

Serbia and Montenegro
Stabilisation and Association Report
2003

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1. EXECUTIVE SUMMARY¹

Some progress has been made, with much still to be done, and not yet the qualitative leap forward required if the state of Serbia and Montenegro is to reap the full benefits of Stabilisation and Association.

The tragic murder of the Serbian Prime Minister, Zoran Djindjic, who courageously worked to build democracy and played a key role in bringing Serbia out of its isolation, has shocked the region and the international community. This crime is a reminder of the difficult legacy of the past and also of the need to continue the Government's work on stabilisation, democratisation and reform at an unabated pace. Zoran Djindjic was dedicated to keeping Serbia and Montenegro on its path towards the European Union and this report reflects the reforms necessary to best carry forward his vision. The Commission will continue to provide all support possible to the authorities of Serbia and Montenegro in their efforts to fight the forces that tried to attack Serbian democracy.

The level of progress in **political reform** has varied: significant success in the areas of human/minority rights and regional co-operation; mixed results in the reform of the judiciary and police; but slower-than-hoped-for progress in the difficult task of state-restructuring and building stable, efficient and credible institutions. The commitment to reform persists, but a number of serious obstacles continue to hamper delivery. The legacy of the past and the continued existence of older structures, the failure to fulfil key international obligations such as co-operation with the ICTY, political disagreements about the interpretation and implementation of the constitutional agreement, and protracted party political disputes – all have contributed to the slow pace of reform in a number of key areas. The assassination of Serbian PM Djindjic is an all too potent reminder of the need, throughout the region, to tackle the forces of organised crime and extremism.

The **economic situation** has improved in the context of stability-oriented macroeconomic policies although fiscal and external sustainability remain a challenge. Structural reforms continued, notably in the banking and enterprise sector, but need to be further accelerated. The key to the state fulfilling its full economic potential – and also a prerequisite for contractual relations with the EU – remains the implementation of an internal market and a single trade policy.

The European agenda and the **Stabilisation and Association process** remain catalysts for reform. But much time has been lost in 2002, and the state must accelerate the pace of reform and improve the implementation of legislation if it is to fulfil its potential. The continued focus on constitutional issues has distracted attention from other fundamental areas – until these are resolved, the state will struggle to achieve the necessary pace of reform. Many of the recommendations made in the 2002 SAp Report, earlier reports, and at the EU-FRY Consultative Task Force have yet to be implemented and thus remain valid – and many are prerequisites for the implementation of any future SAA. The success and speed of any SAA negotiations will depend on the state's ability to demonstrate its capacity to implement such an Agreement, with much attention focussed on its track record on delivering reform. The Commission will continue to provide support and advice to the state. But EU efforts, even on the scale of recent years, cannot substitute for a lack of political will within the state. Only

¹ The state of Serbia and Montenegro is composed of the Republic of Serbia, Kosovo (under international administration under UNSCR 1244 of 10 June 1999) and the Republic of Montenegro. This state is the same international legal entity as the Federal Republic of Yugoslavia.

with full commitment and co-operation within the state, and decisive action to pick up the pace of reform. Will the state be able to make the necessary progress.

The situation in **Kosovo** has its own characteristics, due to the presence of an international civil and military administration, yet many of the issues are the same. Work continues on building democracy and rule of law, as well as other EU-compatible reforms including in the economic sphere. The future challenge is for the provisional institutions to take greater responsibility for reforms and their implementation – working within the powers which have been transferred – and to devote less time and fewer resources to challenging UNMiK and seeking a premature debate on status issues.

2. POLITICAL SITUATION

2.1 Democracy and rule of law

Democratic transition and reform continued to be affected by the prevailing climate of constitutional and legal uncertainty. A breakthrough in the resolution of the constitutional crisis came in March 2002 with the signing of the EU-brokered Belgrade Agreement² on restructuring and renaming the FRY so as to have a functional state³, though its implementation was more problematic, with delays blocking reforms in many important sectors. EU concerns on certain elements of the Constitutional Charter were made clear during the summer and largely taken into account in the draft text though subsequently contradicted in some important respects in the draft law on implementation.

The Belgrade Agreement, signed on 14 March 2002, created a positive momentum for state reform. The fact that the Constitutional Charter was only adopted on 4 February 2003 not only affected reforms in some crucial sectors, but also negatively influenced the international standing and ambitions of the state, delaying its stated foreign policy targets of accession to the Council of Europe, Partnership for Peace and making progress within the SAP. The first recommendation of the April 2002 SAP Report - that the constitutional stalemate be clearly resolved through constructive co-operation within a restructured and functional federal state - has therefore unfortunately not yet been implemented.

Federal acts and policies continued to be implemented only in Serbia (and even there in a discretionary manner). Despite months of political/party disputes, coupled with the endemic lack of quorum, the Federal Parliament did manage to adopt some important legislation. There is, however, a parallel existence of obsolete legislation from the previous era and newly adopted acts and a lack of harmonisation between laws and policies at different levels. The fragility of state structures was obvious in a series of affairs involving the military (the Perisic affair, sales of weapons to Iraq) that pinpointed the outstanding problem of lack of civilian authority and control. Equally worrying was the disrespect shown towards federal judicial instances (Federal Constitutional Court).

Respect for the hierarchy of norms and the rule of law continued to be adversely affected by the constitutional vacuum in which the entities continued to follow their separate, and in some cases separatist, legal and political agendas. The failure of the federal institutions to cope with problems (e.g. excise law) led the Serbian government to unilaterally adopt further measures in areas still under the federal competencies and to take over more state competences. The continued non-recognition by Montenegro of the current federal institutions resulted in non-implementation of important newly adopted federal laws (e.g. Criminal Procedure Code, Law on Minorities) and a continued split of the country into two economic systems. On the positive side, Montenegro agreed to the inclusion of members of the Federal Parliament in the

² Since the Constitutional Charter was only adopted in February, it would be premature to assess its implementation. The *potential* for implementation, based on indications during the drafting of the texts and work on the draft Internal Market and Trade Action Plan, and the fact that little advance planning for implementation has yet been done, is assessed.

³ Throughout this report, the terms from the Constitutional Charter are used i.e. state-level (for federal) and member state or sub-state (for republican). References to FRY are maintained in documents or bodies which still contain this in their formal titles.

Constitutional Commission and formally agreed on the concepts enshrined in the Constitutional Charter. The Serbian Government has shown stability and calm in their reaction to the tragic assassination, on 12 March, of PM Zoran Djindjic. Beyond this, it is too early to assess the consequences in terms of the impact on Serbian politics or action against organised crime and extremist elements.

Institutional difficulties in Serbia and Montenegro, caused by deep divisions between the main political actors continued to undermine credibility and transparency. The Serbian Parliament was blocked for months due to a dispute concerning the reallocation of seats within the ruling coalition and the effective expulsion of DSS members from the Parliament. Lack of public consultation in law-making resulted in the adoption of dubious solutions, subsequently suspended by the Constitutional Court (e.g. the judiciary laws). In Montenegro, the signing of the Belgrade Agreement generated a protracted government crisis, blocking the legislature and causing the adoption of highly controversial acts, such as the election-related laws, and ultimately led to the dismissal of the government and early parliamentary elections.

Despite these difficulties, there was welcome progress in many areas. Discussions on the Constitutional Charter, despite arguments and likely problems with implementation, began long-awaited co-operation on some issues and led to the launching of talks on harmonisation. Many valuable legal drafts have been prepared, elections have been held (albeit mostly unsuccessfully), the civic sector has re-enforced its pro-active role, the first promising efforts towards Army reform were made, the judiciary has started to resume its role as an independent branch etc. These positive signals have been acknowledged by other international organisations, including the Council of Europe, where the debate on the state's accession also reflected, however, strong dissatisfaction with non-co-operation with ICTY.

Progress has already been made in democratisation, but work remains to be done in Kosovo. Rule of law - both in terms of implementation by the authorities and in terms of respect shown by political leaders and individuals - remains a major political priority for both UNMiK and the PISG in 2003.

2.1.1. Assessment of democratic institutions and attitudes to the state

Constitutional: After protracted constitutional deadlock, EU efforts to initiate serious dialogue between Belgrade and Podgorica brought a breakthrough. The signing of the Belgrade Agreement on 14 March 2002 established the principles for the restructuring of the state in a looser form with five state-level portfolios. The State Union is the same subject of international law as the FRY (i.e. not state succession). While affirming the commitment to a single market, the Agreement was less explicit in the area of economic relations, thus leaving space for long drawn-out debate. EU advice throughout the process re-iterated the minimum standards required (in particular concerning foreign trade, the internal market, the overall viability of the state and state continuity) in order for the restructured state to be efficient and functional, *i.e.* capable of acting as a single international interlocutor and thus capable of having a contractual relationship with the EU. It took over 10 months for the Constitutional Charter to be adopted by all Parliaments. Reassuringly, advice provided by the European Union was largely taken into account, although in partly ambiguous wording and subsequently contradicted in some important respects in the law on implementation. Generally, short-term thinking and the lack of clear political will to implement agreements, as reflected most recently in statements by the Montenegrin Prime Minister, has created long-

term uncertainty about the new institutional and administrative structures and may impede their operation. A final assessment of the Constitutional Charter can only be made once institutions have started to function and to credibly exercise and enforce their competencies.

On republican level, constitutional reform remained blocked. The revision of the Serbian Constitution, the first priority after the adoption of the state-level Constitution, will be yet another issue of major dispute between the former coalition partners, DOS and DSS. While there is a basic consensus on the governance issues (separation of powers, checks and balances) and on human rights standards, there is a wide debate about the level of decentralisation of Serbia with differences between the DSS vision and that of the rest of DOS (particularly the mainstream autonomy parties in Vojvodina). By contrast, there has been little debate on revision of the Montenegrin Constitution although it is required due to events since the early 1990s and the restructuring of the federal state

Elections: Elections were conducted mostly in accordance with international standards. Still, reform of election legislation at all levels remains necessary as demonstrated by the failure of three elections. Whereas revision of the federal laws has been contingent on the adoption of the new Constitution, there were no such objective reasons for the failure to revise Serbian legislation, on which the EU was clear (Gonzalez recommendations) as far back as 1997 and in the 2002 SAp Report. The exception was the adoption of the new Law on Local Elections in June which introduced significant improvements, in line with OSCE recommendations, e.g.: proportionality, reduction of the threshold (thus favouring minority communities) and a requirement for an increased representation of women. The first elections under this new Law were the by-elections in three municipalities in South Serbia in July, the first multi-ethnic elections in the region in a decade and the first with direct mayoral elections (new Law on Local Government). These marked an important step towards further stabilisation in the region and the integration of ethnic Albanians into official structures. The OSCE / ODIHR assessment was largely positive, although it did note some shortcomings (concerning party control of seats, lack of legal provisions on domestic observers who were in practice given wide monitoring access). In contrast, almost nothing was done to amend regulations on republican elections (parliamentary and presidential, including the financing of political parties), which contributed to the failure of the presidential elections (September/October). Only after strong international pressure in support of ODIHR recommendations for revision, was the Law on Election of President changed partially (November), retaining the controversial 50%+1 threshold requirement for the first round leading to failure on 8 December. A comprehensive review of election legislation is still overdue before new elections are called. The crisis about the take-over of the DSS seats also pinpointed the urgent need to tackle the provision allowing party control of electoral seats, while the presidential elections also showed the need for immediate action on revision of voter registers. The Serbian elections also showed a worrying increase in support for nationalist candidates, including among voters in Kosovo, playing on the various political and economic uncertainties.

Legislation in Montenegro was formally assessed as more satisfactory than in Serbia. In practice problems remain, particularly relating to electoral provisions which resulted in the failures of presidential elections on 22 December and 9 February and allow for endless cycles of unsuccessful elections. ODIHR deplored the unacceptable pressure on state employees to vote. Electoral-related media provisions and behaviour also remain problematic. The political crisis over the Belgrade Agreement and the alliance between the Liberals and the pro-federal coalition, two fundamentally opposed political groups who combined to oust the DPS, created

a confused environment for early parliamentary elections (initially scheduled for 6 October), including the adoption of a highly controversial set of election and media laws, followed by obstruction in appointing members of the Constitutional Court. The crisis was resolved with OSCE involvement and early parliamentary elections took finally place on 20 October. Although ODIHR assessed them as generally in accordance with international standards, it reiterated previously noted shortcomings, notably the undemocratic party control of seats and continuing mingling of State and party functions. They further recommended the reinstatement of the number of seats reserved for the minority Albanian community, which had been reduced by the Liberals and the Together for Yugoslavia (TfY) coalition, and that similar action should be taken in favour of other communities as well.

Municipal elections, the last to be fully organised by OSCE, were held in Kosovo on 26 October. The conduct of the elections and the campaign, was improved on previous occasions. Despite international efforts, turnout was disappointingly low especially among Kosovo Serbs. The boycott in the north of Mitrovica - partly due to confusing and last-minute messages from Belgrade - was a lost chance at power-sharing in several municipalities. The low turnout, and the results, were also interpreted as a protest vote against Belgrade, as also evidenced by divisions within Koalicija Povratak on the subject of a more autonomous political line vis a vis Belgrade.

President: Allegations were made about potential abuses by the Federal President's Cabinet in relation to the military (e.g. the Perisic and Pavkovic affairs) and there were also some nationalist statements by President Kostunica's about Republika Srpska and about ICTY. The awkward situation of an ICTY indictee continuing to hold the office of Serbian President finally ended with his voluntary transfer to the Hague in late January, some weeks after the expiration of his mandate. In late 2002, attempts to elect republican Presidents failed (twice in the case of Serbia). The former Serbian President had in any event been largely ignored for two years (and it is not now intended to replace him before the revision of the Serbian Constitution) and the dividing lines between President and party leader have long been blurred in Montenegro.

Parliament: The long debates over the Constitutional Charter, coupled with party disputes, seriously affected the credibility, efficiency and transparency of the Parliaments' working. The recommendation of the 2002 SAp Report has thus not been implemented. Work in the Federal Parliament continued to suffer from the difficult alliance between DOS and the Montenegrin TfY coalition (partners with sometimes incompatible positions on key issues). The DOS-DSS conflict is an additional destabilising factor. Together with the endemic problem of a lack of a quorum, these disputes resulted in parliamentary obstruction, delayed sessions and law-making and political bargaining over some legislation (such as the Law on Co-operation with ICTY and its controversial Article 39). Due to lack of parliamentary reform, parliamentary committees largely remained inefficient. Several affairs involving the military (sale of weapons to Iraq, Perisic's arrest by military security) again raised the issue of lack of civilian, including parliamentary, control of the Army. On the positive side, the Federal Parliament succeeded in adopting some important laws (e.g. the Amnesty Act, Law on Protection of National Minorities, Law on Security Services). With international assistance (OSCE, bilateral initiatives), seminars on improving parliamentary efficiency were organised (e.g. control of armed forces, code of conduct for MPs).

Positive steps towards improvement of the organisation of the Serbian Parliament (e.g. transparency: broadcasts, public access, website) were overshadowed by the crisis involving

the take-over of the DSS seats (July until November). Although the decision on the take-over had a legal basis in the current Law on Election of MPs (repeatedly criticised by ODIHR), it did generate domestic debate on its legitimacy. The case went to both the Federal and Serbian Constitutional Courts, but the final resolution was reached through a political settlement, after which DSS returned to Parliament. While this crisis was triggered by absenteeism and obstructionism, deeper reasons concern the growing political differences and contradictory priorities of the former coalition partners. Parliament was blocked for months, its autumn session was delayed, delaying the adoption of around 50 important laws and prolonging the repeat presidential elections beyond the constitutional deadline. Parliament also continued to only partially respect the principle of public consultation, the most glaring example being the changes to the judiciary laws. The takeover of the DSS seats in the Serbian Parliament raised issues in relation to protection of the passive voting right (i.e. the right of elected representatives to exercise their mandate), with repeated OSCE/ODIHR requests for the repeal of provisions in electoral legislation at all levels allowing for party control of seats. The relevant provision in the Serbian Election Law is currently challenged before the Republican Constitutional Court, though there has been no similar initiative in Montenegro. At any rate, it is obvious that new election legislation must provide instruments for the protection of elected representatives and their mandates (including before courts) beyond the electoral process.

Deep divisions between the main actors, generated by the signing of the Belgrade Agreement, also adversely affected the functioning of the Montenegrin Parliament, resulting eventually in the government's dismissal (22 May) and early parliamentary elections (20 October). The protracted government crisis, as well as procedural weaknesses, blocked the legislative work of the Parliament for much of the year, holding up important laws (e.g. on local government). In addition, a one-off alliance between the Liberal Alliance (which provoked the government crisis over the Belgrade Agreement) and the pro-Yugoslav coalition led to bargaining about election legislation and the adoption of an unsatisfactory solution (July). The crisis was eventually resolved (September) with OSCE involvement, and early parliamentary elections took place on 20 October. The new Parliament (with an absolute majority for the DPS-led coalition) was constituted on 5 November and a new cabinet sworn in in January 2003.

The Kosovo provisional Assembly began to function during 2002 but suffered many teething problems, well illustrated by the difficulties with the Education Bill and the Law on External Trade. Continued difficulties experienced by minority parties led to a walkout by Kosovo Serb representatives (November 2002 to February 2003) and to SRSG Steiner asking the OSCE to monitor Assembly proceedings. The Assembly also spent undue energy on pointless challenges to UNMiK's authority in the areas of the reserved powers, with the result that only 2 laws were passed in 2002 instead of the 20 in the government programme.

Executive: The continuing problem of the jurisdiction of the federal government, not recognised by Montenegro, persisted. The constitutional debate impeded any major activities of the federal ministries, with several major issues being on hold, e.g. border management, visa policy, telecommunications, although the government had legislative initiatives in some important areas like amnesty and minority protection. Within the constitutional vacuum, the most pertinent problem was lack of civilian control of the military. This was even thought to have provoked the resignation of Defence Minister Krapovic and was also apparent in the arms sale to Iraq, resulting in dismissal of the Deputy Defence Minister. DOS-DSS failure to agree on a candidate also resulted in delays in appointing a new Finance Minister. The workings of government continued to suffer from simmering political disputes. However, the

DOS reaction to the murder of PM Djindjic indicates fundamental unity and commitment to continuing reform.

