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Stabilisation and Association Report

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Federal Republic of Yugoslavia

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1. EXECUTIVE SUMMARY¹

During 2001, a full-fledged strong commitment to reform, and some real progress, has been evident in the Federal Republic of Yugoslavia (Republic of Serbia, Kosovo and the Republic of Montenegro). The "classical" problems of a country in transition are of course compounded by unsolved issues of constitutional status, and, until recently, the less cooperative attitude shown by one constituent Republic, which undermines the functioning of the state. It is vital that these do not interfere with reform efforts - reforms which are in any event required throughout the country - and is not permitted to cause instability beyond the borders of the FRY.

In terms of **political reform**, the overall impression is positive. In the relatively short period since the new Governments took office, Belgrade has shown clear political determination to undertake the necessary reforms. Respect for fundamental principles has improved, though better coordination and implementation is required. FRY has continued its efforts to build bilateral and multilateral relationships throughout the region and beyond. FRY respect for international obligations (ICTY) requires urgent improvement if it is not to become an obstacle to integration into European structures. There has been progress too in Kosovo, with continuing international efforts to build democracy and the rule of law, and political change in the form of the development of a Constitutional Framework and the successful elections to the new provisional institutions of self-government. The transfer of competencies to the elected representatives would have been possible more quickly had they shown more leadership. More progress might have been expected in Montenegro, after three years of democratic government. It is important, throughout the FRY, that momentum for difficult political reforms does not falter in the face of the challenges ahead, and that potential brakes on progress - such as corruption - are tackled urgently.

Substantial progress has been made on the **economic** front, with the ending of the isolation of the FRY, the holding of a successful Donors' Conference and the delivery of substantial quantities of assistance, the resolution of most of the country's external debts and the rapid move from post-conflict reconstruction to transition. There is clear international consensus that Belgrade has already laid the correct bases of economic reform and development in the first year of transition. At macro-economic level, the correct financial and fiscal steps have been taken. The economic development of Kosovo, though from a low base, continues with donor support and guidance. More progress in implementation of economic reforms should have been evident in Montenegro, in its third year of transition. The implementation of economic reforms slowed down in the beginning of 2001, but after the April elections further progress was made in some sectors although budget financing remains difficult.

¹ This report does not take account of events after 13 March, including the Agreement on Principles between Belgrade and Podgorica, the implementation of which, at time of writing, it would be premature to assess.

As the pace of transition picks up in 2002, there should be **deepening structural reforms** throughout the FRY - moving from the adoption to the implementation stage of reforms, bringing all parts of the FRY to the same level so as to permit the state to move forward. The authorities will also face the challenge of maintaining public support for the difficult and necessary reforms ahead. For the mutual benefit of all parts of the FRY, and with a view to FRY drawing closer to the EU, priority must also be given - particularly but not only in the economic field - to the recreation and efficient functioning of the single economic space within the state and the implementation of EU-compatible reforms throughout the state.

2. POLITICAL SITUATION

*The potential for successful reform is present. Energy and ability are evident. There is a clear wish for **democratic reform** and **rule of law** both at the level of the authorities and the population. These obstacles are not of their creation. In fact, the very detail of the description below reflects, on the one hand, the ever-present and overriding complexity of the situation within the country and, on the other, the ferment of reform activity.*

On balance, the overall assessment is positive - considerable work has been done in the year since the democratic authorities came to power - eighteen months ago, it would have been unthinkable in the region that a peaceful defusion of interethnic tensions would have occurred - in Serbia. Many - but not all, and in any case time will be required - of the obstacles to progress described below will resolve themselves once the constitutional issues are settled.

The state continues its efforts to function and reform despite these obstacles. The longer the situation continues, the greater the concerns will be that the momentum of political reform might be negatively affected due to this continuing uncertainty.

2.1. Democracy and the Rule of Law

Any assessment of the Federal Republic of Yugoslavia must take account not only of the "classical" problems of a country in transition but also of unsolved issues of constitutional status. The country consists of several more or less separate entities. Despite sharing a common federal constitution and institutions, the Republics of Serbia and Montenegro in reality have separate legislative processes, laws and policies, including in areas which remain formally of federal competence. In addition, the province of Kosovo is currently under international civil and military administration under UN Security Council Resolution 1244 which, however, makes specific reference to the territorial integrity and sovereignty of the Federal Republic of Yugoslavia. These constitutional difficulties have effects between Belgrade and Podgorica, on relations between Belgrade and Kosovo, and on the wider reform processes. The dual administrative systems in parts of Kosovo are a further cause for concern.

Unresolved issues between Belgrade and Podgorica cause blockages in federal institutions, which occasionally leads to unilateral measures. The institutional fragility is evident in the federal parliament, where the Montenegrin ruling parties' boycott of the federal state forced the ruling coalition in Serbia (DOS) into an alliance with Montenegrin opposition parties whose positions on several important issues are not compatible. This has already resulted in the resignation of one federal government and remains a serious obstruction to the work of the federal parliament, as well as to legal reforms and reform of the military.

The lack of clarity in the de facto and de jure distribution of powers between federal and republican level also leads to a lack of harmonisation of legislation and policy and even to the continuing application of obsolete laws. Moreover, there is a problem of dualism, the continued presence of elements of the old régime even within the new structures. All of this leads to a climate of constitutional uncertainty. At lower levels, there are also difficulties with the functioning of the institutions. In Serbia, increasingly open conflicts within the ruling coalition have seriously undermined the authority and transparency of

institutions. As has the manner in which some laws are passed without public consultation and the difficulties which the government experienced with elements of the state security services. The failure of the federal institutions and authorities to resolve issues has also led to unilateral actions as well as a tendency to govern by decree pending the adoption of federal regulations. There are also institutional difficulties in Montenegro, where deep divisions among political actors and the public, on constitutional issues, continue to impact negatively on the efficient functioning of Parliament. In Kosovo, where the provisional institutions of self-government, the first multiethnic assembly there since 1989, have only recently been established, it is too early to assess their functioning although the difficulties in electing the President and forming a government give some cause for concern.

Reassuringly, despite these difficulties, there has been progress and a strong commitment to reform during 2001, widely recognised by international organisations, including the Council of Europe. The degree of success, obviously, depends both on the degree of institutional resistance and time. For that reason, the bases of reform are more advanced in the economic than the political sectors. On the political side, there are democratically-elected and legitimate parliaments and functioning multi-party systems throughout the FRY, developed and active civic sectors, and preparations for comprehensive constitutional and legal reforms. The desire to draw closer to the EU has led to some promising signs of cooperation, between the parts of the FRY, on issues of mutual concern.

2.1.1. Assessment of democratic institutions and attitudes to the state

Constitutional issues. The three existing Constitutions – Federal, Serbian and Montenegrin – and the Constitutional Framework in Kosovo are not harmonized. The reasons are historical and political. There are also unresolved issues regarding existing federal or republican constitutions and laws and those in Kosovo. Whatever the problems, in any event all entities within the FRY should henceforth be aiming for increasing compatibility with European standards.

Constitutional reform, meanwhile, is blocked. The federal Constitution cannot be revised through normal democratic process because of the makeup of the federal parliament. Little progress was made on the restructuring of the federation, and its institutions, during 2001. Public opinion in Montenegro remains so evenly split that it is unlikely that a necessary majority for independence can be obtained through democratic processes (referendum and parliamentary approval). In December 2001, following intervention by the EU, the process of dialogue recommenced and continued at technical and political level through February 2002. The constitutional uncertainty at federal level is also blocking necessary constitutional reforms in Serbia where there is a basic consensus on the need to address governance issues (separation of powers, checks and balances, parliamentary system) and on respect for the human rights of all citizens. There is a continuing source of frustration, in Serbia, that new legislation there - but not, in practice, in Montenegro - is aligned to a (federal) constitution which Serbia cannot change. The Constitutional Framework for Provisional Self-Government in Kosovo, developed with international expertise, consulted with local representatives and promulgated by UNMiK in May 2001, while specific to the Kosovo situation, is in line with European standards.

Parliament. All of the parliaments in the FRY were constituted in a democratic manner and are legitimate. A partial exception, as regards the **representative nature** of government, is the composition of the federal parliament, due to the boycott by the governing parties in Montenegro of the last federal elections (in reaction to the

constitutional changes effected by Milosevic in mid-2000). This problem negatively affects the functioning of the Federal Parliament, leading to unworkable compromises and delays.

Overall, except in Kosovo, there are problems with the **functioning and efficiency of parliamentary structures**, and little has yet been done in terms of reform.. The structure of the government and legislature discourage or disregard alternative, civic, initiatives for legislative reform. Although there have been positive steps, in Serbia, in improving efficiency and transparency, some important initiatives (e.g. laws on judiciary) have been the subject of non-transparent political trade-offs. The authority of the Serbian Parliament was damaged in December 2001 during discussion of the Labour Law, an important precondition for economic reforms. Deep divisions between the main actors, over constitutional and other issues, have also adversely affected the work of the Montenegrin Parliament, most notably with the referendum law and with the prolonged boycott of parliamentary sessions by opposition parties (linked to refusals to extend an investigation into allegations of elected officials' involvement in cigarette smuggling). The Joint Interim Administrative Structure (JIAS) established in Kosovo in December 1999 continued to function throughout 2001 until the establishment of the new provisional institutions of self-government. It is still too early to assess the functioning of the new provisional institutions. It will be essential, for stability, for them to reflect, at all levels, the interests of the entire population of the province; focus on learning the art of self-government on issues within their competence; and maintain and develop the good working relationship, on issues of mutual concern, which UNMiK has already established with Belgrade.

The framework in which **elections** are organised requires revision, at all levels except in Kosovo, though the conduct of elections now, generally, meets international standards. At federal level, a law on the financing of political parties has been adopted. However, further revision of Milosevic-era election laws is required, in particular in order to ensure guarantees of transparency, election monitoring (particularly by domestic observers) and access to media, independent scrutiny of accuracy of electoral rolls, and a more efficient complaints procedure. The Serbian Law on Election of Representatives, adopted prior to the latest parliamentary elections introduced a set of positive changes as regards transparency and ballot-security, but there are still shortcomings (many of which were originally noted in the Gonzalez recommendations of 1996). OSCE welcomed and positively assessed the November 2001 local special elections in eighteen municipalities in Serbia. It reiterated, however, that election legislation, as well as the Local Government Law, should be reviewed as soon as possible and that failings in the technical voting procedures and inaccuracies in voter lists should also be addressed. Election legislation in Kosovo is in line with international standards, as was the preparation and conduct (including out-of-Kosovo voting) of the November 2001 elections for the provisional institutions of self-government. The campaign itself was marked by less violence, and more political maturity - though unfortunately some parties allegedly campaigned against participation - than those for the municipal elections a year earlier. The diversity of elected representation in the new institutions, an improvement on the situation following the municipal elections, was an opportunity for an inclusive approach to self-government. The encouragement by Belgrade of full participation in the elections by Kosovo Serbs, albeit belated, and the FRY-UNMiK Common Document (5 November 2001) were also welcome contributions to democratisation. The Election Law in Montenegro, under which the April 2001 parliamentary elections were held is generally assessed as positive, although OSCE did note undemocratic party control of electoral seats and a lack of transparency in the allocation of five seats reserved for the

Albanian minority. A draft law, subsequently rejected by Parliament (November 2001) was heavily criticised, notably regarding the lack of a qualified majority requirement.

Executive. There is a continuing problem of **jurisdiction** - the non-recognition by some parties from one constituent Republic of the federal government. Following the resignation of the federal government in June 2001 (in the aftermath of the transfer of ex-President Milosevic to the Hague) the number of federal Ministers and Ministries was reduced. However, the ensuing merger of Ministries (e.g. transport and telecommunications) resulted either in apparent suspension of important legislative activities (e.g. the Federal Telecommunications Law) or a slowdown in work (e.g. the Justice Ministry). The reverse is the case in Montenegro, where the government is generally considered to be oversized, with the proliferation of Ministers, Ministries and agencies of various sorts making coordination difficult.

