Investment Corporation (OPIC) is a fund of the American government that invests in over 140 countries. OPIC investments in Eastern Europe (apart from Turkey and FSU countries) make up about $500 million, $8.8 million of which is allocated to Serbia.

Donor funds are a large source of investments in Serbia. Donor organizations include EBRD, World Bank, European Investment Bank, and government organizations of EU countries. Donor projects are financed by grants or soft loans.

Funds Allocated by Donor Organizations, € million

Sector	2000	2001	2002	2003E	TOTAL
Electricity Sector	€45.15	€143.51	€172.68	€162.30	€523.65
Social Programs	€52.62	€148.26	€47.04	€91.39	€339.31
Local Projects	€8.35	€26.92	€87.96	€11.37	€134.60
Agriculture	€4.33	€69.05	€18.49	€20.44	€112.30
Health Care	€12.64	€35.01	€38.65	€37.53	€123.83
Civil Society	€12.94	€41.81	€17.97	€9.15	€81.88
Private Sector	€0.65	€28.46	€53.94	€137.55	€220.60
Others	€0.90	€15.65	€41.76	€68.34	€126.64
Education	€9.75	€4.50	€12.53	€22.08	€48.86
Banks	€0.13	€4.05	€13.42	€19.14	€36.73
Public Management	€0.25	€3.31	€10.82	€23.65	€38.04
Water	€0.36	€0.80	€13.58	€31.00	€45.74
Transport	€3.02	€7.31	€72.40	€185.52	€268.25
Construction	€0.42	€2.48	€7.93	€26.00	€36.83
Environment	€1.28	€4.68	€4.86	€4.41	€15.23
Justice	—	€2.41	€6.83	€2.77	€12.01
Budget	—	€17.24	€162.90	€66.48	€246.63
Culture	—	€0.19	€1.21	€1.31	€2.71
Home Affairs	—	€0.26	€0.47	€0.44	€1.17
Labour	—	€0.23	€0.23	—	€0.46
Science	—	—	€0.27	—	€0.27
Telecommunications	—	€0.14	—	—	€0.14
TOTAL	**€152.79**	**€556.30**	**€785.93**	**€920.87**	**€2,415.89**

Source: Ministry of International Economic Relations

Stock Market

In 2002, trading volume on the Belgrade Stock Exchange (BSE) increased by over 100%. Stakes trading volume saw the largest increase. This is primarily due to the start of active privatization of Serbian companies on the stock exchange. The NBS treasury bonds and corporate bonds sector activity increased by almost 2 times.

Trading on the Belgrade Stock Exchange, $ million

	2002	2001
NBS Treasury Bonds	$729.72	$372.36
Corporate Bonds	$653.58	$343.60
Shares	$109.00	$1.45
Others	$94.73	$36.05
Total	**$1,587.03**	**$753.45**

Sources: Belgrade Stock Exchange, SigmaBleyzer

Consultants

When Serbia started implementing reforms in 2001, the consulting services market began its active development. Today, representative offices of all leading consulting companies operate in Serbia. These include Deloitte&Touche Yugoslavia, KPMG d.o.o. Beograd, PriceWaterhouseCoopers, and BC EXCEL (Arthur Andersen representative in Serbia). Local consulting companies also operate on the consulting services market.

INDUSTRY SECTORS

The largest Serbian sectors are mining, processing, electricity, and petrochemicals processing. In the processing industry, food, chemical, and metallurgy are the largest sectors. Over half the working population is employed in industry.

Structure of Serbian Industrial Production

Sector	Share in Industrial Production
Food Industry	19.97%
Electricity Sector	19.69%
Metallurgy	5.74%
Non-Metal Materials	5.49%
Metal Mining Industry	5.13%
Textile	4.11%
Plastics and Rubber	3.63%
Metal Processing	3.20%
Machinery	3.11%
Car Industry	3.10%
Clothing Industry	3.00%
Pulp and Paper Industry	2.68%
Others	21.15%

Sources: Serbian Government, SigmaBleyzer

In the near future, food, tobacco, construction materials production, and electricity are expected to show the most rapid growth. Outside industrial production, the insurance market is the most prospective.

It is worth mentioning that in 2002, leading Serbian industries had large losses due to the fact that the Serbian economy still deals with consequences of civil war and economic sanctions.