In Montenegro, conflicts over the Belgrade Agreement led to the dismissal of the government in May. Discussions on the formation of the new cabinet failed, resulting in early parliamentary elections. The government crisis blocked most reform activities (several valid bills were prepared but not passed by Parliament). A new government was only formed in January 2003. The Serbian Government functioned against the background of continuing disputes with DSS, but also within DOS. Its first restructuring since the DSS left (August 2001) took place in June, but was rather symbolic in nature. The appointment of another Deputy PM was the result of bargaining within DOS, substantial changes were made with the establishment / separation of new portfolios. The Government also continued with the practice of passing decrees in areas where the federal level was inactive. Even more worrying was the practice of substantial last-minute changes to legislation despite previous public consultation (e.g. the Broadcasting Law, the apparent lightening of some key anti-corruption provisions in the Bill on Financing of Political Parties), as well as a lack of transparency (e.g. preparation of the telecommunications law).

In Kosovo, the formation of the provisional Government was finally completed in June with the inclusion of Kosovo Serb members. An ambitious Government Programme was announced (May 2002), but as in the Assembly as a whole, some Ministers have devoted more effort in recent months to challenging UNMiK reserved powers and to making ultra vires declarations (e.g. on external trade and state borders), rather than on the business of fulfilling the responsibilities which have been transferred. This focus more on the horizon than the road is in contradiction to the internationally-supported "Standards before status", the benchmarks launched in April 2002 by the SRSG⁴, the aim of which is to provide a methodology for assessing progress in democratic reform, rule of law, economic development, improved conditions for minority communities, preconditions for beginning work on "facilitating a political process designed to determine Kosovo's future status".

Local government: Mixed progress was recorded on decentralisation and reform of local government, on which a recommendation was made in the 2002 SAp Report. New legislation had been adopted in Serbia in February 2002 introducing important innovations in line with Council of Europe recommendations: widening of municipal competencies, direct election of mayors, establishment of new institutions, special institutes for human rights and minority protection and limitation of undue interference by central authorities. The problem of a lack of municipal property rights has still not been addressed. Reassuringly, the Serbian Government took action towards enhancing the financial autonomy of local authorities by increasing municipal budgets through an enlarged share in tax revenues in March 2002 and the welcome establishment (June) of a separate Ministry to deal with local government. Local authorities have taken a pro-active role in cross-border co-operation (creation of a Balkan Euro-region by trans-frontier municipalities from the state, Bulgaria and the former Yugoslav Republic of Macedonia). Despite these positive signals, much remains to be done to tackle the inherited problems of local administrations' inefficiency, corruption, lack of training, lack of human rights and gender equality awareness, etc. Some of this has already been addressed in co-operation with international partners (e.g. in the Council of Europe, OSCE, bilateral initiatives). An additional problem concerns the spillover of party disputes from central level

⁴ Featuring detailed goals and benchmarks in relation to: functioning democratic institutions, rule of law (police / judiciary), freedom of movement, returns and reintegration, economy, property rights, dialogue with Belgrade, Kosovo Protection Corps.

to local level (political interference in appointing and dismissing local officials, take-over of electoral seats, pressure upon local media). The issue of provincial autonomy for Vojvodina has partially been addressed through the adoption of the Omnibus Law and the reinstatement and strengthening of some of the constitutional competencies previously suspended by Milosevic through a separate budgetary allocation in June. This, however, is far below the level of autonomy requested by even the mainstream parties in Vojvodina, which led to debate (November) on a draft constitutional act for the province. The text envisages wide legislative, executive, judicial and economic autonomy and has already provoked serious debate on these issues, which must be addressed during the reform of the Serbian constitution. In contrast, very little has yet been done to reform local government in Montenegro. Several valid drafts on local government, financial decentralisation and local elections, prepared with international expertise, are still awaiting adoption by Parliament.

Municipal elections were held in Kosovo in October 2002, following which a local government reform programme is being prepared with the help of the Council of Europe.

Public administration: Much still remains to be done, at all levels, to reinforce administrative capacity, especially in view of the expressed desire for closer relations with the EU. The reform of the federal administration (including its downsizing and transfer of staff, with competencies, to republican administrations) is awaiting implementation of the Constitutional Charter. Though there is no clear-cut proposal yet, the latest thinking - by Serbia rather than federal structures - is that the restructured state will only employ around 3,000 people, who will still then have to be adequately trained. For the remainder, a social program will be required. Apart from progress made in modernising public finance institutions, reform of the republican administrations has been quite slow (in Serbia, this even caused a delay in implementing some related EC-supported projects). After the establishment of a separate Serbian Ministry for Public Administration and Local Government in June, efforts increased to draft the national strategy paper (October) and establish a clear separation of competencies and co-ordination between the existing institutions. Draft legislation to improve efficiency and tackle corruption (Bill on Public Administration, Civil Service Act, Code of Conduct for Civil Servants, Bill on Prevention of Conflict of Interests, etc.) is still in the pipeline and should be adopted as a matter of priority. Reform in Montenegro is also proceeding slowly. The role of the existing institutions has been assessed, with new ones envisaged, such as the Council for Public Administration Reform. Draft legislation (Civil Servants Bill, Bill on Public Administration) is still at an early stage of the adoption procedure.

Public administration establishment and progressive transfer of authority continues in Kosovo with significant international advice in the daily application of European and international standards regarding good governance, human rights and equal opportunity principles. Reform, particularly concerning the separation of powers, is needed since the civil service is currently highly politicised. Efforts have been made to modernise the civil service in a number of sectors, including judicial and local authorities, but further depoliticisation is required. The basic legislation on the equality, non-discrimination and minority inclusion was brought into force in December.

Civil society: NGO legislation is more satisfactory in Montenegro, but there has been no progress in Serbia despite this being a priority Council of Europe post-accession commitment. The new Law on NGO status is still pending and provisions of the draft Serbian Law on Donations allowing interference of the executive, have raised serious concerns in the civic

sector and with donors. The civic sector continued nonetheless to play an important pro-active role in legislative initiatives, especially in Serbia (e.g. through drafts on the Serbian Law on Presidential Elections, federal army statute, access to public information, internal affairs, Constitutional Court etc) and in monitoring the performance of the authorities. The role of civil society in the reform process should be further strengthened in Montenegro. NGOs in Kosovo have little impact, with public opinion heavily influenced by political factions.

Armed forces: Despite clear recommendations in the April 2002 SAp Report, at CTF meetings, and by the Geneva-based Centre for Control of Armed Forces, only limited progress has been made in the reform of the military and its placement under civilian control. Even this only took place in response to international pressure and several damaging affairs involving the Army. Reform of the military sector has been hostage not only to the constitutional issue but also political disputes (cf. the case of the belated dismissal of former Chief of Staff Pavkovic). The lack of civilian control, coupled with the disturbing presence of elements from the previous regime, was evidenced by the handling of the arrest of Serbian Deputy PM and federal MP Perisic (March), the scandal concerning sales of weapons to Iraq (October) and mutual accusations between Pavkovic and the Cabinet of the Federal President. This also illustrated the problematic relationship between various institutions, as well as potentially problematic links with the Army of Republika Srpska. On the positive side, changes to the Law on the Army from January 2003 reducing compulsory military service and strengthening the principle of conscientious objection, but this is still far from a comprehensive military reform. The Supreme Defence Council reacted quickly and in a united manner to the murder of PM Djindjic.

In response to the Perisic arrest (of which governments were uninformed), the Federal Parliament adopted the welcome new Law on Security Services in July. Contacts with NATO intensified, although prospects for accession to the Partnership for Peace remain contingent on comprehensive military reform and full co-operation with ICTY. There is a marked contrast between the Army's obstruction of co-operation with ICTY and its continuing constructive role and good contacts with KFOR. Issues of border demilitarisation and of the abolition of military judiciary (whose jurisdiction should be transferred to regular courts) must be addressed urgently in the implementation of the new constitutional arrangement.

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

Judicial system: There has been undeniable progress in the establishment of a more efficient and independent judiciary, but much remains to be done to restore public confidence and enhance legal awareness, as recommended in the April 2002 SAp Report. Although the federal court system is quite limited, the Constitutional Court has begun to make efforts to restore its competencies, notably as regards constitutional appeals. This has, however, been undermined by the attitude of political actors and executive officials at the Serbian level (including a disturbing campaign against the Acting President of the Court).

Promising steps to enhance judicial independence, taken in November 2001 with the adoption of new Serbian laws, were seriously undermined by changes adopted in July 2002, contrary to the solutions proposed by experts and judges, which the Constitutional Court declared not to be in accordance with the Constitution (11 February). The changes adversely affected the position of the newly established High Judicial Council and prosecutors and increased the competences of the legislative and executive branches to appoint and dismiss judges and court presidents. Provisions on the removal of compromised judges were also vague, with potential

for abuse. Reassuringly, the Serbian Constitutional Court suspended the new provisions (September) pending a final ruling on their constitutionality. There have also been inappropriate statements by the Serbian Government on judicial issues. On the positive side, however, members of the judiciary seem to be resuming their independent role. The major development is the launch of domestic trials for war crimes, although these are still rare and take place in a difficult environment in both Republics (procedural problems and threats to judges). In view of the inherited problem of very low court efficiency, possibilities for reducing the backlog, especially in civil matters, are being explored. The government has made efforts to improve judicial infrastructure, including a significant step with the salary increase for judges (July), but financial problems of court administration persist. Although it is a very sensitive issue, dismissals of compromised judges (on the grounds of under-performance, corruption, participation in election frauds or politically motivated trials) have taken place though in some cases family connections between judges and complainants, as well as some controversial court decisions in high-profile cases continue to affect the efficient functioning of and confidence in the judiciary. There are active professional associations of judges and prosecutors and the Judicial Training Centre is now fully operative. The new Serbian Council for the Reform of the Judiciary has drafted a comprehensive strategy for judicial reform.

The new Montenegrin Law on Judges which came into force in February 2002 introduced wider guarantees of independence, clear criteria for appointing and dismissing judges and organisational changes (establishment of an appellate and an administrative court). A Bill on the Public Prosecutor is still not adopted. With international assistance (including EC), a project on establishing common information links between the judiciary, prosecution, and the Justice Ministry and penitentiary institutions has begun well. The Training Centre has continued to operate successfully. In addition to an active Association of Judges, a prosecutors' association was also established. However, the functioning of the judiciary still remains affected by the politics (e.g. the Montenegrin courts' refusal to apply the new Federal Criminal Procedure Code, although this act introduced more modern criminal procedure standards).

The SRSG retains full competence over Kosovo's judicial and law enforcement structures. Courts are functioning at every level throughout Kosovo, with local judiciary and prosecutors. The independence of the judiciary from executive control is guaranteed under the Constitutional Framework and members of Kosovo's local judiciary are appointed for the duration of UNMiK's mandate. The number of Kosovo Serb members of the judiciary is expected to increase following an agreement between UNMiK and Belgrade in July 2002. International judges and prosecutors are appointed by the SRSG to handle sensitive cases. Members of KFOR are still not answerable to the civilian authorities, or Ombudsman.

Police: In spite of genuine commitment, progress in police reform in the state has been limited. This has less to do with constitutional uncertainty and more with the legacy of the past, coupled with the adverse effect of internal political disputes. Still, there has been more transparency, international involvement and promising signs of accountability to Parliament (regular reports to relevant committees). But the delay in implementation of constitutional reform has negatively affected clarity in the division of competencies, legislative reform, border demilitarisation and efficient inter-service and inter-entity co-operation. The painful process of depoliticisation and removal of people from the previous regime, as well as sanctioning of incumbent officers for abuse of office has begun.

Federal activities remained affected by the constitutional debate, although the Constitutional Charter clearly envisages that policy will remain at state-level. The implementation of the border demilitarisation project and the adoption of accompanying legislation on asylum and migration (*cf.* 4.4.1) have also been held hostage. On the positive side, the Federal Bureau of Interpol developed wide international and regional co-operation. Numerous readmission agreements signed or negotiated. The Ministry spearheaded legislation aimed at human rights protection (e.g. changes to the Law on Travel Documents to abolish the military's discretionary powers over passports for future recruits). It has also been very active in measures against trafficking in human beings.

There has been little progress in police reform in Serbia. The Internal Affairs Law, together with the Code of Ethics, is overdue. Connected legislation was passed, leading to piecemeal reform. Newly adopted legislation has major shortcomings: the Law on the Security Agency separated state security from the Ministry of Interior, but failed to address the issues of civilian control and human rights protection in a satisfactory manner; the Law on Special Institutions in Fighting Organised Crime has been blocked due to the delay in adopting accompanying special procedural rules in the Federal Parliament and its enactment may also be obstructed by the structures of the former regime. In this respect, the excellent action by the police in tracing suspects concerning the murder of General Buha is not the norm. There is also an apparent lack of internal accountability and inter-agency co-ordination, especially with the judiciary, also needs to be urgently improved. Initial, encouraging, progress has been made in police training with OSCE and Council of Europe assistance, and multi-ethnic police training in South Serbia has been a widely acknowledged success. Regional and international police co-operation has been further intensified, with Memoranda of Understanding on police co-operation and the fight against organised crime signed between FRY and UNMiK and with the former Yugoslav Republic of Macedonia, Albania, Slovenia and Croatia. While co-operation with the Montenegrin police still needs to be re-enforced, the launch of co-operation with UNMIK police is a sign of improvement.

Montenegro has also, with international assistance, prepared new legislation, including a Code of Ethics, which foresees separation of state security from law enforcement. Police training has taken place and some efforts towards downsizing have been made. It is worrying, however, that the Montenegrin authorities have not implemented the new Federal Criminal Procedure Code. Efforts have been made to implement stricter internal control (hot lines for citizens' complaints), but the issue of internal accountability needs to be addressed in a comprehensive way through clear legislative provisions. The Ministry had some limited success in fighting elements of organised crime. Although extensive regional co-operation has been developed, this has been done bilaterally without regular co-ordination with federal and Serbian counterparts.

Border control is still shared between the Yugoslav Army (borderline) and the Republican Ministries (border crossings). The border demilitarisation project is contingent on implementation of the Constitutional Charter - the separate draft prepared by the Montenegrin Ministry is contradictory to the process. Co-operation with KFOR at the administrative boundary with Kosovo is at a high level. The overall poor situation at border points is due to obsolete equipment, lack of proper training and unclear division of competencies. There have been several successful but small-scale actions in combating illegal trafficking.

The SRSB retains full authority in matters pertaining to law enforcement in Kosovo and KFOR has agreed a strategy for the transition of security tasks to UNMiK (e.g. checkpoints

on the administrative boundary line). A strong multi-ethnic Kosovo Police Service (KPS) has been established, outnumbering the international civilian police force, and will receive further powers in due courses. The deployment of ethnic Serb KPS officers began in December 2002 after UNMiK's moves to dismantle parallel institutions in Mitrovica and northern Kosovo. Multiethnic KPS patrols will now gradually take-over policing functions from international officers. UNMiK made increased efforts to apprehend suspects in 2002, including former KLA members alleged to have committed serious crimes during and immediately after the 1999 conflict, with several arrests since summer 2002. Following public reactions and protests to the arrests, and the attempts to arrest Milan Ivanovic, there was strong international support for UNMiK and KFOR assertions that the arrests were not political in nature and, eventually, calls from local political leaders to support the judicial process.

Prison system: Both Serbian and Montenegrin authorities have made commendable efforts towards improving conditions in prisons. The Serbian judiciary has begun to tackle cases of police torture in prisons. The Serbian Helsinki Committee for Human Rights is implementing the first regular Prison Reform Monitoring project, under the authorisation of the Serbian Justice Ministry. There is also improvement in Montenegro, but with occasional cases of discrimination towards victims of police torture and favouritism toward the police officers involved. Generally, there has been an increased level of international co-operation in prison reform (a regional inter-ministerial conference took place in Montenegro in December). In Montenegro, the physical conditions in prisons are somewhat better but still not satisfactory. A permanent Centre for Education of Penitentiary Personnel was established.

Respect for rule of law: Whereas the rule of law is enshrined in the Constitutions, problems persist with lack of implementation and awareness and glaring examples of lack of law enforcement. The prevailing climate of legal uncertainty, due to the regrettable non-respect for the hierarchy of norms, is complicated by unresolved constitutional and political problems. This results in the parallel existence of obsolete and newly adopted acts, lack of harmonisation in legislation and policies between different levels, and unclear distribution of competencies. The Federal Constitutional Court, denied by Montenegro, could not examine the constitutionality of Montenegrin legislation, although large parts of these statutes passed since 1997 clearly contradict the current constitutional division of competencies. Nor has the Montenegrin Constitutional Court conducted such assessment, even where the legislation is also partly in contradiction with the Montenegrin Constitution. There have been important efforts by the constitutional courts to resume some of their powers, but this has in practice been undermined by the lack of enforcement and attempts to exert political pressure. The Serbian Constitutional Court eventually became operational in June and has already demonstrated commitment to independence and refusal of political interference. Pre-election political deals in Montenegro in September affected the appointment of new members of the Republican Constitutional Court. The inherited problem of low legal awareness, the failure to remove political appointees, the legacy of the non-respect of judicial independence was reflected in further attempts by the executive to interfere in the functioning of the judiciary. Some members of the judiciary showed serious professional commitment and independence, but the maintenance of law and order suffers from the lack of co-operation between different services. The position of the military courts should be corrected with the transfer, under the Constitutional Charter, of their jurisdiction to regular courts, but this must be done in such a way as to ensure unified enforcement of rulings throughout the territory of the State Union. In light of the wide powers given to organisations which have not been adequately reformed, the state of emergency introduced in Serbia on 12 March should be as limited as possible.

Increased respect for the rule of law is needed in Kosovo, as evidenced by the failure of Kosovo Albanian politicians to respect the Constitutional Framework e.g. their challenges to UNMiK authority and the Assembly's ultra vires actions and their failure to adequately support the rule of law during the arrests of KLA and other suspects. The action of a part of KFOR in removing a suspect from the jurisdiction of the Kosovo courts, and the relevant state's failure to reply to UNMIK's indictment, is surprising.

Anti-corruption: The presence of corrupt structures from the previous regime, at all levels, has continued to obstruct reforms and has been instrumental to implementing anti-corruption commitments (delay in strategies and legislation, proliferation of institutions lacking clear mandates / enforcement capacities). The perception of the lack of political will was enhanced by non-transparency concerning potentially conflicting posts (e.g. in state companies) held by members of governments and by some judicial decisions. The Serbian government was especially criticised for its undermining attitude towards the Anti-Corruption Council and its initiatives (resulting in the resignation of its Head). Changes are also being prepared to the Montenegrin Law on Financing Political Parties, which is more satisfactory than the Serbian one. Nonetheless, corruption remains a serious problem in Montenegro, where the Government has again committed to rapidly adopt outstanding measures and establish relevant institutions.