Regarding the **workings of government**, the country presently demonstrates the difficulty rather than the stabilising potential of coalition government: There is a difficult coalition between DOS and Together for Yugoslavia at federal level, simmering disputes within DOS in the Serbian Government, differences on goals and methods within the minority coalition government in Montenegro and likely problems in coalition formation in the provisional institutions in Kosovo. There is a marked contrast, at federal / Serbian level, between the economic sphere where serious reforms are underway and elsewhere, where party affairs sometimes block the wider reform agenda, and institutional/ legal changes lag behind. With the slow pace of legislative action at federal level, the Serbian government has developed a tendency to pass decrees, a practice strongly criticised domestically. In the field of law and order, the Serbian government took firm action on several anti-corruption measures but resorted to compromise, without disciplinary measures against the initiators or instigators, to resolve the illegal strike by Special Forces of the State Security in November 2001, a direct challenge to elected authority. As with the issue of army reform, the lack of reform of the security and police services, the continuation in key positions of individuals connected with the former regime or under investigation for war crimes continues to send a mixed message.

New legislation on **local government** is being prepared. In Serbia, where municipalities are still disempowered compared to Council of Europe standards, the new Act on Local Government has been positively assessed by the Council of Europe. It envisages more competencies and resources for local administrations, limits on undue interference by republican authorities, greater involvement of citizens, and specific provisions on protection of minorities. The adoption of the Omnibus Law, restoring to Vojvodina some of the constitutional competencies which, like those of Kosovo, were suspended by Milosevic, is welcome. Further decentralisation is an issue to be resolved within constitutional reform, both federal and Serbian. Although ethnic Serbs did not participate in the 2000 local elections in Kosovo, ethnic Serb members of the community were appointed by UNMiK to represent the interests of that section of the population. To reduce the republican government's political and economic monopolies, new legislation in Montenegro should introduce wide decentralisation as well as addressing minorities' demands that they be involved in local appointments.

In terms of **public administration**, a reform programme has been established in Serbia, along with an Agency for the Development of Public Administration Reform (February 2001), a Civil Service Council (February 2001) and an Institute for Public Administration Reform (November 2001) the relationship between which is not yet clear. In December 2001, the federal government decided to reduce the size of the administration by 10%. Reform of public administration has also been launched in Montenegro. In Kosovo, the

Institute for Civil Administration has focused on supporting and developing the administrative capacity not only of the provisional administration but also political parties and civil society.

President. There is a federal President as well as Republican Presidents. The President of the Republic of Serbia continues to hold office despite being indicted by the ICTY.

Civil Society. The civil sector, throughout the FRY, is very active and well-developed. It played an important role in Kosovo society throughout the Milosevic era and, in Serbia, played a widely recognised role in the establishment of the current democratic regime. Except in Kosovo, civil society plays an important role in stabilising democratic changes, drafting legislation as well as acting as an external monitor on the performance and behaviour of the government and institutions.

Army. Various reforms are necessary, including civilian control and general modernisation / restructuring. Some reform proposals, including the reduction of compulsory service, have been adopted but the question of comprehensive military reform does not appear to be an immediate priority. The Federal Parliament is unable to exercise proper parliamentary or budgetary control, the military budget accounting for a rather high portion of the overall federal budget. The control by the Ministry of Defence over the Joint Chiefs of Staff also appears to be quite limited, although the accounting Unit was recently transferred to the Ministry. Similar problems of civilian oversight also arise regarding the links - financial and political - between the federal army (VJ) and that of the Republika Srpska. Questions were also raised about a proposal to transfer VJ arms to the former Yugoslav Republic of Macedonia at the height of the 2001 tensions. There are continuing concerns, and disputes within DOS, on the question of the removal of officers linked to the former regime. While paramilitary structures in Serbia have been dismantled, or partly incorporated into official structures (e.g. the Red Berets), the size of the police force in Montenegro, considered by some observers to be quasi-military, remains of concern. In Kosovo, the military and police remain a reserved power of the SRSG or under KFOR control.

2.1.2. Assessment of judiciary, law enforcement and respect for the rule of law

The rule of law is, in principle, enshrined in relevant constitutional and legal texts. The problem in the past was the lack of implementation - for political and systemic reasons and, even now, many improvements are still needed.

Legal Framework. Ongoing constitutional and political problems in the country have undermined the principle whereby laws must be in conformity with the constitution(s), as well as the hierarchy of constitutions. The climate of legal insecurity is not challenged by the constitutional courts which are in practice inefficient with sometimes little sense of independence from the executive and legislature. The work of the Federal Constitutional Court was blocked for most of the year until four new members were elected and it still includes Milosevic appointees. The Serbian Constitutional Court has not functioned for months, and the Montenegrin Constitutional Court has still not addressed issues relating to referendum conditions. Implementation, even of the many valid laws, is often lacking and influence is sometimes exerted by extra-judicial means. Contrary to the constitutional principle that courts should be established by law, military courts are established by decision of the military authorities (i.e. the executive) and, worryingly, appear to be authorised to hold trials, in certain cases, of civilians. The elimination of dual jurisdiction over crimes committed in Kosovo, as foreseen in the new Serbian law on courts, is welcome but the continued existence of parallel courts in northern Kosovo and

the claims by some Serbian courts to jurisdiction over Kosovo remains a matter of legal concern.

Judicial system. As a legacy of the previous régime, public confidence in and perceptions of the judicial and prosecutorial system, as well as general legal awareness and perception of law, are negative and there are lingering problems with judicial perceptions of their own independence. The federal courts system is relatively limited, with most issues dealt with at republican level. The issue of **judicial independence** has been addressed in newly adopted Serbian laws. Criteria for judicial appointments in Montenegro is unclear and further work is needed. At Serbian level, dismissals are underway of judges and magistrates involved in corruption, election fraud, politically-motivated trials or inefficiency, although the issue is extremely sensitive. In Serbia, the newly established Association of Public Prosecutors has forwarded its own proposals to parliament on increased prosecutorial independence. In Kosovo, where the independence of the judiciary is guaranteed in the Constitutional Framework, all local or international judges and prosecutors are appointed and removed from office by the SRSG, with limited terms and a high degree of oversight. To ensure fairness and a representational ethnic mix, appointments of local judges and prosecutors (though not decisions on promotion, transfer and dismissal) by the SRSG will henceforth be from lists of candidates proposed by the Judicial and Prosecutorial Advisory Council and endorsed by the Assembly. The OSCE Pillar of UNMiK, as well as the Council of Europe, has been involved in creating a judicial system in Kosovo, legal and human rights training of judges and prosecutors as well as local defence lawyers and students, the creation of the Kosovo Judicial Institute and Criminal Defence Resource Centre.

Generally, problems of **enforcement of court judgments** persist. Throughout the FRY, classic "transition" judicial issues need to be addressed: anti-corruption measures including the question of judicial remuneration and human rights training. Work is needed, first and foremost by the authorities, to change legal culture and behaviour as well as public attitudes to, and enforcement of, fundamental human rights. Although the adoption procedure, in Serbia, of the long-awaited set of laws on the judiciary and prosecutors deviated from basic principles of transparency and public consultation, their content, within current constitutional constraints, is satisfactory. Similar measures on judicial and prosecutorial independence, court organisation and disciplinary measures were recently adopted in Montenegro.

Police. The police, as an organ of law enforcement, are the most obvious illustration of the legacies of the previous regime: obsolete legislation, unclear division of competencies, oversize, lack of civilian control, connections to organised crime and – in particular in Serbia – responsibility for serious human rights violations in the past decade. Much remains to be done in terms of coordination, legislation and implementation and here, as elsewhere, the lack of constitutional clarity has a negative impact. The Federal Interior Ministry has limited competencies (mostly regarding international issues and citizenship) and resources, with all operational tasks implemented by Republican police forces. An important step in providing human rights safeguards was taken within the adoption in December 2001 of the new Federal Criminal Procedure Code, which removes some of the deficiencies of the previous legislation (e.g. police detention, interrogation of suspects etc). Both Republics are preparing new legislation on police, to redefine the sector as “serving” the community rather than as a “force” or “state organ”, as well as a Code of Ethics. While some positive steps (including integration of minorities) have been taken, police reform is a major challenge for Belgrade, and is therefore also likely to meet strong obstruction and resistance - the protest by Special Forces of Serbian State Security was a clear indication that some segments of the sector still escape control. In Kosovo,

both police services, UNMIK police and the Kosovo Police Service (KPS), are under the supervision of the SRSG and the International Police Commissioner. The KPS answers directly to the Police Commissioner and the SRSG, and close attention has been paid to ethnic and other balance in the KPS, with 18% of recruits from minority communities, and 17% women.

In terms of international cooperation and internal coordination, FRY joined Interpol (24 September 2001), though internal lack of coordination within the FRY affects efficacy. Formal channels of cooperation - mostly on exchange of information on criminals and patterns, have been established between UNMIK Police, but not KPS, and the Federal and Serbian Ministries of the Interior. UNMIK police, due to their UN character, also have access to Interpol. Border control is shared between the Yugoslav Army, for the state border, Republican Interior Ministries, and KFOR (at the international FRY border with Albania and the former Yugoslav Republic of Macedonia). KFOR is present at the administrative boundary line between Kosovo and the rest of Serbia and Montenegro. The overall situation of border entry points is generally evaluated as poor, both in terms of equipment and human resources, which makes movement of goods and persons difficult. The Federal Interior Ministry's draft project on demilitarisation of borders (whereby it should take over the overall control of borders, including the investigation of border incidents) has been agreed, including by Montenegro, though implementation is dependent on a final settlement of constitutional issues.

The main reform issues are the relationship with the judiciary and prosecution services; the need to focus on law *enforcement*; depoliticisation, demilitarisation, reduction in size and increase in civilian control over the police (especially in Montenegro where it almost amounts to a defence ministry); reform of State Security to make it an independent service under strict civilian control; human rights training; decentralisation and the possible extension of the multi-ethnic model from Southern Serbia (which itself draws on valuable expertise from Kosovo) to other, minority-populated regions; equality within the sector; and transparency and efficient independent internal control and complaint investigation, all of which would also restore public confidence.

Prisons are under the authority of the Republics. In Kosovo both the prison system and the Kosovo Correction Service are administered by UNMIK. Conditions in prisons in the rest of the FRY have improved but still do not comply with the Council of Europe's European Prison rules. OSCE is working on comprehensive prison reform.

General respect for the rule of law. As with many transition societies, particularly after such a handover of power, **corrupt** elements of the old regime remain present, in silent or active opposition to reforms, in or parallel to the new structures. Delays are also caused while members of the old regime attempt to secure new or existing positions. This issue - and that of interference in day-to-day administration, the scope of parliamentary immunity, and of conflicts of interest - needs to be tackled at federal, Serbian and Montenegrin level, before reforms can be implemented. For instance, obstructionism *within* governing structures continues to impede the Danube clearance project. Corruption and nepotism, particularly in Montenegro, also needs to be tackled.

2.2. Human Rights and the Protection of Minorities

Generally, legislative provisions on human and minority rights are well developed and mostly in accordance with the international instruments to which FRY is a contracting party. Under the previous régime, it was implementation of these rights that fell short - as well as non-implementation, severe abuses and violations. This practice has stopped with the change of régime: the new authorities, while taking over long in adopting some of the necessary legislation, have generally put an end to previous discrimination and violations. Human rights training, however, remains insufficient.