Food Industry

Serbia food industry companies can be divided into nine groups by manufactured products:

- Grain sieving and milling
- Bread baking and pasta production
- Processing and canning of fruit and vegetables
- Processing and canning of meat and fish
- Processing and canning of milk
- Sugar production
- Confectionery
- Production of vegetable oil and fat
- Production of other food products

The largest companies in the food industry sieve and mill grain (21% of total number of companies, 13% of revenues, 20% of profits, and 2% of losses in the industry), process and can fruit and vegetables (20% of total number of companies, 11% of all revenues, 20% of profits, and 6% of losses), and process and can meat and fish (16% of total number of companies, 18% of revenues, 4% of profits, and 9% of losses).

Performance of Serbian Food Companies by Products, 2002

	Number of Companies	Number of Employees	Revenue, $ million
Grain Sieving and Milling	66	11,427	$177
Processing and Canning of Fruit and Vegetables	65	8,183	$157
Processing and Canning of Meat and Fish	50	17,800	$249
Bread Baking and Pasta Production	48	7,209	$66
Processing and Canning of Milk	27	6,577	$204
Confectionery	22	11,156	$181
Production of Other Food Products	18	2,975	$65
Sugar Production	16	4,270	$120
Production of Vegetable Oil and Fat	8	3,949	$148
TOTAL:	**320**	**73,546**	**$1,367**

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

Ten companies with the largest income account for about 30% of food industry revenues. They employ about 24% of the food industry workforce. Six of ten largest companies posted a profit (PKB IMLEK, KARNEKS, SOJA PROTEIN, VITAL, NEOPLANTA, and BAMBI) and four companies had losses (TAKOVO, SOKO NADA STARK, PKB FRIKOM, SUNCE).

Company Rating by Revenue in 2000

#	Company	Location	Sector
1.	IMLEK DD	Belgrade	Milk Processing
2.	CARNEX	Vrbas	Meat Processing
3.	SOJAPROTEIN AD	Becej	Soya Processing
4.	TAKOVO DP	Gor.Milanovac	Processing and Canning of Fruit
5.	SOKO NADA STARK	Belgrade	Confectionery
6.	VITAL AD	Vrbas	Production of Vegetable Oil and Fat
7.	NEOPLANTA AD	Novi Sad	Meat Processing
8.	FRIKOM PKB	Belgrade	Production of Frozen Products
9.	SUNCE AD	Sombor	Production of Vegetable Oil and Fat
10.	BAMBI DP	Pozarevac	Confectionery
11.	CENTROPROIZVOD AD	Belgrade	Instant Food Production
12.	JUHOR-EKSPORT AD	Jagodina	Processing and Canning of Meat
13.	MITROS	S.Mitrovica	Meat Processing
14.	NOVOSADSKA MLEKARA AD	Novi Sad	Milk Processing
15.	BACKA AD	Vrbas	Sugar Production
16.	GRANEKSPORT AD	Belgrade	Grain Sieving and Milling
17.	SECERANA DP	Sabac	Sugar Production
18.	AGROEKONOMIK AD	Belgrade	Production of Juice and Frozen Products
19.	SWISSLION DOO	Novi Sad	Confectionery
20.	MLEKARA AD	Subbotica	Processing and Canning of Milk

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

Over the last year, investment activity has been most intensive in sugar production and milk processing. In October 2002, Hellenic Sugar Industry (Greece) purchased sugar refinery Zablje for

€1.1 million, and in early 2003, it bought a 70% stake in Crvenka sugar refinery for €3.0 million. Apart from two sugar refineries in Serbia, Hellenic Sugar Industry owns 5 sugar refineries in Greece. The purchase of two Serbian sugar refineries will enable the Greek company to increase sugar output from 320,000 to 450,000 tons per year.

Stradivarus (Holland) is the largest foreign investor in the milk processing sector. Stradivarus plans to invest $100 million in the sector and has already invested $35 million. Today, Stradivarus owns two large stakes in Serbian milk processing companies (Zemun Dairy and Imlek).

Tobacco Industry

There are 11 companies in the Serbian tobacco industry. Two of them specialize in tobacco production, and the other nine in production of fermented tobacco. Tobacco manufacturers are the largest in the sector; they employ 80.9% of the total workforce in the sector, account for 86.3% of revenues, and 80.5% of profits. To boost the sector's attractiveness, the government announced that during the next 1.5 years Serbia will not issue new licenses for the production of cigarettes.