2.2. Human rights and protection of minorities

Although problems persist progress has continued on human rights and fundamental freedoms⁵, both in terms of legislation and implementation. This should be further improved, throughout the entire country, not only for future accession to the Council of Europe.

The good record in this area (e.g. progress in Southern Serbia) is in excellent contrast to the heavy burden of human rights violations in the past. Progress is clear especially in the area of minority rights, with the new, highly praised Federal Act. This, however, has yet to be followed by adoption of implementing legislation, most of which falls under republican competencies. To ensure human and minority rights protection in the future State Union, clear safeguards and instruments must be provided for full enforcement of international standards, which the state, as a signatory, must guarantee. Particularly as regards the still-outstanding establishment of the Ombudsman, clear division of competencies and co-ordination between the different levels must be ensured. The constitutional stalemate held hostage further progress in this field.

Since the universal value of the principles in the European Convention of Human Rights and Fundamental Freedoms goes beyond pure contractual obligations, implementation of its standards should not wait for accession to the Council of Europe. Some significant steps forward have already been made (e.g. abolition of the death penalty), and the launch of domestic trials for war crimes, although these are still rare and have been taking place in a volatile environment, without adequate judicial training. The legal system has a variety of anti-discrimination provisions, but these are dispersed across different laws at all levels. Some of the inherited legislation from the previous period is discriminatory in content. The text of an Anti-discrimination Act has been prepared, but its adoption is contingent on the new constitutional division of powers. In practice, although important improvements have been

⁵ The effect of the state of emergency declared on 12 March in Serbia has not been taken into account.

made, problems remain in representation of women or minorities (especially Roma) in public life. In addition to legislative reform, a public awareness campaign is needed.

Not all laws in Kosovo are yet in compliance with the European Convention on Human Rights and Fundamental Freedoms (ECHR), which binds the PISG under the Constitutional Framework. Sustained monitoring and implementation efforts are therefore required by UNMiK and the PISG. A Human Rights Oversight Committee was formed to ensure that laws and processes comply with these standards. Improvement is required in the protection of the right to life and security. The Omnibus Anti-Discrimination Law should be adopted.

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

Freedom of expression: In this field, one of the key barometers of democracy, the removal of all impediments to free operation of media outlets has still not taken place. Previous recommendations remain unfulfilled. Although constitutionally guaranteed, media freedom is still hindered by Criminal Code provisions on slander and libel and their actual implementation, with cases in both Serbia and Montenegro. While some Serbian media understand their role, and also cover sensitive issues such as war crimes or minorities, the state does not clearly understand its role in relation to independent media in an open society. Political interference continues in Serbia, with several cases of direct pressure and intimidation by some leaders of the ruling coalition (mostly on local media). There is a wide perception of unequal treatment of media in terms of access to public information and protection of information sources – the Law on Free Access to Information is still not in place. Allegations persist of favouritism towards electronic media that were close to the previous regime. In Serbia, the significant delay in adopting new media legislation negatively affects both print and electronic media. The Broadcasting Act was eventually adopted in July, but in a contested procedure and the legal deadline for the establishment of the independent regulatory body was then not respected. Complete implementation is in any case blocked by delays in adoption of the Telecommunications Law, which should not be linked. Meanwhile, the transformation of the state broadcasting company (with EC support) is progressing, but slowly. The Public Information Act is still pending and has drawn criticism from experts (for being too detailed, going beyond the usual standards of government intervention). There has also been no progress in the investigation of the murders of journalists Slavko Curuvija and Milan Pantic (the latter assassinated *after* October 2000). In Montenegro, the media remains divided on the independence issue and operate under political interference. There was a glaring case in summer 2002 of pre-election political bargaining over media legislation - on which Montenegrin experts had worked, with EC and Council of Europe support, for 11 months. These laws (the implementation of which was initially to be delayed until May 2003 i.e. *after* all expected elections) are now in force and are compatible with international standards, although international organisations have reservations as to the authorities' enforcement capacity. There are also questions about understanding of the provisions designed to prevent government interference, as evidenced by the rushed introduction of Media Councils, an attempt to remove editors installed under the previous government.

Media legislation in Kosovo requires further development and alignment with the EU's media standards and best practices and those in the rest of the region - media continue to publish ethnically biased material and misrepresent facts. The establishment of the Independent Media Commission is still pending due to donors' divergent views on advertising. Private media development continues, also at regional level. Important initiatives include co-ordination and training exchanges and workshops, mainly for Kosovo Serbs and Roma, with

the Belgrade-based Association of Independent Electronic Media (ANEM) and *Danas*. A Freedom of Information Act and a civil Law on Defamation are still lacking.

Constitutional appeal and Ombudsman: The right to constitutional appeal is guaranteed – though in an unclear and potentially restrictive manner - in the Federal and Montenegrin, but not in the Serbian Constitution. Efforts have been made to reduce the politicisation of the Federal Constitutional Court, but they have met with obstruction and political pressure (e.g. the case of the takeover of the DSS seats). Constitutional delay has put on hold the draft federal bill on an Ombudsperson and the Republics are at an advanced stage of preparing their own separate legislation, as has Vojvodina. It is essential that the division of competencies in the future State Union, where protection of human and minority rights will be a state competence, provide for co-ordinated implementation of the legal texts, and most importantly, uniform and efficient protection of citizen's rights. Guarantees must be provided by the state, as the signatory to international human rights instruments.

Access to court and fair trial: The new Federal Criminal Procedure Code came into force in March 2002. Drafted with Council of Europe expertise, it provides important human rights safeguards, but its implementation has already encountered difficulties. Refused completely by Montenegro, even in Serbia full enforcement is prevented by lack of prior training of the relevant services, insufficient funding of new mechanisms (e.g. witness protection), and uncoordinated adoption of accompanying legislation (e.g. the Law on Internal Affairs). In addition, there seems to be an uncooperative attitude on the side of law enforcement agencies.

In Kosovo, as OSCE has reported, KFOR's detention of suspects without charge and failing to bring them promptly before the courts is a breach of the principle of *habeas corpus* and the right of access to court and fair trial. Access to detainees in Pristina prison is also insufficient.

Death penalty: In line with previous recommendations and obligations under the Second Optional Protocol of the UN Covenant on Civil and Political Rights and the recommendations in previous SAp Reports and the CTF, the death penalty has now been abolished throughout the state in a highly welcome move and replaced by terms of 40-year imprisonment. Commutation of sentences which have not been executed or are subject to appeal, is expected.

Freedom of association: There has been little progress on federal and Serbian levels in revising obsolete legislation regulating freedom of association. The federal draft on foreign foundations is still on hold, pending the new Constitution. NGO opposition to the flawed Serbian draft law on NGOs finally resulted in its withdrawal. The obsolete Serbian Law on Citizens Associations (1982) is being examined by the Republican Constitutional Court. A new bill on political associations was drafted in Serbia, envisaging stricter criteria for registration (to reduce the number of registered, but non-existing parties). By contrast, the legal status of NGOs in Montenegro is generally seen as satisfactory.

Other: Conditions have certainly improved since October 2000, but sporadic cases of **torture** in custody and prisons still occur. The courts are trying to address this. First encouraging steps were made (sentencing of police officers), but much remains to be done in terms of raising human rights awareness of the law enforcement agencies. FRY applied (April 2002) for accession to the European Convention for the Prevention of Torture. Major progress was made in March with the transfer of all Albanian **detainees** from Serbian prisons to UNMIK. In addition, as part of the stabilisation of the situation in Southern Serbia, the Federal

Amnesty Act (June) granted amnesty to former members of the Liberation Army of Presevo, Bujanovac and Medvedja, charged with or sentenced for terrorism. While important progress has been made in launching domestic trials for **war crimes**, other trials have not yet begun, investigations into several mass graves identified in Serbia have been put on hold and the Truth and Reconciliation Commission has not held hearings on the subject, raising doubts as to the real commitment of the authorities to tackle the issue of past human rights violations. Investigations throughout the state into disappearances and killings made little progress.

Labour rights: While these are in general well regulated, implementation often falls short, with illegal practices from the past still in force (especially in large private companies). Trade unions are weak and remain politicised. Some basic workers' rights (working conditions, health care, holidays etc) are not respected. Although there are no legal restrictions, trade unions and professional associations do not exist or function in all companies. This, together with inert labour inspections, creates an overall climate of legal uncertainty for employees.

Property rights: Although discriminatory regulations from the previous period were repealed, some issues remain in relation to property rights in both Serbia and Montenegro. The launch of the privatisation process, without prior resolution of restitution claims, has already created major problems and generated numerous claims for return of confiscated property. The Serbian Government has made limited efforts to tackle the problem. The bill on restitution of property to churches and religious communities has been finalised. A comprehensive restitution act is also in preparation, but its implementation is likely to meet financial difficulties. The Montenegrin Parliament adopted a Restitution Act in June (proposed by an NGO), currently challenged before the Republican Constitutional Court, in a case lodged, on a procedural point, by the government.

Establishing clear ownership of residential and commercial property is one of the SRSG's benchmarks in Kosovo. The Housing and Property Directorate has been brought under UNMiK control and has drafted an ambitious three-year action plan to resolve claims. Widespread violation of fundamental property rights, including illegal occupancy of residential property and illegal seizure and use of commercial property, continues and hinders returns and economic growth. Discussions with Belgrade on the transfer of cadastral records are key also for the privatisation process, as is the enactment of the land use regulations.

Academic freedom: Education reform is important, with particular emphasis on the need to reform history teaching and to inform the population about crimes committed by the previous regime. Work on revising school textbooks has continued, but comprehensive revision of curricula is not yet implemented. Although the new Serbian University Law was adopted in April, to fill the gap created after repeal of a former restrictive Act, the necessary comprehensive reform is still only under preparation. A Council for the Development of University Education was established in October. The outstanding issue of removal of personnel (appointed by the previous regime after the adoption of the restrictive 1998 University Act) has resurfaced in Serbia, but still lacks a consensual approach or solution. Greater implementation of education reforms, at all levels, is also required in Montenegro.

Religious freedoms: Religious freedom is constitutionally guaranteed throughout the state. However, there are differences of opinion as to whether the Serbian law, introducing optional religious classes in state schools, is a violation of the principle of separation of church and state, and an appeal against the law remains before the Federal Constitutional Court. The Federal Bill on Religious Freedoms, regulating the status of religious communities, is still in

parliamentary procedure, but some of its provisions are seen as restrictive and discriminatory (e.g. registration criteria). A draft Serbian Law on Restitution of Church Property has been prepared. In practice, respect for the right of conscientious objection has improved, but there are concerns that the Army management does not fully understand the principle so problems with implementation persist.

In Kosovo, religious freedom is ensured in the Constitutional Framework though the practice requires serious improvement. Isolated extremist incidents of destruction have continued, though condemned by political and religious authorities and reconstruction funding will come from a reserved fund under SRSG control.

Equality: The Federal Parliament ratified the Optional Protocol to the Convention of Elimination of all Forms of Discrimination against Women (CEDAW) in December. Although there are no legal restrictions, the representation of women at higher levels of politics, administration and business is still very low. Some improvements have been made recently (e.g. on composition of local electoral lists, NGO training of municipal administrations, an inter-ministerial body for gender equality in the Serbian Government). Montenegrin NGOs also sought increased equality in the republican administration. The scale of the problem of domestic violence is high throughout the state, but so far it has been marginalised due to a patriarchal society and lack of awareness on the part of law enforcement agencies. Recent changes in the Montenegrin Criminal Code introduced wider protection from domestic violence.

2.2.2. Minority rights and refugees

Rising above the negative legacy of the past, there have been real improvements towards re-integration of ethnic communities, at the federal level in particular. Although some problems persist (e.g. sporadic discrimination against some ethnic groups), the authorities have continued to demonstrate a strong reform commitment. Major legislative changes were introduced by the new Federal Law on Protection of Minorities, which established a comprehensive set of individual and collective rights, including protection instruments. National Councils, institutions of minority self-governance, are being established under this law. In addition, the Federal Ministry for Ethnic Minorities initiated a broad campaign on tolerance, which has been very well received. A National Strategy for Roma integration has been worked out, in co-operation with OSCE and UNHCR. A comprehensive review of school curricula has been conducted, and minorities will, in future, have a say. The Federal Ministry established very good co-operation with local NGOs, which have been instrumental in the implementation of many activities. Although the situation on the ground still remains volatile, fragile progress has been achieved in South Serbia: the first multi-ethnic elections in the last decade were held in July, the multi-ethnic police project trained almost 300 police officers, an Amnesty Act was passed in the Federal Parliament, and the first Albanian-language broadcasts.

In September 2002, FRY submitted its first report on compliance with the Council of Europe Framework Convention on the Protection of Minorities. Preparations are underway for the state to join the European Charter on Regional and Minority Languages. Meanwhile, the Federal Ministry has negotiated bilateral agreements with several neighbouring countries (the former Yugoslav Republic of Macedonia and Croatia), and signed with Romania and Hungary. For political reasons, Montenegro still does not implement the federal law. Despite recent set-backs, affirmative action has been taken concerning Albanians, allocating

parliamentary seats. However, it is worrying that none of the implementing acts has been adopted, except the Law on the Use of National Symbols. In addition, dialogue with the Albanian community to address its dissatisfaction with the implementation of certain rights has been slow. Positive discrimination so far does not apply to other communities in Montenegro, such as Bosniaks and Roma.

There has been obvious progress but problems persist throughout the state. Discrimination is still present especially against Roma. Hate speech occurs sporadically and, worryingly, involves prominent politicians or officials. In addition to the commendable efforts of the proactive Federal Ministry, there is a network of NGOs and some private media who are playing a very important role in improving the position of minorities and raising public awareness.

Minorities in Kosovo still face serious problems. Condemnation of violent incidents is largely limited to the Prime Minister's office, where there is a Kosovo Serb Inter-Ministerial coordinator for returns. Minority representation in the Kosovo civil service is required by law but estimates are that it has not yet met the targets set by the SRSG. There is inadequate provision of media or municipal services in minority languages. Following UNMiK's assessment in November that members of ethnic minorities in the Kosovo Assembly are sometimes prevented from fulfilling their functions in line with the regulations of the Assembly, SRSG Steiner requested that OSCE monitor the working of the Assembly.

The high number of **refugees and IDPs** in the state (approximately 350,000 refugees and 230,000 IDPs) continues to pose a serious economic and social problem. There are still around 500 collective centres, housing more than 21,000 refugees and almost 14,000 IDPs. The existing Law on Refugees, adopted in 1992, still has not been aligned (e.g. definition and cessation of refugee status, abolition of military service for refugees) with the Geneva Convention on Refugees. The authorities have made efforts to provide solutions (working on both the integration and the repatriation options), but these require substantial financial resources which are scarce. The Serbian government adopted a "National Strategy for Resolving the Problems of Refugees and Displaced Persons" in May 2002, focussing on return or local integration of refugees from Croatia and Bosnia, according to their choice. The status of IDPs has, however, not yet been regulated. There has only recently been progress in implementing the Regional Principles of Return adopted by FRY, Croatia and BiH, as the Croatian authorities made efforts to resolve the problem of tenancy rights for Croatian Serbs. In contrast, the Agreement on Dual Citizenship signed with BiH in October generated mixed reactions in BiH. Earlier changes to the FRY citizenship Law allowing for dual citizenship have resulted in approximately 152,000 people being granted FRY citizenship.

In Kosovo, ensuring sustainable returns and integration is one of the SRSG's benchmarks and a high priority for 2003. Progress is still slow, but returns are beginning in areas of mixed ethnicity and now outnumber departures. Security incidents have, despite some disgraceful incidents, reduced and PM Rexhepi and the PISG have made statements in support of returns and tolerance. In order to obtain donor support, the UNMiK Strategy on Returns presented at the Donor Co-ordination Meeting in November 2002 requires further work and dialogue with Belgrade which is presently working on its own separate strategy.

2.3. Regional co-operation

The state continues to make progress in regional relations, although with sporadic setbacks, e.g. the Danube border incident with Croatia in July and President Kostunica's ill-considered

statements about Republika Srpska. Intensive political dialogue (e.g. the FRY/Croatia/Bosnia and Herzegovina Trilateral Summit in July, or the FRY/Bulgaria/Romania Trilateral meeting of Foreign Ministers in September) has been accompanied by the signing of important agreements (regulating dual citizenship, fight against organised crime, etc). While some border demarcation issues with the former Yugoslav Republic of Macedonia and Croatia have been formally resolved, outstanding issues remain with Croatia and with BiH. The state has made some progress in regional trade liberalisation but the lack of a single trade policy is an obstacle here too.

2.3.1. Multilateral relations

Progress in complying with its international obligations has been mixed. While there were positive developments with regard to the International Criminal Court, and in co-operating with UNMiK on the transfer of remaining Kosovo Albanian detainees from prisons in Serbia, co-operation with the International Criminal Tribunal for former Yugoslavia (ICTY) and in dismantling parallel political, judicial and financial structures in northern Kosovo was less forthcoming until the reassertion of UNMIK authority in Mitrovica in November. Similarly, the overall positive situation regarding the Dayton / Paris Agreement, ratified in the Federal Parliament in December, was overshadowed by statements by the state President and by revelations about arms sales to Iraq by structures from both FRY and Republika Srpska. The constitutional stalemate and the lack of co-operation with ICTY has adversely affected accession to the Council of Europe and Partnership for Peace.

Despite statements in bilateral contacts and during CTF meetings and a recommendation in the 2002 SAP Report, the overall state of co-operation with the **International Criminal Tribunal for Former Yugoslavia (ICTY)** remains slow, reluctant and insufficient. It remains a serious problem affecting the country's international position and accession to international organisations. Given the links between those responsible for organised and other crimes, the domestic need to tackle this quickly is evident. It remains to be seen whether the new impetus will deliver results.