Future constitutional reform must provide wide, constitutionally-based guarantees of human rights and fundamental freedoms, and clear instruments for protection. The Council of Europe has noted that the level of protection required by the European Convention of Human Rights is not met in a number of areas of fundamental right

*As regards monitoring by an **Ombudsperson**, the multitude of texts (currently five: federal, republican, municipal level in both republics) demonstrates a clear lack of coordination and delimitation. There is also no coordination foreseen by or with the existing Ombudsperson in Kosovo who has wide powers (except over KFOR) to receive complaints, monitor, investigate, offer good offices, take preventive steps and promote ethnic reconciliation..*

2.2.1. Civil, political, economic and social rights

While media, in general, operate in an open and pluralistic environment, and the situation is immeasurably improved compared with the past, the expected complete reversal of long-standing problems in the field of **freedom of expression and media** has, unfortunately, not yet materialised. Although state censorship no longer exists, total freedom of expression is still partly limited by existing Criminal Code provisions on slander and libel, by unequal treatment of media, by republican ownership / control of the main channels, papers and printing houses and, at federal level, by the failure to resolve broadcasting and frequency issues. There is growing international concern about the continued delay in the adoption of the new Serbian Broadcasting Act, after a less than transparent drafting process, promised to the EU and Council of Europe by January 2002, a delay which is only partly due to linkage with another controversial issue (Federal Telecommunications Law). Speculation continues that the authorities preferred to keep the electronic media under control in advance of elections. A draft Public Information Act has been finalised in Serbia and is undergoing wide public consultations, and the expert group involved did take heed of some of the media's objections. In Kosovo, appropriate broadcasting regulations are already in operation. Greater technical coordination is, however, needed within the FRY. The regulatory regime, media-monitoring, and professional / technical training provided in Kosovo ensures compliance with internationally recognised standards, and a level playing field exists, with a professional, sustainable and independent media. Unfortunately, allegations of persecution and harassment of journalists persist in the FRY, with the most obvious example being the recent jailing for libel of the editor of DAN (Montenegro), the marked lack of progress in investigating the killing of Slavko Curuvija or Milan Pantic, and intimidation of journalists including in Kosovo. RTK in Kosovo has been reformed into a public and independent broadcaster addressing the needs of all ethnic communities, but former state media in Belgrade and Podgorica have not yet undergone similar

transformations and, amid continuing allegations of political pressure and interference, sometimes present one-sided views and fail to report or present issues which discomfit the authorities. The media in Serbia understand their role as a public watchdog on the authorities' activities (though rarely conduct independent investigative research). This degree of independence and a clear understanding of the concept of freedom of speech and balance does not exist in Montenegro.

Most of the abuses of **academic freedom** under the former Serbian University Law have been reversed, though the pace of reforms of university legislation in Serbia, where a draft law was presented in December 2001, causes dissatisfaction in academic circles. Both Republics are engaged in the process of revision of school curricula, with Council of Europe involvement. Necessary working relations between the UNMiK department responsible for education reform and the Serbian Ministry for Education depend on recognition of UNMiK's role and political will to compromise on both sides.

The Federation and Serbia are also lagging behind with planned legislation on **freedom of association**, delays which affect the NGO sector in particular, as well as the revision of obsolete laws on political association. The legal position of NGOs also differs greatly - the situation in Montenegro and Kosovo is generally positive, but federal and Serbian legislation in this field is obsolete, not recognising the existence of the civic sector or NGOs and not regulating foreign foundations. The draft Serbian Government proposal for an NGO law, unlike the version drafted by the NGO sector, only covers domestic NGOs and does not provide sufficient guarantees on tax exemptions or subsidies. By contrast, in Kosovo, domestic and foreign NGOs are treated largely identically, with all public benefit NGOs also entitled to large tax and fiscal benefits. In Montenegro, the 1999 Law on NGOs stipulates not only fiscal and other exemptions but even that the government should assist NGOs financially.

Regarding **access to court and fair trial**, major progress has been made in the FRY, in reform of criminal procedure, in close co-operation with the Council of Europe. New and important human rights safeguards have been introduced e.g. access to attorneys, limit on detention periods. In general, however, while there is access to courts, they are inefficient and slow. Progress has been made since November 2000 concerning Kosovo Albanian detainees in Serbian prisons, most of whom were released under the Amnesty Law (January 2001) or following systematic review of their cases. Only approximately 154 Kosovo Albanian detainees remain, of whom some were sentenced for terrorism and others for common crimes. The UNMIK/FRY Common Document of 5 November states that all remaining detainees should, after a review of their cases according to international standards, be transferred to Kosovo and the authority of UNMIK prison system, as soon as possible though there have since been attempts to link this with the entirely separate question of Kosovo Serbs convicted by or charged before Kosovo courts. In Kosovo, international and European human rights standards are a part of the applicable law, and the OSCE analyses domestic law and practice, including closely monitoring the fairness of trials (from the moment of arrest until final disposition), on the basis of domestic law (the FRY Code of Criminal Procedure (FRY CPC) and the Kosovo Penal Code (KPC). There were reports, throughout the FRY, of **arbitrary arrest and detention**, of use in Serbia and Montenegro of "informative talks" (including against human rights activists and journalists), use of excessive force, abuse by military and police forces (including sexual) of suspects and discrimination against minorities. Difficulties have also arisen in Kosovo with prosecutions, including of serious crimes, based on military intelligence not provided in court. While investigations of human rights abuses made some progress (the Danube truck case) in Serbia, investigations throughout the FRY of killings and disappearances under the previous regime made little progress.

The **right to constitutional appeal** is guaranteed by the Federal Constitution, but interpreted restrictively by the Federal Constitutional Court. Measures protecting citizens against public administration should not be split between Serbian and federal level - most of the competencies which can interfere with those rights are at republican level but the FRY, as contracting party to international human rights instruments, is a guarantor of the implementation of those rights, at all levels, throughout its territory.

A draft law against **discrimination** has been finalised (though unclear as to whether at federal or Serbian level) addressing, in a comprehensive way, specific types of discrimination and including provisions on discipline, civil and criminal liability. Although there are no legal restrictions, women and minorities are not well-represented in politics, government or business. Although there is not yet a general anti-discrimination law in Kosovo, the applicable law incorporates international human rights standards. The Constitutional Framework provides equal opportunities for non-majority communities, and the draft Basic Civil Service Law envisages the civil service (as was the case in the Joint Interim Administrative Structure) reflecting " the diversity of the population of Kosovo". Affirmative / positive discrimination, already seen in recruitment for the KPS, may yet be introduced into the draft Basic Civil Service Law. Affirmative action provisions already exist in Montenegro election legislation, though only for ethnic Albanians.

Following Council of Europe recommendations, and in line with ratification of the UN Covenant on Civil and Political Rights, the Federal Criminal Code has been amended, replacing the **death penalty** with 40 years imprisonment. While similar changes were made in the Serbian Criminal Code, and are already in place in Kosovo, no similar initiative is underway in Montenegro where, moreover, a death sentence was actually delivered in October 2001.

Religious freedoms – the separation of church and state, the equal treatment of religions, and the freedom to exercise religion - are guaranteed throughout the FRY. However, a recent Serbian Government decree introducing optional religious classes in state schools, and some public activities by government officials involving the Serbian Orthodox Church, have been criticised domestically as a violation of these principles. The status of religious communities is not yet regulated, although there is a draft law under preparation. There are also concerns that the constitutionally guaranteed principle of “conscientious objection” is not respected by the Yugoslav Army. While the Constitutional Framework guarantees religious freedom in Kosovo, security issues are an obstacle in practice.

Trade Union and workers' rights are already guaranteed in existing legislation, and the draft Federal Ombudsman law includes an organisation unit for the protection of labour rights. Recent Serbian legislation (December), while controversial for domestic political reasons, also respects international standards and, by removing some of the illegal practices of the previous decade, improves workers' basic rights. In Kosovo, employees' rights to form trade unions, and to collective bargaining, are safeguarded in the Essential Labour Law, and trade unions can also rely on the terms of the Convention on Freedom and Rights of Trade Unions, signed by FRY.

The previous and discriminatory Serbian Property Transactions Act has been repealed. There are, however, still some outstanding issues in relation to **property rights** in Serbia, resulting from a lack of clear rules, e.g. in the current privatisation process and for restitution / privatisation of nationalised property / compensation issues. In Kosovo, property transactions, individual or commercial, remain difficult due to unresolved issues linked, in some cases, to the status question. A Housing and Property Directorate /

Claims Commission deals with claims of unlawful possession of residential property, which constitutes both an obstacle to refugee returns and to the rule of law. Offices in Serbia proper have been opened, though the issue of property returns is also included in the FRY-UNMiK Common Document. Discriminatory legislation preventing the purchase of property in Kosovo by non-Serbs has been removed, though inter-ethnic sales of property in Kosovo are limited in certain circumstances, not as a restriction on property rights *per se* but with a view to *preventing* potential restrictions. Measures have been introduced to ensure case-by-case examination of proposed property sales by ethnic Serbs to ensure fair, non-coerced transactions.

2.2.2 *Minority rights and refugees*

In this, more than any other area, the actions of the previous regime had extremely negative consequences. Considerable work is therefore needed. The new democratic authorities in Belgrade have demonstrated a high level of commitment to change. FRY is already a party to the Council of Europe Framework Convention on the Protection of Minorities and has applied for accession to the Charter on Regional and Minority Languages. The Federal Ministry of National and Ethnic Communities, established under the new regime, has so far launched or implemented a wide range of activities, with the aim of confidence-building and re-integration of all communities. The most obvious and successful confidence-building activities to date have been in southern Serbia, with a particular accent on multi-ethnic police, multi-ethnic journalism training. Some ethnic groupings (e.g. Bosniak Muslims in Sanzadak) still express concern that repressive acts previously committed against them have not been explicitly condemned or investigated, particularly where the allegations concern police and judicial officers. Bilateral agreements, on minority issues, are being negotiated with Croatia, Hungary and Romania, and a comprehensive program for Roma integration is being prepared. A long-term awareness-raising campaign on tolerance has been launched, and review of school curricula to take account of minorities' specificities is also being prepared.

The main legislative changes are contained in the much-welcomed recent federal Law on the Protection of National Minorities, prepared in cooperation with the Council of Europe, which contains all the main guarantees for individual and collective rights of national and ethnic communities and envisages several instruments for the protection of these rights (Federal and National Councils for National Minorities and Federal Fund). The violation of minorities' rights and freedoms is now a criminal offence at federal level.

In practice, in Kosovo, the right of "non-majority communities" (defined in the Constitutional Framework as those belonging to the same ethnic, religious or linguistic group) to use one's own language before courts and with public authorities, and to establish and maintain own education, cultural and religious institutions cannot yet always be guaranteed due to problems with security and lack of freedom of movement. UNMiK is endeavouring to find a solution to the question of higher education in Serbian, as well as Albanian, in the province. Awareness-raising strategies, though still nascent, are also envisaged.

In Montenegro, the legal situation was already satisfactory, with cultural and linguistic rights of ethnic and national minorities are given wide guarantees in the constitution, and no major complaints by the minorities. In response to dissatisfaction expressed by the Albanian community regarding implementation of certain rights, discussions are underway on issues such as free use of language, minority cultural issues and history in school curricula, and proportional representation in public administration. There are also some issues raised by Sandzak parties concerning party registration and media access in Montenegro.

The total number of **refugees** and internally displaced persons (idps) in the FRY is still very high (estimated around 700,000) and continues to be a serious humanitarian and socio-economic problem. At federal level, changes to citizenship laws (February 2001) allowing dual citizenship for citizens of the former SFRY was a major step and resulted in approximately 80 000 persons being granted dual citizenship. In Serbia, the Inter-Ministerial Task Force (established July 2001) prepared a draft National Strategy Paper for Resolving the Problems of Refugees, Expelled and Displaced Persons, covering strategies for both repatriation and local integration. The next major issue will be the implementation of the Regional Principles for Refugee Return adopted under OSCE auspices, by FRY, Croatia and BiH. The Croatian side is, however, refusing to acknowledge tenancy rights of Croatian Serb refugees. In Kosovo, the indisputable right of refugees and idps to return to their homes has been reconfirmed in the UNMiK-FRY Common Document, under which an Office of Return under the SRSG's direct supervision will assume responsibility for coordination. The Provisional Institutions of Self-Government are also expected to actively support returns.

2.3. Regional Cooperation

2.3.1. Multilateral Relations

Cooperation with the **International Criminal Tribunal for former Yugoslavia (ICTY)**, FRY's international obligation, both as a UN Member State and as a signatory of the Dayton / Paris Agreements, remains insufficient. In her report to the UN Security Council in November 2001, the Chief Prosecutor reported that the picture regarding cooperation with the Federal Republic of Yugoslavia was "very complex and often discouraging". While some cooperation has taken place e.g. the opening of an office, cooperation on some investigations, in general there has been a lack of real cooperation and even obstruction at federal level. There have been some voluntary surrenders, and the welcome Serbian decision to transfer ex-President Milosevic (28 June 2001), but others indictees remain at large, with several continuing to hold high public office (Serbian President, Federal MPs). ICTY has publicly criticised the federal army for continuing to harbour known indictees, particularly Ratko Mladic. At federal level, the necessary access to evidence (witnesses, documents, archives - particularly military) is denied on the pretext that no domestic legislation authorises it. Even if a law is necessary on procedural aspects of the cooperation UNSCR 1207 specifically states that no state may invoke provisions of domestic law, or the lack of any procedural law, as a justification for its failure to cooperate. Little progress has been made, despite announcements by the authorities, and the delays continue to damage the functioning and reputation of the federal state. Proposals which exclude federal army and police and leave to domestic courts a decision on compliance with an international obligation are inherently flawed. ICTY reports better cooperation with the Serbian authorities, and improving cooperation with the Serbian police, courts and prosecutors. In fact, the lack of federal cooperation has had a negative impact on ICTY's ability to conduct investigations into events in Kosovo. Better cooperation is reported with the Montenegrin authorities and with UNMIK.