Performance of Serbian Tobacco Companies by Products, 2002

	Number of Companies	Number of Employees	Revenue, $ million
Fermented Tobacco Production	9	667	$18.0
Tobacco Production	2	2,827	$113.4
TOTAL:	**11**	**3,494**	**$131.4**

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

The largest companies in the sector are Fabrika Duvana DP and Vranje AD. Fabrika Duvana DP accounts for 68.3% of total revenues in the sector and 65.1% of the workforce. At the same time, in 2001, this company had the greatest losses ($1.75 million). In 2001, the biggest profits were posted by Vranje AD ($1.3 million or 80.5% of the total profits in the sector).

Company Rating by Revenue in 2000

#	Company	Location	Sector
1.	FABRIKA DUVANA DP	Nia	Tobacco Production
2.	VRANJE AD	Vranje	Tobacco Production
3.	DUVANSKA INDUSTRIJA AD	Senta	Fermented Tobacco Production
4.	COKA AD	Coka	Fermented Tobacco Production
5.	BUJANOVAC DP	Bujanovac	Fermented Tobacco Production
6.	TABAK DP	Nis	Fermented Tobacco Production
7.	PRESEVO DP	Presevo	Fermented Tobacco Production
8.	NISAVSKA DOLINA DP	Pirot	Fermented Tobacco Production
9.	BAJINOVAC DP	Bajina Basta	Fermented Tobacco Production
10.	DUVANKOOP AD	Backa-Palanka	Fermented Tobacco Production
11.	DP ZA PROIZ. I OBRADU DUVANA	Vladicin Han	Fermented Tobacco Production

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

Mining Industry

There are 6 non-ferrous production companies in Serbia. They can be divided into 3 groups:

- Production of copper concentrate and ores
- Production of lead-zinc concentrate and ores
- Production of non-ferrous concentrate and ores

The largest in the sector are the companies that produce copper concentrate and ores. They employ 91.1% of the total workforce in the sector and account for 95.2% of revenues in the sector.

Performance of Serbian Mining Companies by Products, 2002

	Number of Companies	Number of Employees	Revenue, $ million
Production of Copper Concentrate and Ores	2	7,324	$118.0
Production of Lead-Zinc Concentrate and Ores	3	480	$4.0
Production of Non-Ferrous Concentrate and Ores	1	239	$2.0
TOTAL:	**6**	**8,043**	**$124**

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

The leading companies in production of non-ferrous metals are RTB-GROUP — GROUP BOR COPPER MINES DOO (accounts for 53.8% of revenues in the sector and 54% of the workforce) and RTB MAJDANPEK COPPER MINE DD (accounts for 46.6% of revenues and 37% of the workforce.)

Company Rating by Revenue in 2000

#	Company	Location	Sector
1.	RTB BOR — GROUP BOR COPPER MINES — DOO	Bor	Production of Copper Concentrate and Ores
2.	RTB MAJDANPEK COPPER MINE DD	Majdanpek	Production of Copper Concentrate and Ores
3.	RUDNIK DP	Rudnik	n/a
4.	ZAJAC DP	Loznica	n/a
5.	BOBIJA RUDARSKO DP	Lubovija	n/a
6.	GROT DP	Vranje	n/a

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

Chemical Industry

Serbia's chemical industry can be divided into two sectors: production of chemical products (base chemistry) and processing of chemical products. Base chemistry companies (about 30% of companies in the chemical industry) employ 44% of the workforce. These companies generate 48.9% of the industry's revenue and receive 20.6% of profits. Companies that process chemical products amount to 70.1% of chemical industry and employ 56% of the workers. These companies account for 51.1% of revenues and 79.4% of profits.

Performance of Serbian Chemical Industry by Products, 2002

	Number of Companies	Number of Employees	Revenue, $ million
Production of Chemical Products	44	17,602	$466
Production of Chemicals (except for agriculture)	17	4,429	$147
Production of Chemicals for Agriculture	10	5,393	$161
Production of Artificial and Synthetic Fibers	2	2,324	$18
Production of Plastic	15	5,457	$141
Processing of Chemical Products	103	22,392	$487
Production of Medicines and Pharmaceutical Materials	19	7,703	$243
Production of Detergents and Makeup Preparations	13	3,755	$68
Production of Paints and Varnishes	13	1,375	$60
Processing of Plastic Packaging	20	3,053	$29
Other Processing of Plastic	22	4,160	$56
Production of Other Chemical Products	16	2,345	$31
TOTAL:	**147**	**39,995**	**$954**