ICTY has repeatedly criticised the authorities for selective or non co-operation. A strong negative message was given by the ICTY President in a formal report to the UN Security Council in October. Problems include the handover of indictees and access to archives, particularly military. Although there was initially some limited progress following the adoption of the Law on Co-operation (adopted, after protracted debate, in April), there has been no real follow-up. The Law itself contains a controversial provision (Art. 39), heavily criticised both domestically and by ICTY for violating international law, which stipulates that it only applies to persons indicted before the Law came into force (now being challenged before the Federal Constitutional Court by a group of NGOs). So far, only six persons were handed over or surrendered voluntarily, with 16 unserved indictments which the authorities claim cannot be processed due to the unknown whereabouts of indictees, although these persons continue to collect state pensions. The handover of the former Serbian President, finally took place in January 2003. A National Council for Co-operation with ICTY was established in April, headed by FM Svilanovic, but without Montenegrin representatives who refused to take part, to process ICTY requests for access to archives. In practice, however, there is reluctance to provide information which might also be used in the ongoing ICJ cases by Bosnia and Herzegovina and Croatia, and obstruction by the military, even in the cases

concerning crimes against Serbs. Some documents have even been destroyed. Moreover, reports on co-operation coming from different sources (such as the National Council – a political body, and the Federal Justice Ministry - technically in charge of co-operation) often contradict each other. Problems are also reported concerning witnesses, with threats of prosecution and with difficulties in granting even partial waivers, thus adversely affecting testimony. There is little credibility to the authorities' public claim that Mladic is no longer on their territory or that the whereabouts of other military officers are unknown, since the same authorities have repeatedly privately conceded that they *had* previously been present and protected, at times this has been publicly denied. Co-operation by republican structures is no longer direct since the centralisation of policy, since April 2002, in the National Council for Co-operation, which has slowed down the process. While the investigation of mass graves in Serbia was frozen in 2002, some fragile efforts are now underway, including on domestic war crimes trials, which must be supported by political backing. In February 2003, KFOR arrested three of the four indicted in relation to the 1999 conflict and its aftermath.

In contrast to the continuing difficulties in co-operation with ICTY, the state made important progress in respect to the compliance with the Rome Statute of the **International Criminal Court** (ratified in June 2001). In September 2002, FRY was appointed a member of the Board of the Assembly of the States-parties to the Statute. A draft Law on Co-operation with ICC has been drafted in the Federal Justice Ministry and the Federal Parliament is debating changes to the Federal Criminal Code, i.e. to provisions on crimes against international humanitarian law and human rights abuses. Although most of these changes go in the right direction, some definitions need further elaboration (e.g. the notion of command responsibility) in order to be fully in compliance with the Rome Statute. Also, some of the conditions for handovers, stipulated in the new Federal Criminal Procedure Code, seem not to be fully in accordance with the obligations under the Rome Statute. The state also resisted a US proposal on a bilateral agreement seeking immunity for its forces and personnel.

The major breakthrough achieved in November 2001 with the signing of FRY-UNMIK Common Document has been followed by significant improvements in co-operation between FRY and UNMIK, in line with UN Security Council **Resolution 1244**. UNMIK activities continued in line with the SRSG's benchmarks (which the UN Security Council endorsed in April), stipulating the conditions to be fulfilled before discussion on the future status of Kosovo could start. In spite of the limited progress on missing persons and the lack of conditions for safe return of Serbs and other non-Albanians, there has been continuous dialogue with UNMIK and implementation of practical steps in the High Level Working Group and its sub-committees e.g. an important protocol on police co-operation, railways, recruitment of Kosovo Serb judges into the Kosovo justice system, cross-boundary vehicle insurance recognition and discussion on other issues such as cadastral records. The welcome transfer of remaining Kosovo Albanian detainees from prisons in Serbia to UNMIK (March 2002) was most welcome. Despite UNSCR 1244 and EU recommendations, parallel structures continued in the northern part of Kosovo (including in education, health, public utilities etc.). The implementation of the Protocol on participation of Serbian judges and prosecutors in the Kosovo judiciary should lead to the dismantling of parallel judicial structures in northern Kosovo. An important step towards dismantling parallel institutions was finally taken by UNMiK in occupying key buildings in Mitrovica and moving the KTA headquarters to the north of Mitrovica (November). The state and UNMIK have, however, expressed different views on the scope of planned decentralisation, and the mentioning of Kosovo (and Vojvodina) as autonomous provinces of Serbia in the state-level Constitutional Charter generated fierce debate in Kosovo with a clear reaction by the SRSG stressing the UN

mandate for Kosovo. In recent months, there have been deliberate attempts by Serbian and Kosovan politicians to politicise and radicalise the situation - including the creation of a Union of Serb municipalities, and attempts by the Assembly to pass independence resolutions, all in contradiction of UNSCR 1244. Constructive co-operation between the Yugoslav Security Forces and KFOR at the administrative boundary continues. In addition, the Federal Government passed a Decree on the administrative boundary (July), setting the conditions and border points (on the Serbian side) for legal crossings. In line with the earlier Border Agreement between the state and the former Yugoslav Republic of Macedonia, UNMIK and the former Yugoslav Republic of Macedonia agreed (March 2002) on border co-operation (despite ultra vires protests by the Kosovo Provisional Assembly, dismissed by the SRSG and the UNSC). After initial difficulties, the Serbian community did take part in the Provisional Kosovo Government and the work of the Assembly. However, the low turnout in local elections (26 October), coupled with the majority vote for the radical option (Seselj) in the Serbian presidential elections, indicates that the level of mistrust towards the international administration but also towards the democratic authorities in Belgrade is still high.

Although the results of a comprehensive investigation are still pending, the first indications of the state's, and RS, exports to Iraq are that there have been breaches of the relevant **UN Security Council Resolutions**. The welcome co-operative attitude of the authorities should continue and include action against those involved.

Important progress has been made in several areas pertinent to the **Council of Europe** criteria (e.g. on protection of minorities, abolition of death penalty and reform of the criminal procedure, *cf. supra*), but the constitutional stalemate delayed accession (November). Although this remains the only formal condition for accession, debate in the CoE has also reflected serious dissatisfaction as to co-operation with ICTY. This problem, together with the need for full compliance with the Dayton Agreement and comprehensive military reform, has affected accession to the **Partnership for Peace**, which is still not on the agenda despite improvements in contacts with NATO.

On 28 March the state assumed the chairmanship of the South-East Europe Co-operation Process (**SEECP**), and chaired the June Ministerial meeting in Belgrade. The state has taken a very proactive approach and initiated the institutionalisation of the process, the largest regional initiative driven by the region itself. Two major conferences, on trade and telecommunications (October) were held, both with Commission participation. The state also participates intensively in the **Stability Pact** for South-Eastern Europe, under which several conferences were held in Belgrade and the regional Clearinghouse for the Control of Small Arms and Light Weapons was opened in Belgrade, and in **other regional initiatives** e.g. the Central European Initiative, the Adriatic and Ionian Initiative and the Danube Commission. The state has applied to join the Black Sea Economic Co-operation and been appointed a member of the **UNHCR** Executive Committee. The state has also submitted its bid for accession to the **WTO**. After initial delays due to the constitutional stalemate, the first discussions have started. Once again, the lack of a single trade regime remains a fundamental obstacle to progress (*cf. infra 3 and 4*).

UNMIK continues to develop ties with Belgrade and neighbouring governments, particularly Skopje and Tirana, and to participate constructively in appropriate regional initiatives e.g. the SRSG's guest status at the meeting of SEECP Foreign Ministers in Belgrade in June, UNMIK's hosting of a regional conference on cigarette-smuggling in May and various Stability Pact initiatives.

2.3.2. *Bilateral relations*

Bilateral economic relations continued to improve in 2002. The end-2002 deadline for implementation of the June 2001 Memorandum of Understanding on Trade Liberalisation and Facilitation in the framework of the Stability Pact, played a major role. In line with the MoU and with the recommendation in the 2002 SAP Report, the state has finalised all the necessary bilateral negotiations. There is, however, a major obstacle to implementation due to Montenegro's current refusal to accept a single state-level trade policy (*cf.* 4.2.1.).

Relations with **Albania** are generally good. Diplomatic relations have been raised to ambassadorial level (November 2002) and various agreements signed or negotiated (including on mutual protection of investments and avoiding double taxation). The FTA which has been negotiated should provide a good institutional base to boost commercial links though trade flows remain low. The Albanian authorities acted constructively in relation to the ultra vires declarations by the Kosovo provisional Assembly on trade issues and on the FRY- border with the former Yugoslav Republic of Macedonia. UNMiK signed a Memorandum of Understanding on economic co-operation with Albania in July and, in December, a letter of intent to begin FTA negotiations.

There has also been progress in relations with **Bosnia and Herzegovina**, despite the various statements about Republika Srpska made in a personal capacity by state President Kostunica, which provoked strong reactions both by the Bosnian leadership and the international community for undermining the country's sovereignty in contradiction to the Dayton Agreement. In contrast, the state took a very positive official attitude to the elections in Bosnia and Herzegovina, encouraging participation. The border demarcation issue is still not resolved, and the ICJ is proceeding with BiH's genocide case against the state, but progress is being made and there is continuous political dialogue, both bilaterally through the Inter-State Co-operation Council and its sub-committees, and in the SEECP framework. Six agreements have been signed and sixteen are awaiting signature: agreements have been signed on dual citizenship, travel documents, pensions, social and health care, agreements which should help to resolve some of the problems still faced by a large number of Bosnian refugees in the state regarding their status in Bosnia. Air traffic between Belgrade and Sarajevo recommenced in July. In December, the Federal Parliament ratified the Dayton Agreement. The Federal Government had previously agreed to end all direct financial aid to the Army of Republika Srpska (VRS) as of March 2002, although pension payments are still made (including to several ICTY indictees such as Mladic) due to the ambiguous legal status of VJ/VRS personnel acting in Bosnia. However, the recent affair concerning weapons sales to Iraq, involving companies from *both* the state of Serbia and Montenegro and from RS, again raised concerns about VJ - VRS relations. The implementation of the FTA with Bosnia and Herzegovina began in June, but is currently stalled due to the Montenegrin refusal to apply it. Since trade between the two states is already high compared with the rest of the region (though mainly with RS), the potential economic damage from this refusal is serious.

Relations with **Croatia** continue to move forward, though slowly. The issue of border demarcation persists (with a border incident on the Danube in July) but negotiations on Prevlaka have been completed and the UN Observer Mission (UNMOP) withdrawn. Political dialogue has continued, with regular working-level contacts, a meeting between Ministers of Interior (May) and a first official visit by the Croatian Foreign Minister in April. The meeting between FRY and Croatian Presidents in May (the first of its kind since the war) resulted in a Joint Statement re-iterating the need for an overall normalisation of relations and the eventual

abolition of visas. The two countries have now signed 5 agreements and are negotiating 7 more: a readmission agreement (signed in April), agreement on co-operation in fighting organised crime (May), Croatian Parliament ratified the agreement on social and pension issues (April) and an agreement on minorities is being negotiated though this will require a resolution of the refugee return issue. In May, print media began to be distributed in Croatia - Croatian press were already available in the state. An FTA has been signed in December 2002. Belgrade's commitment has not always been matched by Croatia - the agreement between the FRY and Croatian Ministers of Interior (May) to replace visas with tourist passes during the summer period and thus facilitate the flow of people was implemented by the state although Croatia only approved a shorter issuing procedure and the possibility of multiple business visas. The Croatian authorities have begun to implement the Regional Principles on Return of Refugees, signed under OSCE auspices but in a delayed and restrictive manner. The ICJ case continues.

There are no outstanding issues in relations with **the former Yugoslav Republic of Macedonia**. Remaining problems in the implementation of the Border Demarcation Agreement (reached in February, with a tripartite Protocol with Bulgaria signed in August) have been overcome although demarcation depends on security considerations and pragmatism. Five agreements have been signed, including on social security and environmental protection and an agreement on mutual legal assistance in civil and criminal matters is under negotiation. An FTA has been in force since 1996 without major issues for Serbia and Montenegro. Several rounds of talks aimed at "fine tuning" the agreement were held between Belgrade and Skopje. A particular problem is related to the Serbian Government decree, violating the FTA, to forbid free transit/import of oil and oil derivatives aimed at preventing smuggling on its territory, as a consequence of which road transport of oil between Croatia and the former Yugoslav Republic of Macedonia is also prohibited. The abuse of origin certificates (e.g. for bananas and sea salt) have caused problems for UNMIK, as has the failure by Skopje to respect the FTA's application, i.e. UNMIK origin certificates, for exports from Kosovo.

Significant progress has also been achieved in relations with other countries in the region. The **Slovenian** Prime Minister visited in June and a set of agreements was signed, including on telecommunications, tourism and investments (13 signed, 5 under preparation). An FTA was initialled in September, but not yet signed. This FTA is not an MoU obligation and will (as for Hungary) in any case cease to be effective upon accession to the EU. Regular air traffic between Belgrade and Ljubljana resumed in December. An Agreement on Minorities was signed with **Romania** on 4 November and negotiations on an FTA have been concluded, as with **Bulgaria**). There has been continuous progress in relations with **Hungary**, with an FTA (asymmetric in favour of the state) in force from July, a readmission agreement, and an agreement on co-operation in fighting organised crime. There have been no negative developments concerning the implementation of the Hungarian Status Law. Hungary has already announced the introduction of a visa regime for FRY citizens (in the course of 2003), since the Hungarian border will become an external EU border after accession.

2.4. Priority areas needing attention in the next 12 months

- Constructive co-operation within a **restructured and functional federal state****. Clear political will – to be communicated to all levels of the administration - to implement agreements. Adoption of implementing laws in line with the Constitutional Charter and their rapid implementation. Amendment of the republican Constitutions, by autumn 2003, in line with the Constitutional Charter. As part of this constitutional reform, promised decentralisation and reform of provisional and local government should be, as relevant, adopted and implemented*.
- Immediately upon adoption of laws, effective **implementation** and appropriate **administrative capacity**** Renewal of respect for the rule of law, damaged by the events of recent years.
- Improved functioning of **democratic institutions**, not least to accelerate reform implementation.
- Immediate revision of **electoral** laws and provisions, including media-related, to align with European standards*
- More efficient **parliamentary** procedures and functioning*. Reform of size and efficiency of public administration *. Improvement in administrative capacity at all levels of government*.
- Government and party focus on **reform responsibilities** rather than party political issues.
- Promotion of effective **decentralisation** and participation. Preparation of local government for undertaking greater responsibility: improvement in municipal management; promotion of civil society participation.
- Urgent implementation of **army reform** in line with the proposals by the Geneva-based Centre for the Control of Armed Forces.
- Continued reform of the **judicial and prosecutorial** systems, with particular attention to independence, criteria for appointments, increased specialised staffing of courts, training, procedure, reduced opportunities for political interference, budgetary provisions, enforcement of court judgements**. Implementation of the Federal Criminal Code and transfer of military courts to civilian.
- Firm action against **corrupt** elements within the state system*
- Continued legislative reform and implementation regarding the **security and police** services, reducing their size and transforming them into a public service under clear internal and external control and accountability**, with improved co-ordination between these and other state services, adopting the Council of Europe Police Code of Ethics*. **Prisons** to be urgently brought into line with Council of Europe standards*. Particular attention to young offenders. Demilitarisation of borders to be urgently put into effect*. The principle of conscientious objection must be fully understood and implemented**.
- Real progress in alignment with European (EU and Council of Europe) standards, even before **Council of Europe** accession*. Ratification of the European Convention on Human Rights and Fundamental Freedoms*. Implementation and guarantees of all human rights and fundamental freedoms**. No further delay in putting conditions in place for the full implementation of freedom of expression* or regarding NGO status and aspects of the right of association*. Support the development of the media sector in line with European standards.

* Recommendation included in the 2002 SAP report, basically not implemented

** Recommendation included in the 2002 SAP report, partially implemented

- Action must be taken, by May 2003, in relation to the January 2003 finding, by the UN Committee on **Torture**, in relation to a 1995 pogrom in Montenegro for which no prosecutions or compensation has yet occurred.
- Improvement in the right of access to court and fair trial in Kosovo, with suspects brought rapidly before the judicial authorities. Improved access to detainees in Pristina prison.
- Clarity on the constitutional **distribution of competencies**, particularly on **minorities***. Implementation of the new constitutional arrangements in such a way as to provide for the full respect and protection of minority rights throughout the country, in line with the Council of Europe Framework Convention for the protection of national minorities*. Adoption and implementation of general anti-discrimination legislation. Progress in gender equality. Creation of an **Ombudsman**.
- Legislation in Kosovo should be available in **local languages**.
- Completion and beginning of implementation of **return** strategies
- Resolution of outstanding issues in relation to **property rights*** by mid-2003, including the transfer of cadastral registers relating to Kosovo to UNMiK.
- Resolution of remaining **border demarcation** issues by mid-2003**
- Improved co-operation with **ICTY** in all regards*.
- Full respect and implementation of **UNSCR 1244**** and further development of co-operation between Belgrade and Pristina (UNMiK and PISG)*. Full and immediate dismantling of **parallel Serbian institutions** and jurisdictions in Kosovo**.
- Continued progress in **bilateral and multilateral** political and economic relations.
- Implementation of international agreements, including **FTAs**, already negotiated / signed.

3. ECONOMIC SITUATION

During the first two years of transition, stability-oriented macroeconomic policies have been sustained. Important structural reforms continued, at the same time, in the area of public finance and the real sector. Public expenditure control and tax collection has been strengthened, the first successful privatisation deals have been concluded, and the systematic cleanup of the banking sector has begun. Macroeconomic stability should be further sustained through 2003, and structural reform should be enhanced in order to improve the overall business environment, encourage investment and lay the foundation for export-led growth. The adoption of related legislation should, however, be accelerated. It is crucial that such legislation enhances market functioning and aims at EU compatibility. A second major challenge will be achieving genuine progress in the economic re-integration of Serbia and Montenegro, in the state's own economic interest. There was some movement on the Internal Market and Trade Action Plan during 2002, but a final version has not yet been produced. To be credible, such a plan would need to be followed by rapid implementation most urgently in the area of trade and customs.

After a strong economic rebound fuelled by foreign assistance and advice, the challenge for Kosovo is to implement economic and financial policies to achieve medium-term sustainability. This will entail movement towards sustainable public finances, enhancement of restructuring of public enterprises and the creation of a favourable business environment.