Full implementation of **UNSCR 1244** is the driving force of the work of the international community in Kosovo, led by the international civil administration (UNMiK) and the international military administration (KFOR). In the context of the peaceful resolution of tensions in Southern Serbia, in the Presevo region, NATO agreed to allow the VJ and

Special Police Forces (MUP) in areas along the administrative boundary line between Serbia proper and Kosovo (the Ground Security Zone established under the Military-Technical Agreement). Practical cooperation was established, in many fields, between Pristina and Belgrade and should continue with the advent of the new provisional institutions. Parallel Serbian institutions in Kosovo, contrary to UNSCR 1244, should be dismantled. The FRY-UNMiK Common Document agreed in November 2001 was a major breakthrough, listing areas for common action (judiciary, police, education, missing persons, Kosovo Albanian prisoners), though these now need to be implemented. This agreement was followed by welcome high levels of ethnic Serb participation in the elections to the new provisional institutions, meetings of the High Ranking Working Group between Belgrade and Pristina and the establishment of sub-groups dealing with specific issues.

In terms of international organisations, the FRY had already become a member of the **United Nations** and the **OSCE** in late 2000, taking on the relevant obligations of membership. Although at this stage, the **Council of Europe**, for membership of which FRY has applied, has concluded that the FRY legal order is not yet in conformity with European standards, there is a "basis and the potential for meeting the requirements in respect of democracy, rule of law and human rights" and "it may be expected that the FRY will comply in the foreseeable future with Council of Europe standards". FRY preparations for **WTO** accession are well underway, with a first draft of the memorandum on foreign trade policy submitted. Final agreement was reached in June 2001 on **SFRY succession**.

2.3.2. *Bilateral relations*

Bilateral relations with different countries, political and commercial, have been improving steadily, though more rapidly with some than others. Outstanding or potential issues are predictable (border demarcation, refugee return, minority issues).

Diplomatic relations with **Albania** were established in January 2001, and relations are generally good. Negotiations between Tirana and Belgrade have recently begun on a free trade agreement.

Political relations with **Bosnia and Herzegovina** have been further developing, with the resolution of some important issues likely in the near future. The Agreement on Special and Parallel Relations with Republika Srpska (March 2001) was assessed by the High Representative as being in accordance with Dayton, and is balanced by recognition (diplomatic relations December 2000, exchange of ambassadors November 2001) and support for BiH as a single, internationally recognised state. A responsible regional attitude, as well as Dayton obligations, requires a reduction in special links with the RS and increased, practical, support for the state and state institutions. Special links, both political and financial, between the VJ and Republika Srpska forces should continue to be reduced and made more transparent. The InterState Council for Cooperation, and working group, have already met, and a Border Commission was also established. Although official talks have not yet begun, an agreement on dual citizenship is being drafted, and will cover areas such as: military obligations, voting rights, tax obligations etc. The implementation of the tri-partite (FRY/CRO/BiH) "*Framework of Enhanced Regional Cooperation on Return Issues*", signed under OSCE auspices, does not seem to pose problems as between FRY and BiH. Inter-parliamentary cooperation was initiated during the first visit of a FRY parliamentary delegation to Sarajevo in October 2001. Talks on a readmission agreement are launched. Two outstanding issues remain to be solved, but are currently not likely to cause disputes: the issue of final border

demarcation, and the BiH lawsuit against the FRY, before the International Court of Justice, for genocide. Business links are developing, and a free trade agreement was signed in February 2001 (BiH had requested non-reciprocal treatment).

Progress in relations with **Croatia** has been slow. However, late 2001 saw some important positive steps, with meetings of Foreign Ministers both in New York and in Zagreb, exchange of ambassadors, and the signature of various bilateral agreements. In practical terms, an inter-state border commission has been established and progress on Prevlaka is still required. Bilateral talks were also held in November 2001 on the issue of missing persons and prisoners, and the recent return of cultural artifacts has also contributed to a more positive atmosphere. Negotiations on a readmission agreement have also been launched, as well as on the FRY initiative on a bilateral agreement to regulate the status of minorities (Croatian Serbs in Croatia and Croats in FRY). There are also some important outstanding issues regarding the implementation of the agreement on refugee return and the treatment of the Croatian Serb minority (*see supra*). The Croatian Government has offered (December 2001) an out-of-court settlement to Croatian Serbs who had taken a case to the ECHR. Croatia, however, continues to make further improvements in relations with the FRY conditional on personnel changes in the Serbian government, namely the removal of a Deputy PM (Perisic) who has been sentenced by Croatian courts for war crimes. Although Croatia also operates a more restrictive visa regime with FRY than towards other countries, it has been announced that this should be liberalised by autumn 2002, further facilitating the links developing between business communities. Negotiations have opened for a Free Trade Agreement.

Pre-existing relations with the **former Yugoslav Republic of Macedonia** have also improved after October 2000, with high-level visits, and no outstanding issues, although regular closure by the former Yugoslav Republic of Macedonia of the border (particularly at Blace) is a continuing impediment to international reconstruction efforts in Kosovo, as well as economic life. An agreement on border demarcation was reached in February 2001 and ratified by the two states. No further developments have been noted regarding a reported agreement to transfer VJ arms to the former Yugoslav Republic of Macedonia. A free trade agreement already exists and applies to the entire territory, though the signatories of this agreement have recently negotiated amendments.

Diplomatic relations with **Slovenia** were established in December 2000, and embassies opened in autumn 2001. Relations continue to progress, particularly on the economic side, with various agreements on trade and economic cooperation as well as the fight against organised crime. Relations with **Hungary** are also good, with the opening of a consulate in Subotica (August 2001), a Foreign Minister visit in November 2001 and the signature of a Memorandum on Co-operation covering road links, regional tourism and economic cooperation, and a free trade agreement, assymetric in favour of the FRY, was signed in March 2002. A potential problem may arise with the Hungarian law on the status of ethnic Hungarians living in third countries. Negotiation of free trade agreements are also being considered with **Romania** and **Bulgaria**. A trade agreement with **Russia**, not yet ratified by Russia, is partially applied since 2000. The change of régime in Belgrade also made progress possible on the implementation of the **Danube Commission's** EC-funded project for the restoration of navigation on the Danube.

2.4. Priorities Areas Needing Attention in the Next 12 Months

- *The constitutional stalemate must be clearly resolved through constructive cooperation within a restructured and functional federal state*

- Existing good **cooperation** between Belgrade and Pristina, including within the competencies of the provisional institutions of self-government, should continue and develop. Parallel Serbian institutions and jurisdictions in Kosovo must, however, be dismantled. All parts of the FRY should be aiming for compatibility with European - EU and Council of Europe - standards.
- The efficiency of **parliamentary** structures should be improved. Parliamentary procedures should be made more efficient. Public administration should be reformed and its size made more efficient. Steps should be taken to improve administrative capacity, at all levels of government.
- **Reform of electoral laws** and provisions, a priority recommendation of the Council of Europe, should be brought into line with Council of Europe and OSCE standards by autumn 2002.
- Promised decentralisation and reforms of **provincial and local government** should be adopted (in Montenegro) and implemented (in Serbia), as well as other constitutional revisions.
- Reform of the **judicial and prosecutorial** systems should continue, with particular attention to independence, criteria for appointments, training, procedures, and reduced opportunities for political interference. Budgetary provisions for the new system of judges' salaries should be introduced rapidly. Steps should be taken to improve the enforcement of court judgements. Action should be taken on corrupt elements within the state system.
- **Army reform** - including security policy, the role of the army and secret services, civilian control, general modernisation/ restructuring, and budgetary issues, in line with the proposals by the Geneva Centre for Control of Armed Forces - should be under way by the end of 2002. Reform of the security and police services should continue, transforming them into a service, adopting the Council of Europe's Police Code of Ethics, bringing them under clear internal and external control and improving coordination between the various services and with other state services. State security and law enforcement agencies must be separated. Prisons must be urgently brought in line with Council of Europe standards. The demilitarisation of borders should be put into effect at the earliest opportunity. The principle of conscientious objection should be safeguarded and implemented.
- Steps should be taken to ensure the implementation of all **human rights and fundamental freedoms**. The findings of the Council of Europe compatibility study should become a cornerstone of human rights throughout the FRY, with implementation under way by the end of 2002. The European Convention on Human Rights should be ratified. Outstanding issues - democratic or technical - regarding media should be completely resolved by mid-2002. Coordination should be established between all Ombudspersons. Appropriate revisions of academic textbooks - particularly history and geography - should be completed before the end of the 2001-2 academic year. Outstanding issues regarding NGO status and political or religious association should be resolved by mid-2002, in line with Council of Europe recommendations. Anti-discrimination laws should be adopted and implemented. The death penalty, including with application to already delivered judgements, should be abolished in Montenegro. Legislation on minority rights, including relevant changes to Criminal and other Codes in line with the Council of Europe Framework Convention for the Protection of National Minorities (in force September 2001), should be urgently adopted and implemented.

- *Outstanding issues relating to **property rights** should be resolved.*
- *In all cases, laws should be followed, immediately upon adoption, by effective implementation, and appropriate administrative capacity ensured.*
- *Continuing the efforts to enhance regional cooperation, **Free Trade** Agreements should be concluded, before the end of 2002, with all signatories to the MoU on trade liberalisation in the framework of the Stability Pact. The necessary amendments to other laws, already identified, should be implemented.*
- *Outstanding **border** demarcation issues should also be resolved by the end of 2002.*
- *Cooperation with **ICTY** should improve. Indictees should be surrendered to the Hague - including and particularly those currently holding elected office or military positions. There should also be full cooperation on investigations, access to evidence (witnesses, documents, archives - particularly military) and, if a law is still considered necessary, it should be adopted immediately.*
- ***UNSCR 1244**, and the Common Document of November 2001, should be fully implemented. Review of the cases of all Kosovo Albanian prisoners should be completed, and the agreed transfers implemented by spring 2002 at the latest.*

3. ECONOMIC SITUATION

The year 2002 will be a year of deepening structural reforms. Further important decisions on the restructuring of the FRY economy will be on the political agenda, and should lead to the closure of a number of large non-viable public enterprises. At the same time the authorities will face the challenge of sustaining general public support for difficult reforms. Further growth in 2002 is expected to come in the agriculture and service sectors, with old industries unlikely to show much growth while some new industrial firms may emerge.

3.1. Current Economic Situation

Since October 2000, the authorities have accomplished substantial progress toward restoring macro-economic stability, liberalising exchanges, price and trade regimes and improving market confidence. The authorities in Belgrade have accomplished much in a short period, but even elsewhere, where reforms began earlier and are to be viewed over a longer time-span, a public commitment to reform is evident. The overall support that reforms continue to enjoy from major parts of the population is encouraging.

Real **GDP** in the FRY grew by some 5.5% in 2001 (incl. some 3.5% in Montenegro), somewhat faster than initially projected. Growth was mainly driven by a strong recovery in agricultural output (20-25%) from the previous year's drought, and increased activity in services, including tourism in Montenegro, and transportation. However, industrial production still performs poorly, with zero growth recorded in 2001. Overall, the FRY authorities expect a lower real growth in 2002 of some 4%, mainly due to a worsening of economic conditions abroad and thus limited prospects for exports and foreign direct investment. In Montenegro, a higher growth rate of 5% is expected for 2002. In Kosovo, there are indications of positive economic developments, even though the economy is still largely driven by donor money. Real GDP growth was estimated in the order of 10% in 2001, albeit starting from a low base. Progress in reconstruction is evident, agriculture

and wine-making are developing positively and there is a vibrant private service sector. The number of registered businesses in Kosovo as of October 2001 has increased by 44% compared to end-2000. There are indications of a shift from trade to other activities including manufacturing.