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

HIP PETROHEMIJA DP, the largest chemical company, accounts for 10% of chemical industry revenues. At the same time, it has the largest losses in its industry. Nine companies with the largest losses are: HIP PETROHEMIJA DP, GALENIKA AD, HIP AZOTARA AD, TEHNOGAS AD, AZOTARA DP, HP PRAHOVO — DJUBRIVA DD, METANOLSKO-SIRCETNI KOMPLEKS AD, ZORKA-MINERALNA DJUBRIVA DD, and PRVA ISKRA-BAZNA HEMIJA. The two companies with the largest loss are HIP PETROHEMIJA DP and GALENIKA AD.

Company Rating by Revenue in 2000

#	Company	Location	Sector
1.	HIP PETROHEMIJA DP	Pancevo	Oil Refining
2.	HEMOFARM KONCERN AD	Vrsac	Pharmaceutics
3.	GALENIKA AD	Zemun	Pharmaceutics
4.	HIP AZOTARA DP	Pancevo	Fertilizers Production
5.	TEHNOGAS AD	Rakovica	Technical Gases
6.	AZOTARA DP	Subotica	Fertilizers Production
7.	ZDRAVLjE AD	Leskovac	Pharmaceutics
8.	ZUPA HI DP	Krusevac	Production of Chemicals for Agriculture
9.	MERIMA DP	Krusevac	Production of Detergents and Makeup Preparations
10.	JUKO-HEMIJA AD	Novi Sad	Production of Detergents and Makeup Preparations
11.	IHP PRAHOVO DJUBRIVA DD	Prahovo	Production of Chemicals
12.	HIPOL DD	Odzaci	Production of Plastic
13.	JUGOREMEDIJA DOO	Zrenjanin	Pharmaceutics
14.	ZORKA-FARMA AD	Sabac	Pharmaceutics
15.	METANOLSKO SIRCETNI KOMPLEKS AD	Kikinda	Production of Chemicals
16.	TIPOPLASTIKA HK AD	G. Milanovac	Production of Plastic
17.	IHP PRAHOVO-SOLI DD	Prahovo	Production of Chemicals
18.	MILAN BLAGOJEVIC — NAMENSKA DP	Lucani	Production of Chemicals
19.	HEMOMED-HEMOFARM DOO	Vrsac	Pharmaceutics
20.	ZORKA-MINERALNA DJUBRIVA DD	Sabac	Pharmaceutics

Sources: Serbian Investment and Export Promotion Agency, SigmaBleyzer

The most profitable company in the chemical sector is HEMOFARM Koncern AD with 22% of revenues generated by the industry. Nine companies (HEMOFARM Koncern AD, ZUPA HI DP, MERIMA DP, ZORKA-FARMA AD, TIPOPLASTIKA HK AD, PAN-FARMA, DELHEM AD, CHEMOS AD и DUGA PREMAZI DOO) make about 70% of total profit of all analyzed companies.

In 2002, investors were most active in the pharmaceutical sector. Stakes in three pharmaceutical companies were sold during privatization tenders. The stakes ranged from 40% to 70% and the total volume of transactions was over $30 million.

Henkel Group is a large investor in the industry. In late 2002, the company bought a 70% stake in Merima chemical factory. The transaction volume was $14 million, investments totaled $43 million, and $12 million was allocated to social programs. Merima is expected to become the largest manufacturer of detergents in the Balkan Peninsula. The products manufactured by Merima will be supplied to Romania, Bulgaria, and former Yugoslavian republics.

RISKS AND OPPORTUNITIES

Investing in Serbia has both unique opportunities and certain risks. Opportunities are due to the fact that Serbia, unlike other countries in the region, is currently undergoing the initial stage of reforms. Therefore, the profitability of investments in Serbia can be much higher than in more developed countries of this region such as Slovenia, Croatia, etc. Privatization is another important factor creating additional opportunities for investors. Serbia is one of the last Eastern European countries where privatization of government property is not yet complete. Below is a list of major opportunities that investors in Serbia will enjoy in the near future:

Opportunities

- Economic reforms in Serbia are aimed at EU accession
- Legislation is focused on encouraging foreign investors
- The privatization process in Serbia is going through its peak; privatization is expected to last until 2005
- Low competition among funds operating on the Serbian investment market
- The Serbian economy is at the beginning of a stage of high growth.