3.1. Current Economic Situation

Two years of stability-oriented macroeconomic policies laid the foundation for a process of continued dis-inflation and a modest increase in the standard of living. In real terms, economic output increased by some 4% (after 5.6% in 2001). Annual inflation fell from

around 40% in Serbia (end-2001) to some 15% by end-2002, i.e. the same level as in Montenegro. Further fiscal streamlining will be needed as the 2002 public sector deficit of some 5% of GDP (excluding Kosovo) is relatively high. The dinar's nominal exchange rate remained stable vis-à-vis the euro, but continued to appreciate in real terms, mainly as a result of price increases in the non-tradable goods sector, partly due to further price adjustments to market levels. In spite of a higher than foreseen trade deficit and the resumption of debt service payments, hard currency reserves increased owing to continued inflows of remittances from abroad, external assistance and foreign direct investment. The sustainability of the state's balance of payments situation has improved with the adoption in May 2002 of a three-year IMF programme until 2005.

In 2002, **growth performance** in the state as a whole was sustained with an increase in real GDP of some 4% in 2002. Montenegro saw a growth of around 2% and Kosovo of up to 9% in real terms. In Serbia, 4% real growth was mainly driven by a strong service sector (10-20%), especially transport, and a 1.7% increase in industrial production, while agricultural output decreased by 5% compared to 2001. Ad-hoc survey data and anecdotal evidence suggest that economic expansion may have been higher in the rapidly emerging private sector that is not covered by official statistics which only include data for large and/or state-owned firms. This makes working with these data increasingly problematic⁶. Economic growth in Montenegro was lower than expected and the increase in industrial output (0.5%) considerably lower than in Serbia. Kosovo shows promising signs of economic growth in the SME sector, albeit mainly in trade and services.

The process of dis-inflation in the state continued. In Serbia, end-of-period retail **inflation** continued to decline from 40% (end-2001) to below 15% (2002). This reduction, well below the policy target for 2002 of 20%, was achieved despite a 50% upward adjustment of electricity prices thanks to the continuation of stability-oriented monetary policies. Montenegro's end-of-year inflation rate reportedly declined from 24% in 2001 to 10% in 2002, in line with the government's policy target. According to the Montenegrin authorities, inflation was mainly driven by further price liberalisation undertaken in the course of 2002. The 2003 tourism season will be an important challenge. In Kosovo, annual inflation was estimated at 6.5% with rapid deceleration towards the end of the year.

Wage developments in Serbia have clearly contributed to macro-economic stability. In spite of inflationary pressures, real wages and living standards have seen a modest increase since the reforms started. According to official statistics, nominal wages reached the equivalent of € 150 in June 2002, compared to € 60 in November 2000. In Montenegro, where the labour market is more directly influenced by government policies, notably by the officially-set minimum wage, real wages did not change over the last two years. In Kosovo, average public sector net wages essentially stagnated or even fell since 2001 (data for the enterprise sector are not available).

Unemployment persists as a structural problem, but official data are incomplete: officially between 25% in Serbia and 30% in Montenegro, it may in fact be considerably lower. The same phenomenon exists in Kosovo. Survey data for Serbia suggest levels of 15% if the non-

⁶ Official statistics are based on data from large state-owned companies. Economic activity is, however, increasingly taking place in the private sector, i.e. in small and medium sized enterprises, not covered by official data, so official data are increasingly losing value for economic analysis (at sector level they even seem useless). With assistance from the EUROSTAT, a modernisation programme is being implemented, which should enable the production of meaningful statistics again within three years provided this is retained at state-level.

measured official economy and the grey economy are included. **Poverty** has risen dramatically in the FRY during the 1990s when GDP per capita fell by 50-60%. In Serbia, with refugees and IDPs estimated around 600,000, one third of the population live in relative poverty (less than € 30 per month per person), and almost a fifth are estimated to live in absolute poverty (less than € 20). In Montenegro, a large segment of population is also affected by poverty (with 27% living below the relative poverty line of € 45 per month per person). A quarter of households spent more than 60% of their resources on food. Poverty remains a very serious issue in Kosovo.

Fiscal performance: The revised consolidated general government deficit of the state (excluding Kosovo) for 2002 was expected to be in the order of 5.7% of GDP. This deficit was expected to be financed by foreign financing (4.0% of GDP), receipts from privatisation (about 1.2%) and domestic borrowing (0.5%). Recent estimates point to a somewhat lower consolidated deficit of around 4.5-5% of GDP.

Revenue performance in Serbia has been mixed. While tax revenues were reportedly below planned levels (due to lower than projected inflation), budget revenues from privatisation exceeded their target of € 130 million and amounted to some € 190 million in the first ten months. On the expenditure side, some costs were kept below budgeted levels. As there was a surplus on federal and local budgets (both financed from the Serbian budget), this was partly used to increase 2002 spending in Serbia in line with original projections. A Serbian draft budget for 2003 was voted in December and foresees a deficit of around 4% of GDP.

Montenegro remained under fiscal pressure. Lower than expected revenues, in particular in the first half of 2002, necessitated some discretionary spending cuts (including capital spending, subsidies and transfers to the pension fund). The consolidated deficit in 2002 is estimated at 2.5% of GDP of the republic (after 8.1% in 2000 and 5.3% in 2001). The budget for 2003 foresees a substantially higher deficit of above 6% of GDP, reflecting new expenditure burdens in 2003 including transfers to the State Union (some € 40 million of 2.8% of GDP) and the beginning of debt servicing (some €26 million of 1.8% of GDP).

In Kosovo, economic growth, the introduction of modern taxes (e.g. income and profit tax) and the broadening of the tax base contributed to a further increase in domestic revenues: based on the mid-year review, revenue estimates for 2002 were revised upwards by some 16%, totalling € 415 million. Preliminary estimates suggest an even higher outturn. Total consolidated government expenditure are expected to have risen by € 29 million (5.8%) totalling € 536.4 million. As a consequence, the 2002 overall deficit before grants totals € 121.5 million, including one-off capital expenditure related to the use of the accumulated cash balance (some € 100 million). The carried over cash balance has reduced residual financing needs.

The National Bank of Yugoslavia continued its stability-oriented **monetary policy** in Serbia. Money supply (M1) rose further, by 72% in the first nine months of 2002, however this was mainly due to foreign exchange purchases by the NBY against the background of large net inflows of remittances and foreign financing. Gross reserves of the NBY, which doubled during 2001 to reach € 1.2 billion by year end, continued to rise, to € 2.1 billion at the end of 2002 equivalent to around 3.5-4.5 months of imports. Kosovo does not carry out a monetary or exchange rate policy since its de-facto currency is the euro.

In 2002, the state registered a higher than expected **trade deficit** of around € 4 billion, despite an estimated 20% increase in exports (to € 2.3 billion). This was due to a substantial increase in imports (by 31%, to € 6.3 billion), mainly as a result of strong domestic demand spurred by wage increases in Serbia, for both consumables and investment goods. The weight of investment goods, in total imports, has increased somewhat during 2002, thus potentially improving medium term growth prospects. However, exports consist mainly of agricultural products, extractive industries and low-skill manufacturing. The structure of exports needs to change, to improve prospects for export-led growth and a more sustainable balance of payments.

Despite a higher trade deficit, the **current account deficit** before grants, projected at 12.8% of GDP in the IMF programme, is estimated at 11.7%, mainly due to a continuous stronger-than-expected net inflow of remittances from abroad. Net capital inflows including higher than expected foreign direct investment (estimated at € 475 million) and loans from official creditors have more than offset the current account deficit, leading to the above-mentioned substantial increase in foreign exchange reserves.

The dinar **exchange rate** remained broadly stable at the level of YuD 59 to € 1 since the end of 2000, reflecting both increased confidence in the domestic currency and favourable developments in the foreign exchange market. In real terms, the dinar has appreciated by about 45% since end-2000, mainly due to price liberalisation and price adjustments of non-tradable goods (mainly services) whereas prices of tradable goods (mainly manufacturing) increased in line with the nominal depreciation of around 2.6% during 2002. However the NBY, does not seem to see any need to affect the real exchange rate through monetary and exchange rate policies in the current economic context.

As for **external debt**, after the overall agreement with the Paris Club (a phased reduction of the debt to 66%), bilateral agreements with Paris Club members followed in the course of 2002. Agreements have been signed with all important creditors, except Italy. Important recent agreements were signed with the Russian Federation in September (two thirds of the € 66 million debt was written off) and with the US in October (€ 353 million written off). The state has not yet achieved a similar agreement with the London Club of commercial creditors, who have been reluctant to grant the country similarly generous terms. Getting substantial write-offs remains the objective of government policy and it is hoped that the total debt of € 11.5 billion (as of end-September 2002) can be reduced to less than € 9 billion by the end of 2003.

The external sustainability of the state economy will, however, remain a challenge. Important financing requirements, mainly resulting from the current account deficit, debt servicing and the need to further increase foreign exchange reserves, will continue to put a heavy strain on the balance of payments. According to an IMF study scenario, debt servicing will rise, in the period 2002-2009, from 2.7 to 7.4 % of GDP or from 6.2 to 18% of government revenues.

As for **relations with the international financial institutions**, a three-year IMF programme for 2002-2005, with a loan worth € 829 million (SDR 650 million) was approved in May 2002, after the Fund had assessed the performance of both Serbia and Montenegro as encouraging. This approval activated an immediate 51% write-off agreed with the Paris Club (the remaining 15% of the debt will be written off upon successful implementation of the three-year programme). As to the World Bank, the Transition Support Strategy Statement of May 2001 outlined a three-year concessional IDA-financed programme of up to € 540

million, on a temporary and exceptional basis, with actual lending depending upon performance against agreed performance benchmarks. The 2002 programme focused on providing quick disbursing funds to support the initiation of the Government's reform programme aimed at: (i) macro-economic stabilisation; (ii) stimulating private sector-led growth; (iii) protecting the vulnerable and developing human capital; and (iv) developing institutional capacity and strengthening institutions in both republics. During 2002, policy performance against the programme benchmarks was strong. By mid-2002, the Bank had approved 4 projects totalling € 171 million and completed negotiations for three additional operations. The EBRD had signed 16 projects with an investment volume of some € 130 billion in the first nine months of 2002, covering e.g. municipal infrastructures, the pharmaceutical industry, banking and road reconstruction.

3.2. Existence of a Free Market Economy and Structural Reform

Structural reforms in 2002, towards establishing a market economy, continued with major achievements. Progress was made in privatisation and the clean-up of the banking sector. Structural reform should be further enhanced to improve the overall business environment, encourage investment and lay the foundation for growth led by private sector development and exports. The adoption of related legislation should be accelerated. It is crucial that such legislation enhances market functioning and aims at EU compatibility.

Price liberalisation continued in 2002, most notably with a further increase in Serbia, by 50%, of electricity prices, thus further reducing the need for subsidies to the electricity company. The average price for electricity in Serbia is now about € 2.8 cents per kWh (the price will rise to the equivalent of € 4 cents in 2003, with the final goal to reach the equivalent of € 4.5 cents per kWh in 2004). Except for public utilities and energy, practically all prices are now liberalised both in Serbia and Montenegro.

Privatisation and enterprise restructuring is progressing. Privatisation in Serbia through tenders and auctions has made progress. Revenues were expected to have been € 300 million in 2002, well above the planned level. Following the tender privatisation of the first three large cement companies in January 2002, another seven enterprises (out of 24 offered for sale) were sold through tenders in the course of 2002. 121 companies were sold through auctions (of 141 offered). The Ministry of Privatisation intends to launch, by autumn 2003, investment tenders for some 74 large socially-owned companies. A total of 4000 small and medium sized enterprises in Serbia, accounting for about 40% of the workforce, will be offered through auctions. Following first rounds of auctions in 2002, held at the Belgrade Stock Exchange with limited success, the authorities adopted a decree in August to substantially streamline auction procedures. The authorities expect to offer around 100 enterprises per month in 2003, against less than 300 for the whole of 2002. The Serbian government has taken measures to restructure state-owned companies. It has identified 50 enterprises or enterprise groups that should be first restructured, employing 160,000 employees. Restructuring has begun in the ailing car factory Zastava, in the copper mining-smelting complex Bor and in another 30 firms where consultants prepare restructuring plans.

In Montenegro, the authorities proceeded with the tendering of companies, including 13 hotels of which two were sold. The main success was the sale for about € 65 million of one of the biggest Montenegrin companies – “Jugopetrol” Kotor – to a Greek company (October). Tender documents for privatisation of a tobacco and a steel company are expected to be issued in early 2003. Privatisation through the issue of vouchers to the public (mass

privatisation programme), together with the direct sale via tenders or auctions, has not yet brought satisfactory results - 40% of industry remains in public hands with hardly any trading in company shares. The government still plans to have privatised all big companies by end-2003. A blueprint for enterprise restructuring was adopted in late 2001, foreseeing voluntary restructuring of a total of 100 Montenegrin companies. A pilot project for 16 companies started in April 2002.

On 1 July 2002, the Kosovo Trust Agency (KTA) took over control over all public enterprises in Kosovo. The KTA has wide responsibilities: with trusteeship authority regarding the administration of all public enterprises (55), including public utilities, and of "socially owned enterprises" (SOEs, up to 550). Enterprise restructuring will be achieved through the transfer of assets to subsidiary companies ("spin-off approach") and the sale of shares as well as the liquidation of enterprises and the initiation of bankruptcy proceedings. Only SOEs will be entirely privatised. The KTA is expected to play a key role in enterprise reform and privatisation, but still encounters a number of issues (e.g. the lack of a law on land use, operational issues etc.), seriously delaying the effective start of operations

A first adjustment of the **pension system** in Serbia occurred in 2001 with the increase in the statutory retirement age and a change in the indexation system for benefits (quarterly adjustment based on a mix of the rise in prices and in salaries). There are 1.2 million pensioners in Serbia as against 2.1 million employed. Pension cost are 13% of Serbian GDP and 40% of these pension costs are covered by the government budget as pension funds are unable to collect sufficient contributions. A law aimed at further reforming the pension system and linking pension rights directly to overall contributions is currently under preparation. In Montenegro, the present system has become unsustainable with a ratio of employees to pensioners of 1 to 1.35 and 17% of Montenegrin GDP spent on pensions. A law for adjustment of the system is in preparation. As for Kosovo, a three-pillar pension system is being developed and legislation for all three schemes has been prepared. The first pillar, a basic pay-as-you-go system, provides a monthly rate of € 28 for people aged over 65 years (the 2003 budget envisages raising the monthly rate to €35 and introducing a war veteran invalidity pension, thus more than doubling pension spending relative to 2002).

In **financial sector reform**, the state authorities have made further progress in strengthening banking supervision by the NBY and in restructuring, as well as further clean-up of the banking system. The closure by the NBY (January 2002) of the four largest banks in Serbia accounted, in book value terms, for 70% of total bank assets and 42% of employment in the sector. Since they had accumulated large debts in the last decade and costs of a possible rehabilitation were estimated at some 30% of GDP i.e. had practically ceased to function as creditors, their closure, although symbolically important, did not lead to a major shock in the real economy. By mid-2002, approximately 48 banks remained in Serbia (compared to 86 banks the previous year) after a number of banks had been closed, merged, or are to be liquidated. In August some 15 banks with unsettled debts towards the Paris and London Club became state property through a debt-for-equity swap (in nine cases, the state became a majority shareholder) and the state took responsibility for debt servicing. The banks concerned will be privatised later - accounting firms and investment companies will be selected in the first half of 2003.

Overall, the determined attitude of the authorities has sent a clear signal of a break with the past in the banking sector. The NBY's policy has restored confidence and contributed to the steady rise in deposits. Its decision to begin reimbursement of frozen foreign currency

deposits⁷ further contributed to sectoral normalisation. The arrival of foreign banks has also played a role in the rehabilitation of the sector. Currently four foreign banks operating in Serbia are in the “Top 10” in terms of deposit collecting. In the new state structures the NBY will be transformed into a Serbian “Central” Bank. State-level bodies should therefore be created to ensure the uninterrupted and smooth operation of international financial relations, notably with IFIs and the EU.

In Montenegro, growing deposits also point to renewed confidence and the banking sector is in the final stage of rehabilitation. At present, there are 10 licensed banks in Montenegro and 3 branches of Serbian banks. In 2002, two domestic banks and three branch offices of Serbian banks were placed in bankruptcy, while the Government took over the largest, Montenegro Banka, with a view to rapid privatisation in early 2003. Despite delays in the privatisation process, after sale of Montenegro Banka and Podgoricka Banka (which is 65% owned by the state) around 90% of the banking sector will be privately owned.

In Kosovo, the Banking and Payments Authority (BPK) has fully licensed seven commercial banks in Kosovo operating 112 branch and sub-branch offices as of November 2002. Given the expansion of operational banks, the BPK closed most of its branches and has transferred the provision of the payments system to commercial banks and only retains inter-bank settlement functions. Wage payments were increasingly effected on a non-cash basis through bank accounts, which represents considerable progress. As regards the insurance sector, BPK so far licensed six companies and is setting up financial rules for sound management and accountancy. Insurance products remain limited to insurance against third-party liabilities. Once the rules for the investment policy of insurance companies are defined, the challenge will be to enable and facilitate domestic investment possibilities.

3.3. Management of Public Finances

Public and tax administration as well as expenditure management remain a priority, not least because of the scarcity of fiscal resources and the state's reliance on donors to finance a significant share of fiscal deficits. In Serbia, the establishment of a single Treasury is progressing and tax reforms continued throughout 2002. Following the transfer to the tax administration of tax-raising functions of the payments bureau in January 2003, tax collection under new institutional structures will remain a key challenge in 2003. In Montenegro, an interim Treasury system was introduced in 2002 and the key reform in 2003 will be the introduction of VAT. In Kosovo, the establishment and consolidation of public administrations requires increased tax revenue collection and therefore a strengthening of the tax administration.

The **Constitutional Charter** does not envisage a federal State budget, either by name or in the commonly accepted sense of a budget. There will be no state-level power to collect revenues (except for minor consular fees). It will be financed by direct contributions by the republics. This does not augur well for the overall financial viability of the state. Secondly, the discretionary spending ability of the common institutions for agreed joint functions is doubtful, as it seems to be under direct control of the republics.

⁷ In 1991, the Yugoslav Government suspended withdrawals from household foreign exchange balances with domestic banks to strengthen run-down reserves at the NBY. A 1998 law converted these deposits into public debt of around € 3.7 billion (or 35% of the 2001 GDP), stipulating repayment beginning in 2000. The precise modalities of repayment over a multi-annual period are regularly discussed and may be revised under the IMF programme.