Inflation in Serbia was reduced considerably from 115% at end-2000 to around 40% at end-2001, despite major increases in electricity prices (a cumulative 120%) during the year. Even if inflation was slightly above the policy target (30-35%), this is a major achievement reflecting tight and stability-oriented monetary policies. The authorities expect that annual inflation can be further reduced by end-2002 to around 20%. GDP inflation is estimated at 13% in Kosovo. In Montenegro, end-year inflation was in the order of 25% up from 22.5% at end-2000, above the policy target of 15%, mainly due to liberalisation of prices for electricity, municipal services, transport and milk and bread during the year.

Wage policies in both Serbia and Montenegro generally supported reduced inflation and protected competitiveness. The structural problem of high **unemployment** (officially 30%, but probably 40-50%) has not yet been tackled. Restructuring policies in 2002 may thus result, short-term, in a considerable rise in unemployment. Precise figures are difficult to establish, with a very active grey economy. In Kosovo, unemployment is estimated to be in the order of 50%. In Montenegro, approx. 20 % of the labour force are unemployed, significantly lower than registered figures, which approach 40%, and suggests that a large number of officially unemployed work in the grey economy.

The **consolidated general government accounts** in the FRY recorded a cash deficit, before grants, of some 2.4% of GDP in 2001 (around €278 million), compared with an original programme target of 6.1% of GDP. The deficit was financed through domestic borrowing (0.5%) and foreign financing (1.9%). The substantial downward revision of the deficit was partly due to structural improvements, namely a better than expected tax revenue performance, but also reflects efforts to compress public spending (by 1.8% of GDP) in the light of a shortfall in foreign budgetary financing and delays in obtaining privatisation receipts in Serbia. Budgetary pressures are very likely to persist through 2002, as new expenditure burdens will emerge. Federal and republican budget plans for 2002 point to a consolidated fiscal deficit in the FRY in the order of 6.2% of GDP, reflecting a postponement of foreign financing, privatisation receipts and corresponding spending. The deficit in 2002 is expected to be financed by foreign grants and loans (to up to 4.2% of GDP), receipts from privatisation (around 1.4%), and some domestic borrowing (0.6%). In Kosovo, while expenditure control, notably concerning staffing levels remained difficult, revenue collection showed good results. Total general government expenditure in 2001, originally budgeted at €250 million but revised up by some €30 million, was financed by increased domestic revenues (estimated out-turn €293 million) and donor contributions.

Monetary policies remained tight throughout 2001. The growth of real base money (30%) was mainly due to purchases by the National Bank of Yugoslavia (NBY) on the foreign exchange market rather than to domestic credit expansion. This helped to stabilise price and exchange rate expectations. After the adoption of a managed float at the beginning of 2001, the Dinar remained broadly stable at the level fixed in October 2000 (YuD 60 per €). Montenegro continued to conduct separate economic and monetary policies, having unilaterally, without formal consultation, adopted the DM/€ as its sole legal tender. In Kosovo, the DM/€ continued to be used as the preferred (but not sole) currency, as legalised by UNMIK in late 1999.

On the **external side**, the FRY balance of payments recorded a widening trade deficit in 2001 of € 3.4 bn. However, large inflows of remittances and service receipts contained the current account deficit to around €1.4 bn before grants. Foreign direct investment is still low, expected to reach €139 million in 2001. Gross NBY reserves reached around €1.5 bn (€2.3 bn with reserves of the commercial banks) in February 2002 (compared to €702 million a year before), equivalent to almost 2.9 months of projected imports in 2002. Preliminary projections for the year 2002 point to a current account deficit of around € 1.74 bn (before grants), reflecting an increase in debt service and in foreign-financed project-related imports.

Huge outstanding **external debt** of some € 14.2 bn at end-2001 or 140% of GDP is a major constraint. The agreement between the Paris Club and the FRY authorities on a phased 66% reduction in the net present value of obligations towards Paris Club creditors (some € 5.2 bn) and a rescheduling of the remaining stock over 22 years with a 6 year grace period must therefore be seen as an important element in fostering the sustainability of the country's external position. The authorities hope to conclude bilateral agreements with Paris Club creditors in early 2002 and seek a similar agreement with London Club creditors. On relations with Bretton Woods Institutions, the second review under the IMF Stand-By Arrangement covering the period was successfully completed in mid-January 2002, making possible the release of the third tranche of € 72.5 million out of the total amount of €290 million. The World Bank agreed with the FRY in November 2001 on the *de facto* restructuring of around € 2 bn of FRY arrears to the Bank, which involves a repayment of obligations over 30 years and allows lending operations to begin. Following a pre-membership grant facility of € 34.8 million, approved in mid-2001 and almost all disbursed, three structural adjustment facilities (IDA credits) are in different stages of preparation, amounting to a total of € 626 million over the next three years.

3.2. Existence of a Free Market Economy and Structural Reforms

Structural reform and the transition to a free-market economy are essential, and price liberalisation, privatisation as well as financial-sector reforms must be completed.

In both Serbia and Montenegro, **price liberalisation** continued in 2001 with the abolition of price controls for almost all categories of goods and the gradual adjustment of prices to more market-oriented levels, in particular for energy in Serbia and for public utilities and essential goods (e.g. milk and bread) in Montenegro. According to recent estimates, some 15-20% of weighted goods in the CPI basket remains under some form of price control (from 60% before reforms started in 2000).

In the area of **privatisation**, significant progress was made, in Serbia, with the adoption of a new privatisation framework in June 2001 as the basis for the privatisation of 150 state and socially owned enterprises through tenders, and some 5,000 other companies through auctions on the basis of transparent procedures. According to the new law, foreign investors can obtain up to 70% of shares through tenders. By end-2001, 35 companies had been put under tendering procedures. In Kosovo, little progress has been made. In the absence of a full-fledged privatisation body, UNMIK has carried out commercialisation tenders on socially owned enterprises and has signed 11 deals committing an investment volume of €54 million. A regulation on a Kosovo Trust Agency, which will henceforth manage the privatisation process, is urgently required. In Montenegro, the mass privatisation programme, covering 221 companies, was completed in early December 2001, and tendering procedures initiated for a further 20. 51% of

Montenegro's telecom company was offered for sale in mid-2001. In 2002, the Montenegrin authorities intend to tender Yugopetrol.

In enterprise **restructuring**, the Serbian authorities identified 39 large loss-making companies that are likely to be subjected to a phased restructuring plan over the next two years, prior to their privatisation or liquidation. All these enterprises are largely diversified, insolvent and –often very significant as sole regional employers. Restructuring plans for two large loss makers (Zastava and Bor) were elaborated, the plan for Zastava being agreed between the government, the management and unions.

The **pension** system in Serbia is under substantial reform. The statutory retirement age has been increased, and a new system of pension calculation has been introduced. In Kosovo, a three-pillar pension system comprising a pay-as-you-go-system financed from contributions has been introduced, a mandatory fully funded system and a supplementary voluntary system.

Regarding **liberalisation of trade**, total FRY exports in 2001 (€ 2.2 bn) were up by 10.4% compared to 2000, while imports (€ 5.61 bn) rose by 30%. As a result, there was a trade deficit of € 3.4 bn 29% of GDP. The stability of the exchange rate against the € since October 2000 implies considerable real appreciation. As foreign reserves (in Serbia) have been rising (€ 1.5 bn) there seems no urgent need to give in to calls by exporters for devaluation, as this would lead to further upward pressure on prices. Moreover, it is questionable whether prices would be the most efficient instrument to render FRY exports more competitive since, in fact, the level of processing of traded goods is more relevant. Most export goods are either raw materials or goods with a low level of processing, while on the import side the situation is quite the opposite (apart from substantial imports of oil). There has also been, in 2001, a clear switch of exports towards the EU, growing by 21% (against overall export growth of 3.5%). The abolition of restrictions on payments has helped, but even more importantly, the autonomous trade preferences granted by the EC have already shown positive effects. Still, overall trade is still very limited and exploitation of the opportunities offered by the EC's autonomous trade preferences remains low due to the lack of quantity and quality of products. FRY's main trading partners are Italy and Germany and its main exports are chemicals, power-generating machinery and agricultural products. Main imports are agricultural products, textiles and clothing. FRY presently has a trade surplus in services though is below its long-term potential.

In terms of financial sector development, bank restructuring progressed rapidly, in line with the Bank Restructuring Strategy adopted by the National Bank of Yugoslavia (NBY) in May 2001. After all 82 banks in Serbia had been reviewed, 19 banks were closed as insolvent, and 15 others were merged with other banks to meet the capital requirements (€5 million as in the EU). New licences for five new banks were issued from May to December 2001. In January 2002, the Bank Rehabilitation Agency took the courageous decision to close the four largest banks which account for 70% of banking assets in Serbia and 42% of employment in the sector. Despite the overall fragility of the banking system in Serbia, there have been signs of renewed public confidence as evidenced by a substantial revival of savings. Repayment of foreign currency accounts seized by the former regime is underway. New foreign currency savings accounts in Serbian banks grew massively in early 2002, up to a total of about €348 million. Among the top 10 banks in Serbia are 3 recently established foreign banks. In Montenegro, reports for 10 banks were prepared, with international support and four were re-licensed on this basis. It is vital that the political decision not to put the largest bank, Montenegro Banka into bankruptcy proceedings has no impact on the budget. In Kosovo, UNMIK has licensed

seven commercial banks, operating 22 branch offices. The growth in deposits (€188 million) reflects both the growing number of banks and confidence in the system. To ensure stability and to avoid overbanking, capital requirements have been raised in January 2002.

3.3. Management of Public Finances

Good progress has been made regarding control of public finances, budget control and revenue collection, but efforts and harmonisation throughout the state must continue.

Federal taxes are relatively low and form a minor part of federal tax revenues which, in total, amount to 6% GDP and 87% of the federal budget. In Serbia, major reform of public finances began in early 2001, both on the revenue and expenditure side. As regards **tax base and revenue collection**, the Serbian parliament adopted a welcome comprehensive tax policy reform with a view to increasing the tax base, lowering tax rates and reducing the previous practice of ad-hoc exemptions and relief. The number of taxes and levies was reduced considerably, excise and turnover taxes unified and a single turnover tax rate introduced. A new system of gross income taxation came into force, broadening the base as fringe benefits became taxable, and allowing for a reduction of tax rates. A new package of tax laws, aimed at combating corruption and tax evasion, increasing revenues through a broadening of the tax base and changing tax culture, is expected to be adopted in early 2002. A new Serbian law on a one-off tax on extra profits was adopted in autumn 2001, with €28.3 million collected to date. Wide-ranging tax reforms in Serbia have significantly contributed to an improved revenue performance. Total tax collection in Serbia in the first 10 months of 2001 reached €2.63bn or 146% up on the same period in 2000. Of this, €0.66bn was transferred to the federal budget, €1.53bn to the Serbian budget (350% on Jan-Oct 2000) and €0.4bn to the municipal budgets.

Progress was achieved in enhancing **public expenditure control** at both federal and Serbian levels, mainly through wage freezes in public administration and state-owned companies. Military spending was brought more under civilian control as the responsibility for spending commitments was transferred from the General Staff to the Defence Ministry in 2001. However, it seems that the high current level of defence spending (4.7% of GDP, approx. 70% of the federal budget) will not be reduced in 2002 (projected 4.8% of GDP), wherefore efforts are needed here. In Serbia, a major step towards improved fiscal management was the adoption in February 2002 of an organic budget law, which regulates the preparation, adoption and control of the budget of Serbia, the province of Vojvodina and municipalities through the introduction of treasuries. Continuation of fiscal reforms, including a further prioritisation of public spending in view of new budget burdens in 2002 (debt service, cost of enterprise restructuring, social support) is necessary for the preservation of sound public finances and sustained macro-economic stability. As a matter of budgetary transparency as well as respect for UNSCR 1244, transfers from the Serb budget, direct or indirect, for use in Kosovo must first be clarified with UNMiK. Montenegro's fiscal performance also improved in the second half of 2001, after some prior slippage, mostly due to a revenue increase due to a robust tourist season and measures against smuggling and tax evasion. However, fiscal transparency in Montenegro remains of concern. An external audit of the budget financing revealed weaknesses in budgetary practices. Montenegro has continued its reform, with international support, to modernise and simplify the tax regime, broaden the tax base, and provide equal treatment to all economic agents. To this end, a number of

new laws have been adopted. In Kosovo, UNMIK succeeded in increasing domestic revenue collection and tax compliance. This is due to the opening of Tax Collection Offices at the administrative boundary line (ABL) with the rest of Serbia, the successful implementation of VAT from 1 July 2001, effective control and improved capacity ensuing from on-going recruitment and training. Thanks to prudent budgetary policy, UNMIK has built up a cash balance, which will allow the maturing of the budget from 2002 onwards and the temporary funding of the conversion to the Euro. The tax system is also expanded to include financial activities on lower levels and to enhance control.