Along with opportunities, there are specific risks in Serbia. Many of them are connected with the unstable political situation in the country. Political forces opposing the economic reforms and integration with Western Europe are still powerful. Over recent years, the country has felt the impact of economic sanctions and the civil war. As a result, the Serbian economy is in a difficult situation. The economic recession resulted not only from the population's decreased income, but also from destruction of industrial infrastructure. High risks in Serbia can also account for a low number of private investment funds in the country. Here are major risks inherent in modern Serbia:

Risks

- Unstable political situation
- Consequences of civil war and economic sanctions still affect the Serbian economy
- Privatization in Serbia is already underway and will complete in a couple of years, so there is little time for participation.

CONCLUSION

Since 2001, the new Serbian government has developed a broad vision of a society where sustained, broad-based increases in living standards are generated by a dynamic private sector that leads growth, with good governance and accountable public institutions, and one re-integrated into the international economy. The country's policymaking has been directed towards implementation of this vision. In a very short period of time, the country has approached macroeconomic stabilization, acquired control of its public finance sector and achieved considerable rates of growth in living standards and in national output for the last three years. Still in need of painful restructuring of its industrial capacities and building up export potential, developing financial institutions and promoting the private sector of the economy, the country has established a sound legal framework for successful implementation of the required transformations.

APPENDIX

Table 1. Serbia: Key Economic Indicators

Year	Unit	1999	2000	2001	2002	2003(Proj.)
Population	mn, eop	10.6	10.6	10.7	10.7	10.7
Unemployment Rate	%, eop	26.5	25.9	27.0	28.9	30.0
Average monthly Salary	US$	118	155	83	141	186
Real Sector						
GDP	US$ bn	10.2	8.6	11.6	15.7	19.8
GDP per Capita	US$	962	811	1,084	1,467	1,850
Real GDP Growth	% yoy	−18.0	5.0	5.5	4.0	3.0
Industry Share in GDP	%	36.3	34.9	37.1	39.2	40
Agriculture Share in GDP	%	20.5	23.3	23.3	23.8	24
Gross Domestic Investments/GDP	%	11.6	14.2	13.6	16.1	16.5
Domestic Savings/GDP	%	n/a	−2.7	−7.2	−7.0	−3.5
Public Finance						
Fiscal Balance (IMF method)	% of GDP	n/a	−0.9	−1.4	−4.5	−4.5
Fiscal Revenues	% of GDP	n/a	36.7	38.9	42.8	40.5
Fiscal Expenditures	% of GDP	n/a	37.6	40.3	47.3	45.1
Monetary Statistics						
Retail Price Inflation	% yoy, aop	42	70	91	21	9.0
Currency in Circulation	% yoy, eop	47.3	52.0	131.6	49.4	9.4
Money Supply-M1	% yoy, eop	63.6	85.2	114.4	80.3	15
Foreign Exchange Rate	US$ aop	11.1	16.69	66.84	64.19	58.1
Balance of Payments						
Exports of Goods	US$ mn	1,676	1,923	2,003	2,412	3,185
Imports of Goods	US$ mn	−3,295	−3,711	−4,837	−6,320	−7,935
Trade Balance	US$ mn	−1,619	−1,788	−2,834	−3,908	−4,750
Trade Balance/GDP	%	15.9	20.8	24.4	24.9	24.0
Net Services, Income, Transfers and Official Grants	US$ mn	855	1,449	2,306	2,524	3,053
Current Account Balance, after grants	US$ mn	−764	−339	−528	−1,384	−1,697
Current Account/GDP	%	−7.5	−3.9	−4.6	−8.8	−8.7
Net Foreign Direct Investments	US$ mn	112	25	165	562	1,400
Overall B/P Balance	US$ mn	−237	183	605	783	−739
Gross International Reserves	US$ mn eop	289	516	1,169	2,280	3,550
Public and Private Debt						
Public and Publicly Guaranteed External Debt	US$ bn eop	9.8	10.3	10.9	10.9	11.1
Private External Debt	US$ bn eop	1.0	1.2	1.0	0.9	1.7
Total External Debt	US$ bn eop	10.7	11.4	11.9	11.8	13.8
Total External Debt/GDP	%	105	133	103	75	69

Sources: IMF, World Bank, OECD, and SigmaBleyzer staff estimates and calculations.