In Serbia, **tax policy reform** continued through 2002, following wide-ranging tax reforms in 2001 which significantly contributed to improved revenue collection as a result of a broadened tax base and reduction in tax exemptions. In June 2002, the Parliament approved the amendments to the Law on Financial Transactions, which foresee decreasing tax rates as well as a one third average reduction of rates. The Serbian Parliament adopted a package of new tax policy measures (“second wave of fiscal reforms”), to stimulate investment and employment creation. On the basis of the Law on Tax on Extra Profit (aimed at taxing profits on incomes acquired by abuse of position during the Milosevic regime), € 60 million was collected. Political leaders have confirmed that this law still applies; a lack of adequate judicial reform had led to at least one damaging defeat for the government in its application.

The **fight against fraud** is receiving increased attention. Tax fraud will, in future, be covered by the Law on Tax Administration adopted by the Serbian Parliament in September 2002, which envisages that all citizens will register property worth more than € 330,000 before June 2003. Subsequently, the difference between declared income and the property’s value will be taxed. All legal entities had to acquire unique tax identification numbers by September 2002. The Lottery Law and the Law on Tobacco, also aimed at combating corruption and grey market activities, were passed in October and February. Also in October, a Centre for Large Taxpayers has been established in Belgrade that will be in charge of determining, controlling and collecting public revenues from large taxpayers in Serbia. An important step was the transfer of revenue collection from the National Payments Bureau (ZOP) to the Public Revenue Agency as of January 2003, when the ZOP was officially closed. In Montenegro, a package of six new tax laws was adopted at end-2001 by the Parliament. Four of these laws, namely the Laws on Income and Profit Taxation, on Excises and on Tax Administration, were implemented in the course of 2002. The two remaining laws, i.e. on Real Estate Taxation and on VAT, should come into force in early and mid-2003. A Large Taxpayers Office was established in Podgorica in mid-2002.

In Kosovo, tax collection of the newly introduced taxes has begun in 2002 (wage withholding and profits taxes). To this end, the administrative capacity needed to be stepped up. Preliminary data point to better revenue collection than expected. In principle government consumption can be financed from revenues, of which some 75% relate to external trade and are still to a large extent collected at the borders. However domestic revenues are insufficient to cover investment expenditure. Difficulties remain as regards access to international financial institutions due to legal requirements relating to the status of the borrower / sovereign guarantees and the debt-servicing capacity of Kosovo.

On **public expenditure management and control**, an organic budget law which regulates the preparation, adoption and control of the budget of Serbia (as well as provincial – Vojvodina- and municipal level) through the introduction of Treasury was adopted in February 2002. As of January 2003, all fiscal transactions will be moved from ZOP to the Treasury. A Serbian Law on public procurement was adopted in July 2002, but implementation, including establishment of a new Agency for Public Procurement has been delayed and the law is not yet applied. In Montenegro, an interim Treasury system became fully operational in early 2002. To support the process of streamlining public spending, a new public procurement law was enacted in mid-2002 (*cf.* 4.2.6). Finally, the authorities have started to elaborate a comprehensive employment and wage policy action plan for the public sector to contain and eventually reduce public sector wage spending.

3.4 Priority areas needing attention in the next 12 months

- The overall **financial viability** of the state and the joint institutions must be ensured. The institutional provisions for smooth relations with international financial and economic institutions and donors must be put in place urgently.
- Achieving a **sustainable fiscal position** in Serbian and Montenegro over the medium-term requires a further prioritisation of public spending to make room for new inevitable expenditure burdens (debt service, social costs of transition, necessary investments in infrastructure). Security/police and military spending should be further reduced as a percentage of GDP and public sector wage spending should be contained**.
- An agreement of the FRY authorities with the **London Club creditors** is essential to settle debt servicing obligations and relevant fiscal appropriations needed in both republics, as well as progress towards future sustainability of the balance of payments**.
- Further improvements in the **business environment** in Serbia and Montenegro, in particular for small and medium-sized enterprises, are essential to support investment and growth. Institutional reforms to that end should be continued, including legislation on mortgages, collateral, and business registration. The administrative burden on enterprises should be further reduced.
- Continuation of the restructuring of the **Serbian banking sector** is essential to improve financial intermediation in the economy. Thus, the authorities should make all efforts to privatise or liquidate banks in which the government has taken majority stakes in 2002.
- The **challenge for Kosovo** will be to design economic policies so as to achieve medium-term sustainability. Particular attention will have to be paid to control the wage bill and to streamline the public employment, to increase the collection rate for public utilities and to improve their reliability. The KTA will have to complete the first wave of enterprises for privatisation and to commence the restructuring of public enterprises.
- The **efficiency of social security** should be increased, notably through improved targeting of the neediest parts of the population.

4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS

4.1. General Evaluation

The conclusions of any report on the feasibility of opening negotiations for a Stabilisation and Association Agreement would depend on progress made in the Stabilisation and Association process i.e. the degree of respect for SAp political and economic conditions, the implementation of EU-compatible reforms and the political will and administrative capacity to make the state both function and be capable of implementing an SAA. Some of the reactions to the 2002 SAp Report derived from a failure to fully understand that it is implementation which matters, not just adoption and certainly not mere drafting of laws.

4.1.1. Current position

Integration, albeit with the EU rather than within the country, remained a formal government objective. Further meetings of the **EU-FRY Consultative Task Force (CTF)** were held in May and July 2002. The work of this technical working group, comprising experts from throughout the state, was interrupted while the authorities in Belgrade and Podgorica focussed on the drafting of the Constitutional Charter and Internal Market / Trade Action Plan. In July 2002 the Commission stated that it would begin drafting a report on the feasibility of opening negotiations for an SAA *when* the Constitutional Charter and the Action Plan (especially the

trade aspects thereof) were in place. Without clarity regarding the basic institutional and legal set-up of the state, and progress towards the harmonisation of those policies which would be at the very core of an SAA, it is evidently not yet possible for the Commission to assess the feasibility of relations with the state. The Commission will continue to provide technical ad-hoc contacts and expert advice.

There are still **no contractual relations** between the EC and the state. Efforts are ongoing within the state to meet the necessary conditions for the negotiation of a Textiles Trade Agreement, i.e. the appointment of a single agreed negotiator with an appropriate mandate, agreement on the common tariffs applicable to textiles products, and the necessary administrative requirements to enforce an agreement. Such an agreement would be important for both republics. If consensus can be reached within the state on these points, it would be a useful test case for the state's ability to negotiate and implement a trade agreement.

4.1.2. General assessment of administrative capacity

The importance of **administrative capacity and internal co-ordination** was stressed in bilateral and CTF meetings and the 2002 SAp Report. Detailed advice was provided from March 2001 as well as contact points in candidate countries. However, the European Integration structures at federal level remain weak, slow to function and without sufficient authority at either state or republican level. In a welcome move, Serbian structures including in line-Ministries began to be operational in late 2002 and appear to have potential. The relevant body was only formally created in Montenegro in early 2003. The approach, like the almost total lack of planning of implementation structures for the Constitutional Charter and Action Plans, is sequential. Since co-operation between the "structures" was minimal, the Commission has begun to organise joint meetings with the various offices at regular intervals (September, November 2002, January, March 2003) both to assess progress on reforms and to encourage contacts and co-operation between the offices. It is, however, increasingly clear that the republics do not see the role of the federal institutions as much more than that of a mailbox, which would be insufficient for relations with the EU.

A European Office was established within the EU Pillar of UNMiK early in 2002 *inter alia* to co-ordinate participation in the EU-FRY CTF and other activities related to the SAp, as well as relations with the appropriate authorities in Belgrade on European integration issues. An informal Kosovo SAp Tracking Mechanism (STM) was established in November 2002 at technical working level between the Commission and UNMIK / PISG, with a view to better monitoring and advising on EU-compatible reforms. In response to manifest difficulties, the Provisional Institutions had already made efforts to improve the quality of legislation and the speed of passage thereof. This should be further improved, also for EU-compatibility of legislation, through the networks and monitoring mechanisms relating to the STM.

4.1.3. Impact of the prospect of an SAA on reform

The prospect of negotiation of an SAA, when conditions are fulfilled and reforms sufficiently advanced, remains a clear, if insufficiently understood, goal and catalyst for reform. With the loss of focus from March 2002, due to difficulties in reaching agreement on the Constitutional Charter and Internal Market / Trade Action Plan, this prospect is seen even within the country to have receded slightly. The EU continues to push all governments, *despite* constitutional difficulties, and to accelerate legislation leading to approximation to European standards. Serious institutional complications and political uncertainty have certainly added to the usual

problems in transition countries i.e. lack of administrative capacity and implementation mechanisms. However, progress on many issues has been slow even in areas *without* constitutional / institutional problems. In Serbia and Montenegro, mechanisms and occasionally willingness is partly lacking either at state or at republican level, or between them, to ensure that reforms are **compatible with European standards** – as evidenced by events in Montenegro (summer 2002) concerning the media and electoral laws and in Serbia (November 2002) concerning the draft telecoms law, on both of which clear EU advice had been given. Such actions risk distance from the EU rather than rapprochement and may indicate a slowing of reform momentum. Earlier messages and recommendations on the need to *implement*, rather than just adopt legislation, continue to be valid, also in the context of the Constitutional Charter and the Internal Market / Trade Action Plan.

A clear **programme** for guiding and monitoring reforms, preferably developed at the level of the EU's future interlocutor (i.e. state-level) is still lacking, as is state-wide analysis. **Co-operation** between the integration offices, previously limited to the preparation of CTF meetings, is gradually improving. The position of the state-level office under the Constitutional Charter (which puts these EU-related competences under the External Economic Relations Ministry) remains unclear. Co-operation with UNMiK, in the context of the EU-FRY CTF meetings, continued to be satisfactory.

4.2. Internal market and trade

It is a fundamental experience of European integration that the creation of a single economic space is a welfare-generating instrument. Therefore, too much valuable time and economic potential has already been lost through the constitutional stalemate. The Belgrade Agreement contained a clear commitment to (re)create a functioning internal market. This must now be translated into reality through the Constitutional Charter and the Internal Market / Trade Action Plan. This requires clear commitment and political will. This crucial problem persists despite clear recommendations, in the 2002 SAp Report and all bilateral and CTF contacts, to establish a functioning single economic space in order to reap the commercial benefits thereof. The concept of an internal market was not even included in the draft Constitutional Charter until late August 2002. Detailed EU advice and technical support has constantly been provided. The assessment of the Action Plan, and its implementation after adoption, will be made in the Commission's eventual Feasibility Report. The lack of a functioning internal market and trade policy is already a major problem for economic reforms and international trade relations, most specifically the implementation of any future SAA.

4.2.1. Movement of goods

Foreign trade policy remains *de jure* a federal competence. *De facto*, three different regimes persist on the territory of the state: The federal policy, limited in practice to Serbia proper, the Montenegrin regime and the regime applied in Kosovo by UNMiK. The state's trade regime had already been substantially liberalised and average tariffs substantially reduced after October 2000 though a licensing system for a few sensitive products is still in place. Remaining export quotas are due to be phased out in the near future. Tariff reduction, to lower levels, began earlier in Montenegro, but a large number of non-tariff barriers persist, meaning that the actual level of trade protection is not very different from the federal regime. There is a flat rate tariff of 10% in Kosovo, except as regards the FTA with the former Yugoslav Republic of Macedonia. Apart from these obstacles to external trade as such, there are divergent, overlapping rules and regulations which hamper the application of *internal* market

freedoms between Serbia and Montenegro. This also affects the state's international position, as it forms a non-tariff barrier to trade with the state *per se*. As a result of these divergent external trade regimes *and* internal rules, the state as such is presently not in a position to fully honour its current contractual trade obligations under bilateral FTAs. This considerable legal uncertainty is a deterrent to the expansion of trade links.

The Belgrade Agreement signed in March 2002 and the related agreed provisions of the Constitutional Charter firmly state the commitment of Serbia and Montenegro to re-integrate their economic systems, notably as regards trade and customs, and to ensure the unhindered functioning of a state-wide internal market. After continuous pressure and support by the EU to specify the necessary steps in an **Action Plan**, a first integration matrix was produced in summer 2002 on which detailed Commission advice was provided. The Commission has regularly advised that harmonisation could and should begin as early as possible within the envisaged maximum period of 3 years, and should be legally and irrevocably enshrined in undisputed automatic phasing-in mechanisms, to ensure that the subject of potential negotiations with the Community is clearly locked in. For this purpose, the Commission also urged the state to calculate its effective single rate of tariff protection, including "tarified" non-tariff barriers. Further clarity on the common institutional framework and the dispute settlement mechanism for the internal market is still required, as well as more detail on flanking policies governing the four freedoms. It is imperative that the state-level institutions possess the adequate legal and political means to enforce the single market as foreseen. A final detailed version of the Action Plan, setting out the precise steps for a single trade and customs policy and internal market integration was promised for end-March 2003. This, like the Constitutional Charter, is vital for further progress in the SAP. The Montenegrin intention to introduce an entirely separate customs law and system, from April 2003, contradicts the fundamental purpose of the Action Plan.

The state's efforts to join the **World Trade Organisation** continued. The Memorandum on Foreign Trade Policy, describing the main elements of the federal economic and trade policy, was finally circulated by the WTO Secretariat after initial delays due to the constitutional uncertainty. A first set of questions - most of which logically focus on institutional issues - has been submitted by WTO members, to which the state must respond before negotiations can open. Progress therefore also depends on the prior resolution of the issue of the lack of a single trade policy and on harmonisation in trade-related policy areas like e.g. intellectual property rights and veterinary and sanitary / phytosanitary standards.

The state has also speeded up its efforts of **regional trade liberalisation** through the conclusion of Free Trade Agreements with all countries in the region (*cf.* 2.3.2.). It has finalised all FTAs under the Stability Pact's Memorandum of Understanding. The Stability Pact has urged the state to harmonise its trade policy to be able to respect these international commitments.

The EU's unilateral **autonomous trade preferences** granted in late 2000, allowing duty free and practically unlimited access to the EU, already played a role in boosting exports in 2001 (+24.8% on 2000). This double-digit growth in the state's exports to the EU has continued but flattened a little in 2002 (+ 13% compared to 2001) and now lies below total export growth (+20% in 2002). Exports to the EU, worth € 930 million, are 40.8% of the state's total, with Germany and Italy remaining the most important individual destinations. Imports from the EU are 42.7% of the total. Therefore, the Union remains the state's biggest overall trading partner. The autonomous trade measures thus continue to have an important impact on exports

and export-led recovery in general. There are indications that the ATMs may not yet be used to the fullest extent possible, mainly due to the structure and quality of exportable products. Some agricultural produce does not yet fulfil stringent veterinary, sanitary and phytosanitary requirements under EC law. EC assistance is therefore targeted at improvement of the system of veterinary, sanitary and phyto-sanitary inspection, which the Commission strongly recommended must be at state-level. There is potential for further export growth in the area of food products, especially meat. The **textiles sector** also has important potential, but the existence of different trade regimes⁸ has so far prevented the state from negotiating a Textiles Agreement with the EC which would further liberalise the present system of import quotas.

Regarding Kosovo, UNMIK has clarified a number of issues concerning the full application of the FRY-FYROM FTA to Kosovo and also announced its intention to enter into free trade arrangements on behalf of Kosovo per se in the future in the wider framework of the Stability Pact.

4.2.2. Movement of persons, services and right of establishment

The adoption of the federal **Foreign Investment Law** in early 2002 set an important general framework for FDI in the state. So far, considerable foreign investment has started to flow into privatised companies, but structural problems (economic and administrative) remain. Concerning green-field investments in the financial sector, the authorities have clarified their approach - discrimination against foreign operators in this key sector must obviously be avoided. A planned new **Accountancy Law**, compatible with international accountancy and auditing standards, has not yet been adopted by the federal Parliament. The Serbian Ministry of Foreign Economic Relations has prepared an impressive legislative programme aimed at stimulating and facilitating foreign investments by overall liberalisation and simplifying procedures. But continuing problems on the division of competencies adversely affected these positive efforts. Serbia plans to reform the **company registration** process to facilitate start-ups. Montenegro already has a more liberal system of incorporation but the very fact that the systems differ without even mutual recognition of registration is yet another example of a hindrance to free establishment throughout the state and hence another potential obstacle to the full implementation of any future SAA. While it is recognised in principle that this must be tackled in the Internal Market and Trade Action Plan, no more than a draft has yet been provided. In Kosovo, a new business register is now operational.

4.2.3. Movement of capital

As with the movement of goods, although the regulation of the **banking sector** was a federal competence (with the National Bank of Yugoslavia as the highest authority), the Montenegrin "central bank" (Central Bank Authority) was *de facto* in charge of the sector in Montenegro. At present, free movement of capital within the state is seriously impeded by the existence of two separate monetary systems and hence mutually exclusive legal tenders in the two republics (leading to transaction costs and exchange rate risks for businesses), by different banking laws and other capital market regulations. A viable compromise on the **inter-republican payments system**, based on corresponding accounts, should be possible in order to allow the free inflow of international capital throughout the state. The rules on banking supervision are not harmonised either, without even an agreement on the mutual recognition

⁸ Recommendations of CTF1 (July 2001): "In line with EU standards, it recommended harmonisation of the differing foreign trade regimes since the existence of different foreign trade regimes within the FRY would be the most serious obstacle to the conclusion of an SAA / free trade agreement between the EC and FRY."

of licenses within the state. This is a serious impediment to free establishment and the freedom to provide services in this key sector and, indirectly, for financial backing of the economy as such. On the positive side, there are few limits in principle on the import of capital from abroad and the acquisition of assets, though much urban land remains in government hands, unavailable for private acquisition.

A package of new **fiscal and economic laws** is still blocked in the Serbian Parliament, including e.g. a Law on Games of Chance. A set of taxation laws and the Tobacco Law have, however, been passed (*cf. supra*). Despite recommendations made previously, a new federal Bankruptcy Law, vital to regulate market exits, has not yet been adopted.

The introduction of **value-added tax (VAT)** is planned in Serbia by the end of 2004. In Montenegro it is scheduled for mid-2003. This gap makes it all the more important to avoid double taxation, also for foreign operators, and thus safeguard the proper functioning of the internal market. Although CAFAO-FRY has brokered meetings between the main advisors on VAT implementation with a view to ensuring coherent implementation, also within the state, and are supporting proper linkage between customs and tax services, this can only work in the context of a single economic space.