3.4. Priority Areas Needing Attention in the Next 12 Months

As regards structural economic reforms:

- *Public finance in Serbia and Montenegro must remain a priority area during the next period. The continuation of **fiscal reforms** and a further prioritisation of public spending will be essential to sustain macro-economic and fiscal stability. Given the need to adjust to gradual phasing out of external budget support, fiscal discipline must be maintained in Kosovo.*
- *Coordination and integration, within the FRY, on trade, customs, taxation and **monetary issues**, must be implemented.*
- *On the federal level, an agreement with London Club **debtors** is required, and an intra-FRY agreement on the internal split of the debts (both regarding the London Club and the Paris Club, as well as World Bank must also be reached, as well as an agreement on the management of these debts.*
- *Implementation of full reform of the **pension** system is also overdue, as well as **price liberalisation** (notably regarding basic consumer goods).*

4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS

4.1. General Evaluation

4.1.1. Status

With the change of regime in October 2000, the FRY became a full participant in the Stabilisation and Association process, participating shortly afterwards in the first summit (Zagreb, November 2000) between the EU and the five SAp states. In institutional terms, the **EU-FRY Consultative Task Force** was established in July 2001 and has held three meetings, July and November 2001 and February 2002. Work in this technical working group, between the EU and a FRY delegation comprising experts from all parts of the state, will continue until sufficient progress has been made to enable the Commission to write a report on the feasibility of opening negotiations for an SAA with the FRY, covering political will, level of development and EU-compatible reforms, national coherence and administrative capacity to ensure implementation of the obligations of such an Agreement, throughout the State. There are, at present, **no contractual relationships** between the EC or EU and the FRY. Based on experience with other transition countries, the importance of **administrative capacity** has been stressed from the outset, and advice was provided (Spring 2001) on possible models and tasks for a European Integration Office. In terms of internal coordination, a loose Inter-Ministerial Working Group had been established in mid-2001, but constitutional issues remained a

hindrance to pragmatic cooperation even at technical level. In November 2001 the Office of the Federal Government for FRY Association to EU (henceforth federal EIO) was finally established at federal level but still lacks staff, political backing which would ensure cooperation even by federal / Serbian Ministries, and a clear programme for guiding and monitoring reforms, essential to the opening of, or being able to handle, negotiations. Cooperation, notably by Montenegro, has not been forthcoming with the federal EIO either generally or regarding preparation / follow-up of EU-FRY CTF meetings. There was, however, good cooperation between the federal, Serbian authorities and UNMiK in preparing for the last two CTF meetings. Due in part to the constitutional situation, the lack of coordination between entities and the federal level and the EIO, and to the relatively early stage (14 months) of the transition process, the FRY understandably does not yet have the full administrative capacity required to analyse or coordinate an EU-compatible reform process, let alone implement present or future obligations. The challenge of recreating a unified state and structures, in line with whatever agreement may be reached, also lies ahead. The importance of putting correct mechanisms in place has been recognised, but the emphasis now must be on building a solid base for cooperation with the EU rather than rushing or raising unrealistic domestic expectations.

4.1.2. *Impact of the prospect of an SAA on reform*

Given the fact that membership of the WTO and the Council of Europe and closer rapprochement with the EU will in due course require specific EU-compatible changes, the FRY has chosen to follow an EU-compatible path from the outset. A specific feature in Kosovo is that UNMiK and the new provisional institutions of self-government, within their competencies, will be responsible for ensuring compliance with European standards, in line with the specific obligation in Article 5.7 of the Constitutional Framework. Regardless of the future relationship between the various parts of the FRY, the same EU-compatible reforms should be pursued by all. The prospect, when conditions are fulfilled and reforms sufficiently advanced, of a Stabilisation and Association Agreement between the FRY and the EU is a clear goal and catalyst for reform, particularly EU-compatible reform. More immediately, the technical work of preparing for CTF meetings and implementing their recommendations is a major motor of the reform and coordination processes throughout the FRY despite the fact that sectoral cooperation from Montenegrin experts is lacking in many fields. Closer rapprochement with the EU also requires such regular and increased coordination between experts (as opposed to representatives) from all parts of the FRY. The key Commission message to Belgrade and Podgorica is that the state which results must be *functional*, particularly with a view to future contractual relations with the EC/EU and WTO membership.

4.2. Internal Market and Trade

While FRY as a whole has accepted to aim for internal market-compatible legislation, the process is in its early stages. A basic obstacle is the lack of harmonisation within the country, and implementation and enforcement mechanisms are also lacking. Movement of goods, services, capital and persons within the state is an issue.

4.2.1. *Movement of goods*

Foreign trade policy remains, legally, a federal competence. Montenegro has, however, established a largely separate trade regime. The legal status of Kosovo also influences the practical implementation of a coherent trade policy. Therefore, the nominal federal competence is de facto reduced to the territory of Serbia (excluding Kosovo). Federal

harmonisation is urgently required. The FRY has introduced necessary trade policy legislation in May 2001 through the Foreign Trade Act, the Customs Tariff and the Tariff Act. Deregulation is on track and average tariffs have been lowered substantially. Export quotas remain in place for a limited number of agricultural products and foodstuffs, but procedures for the allocation of these quotas have been reformed. Import licences are still required for some steel and iron products as a trade defence instrument (against preferential imports under a trade agreement with Russia). The structure of customs tariffs has been simplified, and tariffs will be further reduced during WTO membership negotiations. Detailed safeguards legislation is required in the framework of WTO negotiations. FRY preparations for WTO accession are well underway, and the memorandum on foreign trade policy has been sent. Negotiations for free trade agreements are already underway or concluded with several states in the region, except Albania. An increased scope of the FTA between FRY and the former Yugoslav Republic of Macedonia, which applies to the entire FRY, is under negotiation.

However, these positive steps towards foreign and internal trade liberalisation are hampered by the lack of a harmonised trade policy on federal level, as Montenegro and UNMIK *de facto* apply distinct trade and customs regimes. This is particularly problematic in view of potential liberalisation towards and rapprochement with the European Union. It is incompatible with the principles of the Stabilisation and Association process, as well as the experience of European integration. It should be noted that some progress towards intra-FRY coordination *has* been made, notably clarification of misunderstandings between Belgrade and UNMIK on tax collection (not customs) points at internal administrative boundary lines. However, the lack of harmonised tax laws between Kosovo and the rest of Serbia remains an obstacle to trade. There is a risk of double taxation when goods move across the administrative boundary line. There is also concern - at policy and budgetary level - about the proposed Serbian hypothecation (reportedly for use in Kosovo) of the 5% surcharge on goods transiting to Kosovo, especially in relation to FTAs with third countries.

Concerning FRY exports, the most important basis for international commerce is the **autonomous trade preferences** granted unilaterally by the EC. After the political changes in October 2000, this preferential treatment was extended to the entire territory of the FRY and, as a result, most products produced in the FRY can now enter the EC without quantitative restrictions and exempt from customs duties. The welcome pragmatic agreement between Belgrade and Podgorica, on certain administrative issues relating to customs, enables this preferential regime to operate. The preferences have undoubtedly already had a positive impact, with FRY exports to the EC increasing from €763 million in 2000 to €952 million in 2001 or +24.8%, while overall FRY exports grew by 10.4% in 2001. However, even with this increase, FRY exports to the EU are still modest from an overall perspective. Kosovo's exports are negligible, whereas its imports - financed by donor contributions and remittances from Kosovars living abroad - amount for 85 % of regional GDP. Given the overall structural constraints [(notably the limited offer both due to low production and inadequate quality),] a major surge in FRY exports looks unlikely in the short term. Therefore, the root problem blocking further growth in exports is the inability to provide appropriate quantities / quality of goods for exports. As regards, **standards and certification** the FRY is associated with CEN and in contact with CENELEC who both advise on making standards compatible with EU legislation.

4.2.2. *Movement of capital*

Regulation of the **banking sector** is a federal competence (i.e. the National Bank of Yugoslavia) although again de facto only applicable to the territory of Serbia (excluding Kosovo), since financial sectors, monetary policy and other related matters are under the control of Montenegro's own "central bank" and the Central Fiscal Authority (CFA) and Banking and Payments Authority (BPK) in Kosovo. The position of the NBY is being aligned with EU standards, and the CFA and BPK in Kosovo act in accordance with these standards. However, the conception and implementation of a harmonised monetary policy throughout the territory of the FRY is hampered by the existence of these other banking authorities. There was a notable lack of contact between them regarding the introduction of the Euro in some parts of the FRY, without prior consultations with the EC/EU/ECB. An awareness-raising campaign on the Euro in Serbia went well, adding to renewed public confidence in the banking system. Banking sector reforms are vital for the creation of a functioning free capital market. The NBY decision to halt efforts to bail out the four major banks in Serbia and to initiate bankruptcy procedures against them constitutes an important and welcome step in this process, demonstrating the federal and Serbian authorities' - but not necessarily Montenegrin - firm determination for a thorough restructuring of this sector. Moreover, the upgrading of the federal Bank Rehabilitation Agency to function as a liquidator and the efficient implementation of capital market laws is essential for both foreign direct investment and the liberalisation of international capital exchanges. A number of laws regulating bankruptcy and liquidation, stock and securities markets are being prepared to address this.

A package of **new fiscal and economic laws** has been presented to the Serbian Parliament, including on the budgetary system, public procurement, games of chance and tobacco. The draft law on the budgetary system regulates the preparation, adoption and control of the budget of Serbia, the province of Vojvodina and local self-governments and introduces treasuries at all levels. This constitutes an important and welcome step towards a structure of sound budgetary management. Draft laws on taxation, including personal income tax, were also adopted in Montenegro. The lack of coherence in the system of **value-added taxes** throughout the FRY remains a serious obstacle to both internal and foreign trade. There is a welcome recent consensus that VAT should be the main indirect tax, with a need for a certain minimum coordination.

4.2.3. *Movement of persons, services and right to establishment*

A new comprehensive federal law regulating foreign investments was finally adopted in January 2002, setting the overall framework for FDI through basic rights of foreign investors, rules on equal treatment and transfer of assets. Policy on foreign greenfield investment in the financial sector is still unclear. Separate foreign investment laws in Montenegro and Kosovo are, at least partly, incompatible with this new federal act. Generally, overall uncertainty regarding the ownership of assets is not conducive to attracting foreign capital. As regards privatisation, the first tender sales of three cement factories were successful. The upcoming first auctions for SMEs are a further litmus test for reform efforts. The adoption of the Labour Law, in December 2001, was an important step in the privatisation process, enhancing potential for foreign investment. The current framework for company law and accountancy needs to be partly updated to serve as a functioning basis of a market economy. Structurally, the different rules in Serbia, Montenegro and Kosovo are an obstacle to the functioning of a single economic space.

4.2.4. Customs

Trade within the FRY is not subject to customs duties, if goods are originating in its entities [cf. 4.2.1 *supra*]. However, Montenegro continues to apply external customs rates different from the tariffs set by the competent federal bodies. Under Kosovo's specific trade regime, imports from outside the FRY or countries with which FRY has a FTA are subject to a 10 % flat rate customs duty, whereas exports are duty free. There are no tariff quotas and tariff ceilings. The existence of different customs regimes is a grave obstacle to the creation of a coherent federal trade policy and, thus, a trade agreement with the EC. The lack of administrative capacity of the customs services is equally problematic. In Kosovo, this is being addressed through Community assistance for UNMIK's customs service.

4.2.5. Competition and state aid

Fundamentally reformed basic legislation for competition policy has not yet been adopted. Most fundamentally, there is no legal framework at all for merger control and state aids. Nor is there satisfactory implementation capacity to ensure a level-playing field for business. A start was made in increasing the independence of the federal Anti-Monopoly Commission. A number of draft bills presently under discussion (the Tobacco Law, Law on Public Procurement, Organic Budget Law, Law on Games of Chances), intended to tackle organised crime, also include monopoly clauses which may not yet be compatible with EU standards. Monopolies or oligopolies in certain sectors, such as telecoms, need to be addressed.

4.2.6. Public procurement

A draft law on public procurement is under parliamentary discussion in Serbia. In Kosovo, a Public Procurement Regulatory Commission - with powers across all PISG departments - was established under the Central Fiscal Authority. Local staff are being trained. Tender rules are in place and fully implemented. In Montenegro, a public procurement bill is being prepared, but without coordination at state level. Procurement practices are problematic, as they seem to favour certain firms.

4.2.7. Intellectual, industrial and commercial property rights

FRY intellectual property legislation is currently being harmonised with the international conventions in this field, including the relevant TRIPS standards, and the EU acquis. Further amendments are foreseen in 2002 to achieve full compliance. There is, however, a lack of legislation and implementation capacity on copyright piracy and counterfeit goods. Generally, federal rules are not fully implemented in Serbia, and not at all elsewhere. Pertinent legislation does not contain any provision on border measures to prevent the import of counterfeit and pirated goods. Talks with the European Patent Office are ongoing. FRY is currently negotiating the generic application of European patent rules even before formal accession to relevant conventions.

4.3. Sectoral Policies

4.3.1. Industry and SMEs

Industry has not yet recovered from the shocks and mismanagement in the 1990s. Losses in the (formerly heavily subsidised) state/socially owned companies are a grave burden on the economy. The impact of this legacy at company level has not been tackled in 2001, during which efforts focused on restoring macroeconomic stability. The Serbian Agency

for SME development will provide support to SMEs as well as to agricultural processing plants, as an attempt to boost this vital part of the economy.

4.3.2. Agriculture

The only sector that substantially improved its performance in 2001 was agriculture, but mainly due to favourable climatic conditions after the severe drought in 2000. Agricultural reforms have started. The Serbian government has abolished subsidies to processors and consumers, whereas direct support for primary producers remains in place. Prices for all products except for wheat have been liberalised, and the privatisation of the processing sector has commenced.

4.3.3. Environment

Environmental competencies are largely at republican level. Serbia has produced a draft environmental law that it is seeking to align to the EC acquis. International and regional cooperation on environmental issues has started. FRY is an observer to the International Convention for the Protection of the Danube River Basin (ICPDR) and cooperates with its neighbours on environmental issues through the Regional Environmental Reconstruction Programme (REReP). Cooperation on water protection in the Danube/Black Sea Region has also been initiated.

4.3.4. Infrastructure

A functioning **transport** system is crucial for economic reform. The FRY has not yet gone beyond immediate reconstruction, and federal policy coordination is still lacking. Responsibilities for **telecommunications** are not clearly identified either, wherefore both federal and republican legislation is still awaiting adoption. Impediments to market liberalisation in Serbia seriously block reforms and have a negative impact on cost and quality of services.

4.3.5. Energy

Supply stabilisation and the reconstruction of energy networks are basic prerequisites for economic reconstruction and development. Despite rapid and significant support from the EC and other donors, for the overhaul of large parts of the energy generation and distribution infrastructure, leading to a 25% increase in domestic production, the situation remains severe. Kosovo's domestic supply situation is critical, compounded by a rise in demand, due to inefficient use, and serious management issues to be resolved. In Montenegro too, demand exceeds domestic production by 30%, largely due to high energy demands, at artificially low costs, by the KAP aluminium plant. Electricity imports from interconnected grids are therefore required, notably from Serbia. Inadequate billing and collection rates are an additional problem throughout the FRY. Initial legislative and administrative steps, including the creation of independent regulatory bodies in both republics, have been taken. A first overall policy strategy for this sector has only recently been put forward. The lack of coherence between the various parts of the FRY is hampering the creation of a badly needed functioning single energy market, with impacts well beyond the FRY.

4.4. Cooperation in Justice and Home Affairs

Considerable international support and advice is needed, bearing in mind that the country faces serious problems (illegal migration, trafficking, organised crime), while lacking basic capacity to deal with this (equipment, expertise, human resources), as well as the perennial problem of division of competencies.

There is strong commitment on the part of the authorities, supported so far by an increasing number of (partly uncoordinated) international actors. FRY is improving bilateral relations in this field and has already joined several international organisations (e.g. Interpol) and regional initiatives (under the Stability Pact). The unsolved constitutional issue is an impediment to new legislation and to its implementation in some important areas, e.g. border management, asylum, legal migrants, law and order, fight against crime etc. The emerging practical cooperation between the two Republican Ministries of Interior needs to be reinforced. Formal channels of cooperation have also been established between the UNMIK Police and the Federal/Serbian Ministry of Interior, which should also be deepened. However, there are no formal contacts between the FRY/Serbian police and the KPS.

4.4.1. Visa, border control, asylum and migration

Visa policy is an exclusive federal competence. This meets both international and European requirements that visa issues must be dealt with by states, and not sub-state entities. Practice, however, undermines this. Montenegro has established its own visa regime, whereby citizens of countries of former Yugoslavia, EU Member States and some other countries are allowed to enter the Montenegrin part of the federal territory without visas. UNMIK does not require a visa to enter Kosovo so, when travelling from Kosovo to other parts of the FRY, it is necessary to obtain a FRY visa (by leaving and re-entering the FRY). Greater policy harmonisation is therefore required within the FRY. Federal authorities have been making attempts towards an increasing harmonisation of visa policy with EU requirements, in line with FRY's signature of the Sarajevo Declaration in March 2001. This more restrictive policy has already shown a positive impact regarding procedures for the entry of Chinese and Iraqi nationals and thus influenced irregular migratory movements further afield, mainly to EU Member States. There is also ongoing liberalisation of the regime for European countries and some other states. Progress was also made in agreeing greater mutual liberalisation in the region but problems persist with Croatia, which continues to apply a very restrictive policy in issuing visas to FRY citizens. The FRY authorities have not yet sufficiently addressed the possible extension of the EU border for the current visa-free regime with Hungary.

The multiplicity of bodies involved in **border control** prevents reform. Control is shared between the Yugoslav Army (controlling the border) and the republican Interior Ministries (managing border crossings). A project by the Federal Interior Ministry to fully take over border control is unlikely to be implemented before a final constitutional settlement. The VJ has no presence along the FRY's international borders in Kosovo. It is only present on the boundary line with Montenegro and the rest of Serbia, following its return to the GSZ during 2001, and there have been no major incidents.

FRY is a known transit country for **illegal migrants** trying to reach Western Europe. Immigrants from African and Asian countries (mainly Chinese and Iraqi) come through Belgrade Airport, although rules are tightening. **Illegal trafficking** - particularly of women and girls - is a serious problem, with the entire FRY becoming not only a country of transit and destination but also a country of origin, and with reports of involvement by

local border guards. A FRY country team to combat trafficking was established last May, with OSCE support. A first shelter for victims has been opened and an awareness-raising campaign has also been launched, run by local NGOs and media. Major reforms are needed in the area of **asylum policy** in FRY, which is regulated by an outdated Law on Movement and Residence of Foreigners (adopted in 1980) which also covers refugee status. New legislation on this issue (separate federal laws on asylum and on foreigners) are envisaged, but pending on the adoption of the Border Law. FRY is a signatory of the 1951 UN Convention Relating to the Status of Refugees, and its 1967 Protocol, although there are problems with its enforcement. In Kosovo, UNMiK does not provide for the granting of refugee or asylum status nor is first asylum provided.

4.4.2. Money laundering

There is no law that prohibits money laundering, which is a source of income for organised crime and, in some cases, political extremists. The economy is still primarily based on cash exchange, meaning that most economic transactions are carried out in cash, both in Dinars and Euro. The conversion into Euro notes and coins in the FRY (the transition period ended on 28 February in Kosovo and runs until 31 May 2002 elsewhere) was an opportunity to legalise cash funds of Euro-zone currencies acquired in an unlawful manner. In Serbia the NBY is registering data on amounts above 10 000 Euro, but without an obligation to reveal the origin. The planned Money Laundering Law will only be implemented as of 1 June 2002, i.e. well after the change-over. In Montenegro, laws on money-laundering are only under preparation, and in Kosovo the first steps are being taken to tackle economic crime.

4.4.3. Drugs

FRY is considered a growing transit point for all kinds of crime networks, including drugs trafficking - not limited to tobacco smuggling, on which serious questions remain in relation to Montenegro - notably from Albania. This is exacerbated by the lack of operational powers on the federal level, Montenegrin non-recognition of relevant federal authorities, and the penetrability of borders. The implementation of a coordinated FRY-wide customs programme should help. Drugs consumption within the FRY has been growing, especially in Serbia, yet there is no national drugs strategy nor coordination between the relevant Ministries of Interior. Administrative capacity is limited and regional co-operation undeveloped. A wide awareness-raising campaign has recently been launched. Efforts have also been made by the UN Office for Drug Control and Crime Prevention to include FRY in a program for drugs law enforcement.

4.4.4. Fighting organised crime and terrorism:

The high incidence of corruption and organised crime is one of the legacies of the past decade in FRY. Cooperation and coordination of customs and police services is urgently needed. The federal and republican authorities and UNMiK are also lagging behind in the formulation of comprehensive, co-ordinated strategies. Except in Kosovo, elements of organised crime are still present in some official structures (particularly the police). Existing legislation does not even contain the concept of corruption or organised crime (to be introduced in the revised Serbian Criminal Code), and even the proposed Law on Money Laundering does not cover asset confiscation. More importantly, law enforcement does not function efficiently in practice, due to the lack of cooperation between the authorities responsible for border management, the banking or judicial services. Cooperation between UNMIK and the Serbian law enforcement agencies has started on

the exchange of crime-related information. UNMIK police, due to its UN basis, has access to Interpol, wherefore there is an Interpol presence in Kosovo.

Some progress has been achieved regarding regional cooperation. A working group of Interior Ministries was established with Bosnia and Herzegovina and Croatia, the main purpose of which is to share information on organised crime. In Serbia, a special commission dealing with financial abuses by members of the former regime has taken up work, but faces practical obstructions. In addition to this, a consultative Serbian Anti-corruption Council and, in the Serbian Ministry of Interior, a special Directorate for the Fight against Organised Crime were recently formed. A package of laws targeting corruption has been drafted. Of these, the Law on Extra Profits has so far led to the collection of €28.3 million. Further measures, like rules on the conflict of interests, the mandatory registration of property of all officials, regulations on financing of political parties, and the establishment of an audit service must be taken.

Within the Stability Pact framework, Montenegro established an Agency for the Anti-corruption Initiative, which has the task of ensuring implementation of an Anti-corruption Action Plan for 2001/2002. A Montenegrin law on conflict of interest is still only under preparation. While there is a department for fighting smuggling and corruption within the customs administration in Montenegro, there is evidence of continued, though reduced, cigarette smuggling, which the European Commission's Anti-Fraud Unit continues to investigate and monitor. The authorities also remain under domestic pressure as a result of their alleged past involvement. Even more broadly, there are serious concerns about corruption in Montenegrin governing structures. In Kosovo, where action and legislation against economic crime is a condition for further EC funding, an Economic Crime Task Force has been established under the supervision of the UNMIK's Pillar IV. In late 2001, first steps towards an economic crime strategy for Kosovo, including the definition of benchmarks, were taken. The strategy should be implemented in early 2002. Moreover, under the supervision of Pillar I, a Criminal Intelligence Unit and the Kosovo Organized Crime Bureau, headed by international officers and with no KPS involvement, are being established. Despite these efforts, there is a clear need, within the FRY and throughout the region, for substantial cooperation to curb organized crime.

On 13 November FRY signed the UN Convention on Suppression of Financing Terrorism.