4.2.4. Customs

The existence of different foreign trade regimes within the state remains a major obstacle to the state's integration into the international trading system. Already, legal uncertainty discourages and deflects trade and this has also had a negative impact on ongoing efforts to reform customs services. The EC's CAFAO-FRY customs assistance mission is now operational throughout the entire state, advising both on modernisation and harmonisation of customs policy and administration. A customs service law for the state has been drafted with CAFAO-FRY support, and expert talks with the administration are in progress, but hampered by the lack of a precise Action Plan on the harmonisation of trade regimes. Plans to formally decentralise customs to republican agencies, as envisaged by the Implementing Law of the Constitutional Charter, and to lay off a substantial number of its staff are worrying (irrespective of the need to radically overhaul customs), as this would complicate the creation of a single trade regime and possibly weaken its human resources base.

After the opening of markets, a significant increase in sugar imports into the Community under the liberal regime of the autonomous trade measures and the parallel increase of EC exports to the countries of the Western Balkans occurred throughout 2002. In order to ensure the proper application of the preferential arrangements for Western Balkans sugar and to protect the EC's financial interests, the Commission published a Notice to Importers in June 2002. This led to precautionary measures within the Community, such as a deposit system and the systematic testing of imports. The Commission, including the European Anti-Fraud Office OLAF, carried out further investigations and reinforced contacts with the state's authorities. The Commission has now come to the conclusion that the customs services of Serbia and Montenegro are currently not in a position to fully respect and enforce the rules of origin as required, both in view of administrative practices and controls and the law as it stands. The Commission is in contact with the state to set out the requirements to address the current shortcomings. If no progress is made in resolving this problem, action may be taken. At the same time, it was decided to abolish the refunds for EU exports to the five Western Balkans states, as this is an incentive for the two-way trade pattern.

4.2.5. Competition and state aid

The existing Anti-Monopoly Act has not yet been amended, despite announcements by the authorities and recommendations of the 2002 SAp Report. CTFs and bilateral contacts. Experts in Belgrade are currently finalising a draft, with international input, to be discussed in Parliament in early 2003. It is still doubtful whether this formally federal statute would be enforced in Montenegro, which continues to work, despite the Internal Market and Trade Action Plan, on its own separate Anti-Monopoly law. In an internal market, state-wide implementation of a single set of rules is vital, also in view of the obligations under any future SAA, in order to combat anti-competitive practices under a liberalised trade arrangement. It is therefore crucial that competition policy is kept at state-level under the new Constitution. On substance, the compatibility of the current federal draft law with core provisions of EC competition law is not yet ensured and the comprehensive legal framework for state aids, demanded in the 2002 SAp Report, has not been created. The Commission will continue to provide detailed advice on these key policy areas. Finally, administrative capacity, notably in the federal Anti-Monopoly Commission, is still very weak and urgently needs to be strengthened and specialist judicial training provided. In fact, some key reform sectors (telecoms, postal services) have recently seen more monopolistic attitudes by public operators.

4.2.6. Public procurement

In Serbia, the new Law on Public Procurement was adopted in July. It should address the previously widespread problem of the non-transparency in the use of public funds. The law does not discriminate against foreign operators, covers all public bodies awarding contracts and all sectors. It also establishes an independent review commission, which, however, cannot act *ex officio*. More fundamentally, implementation, including establishment of the (EC-supported) Agency for Public Procurement has been delayed and the law is not yet applied. A similar but not co-ordinated law is in force in Montenegro since 2001. Steps towards state-wide harmonisation, as recommended by the EC, have not yet been taken. This legal fragmentation is a serious obstacle to the enforcement of a potential SAA. Basic procurement rules have been established in Kosovo.

4.2.7. Intellectual, industrial and commercial property rights

There have been positive efforts to reform federal legislation on patents, copyrights and trademarks, but these amendments have not yet been adopted. Despite important efforts to ensure compatibility with European and international standards from the outset, in line with EC recommendations, there are still lacunae in the drafts, notably in the Copyright and Related Rights Law, which would affect thorough IPR protection. Provisions on the rights of interested parties and criminal prosecution need to be strengthened and, more fundamentally, TRIPS-compatibility has not yet been ensured. The WIPO IT treaties and the Rome and Geneva Conventions are still not ratified by the federal Parliament. Enforcement capacity is still extremely weak and uncoordinated, posing a major problem within the state and for international trade. The staffing situation of the Federal IP Office has not yet improved. A major raid on illegal CD production facilities was not followed up appropriately by the judicial branch. Regular links between IPR and customs services to allow effective border controls have not been created either. A new customs law containing provisions on piracy and counterfeited goods is blocked due to the abovementioned trade policy differences. All this

seriously hampers international efforts to combat the illicit trafficking of pirate goods and is a potential problem for the implementation of an SAA in this field.

4.3. Sectoral policies

4.3.1. Industry and SMEs

Industry still suffers from the chronic under-investment of the past, coupled with the difficult climate of insufficient commercial banking capacity and competition from the shadow economy. Privatisation has made good progress, with revenues exceeding planned profits, and should be further accelerated in 2003. Still, despite positive efforts, industrial restructuring has not yet fully begun at enterprise level. About 83% of the workforce are still employed in large socially owned or mixed enterprises. The start of their crucial restructuring is planned for 2003. The Serbian Government's strategy is also to boost the SME sector to absorb the redundant workforce from ailing industries, but the SME development itself is still rather slow. An Agency for SMEs has been established in Serbia, with an improved network of regional agencies that assists entrepreneurs. Some sectoral policy strategies have been developed in Serbia and in Montenegro, but there is no state-wide strategy that would guide government actions. EC-funded Euro-Information Centres, giving SMEs access to wider networks, have been established in Serbia, Montenegro and Kosovo.

4.3.2. Agriculture and Fisheries

After a sharp rise in 2001, agriculture production in 2002 is expected to be about 2001 levels for most products. Structural reforms in this key sector, which accounts for about 40% of GDP, have begun and privatisation of some of the larger food processing companies is under way. Their substantial capacity is currently underused. The sector should also continue to play an important role in international trade, helping to bring the country back to a position of net exporter. Currently, the trade deficit is projected at about € 100 million for 2002 in trade of food and agriculture products. The Serbian Ministry of Agriculture has prepared a long-term policy strategy, with EC support.

Improved veterinary, sanitary and phytosanitary standards and their efficient inspection are important to help the country to exploit its export potential. In view of international requirements, notably under WTO rules, it is also important to retain state-level policies in this field. The EC is therefore providing substantial assistance in this area. Some laws (e.g. on genetically modified organisms and food safety) have already been adopted. However, despite progress on technical level, institutional and competence issues still complicate their enforcement and the implementation of state-wide veterinary and SPS rules, to the state's own detriment. In October 2002, the FRY was finally included in the list of third countries from which Member States are authorised to import certain fishery products. Lack of administrative capacity initially led to long delays, hampering its own export opportunities, but continuous assistance by the Commission helped move this issue forward.

In Kosovo, EU standards on veterinary and phytosanitary controls are followed by default as EU experts and consultants have provided most of the external expertise. EC-funding is also being provided for an Agricultural Statistics and Policy Advisory Unit within the Ministry, the only one headed by a Kosovo Serb.

4.3.3. Environment

The state has started its co-operation with the European Environment Agency as participant country and has finally identified a National Authority for co-ordination, as has UNMiK. The two republican Ministries signed a welcome co-operation agreement in July, to ensure the co-ordinated enforcement of environmental standards throughout the state and the necessary state-level participation in international bodies. Still, unclear responsibilities both between sectors and the various government levels persist. A separate Serbian Ministry for Protection of Natural Resources and Environment was established in May (up to then together with the Ministry of Health), including competences for fisheries, forestry and geology. Its administrative restructuring is underway, with EC assistance, as well as the establishment of a Serbian Environmental Agency. There is still no long-term national strategy on environmental protection and sustainable development, though Serbia has established some priorities. Serbia also prepared an Environmental Protection Law with international (including EC) support, which has been submitted to Parliament. Montenegro defined itself as an “ecological state” in 2001, but due to financial difficulties no substantial follow-up was achieved. In general, NGOs are still not involved in the environmental decision making process.

4.3.4. Infrastructure

The 2002 SAP Report and EU-FRY CTF recommendation about the need to rapidly put transport policy and co-ordination in place at state-level have not yet been implemented. Liberalisation of road transit traffic, guaranteeing non-discriminatory treatment for EC operators, is only at the drafting stage. State and republican priorities in 2002 included the rehabilitation of the existing **transport** network and completion of the missing motorway sections on the main Pan-European corridors (VII, X) and its branches. The Montenegrin authorities also prioritised strengthening transport links with Serbia and Kosovo, as well as Croatia and Albania. The new company “Serbian Railways” is not yet operational. Restructuring of this enterprise, with a distinction between asset-holders and operators, is key to sectoral reform. Following agreement between the two republics, two airports have been handed over to Montenegro, but their ownership status is still pending. There is complete liberalisation of maritime navigation, with equal treatment of foreign and national operators.

Energy was also a subject of recommendations by the EU-FRY CTF, some of which have been implemented. The reconstruction of the Serbian energy sector continues to be one of the main priorities of the authorities, significantly dependent on support by the EC and other donors for both imports and repairs. This overhaul of the energy generation and distribution infrastructure has already led in Serbia to a 16% increase in coal production, 70% in coal overburden removal and 11% in electricity production compared to the same period in 2001. There has been a substantial increase in electricity prices and new tariff systems have been adopted and billing and collection rates appear to have somewhat improved in both republics in 2002 (Montenegro 90%, Serbia 70-80%). In line with EC recommendations, the Serbian Energy Efficiency Agency (SEEA) has been established, while the Serbian Energy Regulatory Agency (SERA) is being set up as well as the Energy Efficiency Unit in Montenegro. New energy laws are still not adopted in both Serbia and Montenegro, though the Serbian decree monopolising petroleum imports (in clear violation of the state's FTAs) is being reviewed by the Serbian Ministry of Energy. Pre-privatisation restructuring has begun. Since energy is a regional issue par excellence, FRY and UNMiK signed the Declaration of Intent and a Memorandum of Understanding for the establishment of the competitive Regional Electricity Market in South Eastern Europe. The state has not made full use of its

observer status in the Energy Charter process due to internal lack of co-operation, which has also prevented implementation of EC recommendations to ensure compatibility and complementarity to create a unitary energy market and achieve liberalisation.

In Kosovo, emergency repair works have been carried out and continue in the Kosovo A and B power plants, after a serious accident caused by a lightning strike last summer. Electricity was imported mainly from Bulgaria and Albania to cover basic needs, but supply was still interrupted until the end of 2002 when some of the repaired power units were returned to the system. International assistance continues to play a key role in this sector, but Kosovo must progressively develop a sustainable investment policy.

The **telecommunications** infrastructure is under-developed due to long-standing lack of investment. The extensive monopoly is currently due to expire only in June 2005. Although mobile penetration is increasing, progress is inhibited by cross ownership of the two main operators. Internet Service Provision is inhibited by the lack of a fair and transparent regulatory environment.

Following recent constitutional changes, policy and legal approaches need to be harmonised at state and republican level, with clarity as to competencies and coordination, as previously recommended during CTFs and bilateral contacts. A policy is needed for the sector if investments are to be attracted and this should be established following consultation with all interested parties, including operators. Federal legislation is at a standstill. The new Serbian law, recently submitted to Parliament, should now take into account EC comments, to strengthen institutional capacity. There are visible conflicts of interest between operational, regulatory and political interests in this sector, on which the Commission has repeatedly voiced its concerns and provided advice. In order to improve the investment environment and development possibilities in the sector, the new law should ensure that the monopoly, whose conditions have not been made public, is neither strengthened nor extended. Fair competition should be established in those parts of the market outside the monopoly and transparency should be assured from the passage of the new law.

4.3.5. Health

The Serbian government, which was without a Health Minister for almost a year until June, set aside significant funds for public health protection and improvement of this particular sub-sector. Lawyers have been designated for the protection of patients in health care institutions since mid-2002 (tackling also cases of corruption), accompanied by Serbia's Charter on patient rights, the first document of this type to define the legal status of patients. Reorganisation of the Ministry and the whole health care system is underway. Donor support for drugs, equipment and medical consumables and reagents for health centres is substantial.

4.4. Co-operation in justice and home affairs

Constitutional uncertainty and unclear division of competencies have adversely affected progress in this area, although some significant steps forward have been made. The Constitutional Charter provides for central state competencies in adopting legislation related to some JHA issues (such as visa, border management, asylum and migration), but there is still a significant lack of clarity in terms of the institutional set-up and co-ordinating mechanisms. Meanwhile, there has been a worrying tendency to prepare unilateral measures and thus pre-empt future solutions (concerning, for example, the border demilitarisation

project). Legislation drafted at the federal level (such as asylum and migration) has been on hold, and the lack of harmonisation of policies persists (e.g. in the case of visa policy). Reassuringly, co-operation between law and order agencies in different entities (including with UNMIK) seems to be improving, but inter-agency co-ordination has been noticeably lacking. Regional and international co-operation is on the right path. The most urgent priority, confirmed by recent tragic events, is to tackle organised crime.

4.4.1. Visa, border control, asylum and migration

Different **visa regimes** still exist within the country despite constant Commission pressure to harmonise and recommendations in the CTF and 2002 SAP Report. Montenegro continues to implement its own visa regime, at variance with state policy. The lack of harmonisation is also reflected in the non-visa regime which UNMIK still applies for entering Kosovo. This is in contradiction to international standards and to EU requirements that visa issues be dealt with by states, and must be addressed as a matter of priority. Although the federal authorities have made efforts to harmonise policy with European Community standards (in line with state commitments under the Sarajevo Declaration), the visa regime is still not fully aligned (e.g. in the case of Iraq, a visa regime was finally introduced recently). Stricter criteria are however now applied by the state when granting entry to Chinese nationals (who make up a large proportion of illegal migrants), resulting in a decrease in irregular migratory flows towards the countries of Western Europe. Although formally there is a visa regime for EU citizens (reciprocity), procedures have been lightened (introduction of tourist passes) and visas for diplomatic / official passport holders abolished. The practice of issuing visas at the airport or borders, without pre-clearance, is unacceptable and should be addressed. Measures have also been taken to improve the security of travel documents and of visa stickers (to prevent forgeries), but this is still at a low level.

The constitutional stalemate has blocked the implementation of an integrated **border management** system. Border control continues to be shared between the Yugoslav Army (borderline) and the Republican Ministries of Interior (border crossings). In addition, Joint Security Forces are present at the administrative boundary with Kosovo (where good co-operation with KFOR is reported), but not along the state's international borders in Kosovo. The federal project on border demilitarisation (envisaging the civilian takeover from the Army and establishment of an integrated border management system) already had political endorsement, including by Montenegro, but its implementation is still delayed, pending the final division of powers. In contradiction, Montenegro announced that it would implement a similar project of its own, thus pre-empting future uniform solutions. On the positive side, in the framework of the overall police reform in both Republics, training of officers, including in border management, has been initiated. The EC-funded CAFAO-FRY programme, including both legislative advice and staff training components, and work on the Horgos and Batrovici border crossings, will help to improve integrated border management.

The unclear division of competencies, permeability of borders, inadequate legislation and the poor state of border crossings (both in terms of equipment and personnel) result in the state being a transit country for **illegal migratory flows**. Human trafficking is a serious problem which the authorities have been trying to tackle, but with limited success. From being mainly a transit and destination country, it is increasingly becoming a country of origin. Both republican Ministries of Interior have taken measures against trafficking in women and prostitution, but given the scale of the problem this remains at a rather low level. Reassuringly, the authorities have started to take measures against local police officers

involved in such crimes, though the dropping / delay in pursuing charges against those allegedly involved in trafficking cases in Montenegro, in one case reaching even to the highest levels of the prosecution service, is disappointing. International and regional police co-operation, including contacts with UNMIK police, has also improved. The state is currently chairing the Regional Working Group for Combating Illegal Migration and Trafficking. With the assistance of OSCE and UNHCR, national co-ordinators for anti-trafficking have been established in Serbia and Montenegro, with a country team on federal level. In addition to the Regional Clearing Centre for victims of trafficking (opened in Belgrade in April), there are shelters in both Republics, with significant involvement of NGOs. Legislative reform has been initiated but drafts on asylum and on aliens, prepared at federal level in the framework of the Stability Pact MAI, have remained in constitutional deadlock. Although a signatory to the relevant international documents regulating the asylum procedure, the country lacks infrastructure (notably reception facilities), legislation, financial means and staff to efficiently address the issue, which in practice has mostly been dealt with by UNHCR. There have been intensive and fruitful negotiations on readmission (11 agreements signed, some provisionally applied though not yet producing expected results on issuance of travel documents) and some awareness-raising campaigns within the state.

Although the Constitutional Charter provides that these areas of traditional state powers will remain at federal level, this is not yet widely accepted by republican bodies. There is also little planning at federal level about where, at state-level, to locate co-ordination competences.

4.4.2. Money laundering

The Federal Anti-Money Laundering Law came into force in July, but applies only in Serbia, as Montenegro continues to work on a separate act. The Federal Law stipulates control of financial transactions beyond € 10,000, by a special Anti-Money Laundering Commission and asset confiscation. Training of financial services for its implementation has been carried out but further training of the police and judiciary remains essential. However, the economy is still largely based on cash transactions. The recently established rule on carrying out commercial transactions through bank accounts is difficult to control in practice. In addition, inter-agency co-operation needs real improvement. The country also faces problems in tracing foreign bank accounts of officials from the former regime, due to political bargaining (e.g. the repeated failure in the Federal Parliament to lift the immunity of Milosevic's former associates, now MPs, against whom criminal charges were being prepared).

4.4.3. Drugs

Drug trafficking is an important part of illicit flows over the territory. The Serbian police have taken action aimed at cutting drug channels, but the lack of integrated border management seriously affects efficiency. The federal police have no operative capacities, but participate actively in international and regional initiatives (including with the UN Office for Drug Control and Crime Prevention). In addition, under current state legislation, the possession of drugs is not an offence so law enforcement agencies can only act against illicit production and circulation. Drug and alcohol consumption has grown, most worryingly among schoolchildren, which has led the Serbian government to launch a wide campaign. There has been some action to tackle tobacco smuggling, which remains a sensitive issue, notably for the Montenegrin authorities which need to take firmer action on this.