4.5. Priority Areas Needing Attention in the Next 12 Months

In terms of **administrative capacity** to coordinate and implement the reform process:

- *The priority for the coming period must be the proper functioning of the Federal Office for European Integration (the EIO, the EC's contact point) and its internal **coordination mechanisms** throughout the state.*
- *Existing good and pragmatic relations between UNMiK and Belgrade must be followed and built upon by the new provisional institutions, experts from which should also participate in the work of the EU-FRY Consultative Task Force.*
- *Since the same reforms are required in all parts of the state, there should be **pragmatic cooperation** between experts from Montenegro and their colleagues elsewhere, even before the final structure of the state is worked out.*
- *Many SAP-related reforms are still only at the legislative stage, and there is a general lack of administrative capacity. A prerequisite for progress is formal*

*adoption, followed immediately by full and efficient **implementation**, based on efficient administrative structures and capacity.*

As regards **reforms in specific sectors** (The following recommendations should be read in conjunction with the recommendations of the EU-FRY Consultative Task Force, as well as the sectoral benchmarks delivered to UNMIK):

- *In all sectors, there should be increased coordination and cooperation between the different parts of the state, in order to ensure the development and smooth functioning of a **single economic space**.*
- *A coherent federal **trade policy and common trade regime** is vital for the integration of the FRY into the world economy and, more specifically, for further rapprochement with the EU. Concrete steps towards greater harmonisation are urgently required.*
- *Within the FRY, **obstacles to trade** should be removed. In addition, double taxation of goods moving between Kosovo and the rest of the FRY must be avoided.*
- *Coordination, within the FRY, on **standards and certification**, should be ensured, with a single policy and point of contact.*
- *Laws on **bankruptcy** and liquidation, stock and securities **markets** should be rapidly adopted and implemented. The further strengthening of capital markets legislation is of the utmost importance. The Agency for Bank Rehabilitation should be further strengthened and its territorial scope extended. Proposed fiscal reforms, throughout the FRY, should be quickly adopted and /or implemented. In Montenegro, this should include a revised legislative framework and a functioning Treasury. Furthermore, the presently irregular contacts between the BPK in Kosovo, the Montenegrin "Central Bank" and the NBJ should be strengthened and outstanding issues resolved.*
- *Efforts should be made to ensure fiscal harmonisation and cooperation between the various parts of the FRY, notably regarding a harmonised VAT system, in order to ensure that there are no **obstacles to trade** within the state.*
- *An EU-compatible **competition law** and legislation on state aids should be adopted and implemented as rapidly as possible. Other legislation should be amended to respect such principles.*
- ***Privatisation** must be speeded up and further steps in the restructuring of big loss-making corporations taken. The fate of socially-owned enterprises and asset-ownership issues should be tackled. The current **company law** needs to be adapted, and diverging rules on entity-level should be harmonised.*
- ***Intellectual property** legislation should be fully aligned with WTO and EU standards. The administrative capacity to enforce intellectual property rights and to combat copyright piracy and trade in counterfeit goods should be reinforced throughout the state. Effective measures at the borders of the FTY should be taken urgently.*
- *The compatibility and complementarity of actions in the **energy** sector throughout FRY must absolutely be ensured, to create unitary FRY energy market and follow the basic liberalisation requirement which underpins the Stabilisation and Association process. Regional energy grids should be gradually opened. Regulation should also be by means of a single, independent regulatory agency. In addition to further investment in power generation, transmission and distribution, there must be further improvement in pricing and collection rates, with a marked improvement already by mid-2002. State controlled prices must be increased to reflect costs more accurately as donors will not be prepared to fund this sector indefinitely. Measures regarding*

the restructuring of the Kosovo Electricity Company (KEK) should be taken rapidly, with a clear business plan and benchmarks in place and under implementation by the third quarter of 2002, and support from the Kosovo budget for the sustainability of EC investment to date. Active measures must also be implemented, throughout the FRY, to promote and increase energy efficiency and to dissuade abuse and waste.

- **Transport** policy and coordination should rapidly be put in place at federal level. Priority should be given to ensuring complete liberalisation of road traffic while guaranteeing non-discrimination towards foreign operators.
- Efforts should urgently be made to adopt and implement separate legislative frameworks for **telecommunications and broadcasting**. As long as competitive restrictions exist in any part of the telecommunications market, the authorities should ensure liberalisation of all other parts of that market and that full competition will occur once restrictions are removed. Outstanding issues on broadcasting should also be solved rapidly.

As regards **justice and home affairs**:

- Full alignment with the EU visa list and an entry policy that supports the spirit of this list should be achieved. Issuance of visas must be in line with international standards. In particular statistical data on the entry of foreigners need to be collected.
- The project on **border control** reform should be fully implemented. Pending this, interim measures on strengthening co-ordination between federal and republican levels on border control should be taken. Further discussions with the EU to ensure Schengen compatibility should be held.
- **Training** of border guard staff on modern migration management should be improved.
- **Asylum laws** in line with European standards should be adopted. Basic standard reception conditions should be put in place, as a priority on Belgrade international airport. Closer relations with UNMIK and local bodies on issues in relation to migration and asylum should be established, notably to combat trafficking in women.
- **Economic crime**, an impediment to economic reform and investment, should be actively tackled, with all relevant legislation and bodies under implementation / fully operational before the end of 2002.

5. EC FINANCIAL ASSISTANCE

Overall, between 1991 and 2001 (included), the FRY has benefited from a total of €1.8 bn -of EC assistance.

During the year 2001, some €550 million of EC funds, under the **CARDS** programme, were allocated for implementation in the Federal Republic of Yugoslavia (FRY). The CARDS Assistance Programme offers a long term assistance approach that addresses through single programme the needs of the country and reflects the ambitious objectives of the Stabilisation and Association process. It focuses on support for the reforms and institution building necessary to implement the obligations in the Stabilisation and Association agreement.

- In **Serbia / federal level**, implementation of the 2000 Emergency Assistance programme of €180 million was completed and steady progress made on the contracting of €203 million of EC funding committed in 2001. The main focus of the

2001 programs was: economic reconstruction and reform (energy, agriculture, enterprise development, health and regional/local development and transport facilitation), civil society and media.

- In **Kosovo**, implementation of 2000 programmes worth €262 million continued, with a further €330 million committed during 2001. The main focus of the 2001 programme was: Public administration (central and local levels, customs assistance), economic reconstruction and reform (energy, transport, housing, enterprise development, environment) and social development and civil society (media, NGOs and health), financial assistance to the budget.
- As for **Montenegro**, contracting of funds inherited under the 1999 (€23.3 million) and 2000 (€19 million) EC budgets continued. At the end of 2001, a further €18 million of new funds were committed, the main focus of which was institution building and transport.

Exceptional Community financial assistance was provided for Kosovo (€30m) and a **macro-financial assistance programme** for the Federal Republic of Yugoslavia (€ 300m, later raised to €345m), with the first payments already made (€ 15m to Kosovo in September, €260m to the FRY in October). Further payments depend on fulfilment of the relevant conditions. EC **humanitarian assistance** (ECHO) in FRY during 2001 amounted to €69.3 million, focused on refugees and displaced persons, social cases and extremely vulnerable individuals, winterisation, self-reliance in water, sanitation and health. The assistance has been wide-ranging in nature, targeted at the most vulnerable. With the escalation of the crisis in the former Yugoslav Republic of Macedonia during 2001, 1.5M€ was allocated to assist the 72,000 registered refugees as well as support for host families. Democratisation assistance was provided under the **European Initiative for Democracy and Human Rights**, with FRY-specific projects worth €4.7m, and micro-projects worth € 0.25m, as well as benefits from EIDHR regional activities. Programmes were also approved - with funding drawn from each of those packages - in the areas of **customs and TEMPUS**, for central implementation by the European Commission.

Implementation has been extremely speedy and efficient, with some programmes completely or almost completely implemented. One of the key reasons is the concentration of resources on a limited number of areas where an impact could be achieved, or where Community support could provide specific added value. Full advantage has been taken of having a unique and **common implementing body** – the European Agency for Reconstruction – to maximise the impact of EC assistance in the whole of the FRY, in order to ensure a coherent approach across and within the sectors. Assistance also takes due consideration of past and ongoing programmes, and provides support for necessary structural reforms in the targeted sectors, paving the way for IFI intervention. Co-ordination with other donors, and on the side of the authorities, has also been important in maximising impact. The European Commission and the World Bank have played a leading role in ensuring **mobilisation** and **co-ordination** of donors via the organisation of international Donor's meetings and Conferences. The first Donors' Conference for the Federal Republic of Yugoslavia, held in Brussels in June 2001, followed a donors' coordination meeting in Brussels in December 2000. This Conference was a major milestone, raising €1.56bn, ensuring complementarity between donors in meeting the needs of the FRY as expressed in the Economic Recovery and Transition Programme jointly prepared by the World Bank and the Commission. The needs of Kosovo had already been addressed in separate Conferences which took place in Brussels in July and November 1999. The technical meeting of donors in Pristina in February

2001, prepared in close collaboration with UNMiK, responded to needs identified in the Public Reconstruction and Investment Programme. The European Commission and the European Agency for Reconstruction ensure particular co-ordination with EU Member States in order to ensure consistency and coherence of intervention.

The EC **Country Strategy Paper** for the FRY defines the main areas for co-operation for the period 2002-2006, and the **Multiannual Indicative Programme** defines, in more detail, priorities for the period 2002-2004. These papers take fully into account the priorities of the Stabilisation and Association Process and mainly focuses on Governance (Public administration reform, Justice and Home Affairs and Customs and Taxation) Economic recovery and reform (Energy, Transport, Environment and Enterprise development) and Social development and Civil Society (University and professional education and civil society and media). While work in the energy and public utilities sector continues to consume nearly 50% of these EC funds, a gradual shift is evident in the move towards longer-term development work and to support institutional reform and development. EC humanitarian assistance is being phased out, first from Kosovo (end 2001), then Montenegro (mid-2002) and finally Serbia (in 2003), with withdrawal already from food assistance, psycho-social support and repatriation due both to the absence of continued strictly humanitarian needs and to the arrival of other actors, and a clear shift towards needs, rather than category-based assistance.

6. PERCEPTION OF THE EU

As in so many other fields, there has been a sea-change in **official attitudes** towards the EU since October 2000, echoing the changed nature of the relationship. There is a clear official policy, at state and republic level, in favour of EU integration. The further deepening of the FRY's relationship with the EU, in the framework of the SAp, is not merely a priority of foreign policy but also correctly seen a vehicle for internal reform. This positive stance among the political and administrative **elite** in Belgrade and Podgorica is, however, not reflected throughout the media which shows less understanding of the process, and there is no government communication strategy on these issues. The presentation of the process has generally been realistic, with welcome pragmatism about the need to carefully lay reform foundations, despite occasional over-optimistic references by politicians (albeit understandable, for domestic consumption) regarding timing. For domestic reasons, inaccurate statements have been made about the EU, and particularly the European Commission. In general, **public attitudes** towards the EU appear to be positive but remain difficult to quantify as it does not feature in regular opinion polls, and the government does not yet conduct such specific polls.

Media coverage indicates a generally **positive overall image of the EU** and of its policies towards the FRY, although stated EU policy on the future of the state is obviously more welcome in Belgrade than in Podgorica, where it contradicts the government's own message and presentation of international positions on the issue. Little attention has been paid by political leaders or the population in Kosovo to EU policies. This failure to understand, or believe, EU policy on status lay behind the statements of newly elected Kosovo politicians (and their subsequent surprise at the clear EU reactions) in November 2001. There is also a lack of awareness, in large parts of the international administration, the newly established institutions and the population, of the EU, the Stabilisation and Association process, the reforms required, or the implications. With the exception of selective or mis-representation of EU messages and even occasional attacks in the Montenegrin media on EU representatives, and reactions in Kosovo to EU attitudes to independence, **media coverage of EU-related issues** and events in the FRY is

generally favourable. The donor events organised by the Commission and the World Bank attracted favourable publicity, and visits by European politicians have attracted high and positive coverage of the scale and speed of delivery of EC assistance. The misinterpretation by some of the role of the European Agency for Reconstruction, an implementing body but not itself a donor, resulted occasionally in wholly unjustified complaints of a lack of EC assistance. The media also highlight the EC's *long-term* commitment to the FRY in terms of integration (SAP), as well as the shift of the focus of assistance from “emergency” to structural reforms. Some have also covered complex issues arising out of the EU-FRY CTF meetings. There is understandably, however, a need for training of journalists regarding EU, integration and reform issues.