4.4.4. Fighting organised crime and terrorism

As was made so clear with the murder, on 12 March, of the Serbian Prime Minister, the high incidence of organised crime and corruption remains a serious problem. The authorities have so far had only limited success in fighting this, in line with their commitments undertaken at the London Conference on Organised Crime of November 2002, obstructed by the heavy legacy of the past (especially within the police forces) and fragile institutions. Action to implement international obligations in other fields would have a favourable knock-on effect in dismantling crime networks. The preparation of a comprehensive anti-corruption strategy has been delayed, as well as the adoption of some key legislation, compounded by a proliferation of institutions, most lacking clear mandate and enforcement capacities. There has been an obvious lack of co-operation between law enforcement agencies, in particular between the police and the judiciary. The new Federal Criminal Procedure Code introduced important innovations (e.g. an increased role for the prosecution), but there is not enough awareness and training among the different services, and it is not implemented in Montenegro. International co-operation has improved, especially since the state was re-admitted to Interpol (in September 2001), and several agreements on fighting organised crime have been signed or prepared with countries in the region (e.g. Hungary, the former Yugoslav Republic of Macedonia and Croatia).

The Serbian government has finalised a set of anti-corruption laws (on conflict of interest, political party financing and a code of conduct for public officials), together with an anti-corruption strategy and a proposal for the establishment of a separate agency. It seems, however, that some of the key anti-corruption provisions (such as the ban on anonymous donations to political parties) have been lightened. The results of the activities of newly established institutions have been modest and the government was widely criticised for undermining the Anti-corruption Council, whose Chair resigned. There has been a worrying lack of transparency concerning other posts held by state officials. The Serbian Public Procurement Law has been adopted, but is not yet enforced. The Federal Anti-Money Laundering Law was adopted in 2001, but since it only came into force in July 2002, the Euro conversion occurred without proper controls. The implementation of the Law on Extra Profits raised important revenues but met obstruction and criticism for not targeting all of the real profiteers. Amendments were adopted to the Serbian Criminal Code, regarding corruption-related offences. The Law establishing specialised institutions for the fight against organised crime (specialised prosecutor, courts and units in the Ministry of Interior) was adopted (July) but its implementation was delayed until December. Action was taken against tobacco smuggling, but failed to target the real organisers. Similar problems were seen with the well-received police arrests of suspects in connection with the murder of Police General Buha. Some encouraging steps were taken against police officers involved in illicit activities (such as trafficking in human beings) but significant further effort is required.

In Montenegro, the limited success in fighting corruption and organised crime was partly due to the political crisis which blocked new legislation. The government has remained under strong domestic pressure and continuing allegations about involvement in tobacco smuggling in the past. The Agency for Anti-Corruption Initiative has been preparing drafts on action to combat money laundering, conflict of interest and anti-corruption strategy. It seems that there has been good co-operation with local NGOs. Montenegro has been preparing its own legislation on criminal procedure, disregarding the existing Federal Code and the federal draft on special procedural rules. Generally, although there have been improvements, co-operation between the entities is still not sufficiently developed.

UNMiK's efforts to combat organised crime, corruption and extremism – also a priority of the Provisional Government - intensified during 2002, under OSCE auspices, with the establishment of the Kosovo Organised Crime Bureau within UNMiK Police and a special unit within the Department of Justice, and related UNMiK Regulations. Smuggling remains a serious problem. Police co-operation agreements were also signed with FRY/Serbia and with Albania, with others under negotiation. Witness resettlement in third countries remains an important problem.

Undertakings to align with international initiatives **fighting terrorism** have been undermined by the sale of weapons to Iraq. The Federal Council for the fight against terrorism was established on 1 August, but with little evidence of activity. In Kosovo, KFOR has conducted operations, with arrests, against extremists, particularly along the border with the former Yugoslav Republic of Macedonia.

4.5 Priority areas needing attention in the next 12 months

Administrative capacity to co-ordinate and implement the reform process:

- Adoption, by April 2003, of the **Internal Market and Trade Action Plan**, followed by rapid implementation.
- **Single interlocutor** to be identified to represent the state, with real competencies, particularly in trade negotiations.
- Proper functioning of the Federal **Office for European Integration**** (EIO), which will remain the EC's contact point, requires its authority and competencies to be clearly enshrined and reinforced in the restructured constitutional setup. Relevant European Integration structures at republican level need to be created or strengthened and full co-operation and co-ordination ensured between these and the EIO**. Internal co-ordination mechanisms are needed throughout republican and state ministries and other structures**.
- Substantial increase in public administration **efficiency** and implementation capacity are required particularly in areas relevant to relations with the EU.
- Formal adoption of laws to be followed immediately by full and efficient **implementation**, based on efficient administrative structures and capacity*. EU compatibility to be ensured as far as possible at an early stage of the process.
- In Kosovo, in addition, the establishment and implementation of **co-ordination mechanisms** necessary for the functioning of the SAP Tracking Mechanism, by early 2003.

Reforms in specific sectors:

- Continued **implementation** of the recommendations of the EU-FRY Consultative Task Force and the sectoral action plans provided to UNMiK**
- Within the state, in all sectors, increased **co-ordination and co-operation** between the different parts of the state and, as necessary, the establishment of single rules, in order to ensure the development and smooth functioning of a single economic space.* The republics should cease their efforts in contradiction to the Constitutional Charter and the Internal Market and Trade Action Plan.
- Competences such as a **single trade and customs** policy (including common procedures and in line with the Customs Blueprint), standards, measures and certification and intellectual property rights, should be retained at state-level as these are key for the integration of the state into the world economy and, more specifically, for further rapprochement with the EU. Concrete steps towards greater harmonisation and the

identification of single contact points are urgently required*. Conformity with EC technical regulations and standards, and the development of national-level quality infrastructures, in particular veterinary, phytosanitary and sanitary inspection services, are also required in order to facilitate trade and improve export performance. Improve border management and customs procedures to fight against fraud and corruption, facilitate legitimate trade, improve revenue collection and continue confidence-building on the movement of persons.

- Customs performance should be upgraded to offer the necessary reassurances on the ability to handle preferential trade regimes (both on the export and the import side)
- Concrete steps towards ensuring a strong central co-ordination of **statistics** are urgently required*.
- Prior to repeal of the existing law, the new EU-compatible Customs Code should be adopted. An EU-compatible model Customs Code should be put in place in Kosovo by summer 2003, at the latest at the moment of repeal of the existing legal basis.
- Efforts should be made to ensure **fiscal harmonisation** and co-operation between the various parts of the state, notably as regards a harmonised VAT system, in order to ensure that there are no obstacles to trade within the state*.
- The Tobacco Law should be thoroughly enforced in Serbia.
- An EU-compatible **competition** law and legislation on state aid should be adopted and implemented as rapidly as possible*. Other legislation should be amended to respect such basic principles of competition law*.
- **Public procurement** procedures should be improved to enhance economic efficiency, reduce public expenditure and fight corruption.
- **Privatisation**, especially of large enterprises, should be continued. In Kosovo, privatisation of SOEs and restructuring of POEs should be implemented as quickly as possible. Establish clear **property** rights, including land, physical (by mid-2003) and intellectual property.
- **Intellectual property legislation** should be fully aligned with WTO and EU standards by mid-2003. The administrative capacity to enforce intellectual property rights and to combat copyright piracy and trade in counterfeit goods should be reinforced throughout the state, including at borders.
- In line with good practice in the EU, the principles of the **European Charter for Small Enterprises** should be adopted and implemented.
- The compatibility and complementarity of actions in the **energy** sector throughout the state must be ensured, to create a unitary energy market in the region and achieve liberalisation*. Ensure reliable, sufficient, low-cost capacity to meet energy demand. In addition, promote rational use of energy by matching energy prices to market rates and by public awareness campaigns. The new Serbian energy law should be adopted before summer. In Kosovo, electricity must receive particular attention: investment and KEK restructuring must continue and collection rates improve.
- **Transport** policy and co-ordination should be put into place on state-level*. Further improve transport infrastructure & accompanying measures to improve safety & speed up economic development, improve transit through the state & reduce congestion.
- Separate legislative frameworks for **telecommunications and broadcasting** should be put in place* by early 2003. 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 by mid-2003.

- Develop and implement a **vocational, education and training** policy. Improve the availability and quality of education and training. Enhance the higher education system and ensure mutual recognition of education systems to foster labour mobility.
- Reform the **health** sector and strengthen public health. Increase and improve the effectiveness of preventive programmes. Improve medicine management and establish a National Medicines Agency.
- Strengthen institutional capacity on both central and local level to ensure effective implementation and enforcement of the Framework Law for **Environmental Protection**. Improve solid waste management and hazardous waste collection, storage and disposal. Improve water management and reduce air pollution.

As regards **justice and home affairs**:

- Immediate decisive action against the interlinked forces of organised crime and extremism.
- Elaboration and implementation of an Action Plan against **organised crime**, particularly the **trafficking of human beings**. Finalisation and implementation of National Strategies against drug-**trafficking**.
- Full alignment with the Community **visa** list should be achieved*. Issuance of visas must be in line with international standards*. Harmonisation of visa policy within the state is vital, in line with the Sarajevo Declaration. Conclusion and implementation of readmission agreements must be speeded up and improved.
- Competencies for **border control** must be clearly identified and the project on border control reform implemented*. Training of border staff on modern migration management should be improved*.
- **Asylum** laws in line with European standards should be adopted.*
- **Economic crime**, an impediment to economic reform and investment, should be actively tackled, with all relevant legislation and bodies under implementation or fully operational* by mid 2003.

5. EC FINANCIAL ASSISTANCE

Overall, between 1991 and 2002 (included), the state benefited from a total of more than € 2.9 billion in EC assistance.

The EC **Country Strategy Paper** for the FRY defines the main areas for co-operation for the period 2002-2006. The **Multiannual Indicative Programme** sets out priorities for the period 2002-2004 in more detail. 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.

During the year 2002, some € 359.6 million of EC funds, under the **CARDS** programme, were allocated for implementation in the state. The CARDS programme offers a long term assistance approach that addresses the needs of the country through a single programme and reflects the ambitious objectives of the SAP. It focuses on support for the reforms and

institution building necessary to implement the obligations of an eventual 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 2002 programme (€ 180 million) focussed on economic reconstruction and reform (energy, agriculture, enterprise development, health and regional/local development and transport facilitation), civil society and media. The 2003 programme (€ 240 million) which is still pending focuses, in addition to economic reform, mainly on good governance and institution-building, reinforcing public finance management at federal, republican and local levels.
- As for **Montenegro**, contracting of funds inherited under the 1999 (€ 22.5 million) and 2000 (€ 20 million) EC budgets continued. At the end of 2001, a further € 20 million of new funds were committed, the main focus of which was institution building and transport. The 2002 programme, with a similar focus, amounted to € 15 million. The 2003 programme focuses on energy, judicial and border police reform and the environment.
- In **Kosovo**, implementation of 2000 programmes worth € 275 million continued, with a further € 335 million committed during 2001. The 2002 programme (€ 147 million) focussed on 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. The 2003 programme (€ 53 million) focuses on energy, economic development, institution-building, education and refugee return.

In addition, the state also benefited from the **CARDS Regional Programme**.

Macro-financial assistance: Out of a first macro-financial package of € 345 million assistance in favour of the state, the second (grant) tranche of € 40 million was disbursed in January 2002, followed in August by the release of the third and final tranche of € 45 million after the authorities had satisfactorily met the structural adjustment conditions attached to the release of the respective tranches. In November 2002, the Council decided to provide to the state further Community macro-financial assistance of up to € 130 million, of which € 75 million in the form of grants. The first grant component of this new package of assistance, € 30 million, was released in December. The objective of this assistance is to underpin economic policies in the context of the IMF Extended Arrangement, in particular to support the balance of payment and strengthen the country's foreign exchange position. The state authorities have allocated 10% of the proceeds of all EC macro-financial assistance to Montenegro and 90% to Serbia.

Exceptional Community financial assistance was also provided for Kosovo (€ 30 million) of which the second and final € 15 million tranche was disbursed in December 2002. From 1999 to the end of 2002, the EC contributed over € 43 million to the running costs of the EU-led Pillar IV of UNMiK which is in charge of creating the framework for the development of a modern market economy with stable institutions.

By the end of 2002, the European Investment Bank had signed projects in the state for a total of €336 million, concentrating on the area of transport - in particular road and rail construction - and financing of small and medium enterprises. Possibilities of EIB lending for projects in Kosovo are being explored with UNMiK.

EC **humanitarian assistance** (ECHO) in 2002 amounted to € 39.5 million (37.5 million for Serbia and € 2 million for Kosovo). In Serbia, the assistance targeted the most vulnerable refugees, displaced persons and social cases. In view of ECHO's phase-out in 2003 (having already left Kosovo at the end of 2001, Montenegro in mid-2002 due to the absence of strictly humanitarian needs and the arrival of other actors), the assistance combined the provision of basic relief items, the consolidation of previous interventions in order to achieve a certain degree of self-sustainability (in the health and psychosocial sectors) and the promotion of durable solutions for the refugees. Under the last heading, ECHO has particularly focused on repatriation efforts to Croatia and Bosnia, as well as on durable shelter solutions for refugees opting to settle in Serbia. In the first months of 2003, projects approved under the 2002 budget will still be running and an additional allocation in favour of refugees and IDPs is foreseen. In Kosovo, although operations largely closed at the end of 2001, a last contribution was provided to UNHCR in support of their protection and assistance to minorities programme in Kosovo (€ 2 million).

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

Implementation continued to be extremely speedy and efficient, with some programmes completely or largely 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 EC support could provide specific added value. Full advantage has been taken of having a unique and **common implementing body** for the CARDS programmes – the European Agency for Reconstruction – to maximise the impact of EC assistance in the entire state, in order to ensure a coherent approach across and within the sectors. Programmes in the areas of customs, TEMPUS and macro-financial assistance continued to be centrally implemented by the Commission. Assistance also takes due consideration of past and ongoing programmes, and provides support for structural reforms in the targeted sectors, paving the way for IFI intervention.

Co-ordination with other donors and with 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. During this period, a donor co-ordination meeting for Kosovo was held in Brussels on 5 November. 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, though this role should increasingly be taken by national / local authorities.

6. PERCEPTIONS OF THE EU

Public opinion towards "joining the EU" remained stable in 2002 but improved compared to the region as a whole. A poll (by Marten Board International) in early December showed 87.4% of Serbians in favour of joining the EU with only 6% opposed. Membership in the Council of Europe, which is popularly seen (encouraged by politicians) as a first step on the road to EU membership, is favoured by 85.1% - an increase of 7% increase compared to a similar survey in April 2002 - with only 6.9% against. The most interesting change can be seen as regards membership in NATO, with 44.1% in favour, the first slim majority in favour, 43.3% against and 10.8% undecided. Public debates about joining the Partnership for Peace

programme and very favourable comments by top military leaders, throughout the year, probably contributed.

EU solidarity with the country was perhaps best exemplified by the immediate visit of Commissioner Patten and SG/HR Solana after the tragic events of 12 March. Throughout the previous year, **EU visibility** in the country was to a great extent driven by SG/HR Solana's continued involvement in efforts to restructure the state. As a result, criticism from Montenegro referred to Solana and the EU as "the last defenders of Yugoslavia" while Serbian frustration focuses on a construction "by which one republic pays 95% of the costs yet gets only 50% of the power". Indeed, the EU role in the process was often used by both Serbian and Montenegrin politicians for their own political agendas to claim EU favour for one or another constitutional solution. The EU endeavoured, through the efforts of the Commission and the Policy Unit, to rectify this perception, insisting that their role was to provide good services and advice to its partners in their efforts to implement their own (Belgrade) agreement. During Commissioner Patten's visits in July 2002 and March 2003 he confirmed the commitment to helping the state to prepare for closer relations with the EU. In a well-received and extensively-quoted speech in July 2002, he clearly spelt out the conditions for further approximation of relations between the state and the EU⁹. Public demands by the authorities, in April 2002, for an acceleration in relations (responded to by the acceleration in the timing of the following CTF meetings), faded somewhat in governmental and public perception as it became obvious that the parties were unable to make rapid progress on these preconditions. The attitude towards the EU was also affected by inaccurate reporting, some deliberate, during February 2003 about the need for co-operation with the ICTY. The Commission continued its sometimes less visible role in the reform process through the meetings of the EU-FRY Consultative Task Force and its work on the Internal Market / Trade Action Plan, advice to the drafters of the Constitutional Charter (the latter together with Policy Unit and Venice Commission experts), and regular technical meetings at expert level. In particular, efforts included explanation of the EC internal market principles and the consequent need for harmonisation within the state in order to have deeper relations with the EU. There has been extensive debate on these issues with and between local experts.

In the context of the development of an EU strategy on visibility, the Delegation continued to affirm its position, vis a vis the media and the EU-literate public, as the main source of **policy-related information**, a "one stop shop", on the EU. The very close co-operation with the Policy Unit and the assistance provided by the Commission Delegation with regard to SG/HR Solana's visits and media relations, included the publication of topical articles in Belgrade and Podgorica papers.. **EC assistance** continues to play a prominent role in the overall visibility efforts and the EU is understood to be the leading and largest donor. Further coherence, including about the role of the European Agency for Reconstruction in implementing *EC* assistance, will follow streamlining and the promotion, within the SAP, of the visibility of EU assistance (i.e. EC plus bilateral) as a coherent whole.

Apart from high-level visits and further official meetings (CTFs, EIB loan signings, macro-financial missions and MoU signings) which drew significant media attention, a number of other **public events** kept the SAP and the European Commission in the media. Two seminars on internal market topics were organised in Belgrade and Podgorica. The Delegation participated in many conferences, often in a keynote role, and other outreach activities e.g. the organisation, with the Education Ministries and Member State embassies, of the "Hello

⁹ i.e. that having the Constitutional Charter and Action Plan in place is a sine qua non to begin work on a Feasibility Study ("If we are to write a Feasibility Study, we need something to study")

Europe" quiz in which over 60% of all high schools participated. The authorities have begun, with EC and MS support, limited efforts to train staff - Serbia in particular has ambitious plans in this regard. There is however still a real need for specialised training for journalists.

EU visibility also continued in Kosovo, with visits by Commissioner Patten and SG/HR Solana, meetings in Brussels with visiting politicians and the organisation, with the World Bank, of a Donor Co-ordination Meeting for Kosovo (November 5). The opening of the Europe Office inside the EU Pillar of UNMiK, and the organisation in Brussels of a seminar on Kosovo in the SAp, for members of UNMiK and the Provisional Government (November 6) as well as briefings for senior civil servants and advisors in Pristina, have also contributed to EU visibility and to a better understanding, at least at UNMIK / PISG level, of the SAp.